BEPS - OECD Releases reports on 7 out of 15 action points

17 September 2014

Background

At the request of the G20[1] Finance Ministers, the Organisation for Economic Co-operation and Development (OECD) launched an Action Plan on Base Erosion and Profit Shifting (BEPS) in July 2013. The plan recognized the importance of the borderless digital economy and proposed to develop a new set of standards to prevent BEPS and to equip governments with the domestic and international instruments to prevent corporations from paying little or no taxes.

BEPS is important because, globalization of the world economy has resulted in Multinational Enterprises ('MNEs') shifting from country specific models to global models which are usually housed in low-tax jurisdictions and are characterized by integrated supply chains or centralization of service functions. The global models led to various issues like distortion of competition at the domestic level, critical underfunding of public investments on account of lack of tax revenue and issues pertaining to fairness leading to non-compliance of tax rules and regulations by tax payers.

OECD had identified 15 specific actions considered necessary to prevent BEPS and in that direction on September 16, 2014 it has released its first set of recommendations on 7 action points for combating international tax avoidance by MNEs. The deliverables of the 7 action points have been agreed in consensus by OECD and G20 countries, which includes India.

We have briefly summarized the contents of OECD reports and instruments in this Flash news.

Action 1: Addressing the tax challenges of the digital economy

Challenges posed by the increasing digitization of the global economy have long been an area of concern to tax administrations worldwide. There are several unique features of this digital economy such as strong reliance on intangible assets, massive use of data, business models that capture value through use of free products etc. These features pose serious challenges from a tax perspective including in determining the jurisdiction where value creation occurs and also in how the traditional concepts of source and residence apply to the digital economy.

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[1] The Group of Twenty (also known as the **G-20** or **G20**) is a forum for the governments and central bank governors from 20 major economies. The members of the G20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.

The objective of the BEPS initiative was to identify the difficulties involved in applying existing international tax rules to the digital economy and to develop detailed options (both from a direct and indirect tax perspective) to address these difficulties. The report provides an exhaustive overview of the key features of the digital economy, various business models that pose challenges from a tax perspective as well as potential options to address them.

The key findings and recommendations are briefly summarized below:

- It is not possible to ring-fence the digital economy for tax purposes.
- One of the options under consideration was the development and adoption of a 'virtual PE' standard that would apply as an alternative nexus rule to digital commerce operations. However, this is not being currently recommended by the OECD.
- Several other aspects relating to tax challenges of the digital economy will be addressed as part of other OECD/BEPS initiatives including VAT, CFC Rules, Artificial avoidance of PE and Transfer Pricing (with inputs from the task force)
- More technical work is required to be undertaken in connection with the various options available to deal with the tax issues arising from the digital economy. The task force will continue to work on these broader challenges including nexus, data and characterization to ensure that these are addressed effectively.

The impact of the other OECD initiatives (referred to above) on the digital economy will be evaluated during 2015 and a supplementary report will be finalized by December 2015.

Action 2: Neutralising the effects of Hybrid Mismatch Arrangements

Hybrid mismatch arrangements are those that involve use of cross-border differences in characterisation of entities and instruments to produce mismatched tax outcomes. A simple example of a hybrid mismatch arrangement would be one where an instrument is considered as debt in the country of the Borrower (thus entitling him to a deduction of the 'interest') but as equity in the country of the Lender/Investor (where a potential exemption may apply to the 'dividend').

The objective of the Report is to identify clear, automatic and comprehensive rules that neutralise the tax mismatch without disturbing the commercial or regulatory consequences of the transactions.

Recommended changes to domestic law:

The key recommendations in this regard are as under:

- In cases of a hybrid mismatch resulting in a deduction in one jurisdiction and non-inclusion in income in another jurisdiction (whether on account of use of hybrid financial instruments, disregarded payments or payments made to a reverse hybrid): The payer jurisdiction should deny a deduction for payments in cases where such payments are not includible in the income in the recipient's jurisdiction. As a secondary defensive rule, if the payer jurisdiction does not neutralize the mismatch as above, the payment should be includible in the ordinary income in the recipient's jurisdiction. This rule will apply to related parties as well as structured arrangements.
- In cases where a double deduction benefit is available in respect of a deductible payment made by a hybrid: In cases where payments give rise to a double deduction outcome, the parent jurisdiction should deny a deduction. As a secondary defensive rule, the payer jurisdiction should deny the deduction. This rule will apply to parties under the same controlled group or to a structured transaction.
- In cases where a double deduction benefit is available in respect of deductible payments made by dual residents: In cases where dual tax resident makes a payment that is deductible under the laws of both jurisdictions where the payer is a resident, each resident jurisdiction should deny the deduction to the extent it relates to a double-deduction outcome.

Recommended changes to treaties:

The key recommendations in this regard are as under:

- In case of dual resident entities: It is recommended that Article 4(3) of the OECD Model Tax Convention be modified to provide for the determination of the residential status of dual resident entities on a case to case basis rather than on the basis of place of effective management.
- In case of transparent entities: It is recommended that treaties should apply to all transparent entities on the same basis as it is applied to partnerships. Thus, all transparent entities should be entitled to treaty benefits to the extent the income is treated for the purposes of taxation as the income as a resident of a contracting state.

Action 6: Preventing the Granting of Treaty benefits in inappropriate circumstances

The BEPS Action Plan had identified treaty abuse and treaty shopping as one of the most important sources of BEPS concerns. In order to address these concerns, the task force carried out work to develop model treaty provisions, design domestic rules and identify the tax policy considerations that should be considered before deciding to enter into a tax treaty.

The following three pronged approach has been recommended to address treaty shopping arrangements:

- Clarification in treaty title and preamble to the effect that the Contracting States intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance;
- Inclusion of a specific anti-abuse rule based on Limitation of Benefit (LOB) provisions (in line with such clauses in US Tax Treaties);
- Addition to tax treaties of a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or "PPT" rule).

The report also deals with additional recommendations that seek to address abusive strategies (other than treaty shopping) to address dividend transfer transactions, situations where an entity is resident of two countries, situations where residence country exempts income of PE and tax benefit is taken by transferring property or shares etc to such PE located in low tax country, transactions circumventing source taxation of shares that derive value primarily from immovable property.

The report emphasizes the need to ensure that treaties do not prevent the application of domestic anti-abuse rules in cases where a person tries to abuse provisions of domestic tax law by using treaty benefits.

The report further lists down the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

As a next step, it is recognized that further work will be needed to refine the OECD Model Tax convention and related commentary.

Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

In order to counter harmful tax practices such as the preferential regimes granted by various countries, the BEPS Action Plan commits the Forum on Harmful Tax Practices (FHTP) to take necessary action. In this regard, the FHTP is required to deliver the following three outputs:

- Finalization of review of member country preferential regimes;
- Strategy to expand participation to non-OECD member countries; and
- Consideration of revisions or additions to the existing framework.

The report outlines the progress made and identifies the next steps towards completion of the work on this Action plan. As regards the review of the existing preferential regimes, the emphasis has been put on:

- Elaborating a methodology to define the substantial activity requirement in the context of IP regimes;
- Improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes.

A progress report on the review of regimes of OECD member and associate countries in the OECD / G20 Project on BEPS is also provided.

Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

The current network of bilateral tax treaties dates back to 1920s. However, as a result of globalization, some features of the current bilateral tax treaty system facilitate BEPS which need to be addressed. The sheer number of the bilateral treaties makes updating the current tax treaty network highly burdensome.

With an objective to expedite and streamline the implementation of the measures developed to address BEPS and amend bilateral tax treaties, the OECD task force has concluded that multilateral instrument is desirable and feasible. As a next step, it is recommended to convene an International Conference in early 2015 to develop the multilateral instrument by OECD and G20 countries.

Action 08: Guidance on Transfer Pricing aspects on Intangibles

Intangibles transfer pricing is considered a key area of concern, with growing numbers of significant transfer pricing audits and disputes related to intangibles. The OECD's effort to revisit and strengthen the transfer pricing aspects of intangibles has significantly evolved since it started in 2010. Considering that significant tax planning opportunities arise for MNEs from the possible location or cross-border relocation of intangibles, this area was specifically considered as one of the Action Items on BEPS.

Still in the draft form, the Guidance on Transfer Pricing aspects of Intangible would stand to replace the existing Chapter VI of the OECD Guidelines (OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration). The Guidance is broadly related to following five aspects.

- Detailed comments on issues such as location savings and other local market features, assembled workforce and MNE group synergies is now included as part of Chapter I of the OECD Guidelines. The focus on issues related to location savings, group synergies, marketing intangibles and research and development arrangements, is particularly relevant from an Indian context as most of these currently are highly debated and litigated TP issues in India.
- Identifying intangibles – with a broader definition of intangible property, the Guidance provides specific example of six categories including patents; know-how and trade secrets; trademarks, trade names; and goodwill and ongoing concern value.

- Ownership of intangibles and entitlement to returns from intangibles - the Guidance emphasizes that while legal ownership and contractual arrangements could be the starting point for analysis but each parties' contribution to development, enhancement, maintenance, protection and exploitation of the intangible must be appropriately remunerated.
- Transactions involving the use or transfer of intangibles – the Guidance discusses the relevant considerations separately for transactions involving transfers of intangibles or rights in intangibles and for transactions involving the use of intangibles in connection with the sale of goods or the provision of services.
- Guidance on determining arm's-length conditions in cases involving intangibles – there is supplementary guidance for determining arm's-length conditions for transactions involving intangibles. One general principal for a transfer pricing analysis involving intangibles is that it must consider the options realistically available to each of the parties to the transaction.

Recognising the strong interaction and interplay of intangible with other Action Points on BEPS (related to risks and capital, high-risk transactions, and hard to value intangibles) the draft Guidance is expected to be finalised during 2015 along with other Action Points, so that issues can be addressed in an integrated and consistent manner.

Action 13 – Guidance on Transfer Pricing Documentation and Country-by-Country (CbC) Reporting

The Guidance on Transfer Pricing documentation states the following:

- The OECD has prescribed a 'three-tier' documentation structure consisting of Master file, Local file and CbC report
  - **Master file** provides an overview of the multinational group and business.
  - **Local file** provides a "zoomed-in" view of operations and transactions relevant to that jurisdiction, and
  - **CbC report** provides aggregate, jurisdiction-wide information on global allocation of income, taxes, and indicators of economic activity.
- The CbC report which earlier was proposed to be a part of the master file is now delinked from the same and has been prescribed as a separate document.
- Based on representations and public consultations OECD has excluded reporting of information such as location of 25 most highly compensated employees, cases under Mutual Agreement Procedure, Bilateral and Multilateral Advanced Pricing Agreements.
- The OECD has significantly diluted the reporting norms in the revised CbC report by:
  - Excluding reporting of information such as place of effective management, royalty, interest, services, employee expenses, withholding taxes, bifurcation of income-taxes paid in home country and other countries, etc.
  - Excluding reporting of financial and tax information (such as revenue, taxes, accumulated earning, number of employees, etc) at the entity-level. Instead, the OECD has now sought such aggregated information at tax jurisdiction level (i.e. one line item consisting of total revenue / profit etc for all Constituent Entities of the MNE operating in a tax jurisdiction)
- The CbC report should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income.

While the OECD has been able to arrive at a consensus with various members on the contents of the master file, local file and CbC reports, the implementation mechanism for the revised guidance is postponed as the OECD is evaluating various options with respect to:

- Filing process of master file and CbC report i.e. whether these reports should be filed by the Parent Company or by the Local Entities;
- Mechanism of sharing information with tax administrations in all relevant countries i.e. treaty information exchange provisions, coordinated technological platforms, etc.

The OECD has indicated that it will provide further guidance on the implementation mechanism by February 2015.

Our comments

OECD has been committed to the BEPS project and a lot of progress has been made in a very short period of time since the launch of the BEPS action plan in July 2013. OECD has taken a step closer to providing transparency, coupled with certainty and predictability, coherence of corporate tax at the international level and realignment of taxation and substance.

The 15 point BEPS action plan will be completed by December 2015 and intends to cover three different areas: (a) best practices and model domestic rules with respect to changes required to domestic law measures (b) changes to OECD's Model Tax Convention and Transfer Pricing Guidelines and internationally agreed guidance on its implementation, and (c) Other recommendation reports.

Once finalized these measures are expected to become applicable via changes in bilateral tax treaties or through the proposed multilateral instrument, through changes in domestic laws. All this will be implemented with support from internationally agreed guidance.

It is important to note that though the OECD and G20 countries are determined and strongly committed to end BEPS practices globally, while implementing the BEPS recommendations each country's Revenue authorities ought to ensure that any of the measure do not lead to legal uncertainty or risk of double taxation. Also, it needs to be ascertained that changes in tax treaties and domestic laws do not have an undue impact or hamper legitimate transactions.

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