

BEPS ALERT

Briefings on Base Erosion and Profit Shifting (Tax)

BEPS: The 2014 Deliverables

The OECD and G20's interim recommendations on BEPS were released on 16 September 2014 and further recommendations will follow in 2015.

Summary

- *The OECD released seven deliverables of the OECD/G20 Action Plan on BEPS on 16 September 2014, several days ahead of the G20 conference.*
- *The deliverables published are in accordance with the BEPS Action Plan and contain three reports which deal with the tax challenges of the digital economy, the feasibility of developing a multilateral instrument to modify bilateral tax treaties and a report on the progress of better countering harmful tax practices.*
- *These recommendations were adopted by the OECD after consensus was reached by 44 countries. Developing countries and other stakeholders also participated in the consultations, which will continue in the coming months.*

In July 2014, we reported on the [OECD's annual tax conference](#), where the main discussion was on the joint OECD and G20 Base Erosion and Profit Shifting project (BEPS). On 20-21 September 2014, the [G20 Finance Ministers endorsed](#) the progress being made towards completing the two-year BEPS Action Plan and committed to finalising all action items in 2015. Prior to this, the OECD released the first seven deliverables of the OECD action plan on 16 September 2014. This *Tax Alert* will briefly examine the highlights of the reports and their recommendations.

Overview

BEPS has become a key political priority for governments around the world, and in 2013, the OECD and G20 countries adopted a [15-point Action Plan](#) to address this.

The primary aim of the OECD/G20 Action Plan is to realign global taxation with economic activities and value creation by creating international tax rules that specifically address BEPS, thus protecting tax bases and ensuring increased certainty and predictability for taxpayers and tax authorities. Although a key focus of this project is to eradicate double non-taxation, the OECD/G20 is equally mindful not to impose double taxation, unnecessary and burdensome compliance requirements, and restrictions to legitimate cross-border activity. The Action Plan provides for 15 actions to be delivered by 2015, with a number of these to be delivered in 2014.

The seven deliverables published on 16 September 2014 were adopted by the OECD Committee on Fiscal Affairs after consensus was reached by 44 countries comprising OECD and G20 members, eight non-OECD members (Argentina, Brazil, People's Republic of China, India, Indonesia, Russia, Saudi Arabia and South Africa) as well as two OECD accession countries (Colombia and Latvia).

Developing countries were also consulted through numerous regional and global meetings. Other stakeholders such as business representatives, trade unions, civil society groups and academics have also participated in the process and provided valuable input. Over the past 12 months, a number of discussion

drafts were published that resulted in 462 comments, five public consultations and three webcasts that attracted over 10,000 viewers. These consultations are intended to continue in 2014 and 2015. The [stakeholder calendar](#) can be found online and will be updated when appropriate.

The 2014 deliverables

The deliverables published are in accordance with the BEPS Action Plan and contain three reports which deal with:

- The tax challenges of the digital economy ([Action 1](#))
- The feasibility of developing a multilateral instrument as one of the ways a jurisdiction can implement BEPS measures and modify, where necessary, its bilateral tax treaties ([Action 15](#))
- A report on the progress of better countering harmful tax practices in the context of transparency and substance ([Action 5](#)).

Then there are four instruments which provide:

- Model domestic law and tax treaty provisions on hybrid mismatch arrangements aimed at eliminating such mismatches and neutralising unintended double non-taxation, including multiple deductions for a single expense, deductions in one country without corresponding taxation in another or the generation of multiple foreign tax credits for one amount of tax paid ([Action 2](#))
- Model treaty provisions to counter treaty abuses in order to restore the bilateral nature of tax treaties and grant treaty benefits only in appropriate circumstances ([Action 6](#))
- Revisions to the transfer pricing guidelines on intangibles and ensuring that they are in line with value creation ([Action 8](#))
- Revisions improving the transfer pricing guidelines on documentation requirements, which also include a template for country-by-country reporting ensuring enhanced transparency for tax administrations and improved consistency of requirements for taxpayers ([Action 13](#)).

The above deliverables will be complemented by the further measures to be delivered by the end 2015.

What follows is a brief summary of each of the seven deliverables, which totalled 720 pages.

Action 1: Address the tax challenges of the digital economy

The discussion draft published in March 2014 provided complex contextual material that considered the impact on the economy of information and communication technology, the utilisation of business models, common features related to both direct and indirect taxation, and broader BEPS challenges.

- The report concludes that as the digital economy is increasingly becoming the economy itself, it is not possible to ring-fence it from the rest of the economy for tax purposes. However, key features of the digital economy and its business models are extremely relevant for tax purposes.
- The digital economy does not generate unique BEPS issues, but some of its key features exacerbate BEPS risks. These risks are already being addressed by the broader BEPS project but there should, in addition, be an analysis of the specific issues linked to the digital economy business model, with particular reference to work on permanent establishment status ([Action 7](#)), transfer pricing ([Actions 8-10](#)) and controlled foreign company rules ([Action 3](#)).
- The report contains the conclusions of the Task Force on the Digital Economy in relation to the broader tax policy challenges raised by the digital economy and the necessary steps to address them.
- Work on Action 1 is to be completed by the end of December 2015, when a supplementary report will be published.

Action 2: Neutralise the effects of hybrid mismatch arrangements

The two discussion drafts published in March 2014 contained proposals for changes to both domestic laws and tax treaties, and left a number of issues open for further comment and discussion. The report contains comprehensive proposed rules with the indication that more work will be carried out in 2015 which will also take into account deliverables from other BEPS actions.

- The report is in two parts: the first part recommends domestic rules to nullify the effects of hybrid mismatch arrangements and the second sets out recommended changes to the OECD Model Tax Convention (OECD MTC) to deal with transparent entities, including hybrid entities, and addresses the interaction between the recommendations included in the first part and the provisions of the OECD MTC.
- The proposed rules will align the tax treatment of income in one jurisdiction with the tax treatment in the counterparty jurisdiction, and will take into account the need for practical and easily administered rules that do not affect the underlying commercial reality.
- The model domestic rules take the form of primary rules, supplemented by defensive rules that will only apply where there is no hybrid mismatch in the other jurisdiction or the rule is not applied to the entity or arrangement.
- There are also model treaty provisions to deal with transparent entities, including hybrid entities, and to address the interaction between the model domestic rules and tax treaties.
- The implementation of these rules is dependent on the production guidance, in the form of a commentary, as well refinement of the domestic rules, for example in the case of certain capital market transactions and rules on hybrid mismatches. This is expected to be completed by the end of September 2015.

Action 5: Counter harmful tax practices more effectively

The plan for the harmful tax practices work in BEPS is based on a three-stage approach of looking first at the tax regimes of OECD members, then at those of non-OECD members, before revising the existing harmful tax framework as required.

- The work on harmful tax practices is progressing, but there is no consensus on how to ensure that preferential regimes require the existence of a substantial activity. Steps have been identified to complete this action with the goal of realigning taxation of profits with substantial activities.
- The emphasis for reviewing existing preferential regimes is on:
 - How to define a substantial activity requirement in the context of intangible regimes
 - How to improve transparency through compulsory spontaneous exchange on rulings related to preferential regimes.
- There is a progress report on the review of the regimes of OECD members and associate countries in the OECD/G20.
- Once the necessary work to strengthen the substantial activity requirement has been agreed, the preferential regimes identified in the report will be assessed.

Action 6: Prevent treaty abuse

A discussion draft on Action 6 was published in March 2014, which recommended far-reaching changes to the OECD MTC. It also included recommendations regarding the design of domestic rules to prevent the granting of treaty benefits, and identified tax treaty policy considerations that countries should adopt. There were two major proposals, both of which were applied simultaneously: a limitation of benefits article (LOB) providing an objective basis of granting treaty benefits to entities with a nexus in the resident country, and a subjective main purpose rule to ensure treaties were not being abused.

- The report's critical recommendation is the introduction of a "minimum level of protection" against treaty shopping which requires that countries include, as a minimum, in their tax treaties:
 - A clear statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including treaty shopping. This will assist the interpretation and application of tax treaties under rules of public international law.
 - One of the following:
 1. An LOB rule based on those found in treaties concluded by the US, which will address treaty shopping situations based on the legal nature, ownership in, and general activities of, residents of a contracting state
 2. A general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or "PPT" rule) in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule (such as certain conduit financing arrangements); or
 3. Both the LOB rule and the PPT rule
- The LOB rule will include a "derivative benefits" provision allowing certain entities owned by residents of other countries to obtain treaty benefits that these residents would have obtained if they had invested directly.
- A number of more specific anti-abuse rules have also been designed to deal expressly with specific arrangements that have attracted attention, such as dual residence companies, source taxation of property companies and dividend transfer transactions.
- Further work is still required on the contents of the model provisions and related commentary, with particular emphasis on the LOB rule and the treaty benefit entitlement of collective investment vehicles and other funds. Consequently, the model provisions and related commentary should be considered as drafts subject to improvement before their final release in September 2015.

Action 8: Ensure that transfer pricing outcomes are in line with value creation

The OECD has conducted a long-running project on intangibles which now forms part of the BEPS actions.

- The report has resulted in revisions to the Transfer Pricing Guidelines that clarify the definition of intangibles, and provide guidance on identifying intangible transactions and for determining arm's length conditions for transactions involving intangibles.
- The existence of location savings, group synergies and assembled workforce are factors that may affect comparability and arm's length prices, but are not, of themselves, treated as intangibles.
- The guidance, in conjunction with further work to be completed in 2015, will ensure that profits associated with the transfer and use of intangibles are allocated in accordance with value creation, and will hinder BEPS structures based on the nominal allocation of intangibles to a low tax environment. Legal ownership by itself does not confer any right to retain the return from exploiting an intangible.
- Guidance has also been developed on a number of issues, but this will be regarded as purely interim guidance until work scheduled for completion in 2015 is finalised. There remain concerns that the revised guidelines will potentially lead to increased uncertainty because tax authorities will be given greater scope to recharacterise transactions involving intangibles.

Action 13: Re-examine transfer pricing documentation

There was considerable resistance from business to the earlier proposed three-tier approach comprising a master file, a local file and a separate country-by-country (CBC) template, with CBC being reported to tax authorities for risk assessment purposes only.

- The report contains a common template for country-by-country reporting of income, earnings, taxes paid and certain measures of economic activity, which has now been agreed upon by stakeholders. The CBC report requires multinational enterprises (MNEs) to report annually for each country in which they do business, including the amount of revenue, profit before tax, tax paid, tax accrued, total employment, capital, retained earnings and tangible assets. MNEs will also be required to identify each entity within the group doing business in a particular country and to provide an indication of the business activities of each.
- There are now revised standards for transfer pricing documentation, with guidance requiring MNEs to provide tax authorities with high-level information regarding their global business operations and transfer pricing policies in a 'master file' that would be available to all relevant country tax administrations. It also requires that more traditional transfer pricing documentation be provided in a local file in each country, identifying relevant related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.

Action 15: Develop a multilateral instrument

At the outset of the BEPS project, the OECD recognised that the ability to effect necessary changes to bilateral tax treaties in order to counter BEPS could hamper the progress of the entire project, notwithstanding the unprecedented political support. Consequently, the OECD proposed developing a multilateral instrument so that countries may implement measures developed in the course of the work on BEPS without having to renegotiate each of their existing bilateral tax treaties.

- The report concludes that a multilateral instrument to modify existing tax treaties is both feasible and desirable, and that negotiations for such an instrument should be convened quickly. Without a mechanism for swift implementation, changes to model tax conventions only widen the gap between the content of these models and the content of actual tax treaties.
- This is an innovative approach with no exact precedent in the tax world, but precedents for modifying bilateral treaties with a multilateral instrument exist in various other areas of public international law. Drawing on the knowledge of public international law and taxation specialists, the report explores the technical feasibility of a multilateral hard law approach and its consequences for the current tax treaty system.

Conclusion

Agreement on policy has been reached on the 2014 deliverables, and with the exception of some technical issues, the necessary rules have been drafted.

Implementation remains critical, and additional work needs to be carried out in a number of areas to ensure a consistent and coordinated application of the rules.

The seven deliverables published on 16 September 2014 contain relatively few surprises. It is clear that the political will remains to implement a BEPS reform package and regain the public's trust in the international tax system. Engagement with developing countries has been particularly relevant and the G20 has called upon the OECD and UN in particular to build on the current dialogue with developing countries, and create clear avenues for these countries to work together and have direct input in the overall project.

While details of implementation are yet to be confirmed, it is important that taxpayers recognise how swift developments have been over the past 12 months and that they remain vigilant for further developments and prepare accordingly.

Over the coming weeks we will take a more in-depth look at the seven deliverables released this month.

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