

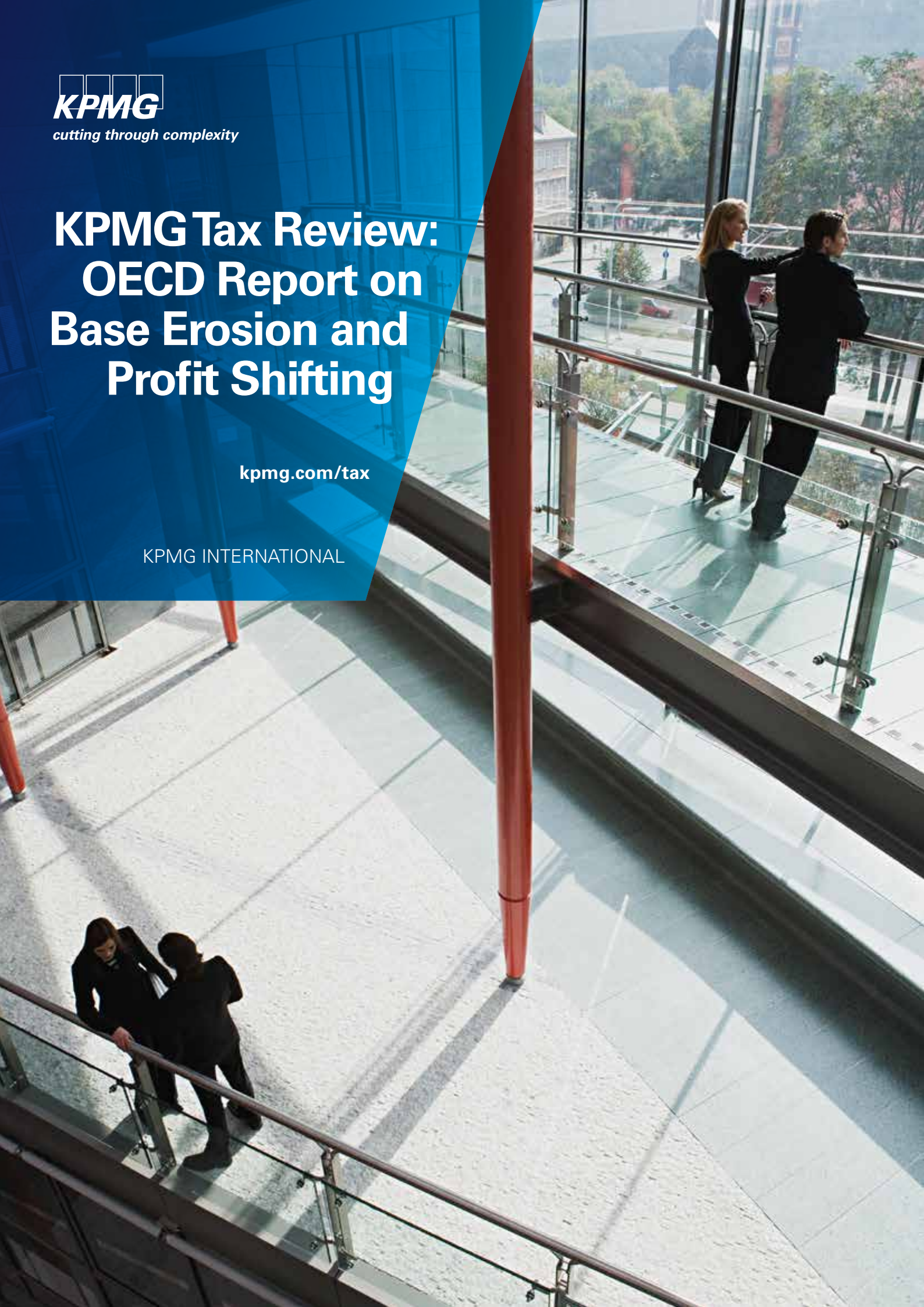


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# KPMG Tax Review: OECD Report on Base Erosion and Profit Shifting

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## KPMG Tax Review: OECD Report on Base Erosion and Profit Shifting

*While its roots trace back to 1948 through the Organisation for European Economic Cooperation (OEEC), the Organisation for Economic Co-operation and Development, the OECD, as we know it today, was established in 1961. Last year (2012), the OECD celebrated its 50th birthday. There are now 34 member countries who collectively work together to promote policies to improve the social and economic well-being of people around the world.*

*Integral to the OECDs work is the issue of tax. Understanding, evaluating and projecting outcomes of tax policy or tax rule changes on investments, business decisions, and government revenues, have massive economic impact. And, while many want quick fixes to global and local economic issues, tax policy decisions should never be made with a short-term view.*

*Through honorable, consultative processes and dialogue with stakeholders all over the world, the OECD is proactively addressing the approaches, rules and regulations for tax that have global scale and impact.*

*KPMG's Tax practice believes that the international tax system needs improvement and the OECD, given its recognized expertise, is best placed to analyze the relevant issues and to propose actions and opportunities.*

*As a welcome fast-track project for the OECD, the Base Erosion and Profit Shifting (BEPS) initiative is top of mind with tax authorities and taxpayers. It represents an unprecedented effort to tackle perceived shortcomings and abuses as it relates to the systems of international taxation.*

*With a June 2013 action plan expected from the OECD, here, KPMG International, provides key highlights from an exclusive interview on BEPS with Pascal Saint-Amans, the OECD's Director for the Centre for Tax Policy and Administration, and a review of the March 2013 Business and Industry Advisory Committee (BIAC) consultation.*

## A conversation with Pascal Saint-Amans

*Mr Saint-Amans told KPMG that the OECD was prompted to tackle BEPS as a result of many factors:*

“Political attention is growing because it is hard to explain why some profitable companies pay small amounts of tax at a time when taxes on individuals or small and medium-sized businesses have increased dramatically almost everywhere. For example, VAT rates have increased in 25 out of 33 OECD countries having a VAT system.”

*Mr Saint-Amans further commented that:*

“Because many BEPS strategies take advantage of the interaction between the tax rules of different countries, it may be difficult for any single country, acting alone, to fully address the issue. An internationally coordinated approach is needed that will not only facilitate and reinforce domestic actions to protect tax bases but will also provide comprehensive international solutions. Unilateral and uncoordinated actions by governments responding in isolation could produce the risk of double – and possibly multiple – taxation for businesses.”

*When asked what options are being considered to address the issue, Mr Saint-Amans commented:*

“There is no magic recipe. The report calls for a comprehensive action plan to address the issue holistically. At the moment, work is ongoing and a number of options are on the table. Policy makers are looking at cases where the existing rules work and where they do not in order to identify possible corrective actions.

*According to Mr Saint-Amans, the OECDs next steps are:*

“... the development of an initial comprehensive action plan to address BEPS by June 2013. The plan will identify actions needed to address BEPS, set deadlines and identify the resources needed and methodology to implement these actions. The action plan will also consider the best way to implement the measures in a timely fashion upon which governments can agree. A comprehensive approach will also consider possible improvements to eliminate double taxation, such as increased efficiency of mutual agreement procedures and arbitration provisions.”

The full interview with Mr Saint-Amans is available at [www.kpmg.com/taxviews](http://www.kpmg.com/taxviews).



## Moving ahead: BIAC – participation and dialogue

On 26 March 2013, to further collaboration and dialogue with stakeholders, the OECD met and consulted with BIAC bringing together representatives from business, country tax authorities and others to address the international tax issues outlined in the OECD BEPS report.

Attendees included representatives from the OECD, the European Commission, specialists from KPMG's Global Transfer Pricing Services practice and other professional services firms, as well as tax authority representatives from Canada, Denmark, France, Germany, India, Ireland, Italy, Luxembourg, Netherlands, Norway, Spain, the UK and the US.

The OECD has organized the BEPS project around three work clusters that are chaired by officials from key member countries: Countering Base Erosion, chaired by Germany, Jurisdiction to Tax, co-chaired by France and the US, and Transfer Pricing, chaired by the UK.

Prior to the meeting, the OECD provided BIAC with a list of questions (OECD Questions) to address in the consultation. The OECD Questions were divided into two parts: one, general; and two, questions arranged along the same lines as the three work clusters.

The OECD said that it recognized that political masters have asked it to move fast on this. The OECD reiterated that its primary work looks at eliminating double taxation to encourage investments and create jobs. Eliminating double taxation is and remains the core business of the OECD.

The OECD stated that this project is not a business-bashing exercise. Planning is fine as long as it's legal. If political leaders are not happy with the result, then we need to adapt the law: that's a tax policy issue but not a tax administration issue.

It is not a country-bashing exercise either. There are rules to define harmful tax practices and there was consensus about these rules. They need to be reviewed and better enforced. Governments need to be able to offer a competitive business and tax environment. The real issue is where there is little or no substance.

There is a need to take a holistic approach. Once there is a sense of direction, then there will be a need to move to implementation and turn the matter over to the relevant Working Parties (WP) who will be tasked with implementing the proposals.

Tax authorities stated that the system is not completely broken and that they are supportive of an exercise about how to divvy up tax in fair shares between countries. However, the tax authorities warned that one should be careful about stepping away from the current system.

Tax authorities believe that it is not fair that MNEs paid relatively little tax where the domestic corporations do under similar circumstances.

## General questions

- Do businesses agree with governments that base erosion and profit shifting is a significant problem? If so, is this contributing to the instability of the international tax system?
- What role can the OECD play in the BEPS project, and in restoring stability to the international tax system?

Business representatives reminded participants that companies have a duty to their shareholders to minimize their costs and tax is such a cost.

Business representatives also stated that, as recognized in the BEPS Document, it is difficult to see the real magnitude of the problem. If the taxes to GDP ratio has not moved, then the perceived problem may or may not exist.

Tax authorities indicate that there is a need to respond to the perceived problem with BEPS. Tax authorities do not like the word “broken” in respect of the system of international taxation as it may invite some tax administrations around the world to play with the rules. But if there is a substantial amount of revenue which is in low tax jurisdictions, then it is probably not what was intended.

Tax authorities’ initial thoughts included:

1. Two things existing at the same time: BEPS and tax competition between countries. The second one may be the cause of the first.
2. Fundamental principles: tax authorities do not think that the purpose of this project is to increase source country taxation even if a side-effect may be to increase source-country taxation. They also think that stability and certainty must not be undermined. There is a need for rules that can be understood by taxpayers and governments and that take everyone away from vague concepts.
3. Governments need the technical help of the OECD WPs.
4. Some tax authorities are inclined to think that the digital economy is not a separate topic. Questions of source and character are not a separate analytical box for which new rules should be framed.
5. Talking about the “moral” tax obligations of companies is not helpful. It is for governments to set the rules and for taxpayers to live by those rules.

## Countering base erosion questions

- How should economic substance be taken into account as a criterion for evaluating the tax treatment of transactions?
- How should governments deal with hybrid mismatches and arbitrage? How can governments ensure legal certainty while doing so? What kind of instrument is the most effective/appropriate?
- Would a general limitation of benefits (LOBs) clause (within tax treaties) be useful? Are there any restrictions that should be placed on the use of tax treaties which can be implemented without overkill/unbalanced negative effects on sound business practice?
- How would business react to more uniformity in the way rules limiting interest deductibility operate? Would businesses favor a more internationally coordinated approach on other deductible expenses, such as headquarters expenses?
- How can MAP processes, including arbitration, be improved to address uncertainties or inconsistencies in how anti-avoidance/abuse rules are applied?

Business representatives stated that there is some comfort in seeing that most proposed courses of action are multilateral rather than unilateral. In addition, it was said that economic substance is already an integral part of transfer pricing.

With respect to hybrids, etc, some business representatives indicated that these are normal consequences of differences of domestic laws (some of which are the result of deliberate actions of governments). This might need harmonization on a multilateral basis.

With respect to LOB clauses in treaties, some countries have found these to be useful. LOBs should be self-executing with clear guidance so that taxpayers know whether treaty benefits are applicable. These should be applied instead of, and not in addition to, GAARs, etc.

Tinkering with the rules will in all likelihood lead to more disputes. Thus, there is a need for inclusion of all questions in MAP (not allow countries to carve out certain cases out of MAP, such as avoidance-based adjustments). In addition, there is a need for true mandatory arbitration to ensure that MAP actually does resolve all issues. Mandatory arbitration is a necessary tool. The OECD could respond to the lingering concerns expressed by some countries about adopting arbitration.

Interest is still an economic cost and it should be fully deductible. More uniformity would be easier to reach if there was a unique concept worldwide. Uniformity should avoid raising complexity.

Another tax authority stated that, if countries had better CFC rules, there may not be transfer pricing issues.

A tax authority said that there are three topics that drew attention: hybrid mismatches; abuse of tax treaties; and limiting interest deductions.

Tax authorities warned not to rely too heavily on MAP as some of these questions involve issues of sovereignty.

■ Business Representatives   ■ OECD   ■ Tax Authorities

## Jurisdiction to tax questions

- What challenges do businesses face in implementing the existing treaty standards? How do they address those challenges?
- Are there artificial arrangements that some businesses use to avoid jurisdiction to tax (e.g. PE status or withholding at source)?
- For purposes of concepts such as PE, is the on-line sale of a digital product (e.g. e-books) different than the on-line sale of tangible products (e.g. printed books)? What are the key differences?
- Should governments coordinate their CFC legislation, and if so, what criteria are appropriate for income that is included in such regimes?

MAP is the only tool resolve many technical issues. There is a need for pre-litigation MAP (like an APA). In some cases, it is difficult access to MAP. Even within the framework of the EU arbitration, governments can pull out.

There are political issues: a lot of countries do not apply treaties fairly. Some countries create taxes that do not fall within the realm of treaties.

On artificial arrangements: only few businesses use these. Most MNEs organize their affairs in accordance with domestic rules.

On PE: the concept being refined as we speak by WP 1. With respect to ecommerce, there is a need to recognize that the revenue simply cannot be captured by income tax. This is probably more likely a consumption tax or VAT issue.

On CFC: all countries have different views with what they want to achieve with CFC rules. Thus, countries would have to agree on common objectives of the CFC rules. It should only cover passive income.

On challenges faced by business: tax treaties address well the majority of issues. International tax rules and BEPS are about international standards and domestic laws – and, in the vast majority of situations, double non-taxation comes more from differences in domestic law rather than from international conventions.

BEPS should not be focused on short term policy and revenue issues.

PE and eCommerce: may require new rules but the PE concept is still a good concept. There cannot be a completely separate set of rules for ecommerce. Countries should consider the ecommerce questions from both an exporter and an importer perspective.

BEPS should not be limited to income tax, but also include other forms of taxation (such as VAT).

Business representatives stated that non-taxation does lead to distortion and it is a matter of competitiveness. The issue is larger. There are many players in the economy who are not being taxed at all (sovereign funds, pension funds, hedge funds) competing with fully taxable companies. There is a need to look at the total arsenal – work consistently to broadening the base and lowering the rate and that will lead to less BEPS. There is also a need to stop focusing on a few ecommerce players that have played an important role developing world markets. It has to go much deeper: look at the heart of corporate income – it is not so much an income tax but rather a cost of doing business.

Tax authorities asked the question whether double non-taxation was really a problem for governments or an issue of tax competition? If you have a company that is fully taxed and another that is not, is this not competition?

Tax authorities stated that it would be odd to have two PE regimes: the classic one and the ecommerce one. Some tax authorities have asked: where is the BEPS and how can we address it? They have difficulty in seeing how the PE definition on a standalone can address this.

Tax authorities support the BEPS and encourage the OECD to lead the BEPS project. On cluster two work: the OECD BEPS report issued is a fine starting point because it shows that there is an issue that has to be addressed. Traditionally, by defining PE, by creating MAP, the OECD tried to avoid double tax and to make cross-border transactions easier. There is a need to examine the rules and principles of territoriality from another perspective. This other perspective is that we now have to avoid other tax issues: double non-taxation, erosion of tax base, mismatches, avoiding harmful or unfair tax competition. In order to answer those questions, we are working on some areas in particular:

- reflection on residence: what is the link between profits and benefits on one side and tax territory on the other side; it can pertain to the notion of PE; issue with e-economy (should we revisit territoriality in the area of e-economy)
- ways to avoid double non-taxation (withholding taxes can be a way to avoid this and not only a way to share rights to tax)
- CFC rules (should we have coordination and what could be possible with common rules)
- how to implement the results of our reflection (very important and difficult; via bilateral or multilateral treaties; via national legislation; particular legal issue in the EU with treaty freedom).

Tax authorities also noted:

1. Work is very difficult and there is a large amount of stakeholders (World Bank, NGOs) with a common point: if the current rules result in double non-taxation, these rules need to be changed. Double non-taxation is as bad as double taxation. In this respect, we all agree.
2. Tax competition: we need to deal with tax holidays vs. unintended results vs. aggressive tax planning.
3. If the BEPS project does not come up with solutions, there is a risk that many countries will take unilateral action. And that is a situation that we do not want.



## Transfer pricing questions

- Are there circumstances in which transfer pricing rules do not currently result in profit being aligned with the location of i) substance, or ii) “core value-driving activities” of a business? If so, what are the best ways to address that?
- In analyzing the risks of a global business, what are the relevant differences between branches and subsidiaries?
- In what circumstances is it appropriate to disregard or recharacterize the form of a related party transaction for transfer pricing purposes?
- Can businesses identify best practices in the current transfer pricing practices by individual jurisdictions that can be used to address key transfer pricing issues (including the use of risk assessment tools to reduce the burden associated with transfer pricing documentation requirements)?

Business representatives do not think that the transfer pricing rules or the arm’s length principle (ALP) are broken but there may be public perception that they are. Business is ready work with the OECD to improve the rules. Business does not think that formulary apportionment is the answer. Tax competition strives under formulary apportionment.

Tax incentives and policies are meant to level the playing field of investment because of discrepancies in countries natural attributes. Therefore, MNEs are simply taking advantage of the very incentives offered by governments.

Industry best practices:

- safe harbors
- early engagement of tax authorities (with and between) – for instance in APAs
- transfer pricing penalties must not be revenue-generating.

Changing domestic legislation is better than changing the global framework if countries want to retain their domestic tax. Recharacterization is adequately covered in Chapter I of the OECD Guidelines.

Tax authorities commented on the main lines of current thinking on transfer pricing guidelines within the BEPS project. What are the instances where the transfer pricing rules work, don’t work but there is a better solution, or don’t work at all? The main discussion is around the fact that ecommerce rules need some fixing, perhaps because they have not been developed or applied. There are three areas to deal with: (1) adequacy of actual rules (intangibles, disregarding transactions – in analyzing the functioning, one should carry out a balanced exercise of considering transfer pricing guidelines and the interplay with domestic anti-avoidance rules); (2) holistic approach described in the BEPS report (the way forward to allow countries to have their fair share of taxes); (3) treatment of attribution of profits to PEs (issue that is to be dealt with care to balance the need for tax administrations to attribute the right amount of profits and the need for MNEs to have certainty).

On best practices: in this area, the development of APA programs can be a significant advance. There may also be a role for discussing the transfer pricing documentation in respect of transparency (the quality of documentation for tax administrations to do their work better and for MNEs to be more certain).

Business representatives expressed disappointment to see transfer pricing in BEPS. In addition, when facing transfer pricing audits and assessments, companies are sometimes facing arguments based on abuse of law – and because of this, cannot rely on tax treaties (MAP) anymore.

The OECD on transparency: the original BEPS report was quite clear that the underlying info on BEPS is not very good, and one cannot draw any particular conclusions. Largely because the data is not in the public domain. If it is a perception problem, the data is in MNEs' hands to prove that this is not a problem.

Tax authorities stated that, in transfer pricing, they are trying to make large distinctions to understand the issues better. One such distinction is mis-pricing (the two parties disagree on the price that was used – but there are methods to get to the bottom of mis-pricing – there are no flaws). Then there are conceptual differences. Before they identify alternatives, it would be helpful to explain what is wrong with the current framework. For example, one conceptual issue that they are worried about is the assignment of risk (putting capital in Bermuda backed by contract). This question of risk and how it attracts profit is a difficult one. It would be helpful if this was done at a conceptual level. With respect to disrespecting contracts and legal entities, the tax authorities feel that it opens the door to approaches without rules.

Tax authorities reiterated the need not to underestimate political imperatives. Examples will be key to dispel false perceptions and to identify actions that they might contemplate. There is a need to be clear about distinction between fair tax competition and artificial profit-shifting. There is also a need to recognize that there is no scope for standing still nor for simple answers. If countries are not satisfied with standing still, they may take unilateral action, including anti-abuse rules (with not MAP to resolve uncertainty).

It would be helpful for the business community to understand where the OECD working group feels that the transfer pricing guidelines do not work. There is no agreement on what economic substance means. The arm's length principle is about replicating market conditions – not about remunerating people functions. Business is hoping for a consensus document and not a catalogue of diverging views.

On the battle with formulary apportionment, tax authorities stated that there is a debate that needs to be engaged in. We cannot just rest on the existing standard and say that this is a perfect thing and we need to simply implement it. We need to re-evaluate the existing standard. Countries introduce anti-abuse rules if they are not happy with the transfer pricing standard and we will then have another problem. There has to be an explanation that satisfies a public audience. We will need to be able to explain what the action does with relatively simple examples. It is not enough to say that it could be addressed but that has been addressed. The suggestion to beef up tax administration is a good one. It is necessary but not a sufficient response because the answer lies in the MNE groups. There are limits into how far you can put money into the tax administration.

Is there a real issue or perception gap? Yes, there is a need to divide the issues between the two.

Tax authorities stated that, even in the BEPS context, the OECD is taking a very unbiased approach. The tax authorities appreciate BIAC's input as provided at this meeting and in the recent past to address these complex issues and to help identify issues that need further clarification, further work going forward. The OECD is very serious about engaging with the business community. There is a need for a little more practical approach with some solutions. There is a perception that there is a problem and democracy is the way government works. So, it would be very useful for businesses to identify examples where things work and where things do not work.

■ Business Representatives   ■ OECD   ■ Tax Authorities

Clearly, tax authorities have a perception that there is a need to review the existing international tax system – perceptions that will drive the OECD’s agenda for the foreseeable future. This agenda may include important structural changes to the international tax system.

The OECD is now working to develop a Global Action Plan for the BEPS project, which with approval by the OECD Committee on Fiscal Affairs, will be delivered to G20 Finance Ministers in July for their endorsement.

Tax policy decisions are seldom appropriately taken with a short term view. One must understand, evaluate and be able to project the incidences of proposed courses of action on investment, business decisions and tax revenues in order to lay out a proper course of action. KPMG will stay on top of these developments as they occur.

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