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OECD issues final reports on BEPS

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Big change is on the horizon regarding how taxpayers doing business around the world are to be taxed. In November 2015, the G20 Finance Ministers' approved a series of final reports on 15 focus areas in the OECD Action Plan on Base Erosion and Profit Shifting (BEPS). This article provides an overview of the main recommendations set forth in the reports. Each of the final reports can be obtained directly from the OECD here.

Addressing the tax challenges of the digital economy

The report notes that adopting special tax rules designed exclusively for the digital economy are unworkable as the digital economy is 'increasingly the economy itself.' The report recommends: (i) modification to exceptions to the definition of a Permanent Establishment with regard to preparatory or auxiliary activities; (ii) modification of the definition of a PE to address 'conclusion of contracts' arrangements; (iii) a correlative modification to the OECD Transfer Pricing Guidelines; and (iv) changes to controlled foreign company rules to address the digital economy. The report also addresses the indirect tax treatment of certain digital transactions, recommending that countries apply the OECD's International Value Added Tax/Goods and Services Tax (VAT/GST) Guidelines.

Neutralizing hybrid mismatches

The report consists of recommendations to address hybrid mismatch arrangements. The report specifically recommends modifications be made to domestic tax law aimed at avoiding hybrid mismatches, including adopting rules aimed at neutralizing the following tax consequences arising out of hybrid mismatch arrangements: (i) payments that give rise to a deduction with no taxable inclusion arising from a hybrid financial instrument and a disregarded payment made by a hybrid entity or a payment made to a reverse hybrid; (ii) payments that give rise to a double deduction arising from a deductible payment made by a hybrid entity or a dual resident; and (iii) payments that give rise to an indirect deduction with no inclusion arising from an imported mismatch. The report contains examples of how the rules are intended to operate.

The report also recommends revisions to the OECD Model Tax Convention: (i) a change to Article 4 of the Model Tax Convention to deal with dual resident entities; (ii) a new provision in Article 1 and changes to the Commentary to address fiscally transparent entities; and (iii) various proposed changes to address treaty issues that may arise from the recommended domestic law changes.

Creating effective CFC rules

The report sets forth recommendations in the form of setting forth 'building blocks' that are necessary for what the action group views as an effective CFC regime. The recommendations are not minimum standards but instead are designed in a manner so that jurisdictions that implement them have CFC rules that effectively prevent its taxpayers from shifting income to foreign subsidiaries. The report recognizes that countries should be allowed flexibility in the design of their own CFC rules that are consistent with their domestic policy frameworks.

Limiting base erosion through interest and financial deductions

The report recommends that countries implement a 'fixed ratio' rule that would limit net interest deductions claimed by an entity (or a group of entities operating in the same country) to a fixed percentage of earnings before interest, taxes, depreciation and amortization (EBITDA). The final report provides that this ratio should be somewhere between 10% and 30% of applicable EBITDA. The final report further recommends that countries adopt a 'group ratio' rule to supplement (but not replace) the fixed ratio rule, and to provide additional flexibility for highly-leveraged groups or industry sectors. Beyond this basic framework, the final report recommends that countries consider using an average of EBITDA for the current year and prior years, to minimize the impact of earnings volatility on interest deductions; and providing for carryforward and/or carryback of disallowed interest expense.

The final report confirms that interest disallowed under Action 4 should still be subject to withholding tax.

Harmful tax practices

The BEPS project is focused on identifying and countering what the OECD views as harmful tax practices. The report explains that a 'substantial activity' test should be applied to determine whether a particular tax practice is harmful.

The report defines the substantial activity requirement in the context of intellectual property (IP) regimes as the 'nexus approach'. Under the nexus approach, the application of an IP regime is dependent upon the level of research and development activities carried out by the taxpayer itself. In addition, the report concludes that IP regimes should be limited to patents and copyrighted software. Interestingly, 16 existing IP regimes were reviewed by the action group, who concluded that none of them meet the nexus approach. The report states that taxpayers should not be permitted to use these existing regimes and to any other IP regime that does not meet the substantial activity requirement after 30 June 2016. Enhanced transparency requirements will apply to new entrants into an IP regime. Further, the report states that the benefits of an IP regime should not be granted in respect of IP acquired directly or indirectly from related parties after 1 January 2016 except in cases of acquisitions as a result of a domestic or international business restructuring.

When applying the nexus approach to activities other than IP, the report states that there needs to be a link between the income qualifying for benefits and the core activities necessary to earn the income.

The report identifies improving transparency as a priority, through compulsory spontaneous exchange of information on certain rulings.

Preventing treaty benefits abuse

The final report recommends changes to the OECD Model Tax Convention and the Model Commentary to address what the action group considers the inappropriate granting of treaty benefits and treaty abuse scenarios. The final report notes that further work must be done with respect to the limitation on benefits (LOB) rule. The final report recommends that countries provide a minimum level of protection against treaty shopping. Under this minimum standard, countries would implement: (i) the combined approach of a principal purpose test (PPT) rule and LOB rule; (ii) a PPT rule alone; or (iii) an LOB rule, supplemented by specific rules targeting conduit financing arrangements. In addition to these minimum standards, the final report recommends that rules be included in tax treaties that would address other forms of treaty abuse, including situations of dual resident entities, and rules that apply to permanent establishments situated in third states.

Preventing arrangements that avoid PE status

The report proposes changes to the PE definition in Article 5 of the OECD Model Tax Convention to prevent the use of the following arrangements that enable a foreign enterprise to operate in another country without creating a PE. Examples include commissionaire arrangements and the use of specific preparatory or auxiliary activity exemptions.

The final report reflects proposed amendments to Article 5(5) and Article 5(6). Article 5(5) requires a person other than an independent agent acting on behalf of a foreign enterprise to have the 'authority to conclude contracts in the name of the enterprise' in order to create a PE. The report recommends that Article 5(5) refers to persons (other than an independent agent) that habitually conclude contracts or 'habitually play the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise'. Changes were also recommend to the definition of independent agent in Article 5(6) by replacing the concept of 'connected parties' with 'closely related enterprises.' The report includes cases where a person possesses directly or indirectly more than 50% of the beneficial interest in the other or, if a company, more than 50% of the aggregate vote and value of the company's shares or the beneficial equity interests.

Transfer pricing

The OECD has included updated transfer pricing (TP) guidance under Actions 8-10. A detailed explanation of that guidance is beyond the scope of this article. Guidance on the following TP related topics include:

- Identification of the actual transaction undertaken, and circumstances in which the actual transaction undertaken may be disregarded for transfer pricing purposes.
- Comparability factors in transfer pricing.
- Pricing for commodity transactions.
- Pricing intangibles, including hard-to-value intangibles.
- Pricing low-value adding intragroup services.
- Cost contribution arrangements (CCA).

The final report also contains detailed guidance on analyzing risks as part of a functional analysis, including a six-step analytical framework.

Monitoring BEPS

Action 11 is concerned with measuring BEPS activity. Action 11 is intended to estimate the size of BEPS, identify indicators of BEPS, and provide recommendations for improving the measurement of BEPS.

Disclosing

The final report recommends mandatory disclosure regimes. The objectives of such a regime are to increase transparency through providing early information to tax authorities.

Transfer pricing documentation and country-by-country reporting

The final report sets out a standardized approach to transfer pricing documentation and country-by-country reporting.

Making dispute resolution mechanisms more effective

The report contains measures aimed at strengthening the effectiveness and efficiency of the mutual agreement procedure mechanism, such as specific actions to be taken by countries, suggested changes to legislation and administrative practices, and changes to the OECD Model Tax Convention and its Commentary.

Developing a multilateral means to modify bilateral tax treaties

Action 15 explores the feasibility of a multilateral instrument to implement the treaty-related measures developed as part of the BEPS project and to amend bilateral tax treaties. The Group aims to finalize the multilateral instrument for signature by 31 December 2016. To date, approximately 90 countries are participating. Note that participation in the development of the multilateral instrument is voluntary and does not require any commitments to sign such instrument, once it has been finalized.

What the future holds for global businesses

Countries around the world now must determine how to implement the various recommendations. Some countries have already passed tax laws based on recommendations in earlier action draft reports, and many others today are proposing new legislation to implement the final report recommendations. Countries who are resistant or slow to change will be identified; putting pressure on them to adopt recommendations contained in the reports. (At a recent meeting, G20 Finance Ministers have asked the OECD to develop a framework for monitoring the implementation by countries of the BEPS recommendations.) The finalization of a multilateral instrument which would modify existing tax treaties on a broad basis is targeted for the end of this year.

What this means for global businesses is that now is the time to evaluate the implications of the recommendations contained in the final reports for their business models and operating structures.

FOOTNOTES

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