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BEPS Actions: An overall perspective

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On October 5, 2015, ahead of the G20 Finance Ministers' meeting in Lima on October 8, the Organisation for Economic Co-operation and Development (OECD) Secretariat **published** thirteen papers and an Explanatory Statement outlining consensus Actions 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.

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 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 United Nations in contributing to the work.

There will be additional policy developments in 2016 and 2017, but the main activity will be in monitoring each country's adoption of the BEPS measures. The monitoring group could be extended even more widely as other countries outside the project are invited to join.

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". The group estimates that **BEPS has cost some 4-10% of annual corporate tax revenues**.

There are two major questions on the BEPS Actions: **when will they be implemented and which countries** will implement them. The Explanatory Statement sets out the various levels of agreement:

> "[A]ll 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. 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."

The European Union may well decide to implement BEPS Actions across the twenty eight member states. The European Commission published in June a Communication on a *Fair and Efficient Corporate Tax System in the European Union*, which aims to set out how the BEPS measures can be implemented within the EU.

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 United Nations 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 are already starting to use material released in the public consultation in their approaches to open cases. The new approach will require that multinational enterprises 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. Further, "capital-rich entities without any other relevant economic activities ('cash boxes') will not be entitled to any excess profits".

The **next Action to take effect is the country-by-country reporting to tax authorities**, set out in Action 13. A fixed template with very clear guidance on its use is provided. 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 both have signed the multilateral *Convention on Mutual Administrative Assistance in Tax Matters*. Some non-governmental organizations may complain that not all developing countries will get the information – but we must remember that there are 127 countries in the Global Forum on Transparency and Exchange of Information for Tax Purposes and approximately 80 that have signed the *Convention on Mutual Administrative Assistance in Tax Matters*. The first data (for December year-end groups with global sales of €750 million) must be delivered to tax authorities by December 31, 2017, which will in turn distribute it by June 30, 2018. If they have not already done so, multinational enterprises must adapt their systems in order to be able to gather the necessary data.

The **final Action to take early effect covers those countries with patent box or other intellectual property regimes**. Patent box incentives may in future be given only where the related R&D is conducted in the same country. We expect the United Kingdom to bring forward legislation quickly to introduce the new regime from June 2016 and close the existing Patent Box regime. It is expected that group transfers into existing Boxes will not be allowed after December 31, 2015. There are indications that Germany, Ireland and the United States may well introduce their own BEPS-compliant intellectual property regimes.

Actions likely to take effect from 2017 or later

Two important Actions – **hybrid mismatches** and **interest restrictions – will require national legislation**. The working party looking at these issues 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 they 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 will be to obtain enough information to establish that there is a hybrid effect. The United Kingdom has indicated it will consider legislation from January 1, 2017; few other countries, including Canada, have yet offered public support – although some (e.g., France) consider that hybrids are already ineffective under their current law.

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 fallback to a group-wide ratio of third party net interest expense, should this be higher. Other options have been 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. Australia has already said that it will not implement this Action and it seems that Germany and other European countries consider that their existing rules broadly satisfy the Action. The United States Congress and 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 United Kingdom will issue a consultation later this fall on how this Action might be implemented there. Canada's views on the recommendations are not yet known, although interest deductibility restrictions have been a controversial topic in Canada for decades.

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 November 5, 2015, under the chairmanship of the United Kingdom, supported by vice-chairs from China and The Philippines. Over 90 countries and jurisdictions, including Canada, are participating in the negotiation. The Multilateral Instrument must be completed by the end of 2016 and will then be available for countries to ratify. It is expected that there will be a range of options within the instrument, such that participating countries may make different choices.

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

The multifaceted **permanent establishment** changes are intended to lower the threshold for recognizing a taxable presence. The first area of change reduces the importance of the place where a contract is legally entered into: "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. An anti-fragmentation rule is also included which limits multinational enterprises from splitting activities so as to avoid a taxable presence.

Additionally, in order to provide greater certainty about the determination of profits to be attributed to the permanent establishments that will result from the changes and to take account of the need for additional guidance on the issue of attribution of profits to permanent establishments, 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 arises from concern that double tax treaties could be used to permit treaty benefits in circumstances not intended by the treaty partners. 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 must 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 the United States) and principal purpose tests (used by many other countries, including Canada in recent treaties). Collective investment vehicles (widely-held funds) will be able to qualify for treaty benefits in some circumstances. There will also be optional specific measures.

Canada had proposed to introduce domestic anti-treaty shopping measures, but deferred further consultation on those measures pending the outcome of this Action. Whether or not Canada's next government, after the coming election, will proceed with those proposals or follow the BEPS recommendations remains to be seen.

The **dispute resolution** Action is considered an important mechanism. 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. As well, the minimum standard will 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 (including Canada), covering 90% of reported open MAP cases, have said that they will add mandatory binding arbitration to their double tax treaties. The mechanism for adding arbitration would presumably be the Multilateral Instrument, although the United States (one of the twenty) 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: finalize design of group ratio carve-out, special rules for banking, insurance.
- Permanent establishments: profit attribution rules.
- Transfer pricing: financial transactions, use of the profit split method.

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