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Tax insights
Final BEPS reports: An overall view

Snapshot

On 5 October 2015, ahead of the G20 Finance Ministers' meeting in Lima, Peru on 8 October, the OECD Secretariat published an Explanatory Statement and 13 detailed papers (covering all 15 actions) outlining consensus positions under the base erosion and profit shifting (BEPS) project. These papers include and consolidate the first seven reports presented to and welcomed by the G20 Leaders at the Brisbane Summit in 2014.

Amidst all of the detail, there are two significant questions on the BEPS actions:

- when will they be implemented? and
- which countries will implement the actions?

The focus is now all about implementation.

As the differing BEPS timelines from one country to another take effect, business will need to navigate a complex path staying abreast of variations in interpretation and application of the new BEPS measures. A risk for business is that it may find itself exposed to potential double taxation risks in the transition period.

Australia is at the forefront of the implementation of the OECD's BEPS recommendations, and has already indicated a likely course of action on many of the BEPS matters.

Australian perspective

Following the OECD's release, the Federal Treasurer, Scott Morrison MP issued a press release entitled "OECD report supports the Australian government action on multinational tax avoidance". The Government considers that the OECD report shows that "Australia is firmly on the right track when it comes to ensuring multinationals pay their fair share of tax", whilst at the same time, "ensuring Australia remains an attractive and competitive place to do business". In assessing the OECD recommendations, the Government will consult widely to ensure that "investment activity is not compromised and that Australia remains an economically competitive place to do business".

An attachment to the press release describes Australia's action in respect of Action items 1-14, as "no major issues expected", presumably meaning that no major issues are expected in terms of Australia meeting or exceeding BEPS standards. In respect of Action 15 on the multilateral instrument, Australia's action is described as "further work on implementation being undertaken".

Action 1: Digital economy
It is proposed to apply GST to a broad range of intangibles supplied from outside Australia from 1 July 2017.

Action 2 : Hybrid mismatch arrangements
The Board of Taxation has begun consultation on the development of rules addressing hybrid mismatch arrangements in line with the OECD's recommendations. The Board is to report to Government by March 2016 to allow this to be considered as part of the 2016-17 Federal Budget.

Action 4: Interest deductions
The Treasurer's press release of 6 October 2015 comments in respect of Action 4 as "no major issues expected" and refers to the fact that Australia has already tightened its thin capitalisation rules.

This appears to indicate that the existing settings in respect of interest deductions are sufficient to address Action 4.

Action 6: Treaty abuse
The Government has committed, with immediate effect, to the incorporation of the OECD's recommendations on addressing tax treaty abuse into the negotiation of Australia's bilateral tax treaties.

Action 7: Avoidance of PE status
Rather than waiting for the final OECD view on PE issues under Action item 7, Australia has already taken action on the multinational anti-avoidance law (MAAL) Bill, which is currently before Parliament, to be effective from 1 January 2016.

Actions 8-10 Aligning transfer pricing outcomes with value creation
The OECD's revised guidance on the application of the arm's length principle can be implemented into Australian law by way of regulation.

Action 13: Transfer pricing documentation and reporting
Australia is committed to the adoption of the BEPS project's Country-by-Country (CbC) reporting regime, together with the recommended changes to transfer pricing documentation encompassed by the Master and Local file reporting requirements.

The Bill has been introduced into Parliament apply from 1 January 2016. The proposed measures will apply to entities within a group with annual global income of more than AU$1billion.

Related to increased reporting, the Board of Tax is consulting on a voluntary tax transparency disclosure code for large business, and the ATO will later this year report limited tax data for companies with a turnover of greater than $100 million.

Action 15: Develop a multilateral instrument
Australia is engaged with the OECD in developing the multilateral instrument which is due for completion by the end of 2016.

OECD final reports

On 5 October 2015, ahead of the G20 Finance Ministers' meeting in Lima, Peru on 8 October, the OECD Secretariat published 13 papers and an Explanatory Statement outlining consensus actions under the BEPS (BEPS) project. These papers include and consolidate the first seven reports presented to and welcomed by the G20 Leaders at the Brisbane Summit in 2014.

Sixty-two countries have collaborated in the G20/OECD-led BEPS project and they have agreed to continue working together at least until 2020. Many more participated in shaping the outcomes through regional structured dialogues. Regional tax organizations, such as the African Tax Administration Forum, *Centre de Rencontre des Administrations Fiscales* and the *Centro Interamericano de Administraciones Tributarias*, joined international organizations including the International Monetary Fund, the World Bank and the UN in contributing to the work.

There will be some more policy developments in 2016 and 2017 (including the development of the Multilateral Instrument) but the main activity will be in monitoring adoption of the BEPS measures. The monitoring group could be extended as other countries outside the project are invited to join. There is a precedent here, in the form of the *Global Forum on Transparency and Exchange of Information for Tax Purposes,* which now includes 127 countries and jurisdictions.

The G20/OECD working group notes that "Although measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, today we know that the fiscal effects of BEPS are significant… with global corporate income tax (CIT) revenue losses estimated between 4% and 10% of global CIT revenues, i.e. USD 100 to 240 billion annually".

There are two significant questions on the BEPS actions:

- when will they be implemented? and
- which countries will implement the actions?

The Explanatory Statement sets out the various levels of agreement:

"All OECD and G20 countries commit to consistent implementation in the areas of preventing **treaty shopping**, **country-by-country reporting**, fighting **harmful tax practices** and improving **dispute resolution**. Existing standards have been updated and will be implemented, noting however that not all BEPS participants have endorsed the underlying standards on tax treaties or transfer pricing" [understood to be only Brazil].

"In other areas, such as recommendations on **hybrid mismatch arrangements** and best practices on **interest deductibility**, countries have agreed a general tax policy direction. In these areas, they are expected to converge over time through the implementation of the agreed common approaches, thus enabling further consideration of whether such measures should become minimum standards in the future."

"Guidance based on best practices will also support countries intending to act in the areas of mandatory disclosure initiatives or **controlled foreign company** (CFC) legislation."

"There is agreement for countries to be subject to targeted monitoring, in particular for the implementation of the minimum standards. Moreover, it is expected that countries beyond the OECD and G20 will join them to protect their own tax bases and level the playing field."

Initial actions to take effect

The first actions to take effect will be the new **transfer pricing approach** (Actions 8-10). Both the OECD and UN model tax treaties require the use of arm's length pricing and the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* provide the main guidance on application globally. The new consolidated version of the guidelines will not be published until 2017, but tax authorities already are starting to use material released in the public consultation in their approaches to open cases.

The new approach will require that multinationals start afresh with their functional analysis. The aim is to ensure that "transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them." This will mean that entities must be able to control the risks that give rise to potential rewards and additionally that mere legal ownership of an intangible asset is not sufficient to generate a significant return.

The OECD states that "capital-rich entities without any other relevant economic activities ("cash boxes") will not be entitled to any excess profits."

The **country-by-country** (CbC) reporting to tax authorities is set out in Action 13. There is a fixed template with very clear guidance on its use. All the main parent company countries have committed to this, so other countries will receive the benefit of additional information for risk assessment, provided they have a double tax treaty or a tax information exchange agreement with the parent company country, or have signed the multilateral *Convention on Mutual Administrative Assistance in Tax Matters*. There are 127 countries in the *Global Forum on Transparency and Exchange of Information for Tax Purposes* and 80 or so have signed the *Administrative Assistance Convention*.

The first data (for December year-end groups with global sales of EU750 million (approximately A$1.4 billion at current exchange rates) for years ended 31 December 2016 must be delivered to tax authorities by 31 December 2017, which will in turn distribute it by 30 June 2018. This will require significant work to gather the necessary data and consider the potential response from revenue authorities.

The proposed changes to **harmful tax regimes** will take early effect, and covers those countries with patent box or other intellectual property regimes. In future, patent box incentives may be granted only where the related R&D is conducted in the same country. The UK is expected to present legislation quickly to introduce the new regime from June 2016 and close the existing patent box regime. There are indications that Germany, Ireland and the US may introduce their own BEPS-compliant intellectual property regimes.

Actions requiring domestic law change

Two important actions—**hybrid mismatches** and **interest restrictions**—will require national legislation. The OECD has provided over 400 pages of guidance to help countries legislate to counter hybrids (an instrument or entity which, through different treatment in two countries achieves two deductions for the same economic expense or one deduction without equivalent income recognition). The approach to hybrids will mean that such arrangements will no longer be effective, even if only one country enacts the anti-hybrid rules. The basic approach is to disallow the expense, with a secondary rule to tax the income, where the payer country does not counter the deduction. One of the challenges is that of obtaining sufficient information to establish that there is a hybrid effect.

The recommendations for interest restrictions provide that countries should limit interest deductions to a fixed percentage of earnings before interest, tax and depreciation (EBITDA). The cap should be in the range 10%-30%. Countries may optionally offer a fall-back to a group-wide ratio of third-party net interest expense, should this be higher. There are other options put forward, including a *de minimis* limit to exclude low levels of debt and the ability to carry forward and back excess interest. Additionally, third-party debt to finance public-benefit projects may be excluded, subject to conditions.

It appears that Australia will not act to give effect to this EBITDA approach, instead relying on existing rules.

It seems that Germany and other European countries consider that their existing rules broadly satisfy the action. The US congress and the treasury department both would like to limit interest deductions, but congress is not expected to legislate except as part of wider corporate tax reform. It is thought likely that the UK will issue a consultation later this year on how this action might be implemented in the UK.

Actions requiring amendments to double tax treaties

The **multilateral instrument** is intended to allow the effective modification of many treaties and will be negotiated during 2016. The initial conference to negotiate the convention starts on 5 November

2015. Over 90 countries and jurisdictions have indicated they will participate in the negotiation. The multilateral instrument must be completed by the end of 2016 and then will be available for countries to ratify. It is expected that there will be significant optionality within the instrument, such that participating countries may make different choices.

The areas to be covered by tax treaty changes are permanent establishment (PE) (taxable presence); treaty abuse; and dispute resolution. There also is a small change to cover part of hybrid mismatches.

The wide-ranging Action 7 **permanent establishment changes** are intended to lower the threshold for recognising a taxable presence.

The first area is reducing the importance of the place where a contract is legally entered into. The OECD notes "As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business. The changes to Art 5(5) and 5(6) and the detailed Commentary thereon address commissionnaire arrangements and similar strategies by ensuring that the wording of these provisions better reflect this underlying policy."

The second area for change limits the use of exemptions "…to ensure that profits derived from core activities performed in a country can be taxed in that country". The exemptions in article 5(4) of the OECD model treaty will be modified to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character. There also is an anti-fragmentation rule to limit multinationals from splitting activities to avoid a taxable presence.

Additionally, to provide greater certainty about the determination of profits to be attributed to the PEs that will result from the changes and to take account of the need for additional guidance on the issue of attribution of profits to PEs, follow-up work on attribution of profits issues will be carried out with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument.

The **treaty abuse** action springs from concerns that double tax treaties could be used to make available treaty benefits in circumstances not intended by the treaty signatories. Countries have agreed to include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping (routing payments via a treaty country to reduce taxes). They also agree that some flexibility in the implementation of the minimum standard is required as these provisions need to be adapted to each country's specificities and to the circumstances of the negotiation of bilateral conventions. The approaches put forward are limitation on benefits rules (used by Japan and the US) and principal purpose tests (used by many other countries). Collective investment vehicles (widely-held funds) will be able to qualify for treaty benefits in some circumstances. There also will be optional specific measures.

The **dispute resolution** action is important. The G20/OECD notes "Double taxation would harm multinationals which have contributed to boosting trade and investment around the world, supporting growth, creating jobs, fostering innovation and providing pathways out of poverty. Double taxation would also increase the cost of capital and could deter investment in the economies concerned."

The measures developed under Action 14 aim to strengthen the effectiveness and efficiency of the mutual agreement procedure (MAP) where cases are settled between countries. The OECD's statistics on MAP show that there were over 4,600 cases at the end of 2013 between OECD members and four partner countries, including 1,900 new cases in the year.

The new minimum standard will ensure that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner and ensure that taxpayers can access the MAP when eligible.

Additionally, there will be a "robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the

G20." This type of mechanism has worked well in the *Global Forum on Transparency and Exchange of Information for Tax Purposes* and it is intended that this will help ensure consistent application of the MAP in future.

Twenty countries, covering 90% of reported open MAP cases, have said that they will add mandatory binding arbitration to their tax treaties, using the "last best offer" approach. This requires the independent arbitrator to choose between one of the proposals put forward by the countries, rather than making his own decision. The mechanism for adding arbitration would presumably be the multilateral instrument, although the US (one of the 20) has not yet decided to participate in the negotiations.

Further work

The G20/OECD will undertake more work in 2016 on several actions:

- Harmful tax practices: Revision of criteria, expanding participation of non-OECD countries.
- Treaty abuse: Treaty entitlement of certain funds.
- Interest: Finalise design of group ratio carve-out, special rules for banking, insurance.
- PEs: Profit attribution rules.
- Transfer pricing: Financial transactions, use of the profit split method
- Multilateral instrument: Development and negotiation of the instrument

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