First phase of BEPS reports issued – What is the impact on your business?

On 16 September 2014, ahead of the G20 Finance Ministers’ meeting on 20-21 September, the OECD published seven papers as a first tranche of deliverables under the Base Erosion and Profit Shifting (‘BEPS’) Project. The OECD will be continuing its work on the remainder of the 15 Actions on BEPS throughout 2015. It is clear that the G20 and OECD governments intend that recommendations under each of the BEPS Actions will form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the model tax treaty and transfer pricing guidelines. As a result, the proposed solutions in the first seven papers, while agreed, are not yet finalised and may be affected by decisions and future work on BEPS in 2015.

Which action items have been addressed in the September 2014 report?

The reports issued on 16 September 2014 address the following action items included in the BEPS project:

- Action 1: Tax Challenges of the Digital Economy;
- Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements;
- Action 5: Counteracting Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance;
- Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances;
- Action 8: Guidance on Transfer Pricing Aspects of Intangibles;
- Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties;

A summary is set out as follows:

Action 1 – Tax challenges of the digital economy

The tax challenges relating to the digital economy has been the focus of politicians, tax authorities and even the general public in recent times, with many of the companies at the centre of high-profile UK Public Accounts Committee hearings or US Senate Hearings operating in this sector. Therefore there was pressure to introduce measures to try to address these concerns.

The main conclusion set out in the report for the Task Force on the Digital Economy (TFDE) is that it would be difficult, if not impossible, to have a separate tax regime for the digital economy given that the digital economy is increasingly becoming the economy itself. While acknowledging that there is no separate digital economy, the TFDE has pointed to a number of particular challenges that need to be addressed given the rapidly changing business models facilitated by increasing digitisation and the mobile nature of commercial operations.
Creation of a taxable presence;
Transfer pricing allocation methodologies given the fragmented business models that MNCs operate;
CFC rules whereby home countries tax profits of overseas entities and the possibility of including digital economy type income within CFC regimes;
Increased focus on the administration procedures to collect B2C VAT/sales taxes.

The TFDE also suggest that given the evolving nature of the economy, work may need to continue following the BEPS project to review any tax challenges resulting from items such as the Internet of Things, virtual currencies, advanced robotics and 3D printing. A supplementary report will be issued by TFDE in December 2015.

**Deloitte comments and issues**

Overall, the outcome is as expected and this is a welcome conclusion for Ireland, which as noted is the second largest exporter in the world of ICT services.

**Action 2 : Neutralising the effects of hybrid mismatch arrangements**

A hybrid mismatch arrangement is an arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement.

Broadly, the focus of the Action 2 report is to recommend cross-jurisdictional linkage of tax rules which jurisdictions should introduce, to align the treatment of cross-border payments under financial instruments so that amounts are treated as a deductible financing expense by the payer jurisdiction and are also treated as taxable income in the payee jurisdiction. Similarly, linking rules are also proposed to deny situations where a duplicate deduction may arise in two different jurisdictions on the same payment. In certain situations, these linking rules would then also be supplemented by jurisdictions enacting defensive rules (where such arrangements are not neutralised) and also by some proposed changes to tax treaties.

In addition to the above, a number of concerns that emerged during the consultation process and other practical issues are also acknowledged by the OECD in their report. These concerns and practical issues will require further consultation and be the subject matter of further detailed guidance.

**Deloitte comments and issues**

The recommendations seek to address a number of concerns raised in consultation - but it remains clear that, where implemented, the proposals will impact many widely used hybrid financing arrangements. The OECD will develop a Commentary by September 2015 to aid countries in implementing the new rules.

The focus on structured arrangements and related party/controlled group helps strike a balance between compliance costs and neutralising the tax benefit from mismatches. The move to a 25% threshold (rather than 10%) addresses concern that tax authorities and taxpayers will find it difficult to obtain information to conclude whether a structure could be a hybrid mismatch arrangement (but the threshold is still below the greater than 50% threshold suggested by a number of Irish organisations and practitioners).
We hope clarity will be provided as soon as possible on the substantive open points, to reduce uncertainty and to limit unilateral measures that may result in double taxation. This is of particular importance to the banking and insurance sectors where there is concern that the recommendations could have a disproportionately negative effect.

The recommendations are designed for translation into domestic legislation and tax treaties. Given the unresolved substantive issues and the need for implementation guidance, it seems unlikely that any country will begin implementation prior to publication of the Commentary in September 2015. Consideration will be given as to whether a number of jurisdictions can agree to introduce provisions that are effective from a common date. The widespread and timely implementation of consistent rules will be the key to effectively tackling the hybrid mismatch arrangements the Action seeks to target and the proposed Commentary is essential to achieving this.

**Action 5 – Counter harmful tax practices more effectively, taking into account transparency and substance**

The work on harmful tax practices focuses on mobile financial and service activities such as financing and Intellectual Property (IP) related activities. The report highlights progress made with particular focus on:

- Establishing a methodology to define a substantial activity requirement in the context of preferential IP regimes;
- Improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes;
- Progress report on the review of member country preferential regimes.

There appears to be consensus among OECD countries that preferential IP regimes should be based on substantial activities. However, the key challenge is deciding on the specific methodology to be used in applying this substantial activity requirement, with the nexus approach currently receiving more support than the other two methodologies put forward, namely the transfer pricing approach and the value creation approach. The nexus approach essentially looks at whether the benefits of a preferential IP regime are conditional on the extent of R&D activities of the taxpayers receiving those benefits. Although the nexus approach appears to have received broad support by OECD countries, there remain questions about its compatibility with EU law which may delay any conclusion on the substantial activity requirement.

Indeed there is a separate ongoing review of patent box regimes in operation across the EU by the EU Code of Conduct Group. The review is also considering the merits of the nexus and transfer pricing approaches of allocating profits to patent box regimes. This review, however, has been delayed as a result of a stalemate on this issue at an EU level which gives an indication of the political sensitivities involved.

This review is ongoing and will continue beyond September 2014. Once the detail on the substantial activity and transparency factors has been finalised, the preferential regimes included in the review will be considered further.

Ireland was not listed as having any preferential regime included in the review.

**Deloitte comments and issues**

If the nexus approach is selected, this could limit the attractiveness of any potential preferential IP regime (such as a patent box regime) that the Irish Government may decide to introduce to enhance Ireland’s competitiveness as an IP location, because there appears to be a limitation on subcontracted R&D to related parties under the nexus approach and typically subcontracted R&D would form a large part of the overall R&D activities relating to Irish owned IP of certain multinationals.
**Action 6: Prevent treaty abuse**

One of the key actions in preventing BEPS is Action 6, Preventing Treaty Abuse which includes combatting treaty shopping. The output is to recommend changes to the Model Tax Convention and recommendations for the design of domestic rules to prevent unintended uses of tax treaties such as generating double non-taxation.

Broadly, it is recommended that countries should include recommended changes to the Title and Preamble to the tax treaty and also focus on additional specific measures in tax treaties as follows:

- A Principal Purpose Test (PPT) which states that the benefits of the treaty should not be available where one of the principal purposes of the transaction or arrangements is to secure a benefit under the treaty unless it is established that granting the benefit would be in accordance with the object and purpose of the convention, or;
- The inclusion of a Limitation of Benefits (LOB) clause, similar to that included in most tax treaties agreed by the United States, including also a derivative benefits provision whereby the benefits of the treaty would be available where the persons that own a treaty resident, while not a resident of one of the contracting states themselves would be entitled to equivalent treaty benefits if they had invested directly. The LOB clause would be supplemented by a mechanism to deal with conduit arrangements not already dealt with in tax treaties or;
- A combined three-pronged approach of recommended changes to the Title and Preamble to the tax treaty, a PPT rule and an LOB provision.

The report also addresses a number of specific situations where existing treaty application criteria are circumvented, namely:

- Splitting-up contracts to avoid a taxable branch or PE;
- Hiring-out of labour cases;
- Avoiding dividend characterisation;
- Dividend transfer transactions;
- Avoiding immovable property characterisation of certain holdings;
- Tie-breaker rule for determining treaty residence;
- Anti-abuse rule for PE’s in third states;

From a domestic tax perspective, the main objective is to ensure that tax treaties do not prevent domestic anti-abuse rules from having effect, resulting in the avoidance of domestic tax. The main change in this regard will be the inclusion of additional anti-abuse provisions as outlined above. There will also be additional clarity in the Commentary, to the extent that Contracting States want to deny the application of treaty benefits to transactions entered into to avail of treaty benefits and the ability for contracting states to introduce a US type “saving clause”.

The Report has included potential circumstances where a Collective Investment Vehicle (“CIV”) can obtain access to a treaty where the limitation of benefits clause is implemented. It has, however, given the Contracting States discretion to include the provision they agree most appropriate. The Report also indicates that further work is needed with respect to the policy considerations relevant to treaty entitlement of CIV and non-CIV funds and is subject to change before the final version is released in September 2015. Ideally, from an Irish funds industry perspective, treaty access would be granted at the level of the CIV itself and not at investor level. For the moment, it is positive that a carve-out is not completely off the table but it is an area that needs to be monitored to see the final outcome.

**Deloitte comments and issues**

There are substantial implications for the financial services and funds industry as well as for structured finance transactions that remain to be determined.
Action 8: Guidance on transfer pricing aspects of intangibles

The report contains guidance in relation to the revisions to Chapters I, II and VI of the OECD TP Guidelines namely:

- Chapter I and II changes on:
  - location savings and other local market features
  - assembled workforce
  - group synergies

- Chapter VI will be completely replaced with sections on:
  - guidance on identifying intangibles
  - guidance on identifying who is entitled to intangible related returns
  - transactions involving the use of intangibles
  - guidance on determining arm’s length conditions in cases involving intangibles.

A key area discussed in the published report is in relation to the compensation for intangible related returns. Part of the report (shaded out and not in final form) reiterates that the intangible related returns should be in line with value creation rather than mere legal ownership. This concept is illustrated below.

To the extent that one or more members of a multinational group other than the legal owner performs functions, uses assets, or assumes risks related to the development, enhancement, maintenance, protection, and exploitation of the intangible, such associated enterprises must share in the anticipated returns derived from exploitation of the intangible by receiving arm’s length compensation for their functions, assets and risks. This compensation may, depending on the facts and circumstances, constitute all or a substantial part of the return anticipated to be derived from the exploitation of the intangible.

The report confirms the position that it will be more difficult for companies that lack people and substance to retain significant intangible related profits. This impact will also be visible by the greater transparency provided for in the new Masterfile and Country-By-Country reporting requirements. During the technical briefing held on the 16th September, Marlies de Ruiter, head of the transfer pricing section of the Centre for Tax Policy and Administration, outlined that WP6 have agreed that profits should be attributable “in line with value creation” and a “cash-box” in a low tax jurisdiction will be entitled to a financial return only on its capital and legal ownership in the intangible assets.
**Action 13: Guidance on transfer pricing documentation and country-by-country reporting**

The output from Action 13 is a new Chapter V of the OECD’s transfer pricing guidelines. The new Chapter V states that the objective of transfer pricing documentation is:

- To provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment;
- To ensure that multinationals (MNEs) give appropriate consideration to transfer pricing requirements in establishing prices for transactions between associated enterprises and reporting the income derived from those transactions in their tax returns; and
- To provide tax administrations with the information they need to conduct an appropriately thorough examination of MNEs’ transfer pricing practices.

A common template is provided for the reporting of detailed global information to tax authorities using a three pronged approach namely the preparation of:

**Master file**
- High-level overview of the MNE group business.

**Local file**
- Detailed information on specific group transactions.

**Country by country report**
- Aggregate, jurisdiction-wide information on global allocation of income, taxes paid, indicators of economic activity;
- Useful for transfer pricing risk assessment and for evaluating other BEPS-related risks.

The enhanced disclosure requirements required by the Masterfile, local file and CbC reporting will impact Irish companies in a number of ways.

The main impact is likely to come from the increased visibility that Irish Revenue and foreign tax authorities will have as a result of the Masterfile and CbC reporting requirements. It will be easy for Irish Revenue for example to identify where companies are paying large royalties and the onus will be on the taxpayer to defend the arm’s length nature of such payments.

The new Chapter V is likely to lead to an increase in the compliance burden for Irish companies as a result of the requirement to prepare three distinct transfer pricing documents and the additional

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**Deloitte comments and issues**

It is clear that low-functioning entities that primarily rely on the provision of capital and the assumption of contractual risk to earn intangible returns will not find support for their position in the final OECD guidance.

For multinational groups with complex structures involving the ownership and use of intangibles, it is recommended that a detailed review is now undertaken to consider the functions and risks of group companies earning intangible returns in light of the new OECD direction and heightened focus by tax authorities on such structures.

As many multinational groups have significant management and control based in the US, the interaction between these rules and the US Tax Regulations will need detailed consideration as to their application and effective date. Whether such rules apply to past years will also be a relevant concern. With US tax law not expected to change until after the next US presidential election, now is the time to assess the impact of this OECD guidance on returns and the effective tax rate for US multinational groups.
requirement to update the financial information of comparable companies on an annual basis. Furthermore, as tax authorities will have a clearer picture of the global supply chains of MNCs and their associated transfer pricing policies, there is a potential for more transfer pricing disputes to arise in the future which may lead to an increase in time consuming and expensive mutual agreement procedures (MAP).

**Deloitte comments and issues**

Irish companies, particularly those with significant offshore IP structures should closely examine the new documentation requirements and carry out a risk assessment of their existing transfer pricing policies in light of the enhanced visibility that both Irish Revenue and foreign tax authorities will have regarding income and expense flows.

When preparing budgets, companies should factor in the additional cost associated with meeting the new documentation requirements, including costs that may arise as a result of reconfiguring IT systems to produce the necessary information for the CbC report, particularly in the first year when the new documentation guidelines are implemented.

It is clear that the new guidance will change the documentation process fundamentally and require most companies to gather and provide to the tax authorities substantially more information on their global operations than they have previously provided. Although implementation dates have not been set, companies should begin to consider the process to compile the information. For some companies, the implementation processes may require substantial lead times and commitment of resources.

The new guidance will provide tax authorities with unprecedented transparency regarding the financial results of a company’s global transfer pricing policies. Companies may want to consider how the new documentation guidance will impact their current transfer pricing policies and their process for implementing, monitoring, and defending those policies.

**Action 15: Developing a multilateral instrument to modify bilateral tax treaties**

One of the key challenges of the OECD in preventing BEPS is ensuring that the agreed BEPS action points are implemented within a reasonable timescale, and the focus in this action is on identifying whether a multilateral instrument could be agreed from an international law perspective, so as to enable participating countries amend bilateral tax treaties.

The report concludes that such an approach is feasible from an international law perspective and is desirable in terms of efficiently amending the terms of thousands of individual bilateral tax treaties.

Work on the negotiation of the multilateral instrument will begin in 2015 with an International Conference being convened to begin development of the instrument. Clearly the work on the multilateral instrument cannot be completed before the treaty-based BEPS actions are agreed upon.

The report acknowledges that flexibility will be required in the extent of the rights and the obligations of various parties to take account of the varying levels of existing commitments between various parties while still maintaining consistency and transparency which provides certainty.

**Deloitte comments and issues**

The negotiation of the final measures is therefore likely to represent a challenge, albeit feasible from a legal perspective.
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