Putting the final BEPS reports into perspective: from recommendations to implementation

Tax Update

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The Organization of Economic Cooperation and Development (OECD) released its final reports on the G20/OECD Base Erosion and Profit Shifting (BEPS) Project on Monday October 5th, 2015.

The final package of BEPS measures includes new minimum standards on: country-by-country reporting, which for the first time will give tax administrations a global picture of the operations of multinational enterprises; treaty shopping, aimed at putting an end to the use of conduit companies to channel investments; curbing harmful tax practices, in particular in the area of intellectual property and through automatic exchange of tax rulings; and effective mutual agreement procedures, to ensure that the fight against double non-taxation does not result in widespread unrelieved double taxation.

The BEPS package also revises the guidance on the application of transfer pricing rules to prevent taxpayers from using so-called 'cash box' entities to shelter profits in low or no-tax jurisdictions, and redefines the key concept of Permanent Establishment, to curb arrangements which avoid the creation of a taxable presence in a country by reliance on an outdated definition.

The reports offer governments a series of new measures to be implemented through domestic law changes, including strengthened rules on 'controlled foreign corporations', a common approach to limiting base erosion through interest deductibility and new rules to prevent hybrid mismatch arrangements from making profits disappear for tax purposes through the use of complex financial instruments.

Nearly 90 countries are working together on the development of a multilateral instrument capable of incorporating the tax treaty-related BEPS measures into the existing network of bilateral treaties. The instrument will be open for signature by all interested countries in 2016.

The BEPS measures were agreed after an intensive two-year consultation process between 62 OECD, G20 and developing countries (herein 'participating jurisdictions') and stakeholders from other countries, business, labor, academia, international organizations and civil society. The BEPS initiative consists of 15 working groups aimed at addressing specific matters. Each working group prepared a final report following earlier draft versions since the start of the project over two years ago.

As the tax and financial world dive deeper into the many technical aspects of the reports (in excess of 1,000 pages) we have set out below some key notes that put the final BEPS reports perspective.

Not all 15 BEPS reports are equal

There is clear distinction between the reports when it comes to the level of consensus and commitment reached between
the participating jurisdictions as well as to how the reports will ultimately be implemented. Certain reports aim to amend domestic legislation whilst other reports facilitate changes to international standards, guidelines and/or tax treaties. The lack of consensus on certain elements of the BEPS project will undoubtedly impact the way in which countries choose to implement (or not implement) those measures.

The reports that have resulted in the introduction of so called ‘minimum standards’ have the highest level of commitment from all participating jurisdictions. These reports should result in changes to domestic legislation at the level of all participants to the minimum standards agreed upon. It is expected, and in fact we are already seeing, that many jurisdictions will start adopting new domestic legislation addressing these matters. Action 5 (Counter Harmful Tax Practices), Action 6 (Prevent Treaty Abuse), Action 13 (Re-Examine Transfer Pricing Documentation and Country-by-Country Reporting) and Action 14 (Improve Effectiveness of Dispute Resolution) fall in this highest category.

The reports that put forward a ‘common approach’ seek to define a general direction for (local) tax policy to develop into minimum standards over time. Action 2 (Neutralize Effects of Hybrid Mismatches) and Action 4 (Limit Base Erosion via Interest Deduction) fall into this category.

The final category of reports focuses on ‘best practices’ for domestic legislation changes. For these reports the lowest level of consensus has been reached. Action 3 (Strengthen CFC Rules) and Action 12 (Disclose Aggressive Tax Planning) fall into this last category.

The report covering Actions 8 through 10 (Transfer Pricing Outcomes in Line with Value Creation) will result in updates and changes to the OECD Transfer Pricing Guidelines despite the fact that not all participants are completely supportive of the proposed changes.

Action 7 (Prevent Artificial Avoidance of PE) is to result in changes to the OECD Model Tax Convention which over time can be adopted in tax treaties. Also for Action 6 (Prevent Treaty Abuse) changes to the OECD Model Convention are to be drafted including the introduction of a Limitation of Benefits article and a Principle Purpose Test.

A final and specific mention on Action 15 (Develop a Multilateral Instrument). The work with respect to the Multilateral Agreement Procedure (“MAP”) is ongoing and it is expected that this should be ready for signature by interested parties in 2016. Whilst there appears to be some progress, it is clear that there is still much work to be done in order to obtain widespread consensus on an instrument that truly provides for binding MAPs.

**Why the European Union might accelerate or supersede BEPS**

Simultaneous to the OECD BEPS initiative the European Commission is also addressing base erosion and profit shifting. In the summer of 2015 the EC re-launched proposals for a common tax base. Part of the objective of this initiative is to reduce opportunities for multinationals to avoid corporate tax. It is expected that the EC will push to integrate certain BEPS action items by way of measures that are binding for all 28 EU member countries. So far, the EU has already implemented certain measures and/or is investigating into others, such as:

- Change to EU Parent/Subsidiary Directive introducing a GAAR and addressing hybrid mismatches
- New EU Directive introducing the Automatic Exchange of Information regarding Tax Rulings
- State Aid investigations around Advance Tax Ruling practices

The EU Directive around the Automatic Exchange of Information regarding Tax Rulings issued on October 6th, 2015 is an example of an EU implementation of BEPS. Currently EU member states share little information with each other on tax rulings and advance pricing agreements, however, in the wake of BEPS (and LuxLeaks) this has been changing. Building on this, the EU Directive of 6 October 2015 will remove member states’ discretion to decide what to share, when to share it and with whom by effectively requiring members states to share key details of tax rulings on a six monthly basis from 1 January 2017. Rulings of the past five years are also covered. In addition, members states are empowered under the Directive to seek more detailed information on a particular ruling and the Commission has been tasked with the role of monitoring the implementation of the Directive and ensuring compliance by member states.

**The US and BEPS**

As an OECD and G20 member country the United States has been a very active participant in the OECD’s BEPS work. Within the United States there has been apprehension by the Treasury Department and Congress as to the scope of the US’s involvement and commitment to the implementation of certain BEPS measures. In particular, commentators point
out that BEPS-related legislative activity in the United States will be difficult due to concerns raised by prominent members of Congress (including Rep. Paul Ryan, Chair of the House Ways and Means Committee and Sen. Orrin Hatch, Senate Finance Committee Chairman). Despite this, actions by US Treasury Department indicate that they will continue to take action and be involved in the implementation of certain BEPS measures.

On May 20, 2015, shortly before the United States was scheduled to meet with the OECD in June, the US Treasury Department released proposed changes to the US Model Income Tax Convention on May 20, 2015 (the ‘Proposed Changes’). The Proposed Changes were designed to ‘influence the debate at the OECD’, according to Henry Louie, a US Treasury Department official. The Proposed Changes as drafted would restrict the use common base erosion structures utilized by US-based multinationals to strip earnings out of the United States and treaty partner jurisdictions.

Since then, the US Treasury Department has issued favorable statements about the OECD’s work with respect to transfer pricing guidelines and country-by-country reporting. Temporary regulations to implement country-by-country reporting for 2016 will be released by the end of the year, Michael McDonald, financial economist (business and international taxation), U.S. Treasury Office of Tax Analysis, said October 7.

In response to the recent release of the BEPS final reports, a US Treasury Department official was quoted on October 5th as stating: “Overall the United States is pleased with the final reports because the work of the BEPS project should make it easier to ensure that income is taxed where the functions, assets and risks that give rise to the income are located, and it will improve the dispute resolution mechanisms that are key to the elimination of double taxation.”

Despite the apprehension in the United States on the potential of BEPS-related legislative activity (such as treaty modifications), US-based multinationals will be affected by the BEPS changes that may be adopted in the near team through Treasury actions (such as country-by-country reporting) as well as by the adoption of BEPS in the jurisdictions in which they do business.

What is next

With the issuance of these final reports the BEPS project enters into its next phase: implementation. For certain Actions more work needs to be undertaken and further clarity will not be provided until one or two years from now (such as the transfer pricing guidance on profit splits and financial transactions). However, on a number of the important matters immediate changes are expected.

The amended Transfer Pricing Guidelines for example will come into effect immediately and the new transfer pricing documentation standards, including Country by Country Reporting and introduction of Transfer Pricing Master and Local files, are intended to be effective as of 2016. Several countries have already passed legislation or have proposed draft legislation that seeks to implement these standards (eg Australia, Netherlands, Poland and Spain) and many others have announced their intention to do so in the near future.

Over the past couple of years numerous countries have introduced or strengthened BEPS related measures in their domestic legislation (such as anti-hybrid rules and new thin capitalization rules) and in some countries we have seen unilateral action outside of the BEPS process (i.e. the United Kingdom’s Diverted Profits Tax). It is expected that this trend will increase following the issuance of the BEPS reports, with more and more countries using these reports as the impetus (and justification) for domestic tax reforms, which may go above and beyond the scope of the BEPS recommendations.

In addition to the changes to the model treaty, domestic laws and the Transfer Pricing Guidelines and the increased transparency, the impact of the BEPS project on tax administrations should not be underestimated. Due to the high profile of BEPS tax administrations in many countries are now under significant pressure to deliver results. This has already began to result in increased audit activity concerning international transactions and, in particular, transfer pricing.

If you would like to discuss the impact of the OECD BEPS project on your business or would like to address the technical aspects of the BEPS Reports feel free to reach out to your regular DLA Piper contacts.

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