The OECD publishes its Action Plan addressing international Base Erosion and Profit Shifting

The OECD released its report, Action Plan on Base Erosion and Profit Shifting (BEPS), on 19 July 2013, which represents a significant development in the area of global cooperation to modernise the international tax system.

The G20 financing ministers called on the OECD to develop an action plan to address the issue of BEPS in a coordinated and comprehensive manner. The report stems from concerns that the development and interaction of domestic tax laws by sovereign states may not adequately deal with the way in which globally integrated groups operate and structure their tax affairs.

Background

Rapid globalisation has resulted in increased integration between businesses and domestic economies and markets. This integration has been accompanied by operating models that have progressed from country specific models to globally integrated models that centralise functions at a regional or global level.

Several governments around the world have expressed concerns in relation to tax planning arrangements that enable global organisations to take advantage of the interaction of domestic tax laws that may result in profits not being taxed at all. Perceived weaknesses in international tax rules can provide opportunities for planning arrangements that lead to double non-taxation or less than single taxation. Such outcomes are being referred to as harmful tax practices, and principally arise because current domestic or international tax rules may not be seen to adequately tax profits in accordance with where the economic interests or value creating activity occurs.

The Action Plan

The Action Plan highlights that fundamental changes may be needed to counteract some of the strategies used by global organisations to minimise their tax liabilities. The Action Plan seeks to take a coordinated approach to modernise the international tax system to better address the operating models and strategies employed by global corporations. The Action Plan has identified 15 Action Plans aimed at addressing profit shifting and base erosion arrangements.

The action points broadly cover the taxation of the digital economy; disparities between domestic tax systems; potential abuse of bilateral treaties; the sophistication of transfer pricing (TP) rules; the integrity of information available to tax authorities; and the consistency of application across domestic tax laws and treaties.

The specific actions and the expected completion dates are highlighted below.

Address the tax challenges of the digital economy

The OECD highlights the need to examine different business models and obtain a more comprehensive understanding of value creation in the digital economy. Issues to be examined include: the potential for a digital presence in a country without the creation of a taxable nexus; the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services; characterisation and sourcing of income from business models; and collection of consumption taxes for cross-border transactions. The findings and recommendations report are expected by September 2014.

Neutralise the effects of hybrid mismatch arrangements

The review will consider the interaction of domestic tax systems and treaties under which hybrid instruments or entities may lead to a double deduction or double non-taxation or long-term deferral results. The OECD's intention is to neutralise these effects by effecting changes to the OECD Model and recommending changes to domestic tax laws. The report is expected by September 2014.

Strengthen CFC rules

The OECD's intention is to effect a more uniform application of the controlled foreign company (CFC) rules in tax jurisdictions to more effectively counter BEPS. Recommendations regarding the design of domestic tax CFC rules are expected by September 2015.

Limit base erosion via interest deduction and other financial payments

The OECD will develop recommendations concerning best practices in the design of rules to prevent base erosion through interest payments, e.g., the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. TP guidelines are expected by September 2015 and December 2015, respectively.

Counter harmful tax practices more effectively, taking into account transparency and substance

The OECD will consider issues such as the compulsory spontaneous exchange of information on rulings related to preferential regimes and the requirement for substantial activity within a preferential regime. Following this, there will be a review of member country regimes, a report on the strategy to expand participation to non-OECD members, and development of revised criteria with respect to harmful tax practices. Recommendations are expected by September 2014, September 2015 and December 2015, respectively.

Prevent treaty abuse

The focus will be on the prevention of treaty benefits in inappropriate circumstances and ensuring that countries take into account instances of double non-taxation before entering into a treaty. Changes to the OECD Model and recommendations regarding domestic rules are expected by September 2014.

Prevent the artificial avoidance of PE status

The OECD intends to effect changes to the definition of a permanent establishment (PE), with a focus on the use of commissionaire arrangements and specific activity exemptions (i.e. preparatory/ancillary activities). Changes to the OECD Model are expected by September 2015.

Assure that transfer pricing outcomes are in line with value creation: intangibles

The report will review the definition of intangibles, ensure that profits associated with intangibles are allocated in accordance with value creation, and develop rules or special measures for hard-to-value intangibles and to update guidance on cost contribution arrangements. Changes to the OECD TP guidelines and potential changes to the OECD Model are expected by September 2014 and September 2015, respectively.

Assure that transfer pricing outcomes are in line with value creation: risks and capital

The OECD's intention is to align profits with value creation by developing rules to ensure that inappropriate returns will not accrue to an entity solely because it has assumed risks or provided capital. Changes to the OECD TP guidelines and potential changes to the OECD Model are expected by September 2015.

Assure that transfer pricing outcomes are in line with value creation: high-risk transactions

Focus areas include the development of rules to prevent BEPS by engaging in transactions that would not, or would only very rarely, occur between third parties. This would involve adoption of TP rules or special measures to clarify the circumstances under which transactions can be re-characterised; clarify the application of TP methods in the context of global value chains; and provide protection against common types of base eroding payments such as management fees and head office expenses. Changes to the OECD's TP guideline and potential changes to the OECD Model are expected by September 2015.

Establish methodologies to collect and analyse data on BEPs and the actions to address it

The intention is to evaluate the scale and impact of BEPS and to subsequently develop methodologies to assess the effectiveness and impact of measures to address BEPS. The OECD specifically acknowledges the need to consider taxpayer confidentiality and administrative costs in carrying out this objective. The OECD's recommendations regarding the type and source of data required and analytical methodologies are expected by September 2015.

Require taxpayers to disclose their aggressive tax planning arrangements

The plan recommendation considered is the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements or structures with regard to the administrative costs involved and drawing on experiences of the countries that have such rules. The OECD's recommendations to domestic rules are expected by September 2015.

Re-examine transfer pricing documentation

The report indicates the need for corporations to provide "all relevant governments" with information on global allocation of income, economic activity and taxes paid among countries in accordance with a common template. Changes to the TP guidelines and recommendations for domestic tax systems are expected by September 2014.

Make dispute resolution mechanisms more effective

The OECD will review obstacles preventing countries from resolving treaty-related disputes under the Mutual Agreement Procedures (MAP). This includes the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases. Changes to the OECD Model are expected by September 2015.

Develop a multilateral instrument

The OECD's intention is to analyse any tax and public international law issues related to the development of a multilateral instrument to enable participating countries to implement measures developed in the OECD's work on BEPS and to amend bilateral tax treaties. A further report is expected by September 2014 and subsequent development of a multilateral instrument is expected by December 2015.

Comment

In the current environment, a review of international tax rules to identify areas for improvement may be seen as long overdue. However, the scope of the report and its ambitions for change represents a potential seismic shift in the international tax landscape.

The OECD's report represents an ambitious plan to overhaul international and domestic tax rules in response to the growing concerns that the existing tax rules do not tax profits in the jurisdiction where value is created.

Completion of the Actions is planned over the next two and a half years, with some of the more consensus driven items to be finished by December 2015.

While definitive action is still subject to the outcome of each Action item, their implementation may face some potential challenges. Some of our initial observations are:

- The OECD's action plan proposes changes to domestic tax systems within an ambitious time frame and it is encouraging that the OECD intends to consult with a range of non-governmental stakeholders.

- Developing a comprehensive understanding of various business models against a background of continued innovation, and extrapolating this understanding in order to develop changes in international tax law, will present complex challenges.

- Actions on transparency require greater disclosure to global tax authorities of certain 'aggressive transactions' by corporations. The effectiveness of this proposal will require clear definitions and consensus as to which transactions they will apply to.

- Actions to address harmful tax practices afforded by preferential regimes in favour of acceptable tax competition may prove detrimental for economies, which rely on the foreign investment and business drawn by their preferential tax regimes.

- With respect to the digital economy and before specific proposals are made, there is a need to understand business models, particularly where TP, PE and substance requirement amendments are involved. It will be important to ensure sufficiently clear, comprehensive tests are in place to facilitate compliance without burdening taxpayers with excessive costs; and ensure that the practical considerations and costs to the taxpayer of the OECD's revised TP documentation requirements are fully assessed and appropriately taken into account relative to the benefits such reporting would serve in addressing BEPS.

- While a multilateral treaty presents the most viable option to implementing a number of the proposed actions within the target time frames, considerable challenges may be faced in obtaining participation by member and non-member governments to agree to such an approach.

- Previously, the OECD had indicated that it did not intend to depart from the arm's-length principle. However, of concern is that the Action Plans indicates that the OECD is considering measures, which go beyond the arm's-length principle.

Going forward, taxpayers will need to be alert to developments arising from the OECD's work on the Action Plan as this could have a significant impact on their business operating models.

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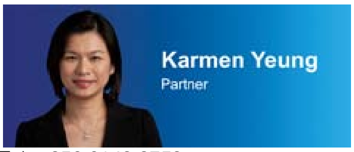

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