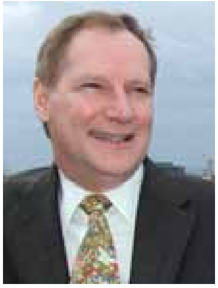


The Changing Landscape of International Tax: the OECD's BEPS Project

Paul Reck *Tax Partner, Deloitte*
Liz Donoghue *Assistant Manager, Deloitte*

Background

Many businesses, in particular multinational enterprises (MNEs), will be aware of and interested in the continuing work of the Organisation for Economic Co-operation and Development (OECD) in relation to base erosion and profit shifting (BEPS). On 12 February 2013 the OECD released its first report on the matter, *Addressing Base Erosion and Profit Shifting*[1]. Unlike earlier OECD-initiated projects on tax-related matters, this 91-page report was commissioned by the G20, in November 2012. Generally, previous tax-related OECD reports and discussion drafts have been perceived as useful commentaries for jurisdictions to consider in applying their own domestic tax laws. Not often have domestic tax laws been explicitly rewritten to reflect these commentaries. The work that the OECD is undertaking around BEPS is distinctive from its previous projects in that there is obvious momentum behind this initiative, indicated through many OECD countries confirming their support for the BEPS initiative. Thus, it is fair to say that change in the international tax environment is certain; what is uncertain is the extent of this change and the form and approach that it will take.

Defining the Problem

The G20 commissioned the BEPS report as a first step in addressing concerns surrounding the transparency of the

1 OECD, *Addressing Base Erosion and Profit Shifting*, http://www.oecd.org/tax/BEPS.htm.

current international tax system. In recent months, there have been numerous articles in the worldwide press regarding MNEs' inbound investments in EU countries and the level of tax that they are (or are not) paying. Large MNEs have come under scrutiny for their implementation of tax structures that are entirely legal but, nonetheless, perceived as aggressive, whereby substantial profits are being reported in tax haven jurisdictions such as Bermuda or the Cayman Islands, resulting in minimal corporate tax being paid on a worldwide basis. With the majority of small to medium-sized companies and individuals paying their share of tax, the fairness of the current international tax system is being publicly doubted. Furthermore, the voluntary tax assessment and compliance systems operated by many countries are also at risk of being undermined should these issues not be addressed. Also highlighted in the report is the need for current international tax standards to catch up with changes in the global business climate, in particular with regard to intangible property and the development of the digital economy. With questions being raised about the fairness and relevance of the current international tax system, and with the world attempting to recover from the financial crisis, the issue of BEPS has become increasingly important.

With questions being raised about the fairness and relevance of the current international tax system, and with the world attempting to recover from the financial crisis, the issue of BEPS has become increasingly important.

Key Areas of Concern

The OECD report analyses the principal causes of BEPS and identifies six key areas of concern:

› international mismatches (double non-taxation);

› OECD Model Treaty concepts in the field of digital delivery of goods and services;

› tax treatment of related-party debt, insurance and other intra-group financial arrangements;

› transfer pricing, in particular the shifting of risks and intangibles, the artificial splitting of assets between different legal owners, and transactions within a group that rarely would take place with third parties;

› the effectiveness of domestic anti-avoidance measures (e.g. general anti-avoidance rules, and controlled foreign company and thin capitalisation regimes) to prevent treaty abuse; and

› the availability of harmful preferential regimes.

These areas discussed in detail below.

International mismatches

The world of taxation follows two contrasting taxation approaches – the worldwide taxation system and the territorial system. The worldwide taxation system generally requires residents to pay tax on their worldwide income, whereas the territorial system requires residents and non-residents to pay tax on any income derived from sources situated in the relevant territory. The interaction of the two tax systems leaves gaps through which taxable profits can escape, creating international mismatches whereby taxpayers can achieve double deductions for a single expense or double non-taxation of income. The BEPS report proposes to address international mismatches through the development of instruments to put an end to, or neutralise, the effects of hybrid mismatch arrangements and arbitrage. This could be achieved through a number of different avenues, which we consider here.

Move to a consistent worldwide basis of taxation

Although a consistent worldwide basis of taxation would go a long way in addressing the issue of international mismatches, in a global world, where each jurisdiction has sovereignty over its tax rules, global regulatory alignment is virtually impossible.

Create specific rules to counter hybrid mismatch arrangements

Specific rules could be created targeting specific hybrid mismatch vehicles. The issue lies in how to execute these rules. Options include through domestic tax rules (arguably the quickest and easiest option), amending/updating individual treaties, or a multilateral agreement to impose the rules on existing treaties.

Apply higher withholding taxes on intra-group payments or limit/deny deductions

Increasing withholding tax rates would certainly discourage base erosion; however, consideration should be given to the negative impact that this would likely have on inbound investment.

Furthermore, it is worth noting that EU Member States can currently apply a Directive to eliminate withholding-tax obstacles in the area of cross-border interest and royalty payments within a group of companies. This Directive would need to be reconsidered should the option of increasing withholding taxes be pursued. One suggestion is to limit the application of higher withholding taxes and the denial of deductions to jurisdictions considered to be "abusive".

Include stringent anti-abuse rules in all tax treaties

The aim would be to include anti-abuse rules in all tax treaties, resulting in the prohibition of conduit companies. The issue of how to execute these rules as considered above in relation to hybrid mismatches is also relevant here.

The OECD's efforts concerning international mismatches build on work undertaken in 2012 addressing tax policy and compliance issues related to hybrid mismatch arrangements. The OECD released a report in March 2012 setting out the most common types of hybrid mismatch arrangements and the results achieved by employing such arrangements.[2] With the increased focus on hybrid mismatch arrangements through the OECD's BEPS work and the EU's separate project addressing the same, the scope for intra-EU tax planning involving hybrid arrangements is likely to diminish.

The aim would be to include anti-abuse rules in all tax treaties, resulting in the prohibition of conduit companies. The issue of how to execute these rules as considered above in relation to hybrid mismatches is also relevant here.

OECD treaty concepts

OECD treaty concepts were identified as a key area of concern in the BEPS report, particularly in respect of the constantly evolving digital economy. The policy of economic allegiance was the basis of the 1927 Model Treaty allocation of taxing rights, which worked by "weigh[ing] the various contributions made by different states to the production and enjoyment of income". As a result of the development of the digital economy, the OECD believes that this 1927 concept of allocating taxing rights may no longer be fit for purpose, and it is therefore revisiting the current rules. The objective of the BEPS initiative is to update solutions to the question of tax jurisdiction, specifically in relation to digital goods and services. The primary consideration is the concept of a permanent establishment. Generally, a substantial physical presence or a dependent agent operating in a jurisdiction is required for there to be deemed a permanent establishment in that jurisdiction. In present days, the internet enables businesses to have substantial involvement in the economic life of a country (for example, through customers buying goods online) without being deemed to have a permanent establishment under current OECD treaty concepts. We consider some different options for addressing the issue of permanent establishment below.

Amend the current permanent establishment exemptions in Article 5.4

All of the permanent establishment exemptions could be restricted to include only "auxiliary or preliminary" activities, which was arguably the original intention in 1927, when the Model Treaty was drafted. Accordingly, this should simply require a clarification of the Notes to the Treaty; however, there could be issues around the interpretation by national courts.

Change the definition of permanent establishment

As acknowledged above, companies can be heavily involved in the economic life of a country without being deemed to have a permanent establishment in that country due to the current definition of a permanent establishment. The definition could be extended to create a permanent establishment where a company is heavily involved in the economic life of another country. Clarification of what qualifies as being heavily involved in the economic life of a country would need to be provided.

Amend the treatment of intangible property/insurance/financial payments

The above-mentioned payments could be grouped and taxed on the basis of location of exploitation, possibly by way of a withholding tax. Again, consideration would need to be given to the current EU Directive providing for the elimination of withholding-tax obstacles in the area of cross-border interest and royalty payments within a group of companies.

---

2 OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, http://www.oecd.org/ctp/exchange-of-tax-information/hybridmismatcharrangementstaxpolicyandcomplianceissues.htm.

With a large focus on the technology business sector, Ireland will be keeping a close watch on developments in this area and seeking to participate in working groups discussing the taxation of the digital economy.

Treatment of related-party finance

Current tax rules permit the differential treatment of debt and equity for tax purposes, giving rise to incentives for leverage. Generally, where a company borrows to fund its business activities, any interest paid is deductible for tax purposes, subject to specific conditions. On the contrary, payment of dividends to shareholders is generally not tax-deductible. As the BEPS report indicates, this, unsurprisingly, may lead to a tax-induced bias toward debt finance. Options for alleviating the bias toward debt finance and the associated tax savings are considered below.

With Ireland already providing for a limitation on tax relief for interest on intra-group debt through its domestic tax rules, the work being undertaken at the OECD level in this area may not have an immediate impact on Ireland.

Deny tax deductions in relation to intra-group debt

This option could be implemented quickly by way of domestic legislation based on OECD agreed metrics. As an alternative to the complete denial of deduction on intra-group debt, the debt deduction could be capped at a fraction of the true group borrowing, as applied in the UK.

Change from a residence-based to a source-based taxation approach

This option would require the interest income of the overseas entity to be taxed in the paying country. To implement this successfully, withholding taxes would likely be required.

With Ireland already providing for a limitation on tax relief for interest on intra-group debt through its domestic tax rules, the work being undertaken at the OECD level in this area may not have an immediate impact on Ireland.

Transfer pricing

The overarching concept of transfer pricing involves the arm's-length principle. Where associated enterprises transact with one another, the arm's-length principle requires the transaction to be priced as if it were between two independent parties. In transactions between two independent parties, the price agreed will generally take into consideration the functions that each party performs, the assets used in undertaking the functions and the risks assumed in relation to the transaction. One of the fundamental assumptions of the arm's-length principle is that the more extensive the functions/assets/risks that a party contributes to the transaction, the greater the remuneration that party should be expected to receive. This creates an incentive for MNEs to shift these functions/assets/risks, and thus profit, to a low-tax jurisdiction. It is most common for MNEs to shift risk and intangible assets between jurisdictions.

Work on the treatment of intangible property from a transfer pricing perspective has already started, with the OECD issuing a discussion draft, *Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*,[3] in June 2012. The draft discusses identifying intangibles and the parties entitled to intangible-related returns, transactions involving the use or transfer of intangibles, and determining the arm's-length range. The likely outcome of the extensive work being undertaken in this area will be a change in the way that the allocation of profits from intangible property transactions are priced, with an increased focus on substance and where the key functions are being undertaken.

The OECD's objective is to improve and clarify the transfer pricing rules to address specific areas where the current rules produce undesirable results from a policy perspective. Options to assist in achieving this objective are considered below.

Introduce a cap on intangible property

Introducing a cap on intangible property, similar to existing thin capitalisation rules, to limit the deduction of payments related to intangible property between associated enterprises would go some way in discouraging the transfer of intangible property between jurisdictions. The cap could be introduced through domestic tax law, amending the Model Treaty or creating a multilateral treaty.

---

3 OECD, *Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*, http://www.oecd.org/tax/transfer-pricing/50526258.pdf.

Apply withholding taxes to all payments related to intangible property

This option would address the profit-shifting issue but, again, runs counter to EU Directives.

Challenge risk-shifting structures

It is well accepted that risk generally arises where sales take place. Shifting the risk to an entity that does not undertake sales should raise immediate concerns regarding substance. There is the option of revisiting/amending Chapter IX, "Business Restructuring", of the OECD Model Treaty to address the issue of risk shifting comprehensively.

As many MNEs with operations in Ireland are in sectors with substantial intangible assets, such as IT and pharmaceuticals, the discussions under way at the OECD level will be of particular interest here.

Anti-avoidance measures

Most countries already have some form of anti-avoidance regulation in their domestic tax legislation, typically by way of general anti-avoidance rules (GAARs), thin capitalisation provisions, controlled foreign company (CFC) rules and the like. In addition, many tax treaties aim to regulate tax avoidance on an international basis through the inclusion of anti-treaty-shopping provisions or specific provisions that limit the benefits under a tax treaty in certain circumstances. The anti-avoidance rules are generally relied on by taxpayers to determine whether a particular tax structure or strategy should be employed, with the OECD implying that taxpayers use various strategies to escape the application of the anti-avoidance rules. In the BEPS report, the OECD questions the effectiveness of current anti-avoidance measures, in particular GAARs, CFC regimes, thin capitalisation rules and rules to prevent tax treaty abuse. Through its BEPS work, the OECD aims to improve the effectiveness of the anti-avoidance rules to be included in national law or international treaties. Potential options for achieving this objective are considered below.

Create an effective GAAR

An effective GAAR would require more standardised wording to apply across all jurisdictions, in addition to fewer or more appropriately targeted exemptions from the anti-avoidance rules.

Create more effective CFC rules

Again, this would require more standardised wording to apply across all jurisdictions, in addition to fewer or more appropriately targeted exemptions from the CFC rules.

Ireland already has extensive rules that address avoidance, specifically the GAAR, provisions limiting the deductibility of interest payments on intra-group debt, and the taxing of passive income such as interest and dividends at the higher corporate tax rate of 25%. According to its 2012 annual report, the Irish Revenue continues to focus on identifying aggressive tax planning and the unintended use of legislation by taxpayers, and challenging it or recommending the amendment of legislation where feasible. While Ireland's domestic tax law incorporates various anti-avoidance statutes, there is potential for the anti-avoidance provisions in Ireland's tax treaties to be modified as a result of the work being undertaken by the OECD.

Harmful preferential regimes

While international trade has had some positive effects on the development of tax systems through broadening the tax base and rate-reducing tax reforms, it has also shaped an environment where tax havens prosper, with other jurisdictions essentially encouraged to offer harmful preferential regimes to attract inward investment. "Harmful preferential regimes" refers to harmful tax regimes that offer preferentially beneficial tax treatment to non-residents or to activities that do not impose on domestic markets. Some countries encourage inward investment by facilitating the reduction of taxes paid in other jurisdictions. The OECD has previously undertaken work on this, releasing a report titled *Harmful Tax Competition: an Emerging Global Issue*[4] in 1998, which in 2000 led to 47 potentially harmful preferential tax regimes in OECD countries being identified. Of those regimes, 19 were abolished, 14 amended to remove their potentially harmful features, 13 concluded not to be harmful and only one identified as being harmful, which was later abolished by legislation enacted on 29 December 2006. While this earlier work could be considered a success, the BEPS report clearly indicates that there is more to be done in this area, with the OECD proposing to identify solutions to counter harmful regimes more effectively, specifically taking into account transparency and substance. Potential options to assist in achieving this objective are considered below.

4 OECD, *Harmful Tax Competition: an Emerging Global Issue*, http://www.oecd.org/tax/transparency/44430243.pdf.

Greater transparency on effective tax rates

Increasing the transparency of MNEs' effective tax rates would go some way in combating the application of harmful preferential regimes, as having the knowledge of what tax rate an MNE is paying on a global basis would allow for harmful preferential regimes to be identified more easily.

Introducing a "bad-country list"

Having a publicly available document identifying the countries offering harmful preferential regimes could put pressure on the Governments of those countries to reconsider such regimes.

Ireland's domestic tax legislation already limits the relief allowable from source-country taxation to related parties resident in EU and tax treaty countries. Accordingly, further work done by the OECD in the area of harmful preferential regimes may not immediately impact on Ireland.

The OECD report concludes that a global response from Governments is required to address the issue of BEPS, noting that it would be difficult for any single country to address on a stand-alone basis.

What Now?

In the currently uncertain territory that is BEPS, the question for many MNEs will likely be: can any pre-emptive measures be taken now? Aside from keeping up to date with the progress of the various BEPS initiatives, we would recommend that MNEs review and consider the potential impact of BEPS on their current tax structure, particularly where hybrid instruments are used. It is also advisable that MNEs have a contingency plan in place, should there be a change in tax law that adversely affects the tax structure of the MNE. Additionally, where any contracts are up for review, it is best to renew these on a short-term basis (if possible) to allow flexibility, should relevant tax law change.

Concluding Comments

The OECD report concludes that a global response from Governments is required to address the issue of BEPS, noting that it would be difficult for any single country to address on a stand-alone basis. The OECD is committed to delivering a global and comprehensive plan to deal with the key areas of concern discussed above, which will be completed for submission to the Committee on Fiscal Affairs for the June 2013 meeting. The OECD promises that the action plan will consider the best way to implement, in a timely fashion, the measures that Governments can agree on, providing countries with instruments, both domestic and international, to address the key areas of concern. Ireland's corporate tax regime is based, in substance, on the 12.5% tax rate, encouraging MNEs to set up significant operations (and, by default, significant employment) in Ireland. While the BEPS work will undoubtedly have an impact on how international operations are structured going forward, Ireland should view BEPS in a constructive light, considering the opportunities that it may present.