OECD Releases Action Plan on Base Erosion and Profit Shifting – July 2013

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The Organisation for Economic Co-operation and Development (OECD) published its promised *Action Plan on Base Erosion and Profit Shifting* (BEPS), after presenting the plan to the G20 Finance Ministers' meeting in Moscow on 19 July 2013. This article is by way of follow-up to an article that appeared in *Irish Tax Review* 26/2 (2013).

In a communiqué on 20 July, G20 Finance Ministers and Central Bank Governors fully endorsed the proposed plan and welcomed the establishment of a joint OECD/G20 project aimed at "ensuring that all taxpayers pay their fair share of taxes".

The Origin

The OECD Action Plan on BEPS originates from statements by G20 leaders at the group's meeting of 18–19 June 2012 in Mexico City. Additionally, a joint statement by the UK, Germany and France, issued on 5 November 2012, urged G20 leaders to support the OECD BEPS initiative.

While individuals and domestic businesses in many countries are suffering the effects of a long-lasting economic downturn and Budget cuts, media reports on low effective tax rates (ETRs) for some multinational enterprises (MNEs) warn against non-taxation (or low taxation) of certain sources of income derived in an international context.

From the very beginning, the international tax system has been based on single taxation of income. The League of Nations' 1927 report, prepared by the Committee of Experts on Double Taxation and Tax Evasion, said:

> *"From the very outset,* [the drafters of the Model Convention] *realized the necessity of dealing with the questions of tax evasion and double taxation in co-ordination with each other. It is highly desirable that States should come to an agreement with a view to ensuring that a taxpayer shall not be taxed on the same income by a number of different countries, and it seems equally desirable that such international cooperation should prevent certain incomes from escaping taxation altogether. The most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once and only once."*

Therefore, it is not unexpected that the G20 leaders consider non-taxation or low taxation to be just as unacceptable and undesirable as double taxation and that they urge action to close the "gaps" in the international tax system that have allowed these results.

On 12 February 2013 the OECD presented a report, *Addressing Base Erosion and Profit Shifting*, to G20 leaders, recognising the need for urgent action to prevent BEPS effects and committing to present a detailed Action Plan for the next G20 meeting in July 2013.

The Objectives

The OECD's BEPS Action Plan is the result of contributions made by representatives of OECD Member States, as well as observing nations such as China and India.

While acknowledging that taxing rights are at the core of sovereignty of nations, the Action Plan mentions that the interaction of domestic tax rules may lead to some "loopholes" in an international context. Specifically, these "loopholes" are seen as giving some scope for double non-taxation or low taxation by allowing MNEs to take advantage of income that is not taxed (or is taxed at low effective rates) in either the country of source or the country of residence. At the same time, the Action Plan warns against uncoordinated reactions by individual countries seeking to protect their legitimate tax revenues. Such unilateral reactions would, according to the OECD, result in increased uncertainty, the "massive re-emergence of double taxation" and cross-border tax disputes.

The Action Plan also rules out fundamental change to the international tax architecture, such as adopting a global unitary tax system, as suggested by some advocating organisations. It also notes that the current balance between source and residence countries remains unaltered by the BEPS proposals. Countries such as China and India have argued for change here; the OECD is clear that this report addresses base erosion alone.

The 15 Actions

The Action Plan sets out 15 areas for further work, including a summary of the key considerations to be addressed and the timetable for the work in each area. OECD working groups are being set up to focus on each of the issues, and interested non-OECD members of the G20 (Argentina, Brazil, China, India, Indonesia, Russia, Saudi Arabia, South Africa and South Korea) will be invited to participate as Associates (on equal footing with OECD Member States).

In addition, the OECD will invite other countries on an ad hoc basis, and the United Nations' input is welcomed to provide insights in respect of the concerns of developing countries. The OECD will also seek the participation of all stakeholders through the Task Force on Tax and Development, its Global Relations Programme or the existing Global Forums on Tax Treaties, on Transfer Pricing, on VAT and on Transparency and Exchange of Information for Tax Purposes. Business and civil society will be consulted in the framework of the Business and Industry Advisory Committee (BIAC) and the Trade Union Advisory Committee (TUAC).

The foreseeable outcome of the BEPS project will be a wide mix of different measures, including analysis reports (i.e. on the tax implications of the digital economy); new metrics on the effects of BEPS; recommendations for countries to amend their domestic tax rules for better coordination on the international field; and changes in international tax rules, such as amendments to the Model Tax Convention or its Commentaries, amendments or new chapters in the Transfer Pricing Guidelines, and even a new multilateral tax treaty to enable fast adoption of changes in the future.

The OECD has staggered deadlines for each action, beginning with September 2014, continuing with September 2015 and ending with December 2015. This is an aggressive timetable, necessary to satisfy public and political scrutiny of the international tax system while also providing some certainty for businesses by the end of that period. Some areas will progress faster, as work has been under way for some time (such as the existing OECD work on the transfer pricing of intangibles). In the table below, the 15 actions, foreseeable outcomes and expected timelines are summarised.

Table: OECD BEPS Actions and Timelines

Action Plan	Output	Timelines
Action 1 – Address the tax challenges of the digital economy	Report identifying issues raised by digital economy and possible actions to address them	September 2014
Action 2 – Neutralise the effects of hybrid mismatch arrangements	Changes to Model Tax Convention Recommendations on design of domestic rules	September 2014
Action 3 – Strengthen CFC rules	Recommendations on design of domestic rules	September 2015
Action 4 – Limit base erosion via interest deductions and other financial payments	Recommendations on design of domestic rules	September 2015
	Changes to Transfer Pricing Guidelines	December 2015
Action 5 – Counter harmful tax practices more effectively, taking into account transparency and substance	Finalised review of member country regimes	September 2014
	Strategy to expand to non-OECD members	September 2015
	Revision of existing criteria	December 2015
Action 6 – Prevent treaty abuse	Changes to Model Tax Convention	September 2014
	Recommendations on design of domestic rules	September 2014
Action 7 – Prevent artificial avoidance of PE status	Changes to Model Tax Convention	September 2015
Action 8 – Assure that transfer pricing outcomes are in line with value creation: intangibles	Changes to Transfer Pricing Guidelines and possibly to Model Tax Convention	September 2014
	Changes to Transfer Pricing Guidelines and possibly to Model Tax Convention	September 2015
Action 9 – Assure that transfer pricing outcomes are in line with value creation: risks and capital	Changes to Transfer Pricing Guidelines and possibly to Model Tax Convention	September 2015
Action 10 – Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions	Changes to Transfer Pricing Guidelines and possibly to Model Tax Convention	September 2015
Action 11 – Establish methodologies to collect and analyse data on BEPS and the actions to address it	Recommendations on data to be collected and methodologies to analyse them	September 2015
Action 12 – Require taxpayers to disclose their aggressive tax-planning arrangements	Recommendations on design of domestic rules	September 2015
Action 13 – Re-examine transfer pricing documentation	Changes to Transfer Pricing Guidelines and recommendations on design of domestic rules	September 2014
Action 14 – Make dispute-resolution mechanisms more effective	Changes to Model Tax Convention	September 2015
Action 15 – Develop a multilateral instrument	Report identifying relevant public international law and tax issues	September 2014
	Development of multilateral instrument	December 2015

Digital economy (Action 1)

One of the more controversial points in drafting the Action Plan was the inclusion of the tax issues derived from the "digital economy". While some countries, led by France, have proposed specific changes in international tax rules to address the provision of digital goods and services through the internet, other countries, including the US, are of the view that the same tax rules should apply to the companies operating through the internet for the taxation of their profits.

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Finally, all countries reached a consensus position on Action 1 to analyse further the main difficulties posed by the digital economy in relation to existing international tax rules, develop detailed options to address them and consider indirect tax alongside direct tax issues. This will include consideration of circumstances where, under current rules, a group has a significant digital presence in a country without a corresponding taxable presence, valuing and attributing marketable location-relevant data and ensuring effective collection of consumption taxes (VAT/GST).

Directly addressing base erosion (Actions 2, 3, 4 and 5)

The OECD's BEPS Action Plan addresses some weaknesses in the international tax system that may be used to erode tax bases or to create opportunities for non-taxation. The workflows for these actions will primarily derive from OECD recommendations for enhancing/coordinating domestic tax rules.

On 5 March 2012 the OECD issued the report *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*. Following the work in this report, the OECD will seek to neutralise the effects of hybrid mismatch arrangements through:

› changes to the OECD's Model Tax Convention to prevent hybrid entities receiving treaty benefits unduly and

› recommendations for domestic tax rules to (i) prevent exemption of payments that are deductible to the payer, (ii) deny a deduction for a payment that is not included in the income of the recipient, (iii) deny a deduction for a payment that is deductible in another jurisdiction (double dip) and (iv) provide guidance on tie-breaker rules where necessary.

As it notes, the OECD has not done significant work on controlled foreign company (CFC) rules in the past. The OECD will expand on this area to develop recommendations on the design of domestic CFC rules. Although CFC rules are considered by many Governments to be a useful instrument to fight tax base erosion, their practical enforcement within the EU may be difficult due to ECJ judgments such as *Cadbury Schweppes* C-196/04.

In recent years, some countries have enacted interest limitation rules to prevent the erosion of national tax bases through debt instruments. The OECD will evaluate the effectiveness of different types of interest limitations and develop recommendations for best-practice rules preventing base erosion through excessive interest deductions or to finance the production of exempt or deferred income. Transfer pricing guidance on financial instruments will also be developed (see below).

Finally, the OECD will revisit the 1998 project on harmful tax practices. In addressing this issue, it will focus on improving transparency, including tax authority rulings where they relate to low-tax regimes, and on requiring there to be substantial activity for any such preferential low-tax regime. This workflow includes completing the ongoing country reviews.

Tax treaties (Actions 6 and 7)

Two issues relating to double taxation treaties are to be addressed specifically.

At a high level, the OECD wants to address the issue of tax treaty abuse. It will develop Model Tax Convention provisions and provide recommendations on domestic rules to prevent tax treaties giving benefits in inappropriate circumstances. The treaty work may be similar in concept to the existing "limitation on benefits" clauses that the US has agreed in its tax treaties or, alternatively, may look at "subject to tax" requirements for treaty benefits to apply. The OECD is keen to clarify that tax treaties are not intended to be used to create situations of no taxation, and at the same time to develop guidance for countries on factors to consider before deciding to enter into a tax treaty.

More specifically, the OECD wants to address the issue of artificial avoidance of a permanent establishment (PE). It seems that the ongoing review of the Commentary to Article 5 of the Model Tax

Convention is not addressing all of the concerns, and a deeper review of the PE concept itself is required. Two of the main concerns being discussed are:

- On one side, recent Supreme Court decisions in civil law countries (i.e. *Zimmer* in France and *Dell* in Norway) have suggested the need to make changes to the definition of a PE in the OECD Model Tax Convention to prevent artificial avoidance of a taxable presence, including through commissionaire arrangements (undisclosed agents).
- On the other side, specific activity exemptions (Article 5, para. 4), such as the exemption for preparatory and ancillary activities, will be limited or clarified.

This work also will address related profit attribution issues in both cases.

Transfer pricing (Actions 4, 8, 9, 10 and 13)

Transfer pricing issues are at the core of the BEPS discussions. The pricing of intra-group transactions and its effect on the allocation of revenue between the tax jurisdictions involved is the key element for tax risk management for both companies and tax authorities.

G20 leaders underlined this point in their communiqué of 20 July: "We acknowledge that effective taxation of mobile income is one of the key challenges. Profits should be taxed where functions driving the profits are performed and where value is created."

In this line, the Action Plan includes three separate workflows:

- Intangibles (Action 8): as widely anticipated, the OECD will undertake further work to prevent profit shifting by moving intangibles among group members, including ensuring that profits from intangibles are not divorced from value creation and introducing special measures for hard-to-value intangibles.
- Risks and capital (Action 9): the OECD will also develop rules to prevent high returns accruing to a company solely because risks have been contractually transferred to it or because it has been allocated excessive capital within a multinational group.
- Other high-risk transactions (Action 10): the OECD will develop rules to prevent profit shifting from transactions that would not, or would only very rarely, occur between third parties, including clarification of the potentially contentious issue of transaction recharacterisation or disregard, and guidance on the use of profit-split methodologies where appropriate, as well as protection against common base-eroding payments, such as management fees or overhead allocations.

The output of these workstreams will be changes to the Transfer Pricing Guidelines and, possibly, to the OECD Model Tax Convention.

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Following on from the G8 declaration at Lough Erne in June 2013, Action 13 will look at transfer pricing documentation to enhance transparency for tax administrations, including developing a common template for providing information on the global allocation of profits, economic activity and taxes paid on a country-by-country basis to local tax authorities.

Finally, Action 4, as discussed earlier, considers the development of specific transfer pricing guidance for financial transactions and instruments, including financial and performance guarantees, derivatives and insurance arrangements.

Transparency and disclosure (Action 12)

In the area of transparency, the OECD will develop recommendations on the design of domestic rules for early disclosure to tax authorities of aggressive tax-planning schemes, drawing on the experiences of certain countries, such as the UK. One specific focus will be on international tax schemes, potentially using a wide definition of "tax benefit".

Enhance tax administration and dispute resolution (Actions 11, 14 and 15)

One of the issues identified in the OECD's February 2013 report on addressing BEPS was the limited data available to assess the scale of BEPS. In this regard, the OECD will develop indicators of the scale and economic impact of BEPS, as well as tools to evaluate the effectiveness of measures taken under the actions.

The OECD remains concerned that double taxation can hinder global trade and investment, and it will therefore address the practical and timely resolution of disputes under the mutual agreement procedures in tax treaties. This will include consideration of binding arbitration clauses to ensure resolution and the removal of blocks from accessing mutual agreement procedures in some cases.

The final action is, as already widely referred to by the OECD, the development of a multilateral instrument to facilitate the speedy introduction of changes to the OECD Model Tax Convention into existing treaties. This will start with an analysis of the tax and legal issues that such an instrument may present, with a view to coming up with an "innovative approach".

Final Remarks

This is a major initiative by the OECD. Its Tax Director, Pascal Saint-Amans, has said that he expects multinational companies to end up paying more corporate tax as a result. The outcomes will depend on international agreement and will take effect in three ways:

- recommendations to countries to change national rules,
- changes to the OECD Model Tax Convention and recommendations that countries adopt the new model and
- changes to the Transfer Pricing Guidelines.

Countries will ultimately choose which measures they wish to adopt – especially in the areas put forward for national action. It is not clear, for example, whether countries would tighten their CFC rules in response to OECD recommendations.

Companies operating in Ireland will need to follow closely developments at OECD level and to consider the impact of potential changes on their business operations in Ireland, as well as across their global operations. The impact for companies is likely to include:

- changes in tax law, treaty interpretation and transfer pricing regulations in the short to medium term;
- increased focus on substance and interaction with the legal form of transactions;
- more emphasis on value creation in highly integrated groups, with a particular focus on intangibles;
- enhanced focus by tax authorities on the global supply chain, including on low-tax or "tax haven" jurisdictions;
- documentation rule changes to provide tax authorities with more information on a group's global activities and allocations of income, creating enhanced visibility of where taxable profits are being reported; and
- increased tax transparency and exchange of information between countries.

Ireland had an active involvement, together with other OECD members, in the drafting of the Action Plan. While the changes, which will be implemented over the coming years, will no doubt have implications for companies operating here, Ireland's corporate tax regime, which is based on substance, will present varying opportunities going forward.

Read more on TaxFind The Changing Landscape of International Tax: the OECD's BEPS Project, *Irish Tax Review*, Issue 2, 2013