KPMG

cutting through complexity

International tax

Current developments and implications for your business

October 2014

kpmg.com.au

CONTENTS

INTRODUCTION

The last two years has seen an unprecedented and substantial focus on our international tax rules in both the press and at backyard barbeques. The rhetorical phase is now moving into deep consideration of detailed rules for addressing many of the issues raised. Now is the time for senior executives and board rooms to take a greater interest in how this debate is progressing and to ascertain how their organisations may be impacted.

Central to this discussion is the OECD-G20 *Action Plan on Base Erosion and Profit Shifting* (OECD-G20 Action Plan) of July 2013. The purpose of this document is to provide an update on developments in the OECD-G20 Action Plan on international taxation in a non-technical manner. The OECD together with the G20 released seven documents on 16 September 2014 totalling 720 pages. There are 15 Action Items in total, but approximately another 20 deliverables for 2015.

Rather than deliver an in-depth analysis of these reports, this paper seeks to provide background and context in a practical non-technical manner. At the end of this document there is a checklist for senior executives and non-executive directors to consider when thinking through these developments.

The deliverables provided on 16 September are really interim reports for a broad project which is due to be finished at the end of next year. Many projects have significant interdependencies which will require skilled co-ordination.

All the deliverables to date require further work. Sometimes this reflects a lack of consensus despite the deliverables being developed by the various countries involved on specific issues. This is hardly surprising. There are 44 countries directly involved in this project: 34 OECD countries, two OECD accession countries, Colombia and Latvia and eight G20 Countries who are not members of the OECD. They are China, India, Brazil, Russia, South Africa, Indonesia, Argentina and Saudi Arabia. In addition, Singapore has observer status at the table and the OECD has sought input from developing countries.

There has been a certain scepticism concerning the consensus that may be achieved on these very difficult issues. However, a few observations should be made.

- Firstly, no country has left the train to date. This is a significant achievement in itself. The 720 pages of documentation largely reflect a consensus, although they do point to areas where further work needs to be done.
- Secondly, degrees of flexibility and optionality within some of the Action Plan items, while not wholly desirable, will enable the train to move forward. Countries will be able to implement changes in their own manner.
- Thirdly, there is no longer the schism of interests between developed and developing countries that once existed. For instance, either this year or next, Outward Direct Investment for China will exceed Foreign Direct Investment for the first time in its history. Some would be surprised to learn that about 70 percent of Burger King in the US is owned by a Brazilian Private Equity fund. This provides some convergence of interests certainly in the long term.
- Fourthly, it is clear that China in particular, wants to be involved. They are not at the edge of this process but have embraced it completely.
- Finally, at the end of 2015 the Treasury officials involved in the Action Plan will be looking at their own administrations and legislatures to implement changes. This will not be easy. Some changes will occur at the administration level, others will require legislative change. As difficult as that may be, the political focus and rhetoric of recent times does suggest many countries, including Australia, will embrace change.

OECD-G20 Action Plan Deliverables

Action Item	September 2014 Deliverables	September 2015 Deliverables	December 2015 Deliverables
1	Digital Economy	Further work on all areas	
2	Hybrid mismatches	Further work on four specific areas	
3		Controlled Foreign Corporations	
4		Interest deductions	Transfer Pricing – Interest deductions
5	Harmful Tax Practices – 1	Further work on key areas	Harmful Tax Practices – 2
6	Treaty abuse	Further work on key areas	
7		Defining 'permanent establishment'	
8	Transfer Pricing – Intangibles 1	Transfer Pricing – Intangibles 2	
9		Transfer Pricing – Risks and Capital	
10		Transfer Pricing – high risk	
11		Data and economic analysis of BEPS	
12		Mandatory disclosure rules	
13	Transfer pricing documentation	Further work on specific areas	
14		Dispute resolution	
15	Multilateral instrument – 1	Embrace a wider group of countries	Multilateral instrument – 2

DIGITAL ECONOMY

Taxation of the digital economy has certainly received significant press in the past 3 years. The Double Irish Dutch Sandwich has entered the vernacular and there is now a common understanding that large internet companies can reap substantial sales from a country without establishing a taxable presence. Many rightly wonder how this can be and what can be done about it.

Action Item 1 of the OECD-G20 Action Plan calls for a review of the taxation of the digital economy and a 200 page report was released on 16 September 2014. This is a work in progress and the report notes that regard needs to be had to most of the other action items when thinking through what could be achieved in the digital economy space.

The Taskforce on the Digital Economy, which authored the report, has drawn two significant conclusions in the report. Firstly, you cannot ring-fence the digital economy. What one is seeing is a digitalisation of the whole economy. Secondly, the so-called digital economy is in a state of revolution.

Current business models in the digital economy include the items listed in the table.

- Free content for paid advertising
- User pays per download
- Online retail of tangible products
- Premium delivery subscription service
- Traditional services (for example, travel agency) provided online
- Technical content, software, algorithms
- Sale of data and customised research, telemetrics
- Alternative currency (for example, Bitcoin)
- Huge social media build, then monetise (advertising)
- Cross subsidy physical operations (for example, online banking)

The digital economy exacerbates risks for base erosion and profit shifting, but it does not generate unique base erosion and profit shifting (BEPS) issues. That said, business models in the digital space present six features which are relevant for taxation, which are listed in the table below.

- Mobility of intangibles, users, business functions
- Reliance on data
- Network effects
- The spread of multi-sided business models
- Tendency towards monopoly or oligopoly and
- Volatility

There have been three main direct options put forward that deal specifically with taxation of the digital economy, which are:

(i) A taxable presence or permanent establishment is created with a 'significant digital presence' based on contracts, payments and functions

(ii) A virtual permanent establishment is created through a website or a technologically-based agency (as against a human being) giving rise to a taxable presence and

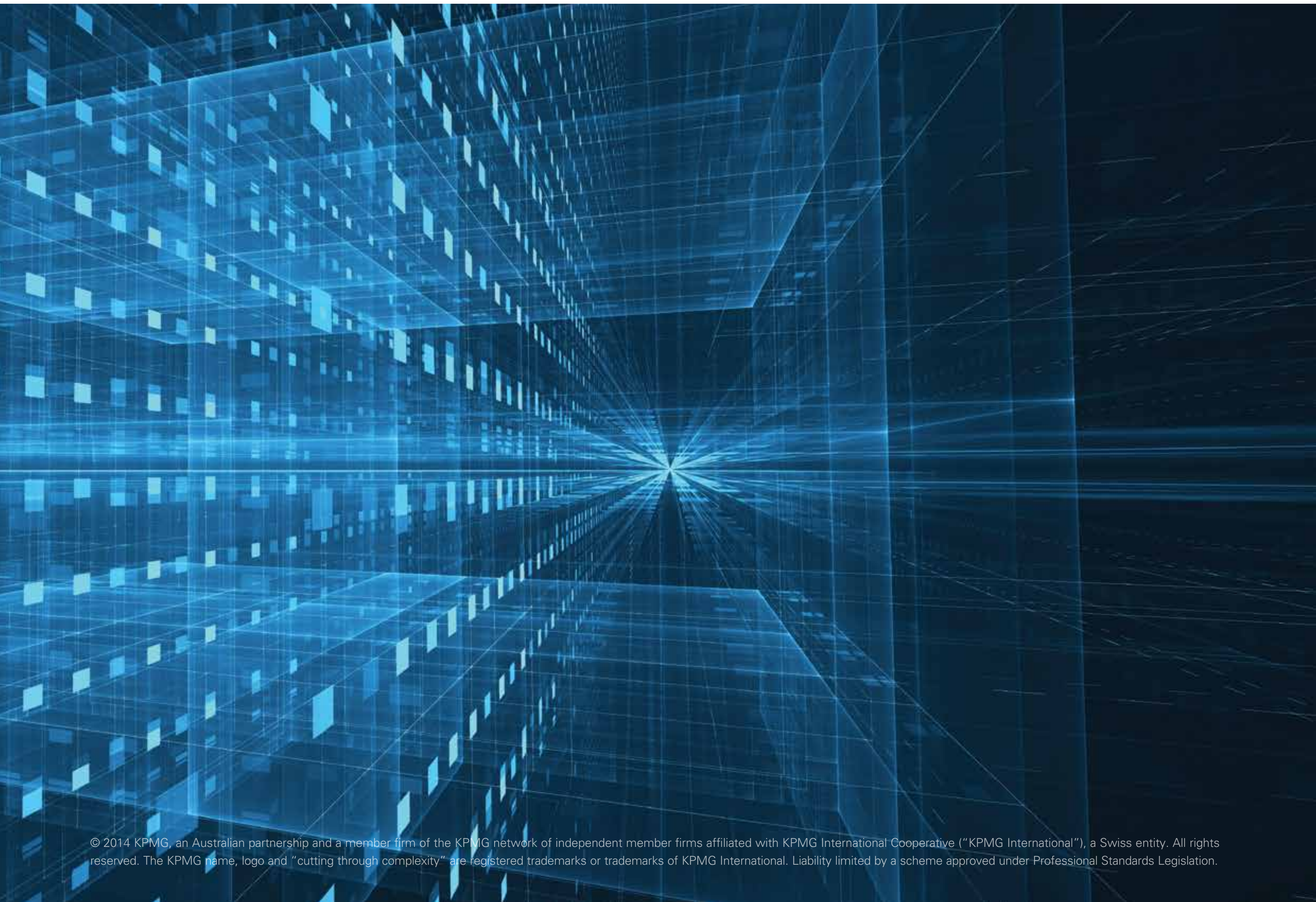
(iii) A withholding tax to be created on digital transactions.

All three are problematic and whilst they have not been rejected outright by the OECD to date, they are likely to be in future reports. It is simply difficult to draw practical rules around these principles that would hold with any resilience. From a taxation perspective, it is hard to draw a distinction between buying a US$30 book through the internet from a major US bookseller and ordering 200 million tonnes of iron ore from a major natural resources company using digital technology.

That said, significant change can be achieved, which will impact taxation of the digital economy through other areas. These will be considered in 2015 by various working parties considering the OECD-G20 Action Plan and include the following:

- Change the definition of permanent establishment so that local sales forces for goods or advertising create a taxable presence
- Change the definition permanent establishment so that truly core activities do not fall within a preparatory or auxiliary exemption in the current rules
- Change treaty rules to prevent treaty shopping
- Deny hybrid mismatches as existing structures within the digital economy often use hybrids
- Counter harmful tax practices that seek to provide intellectual property deductions where there is little substance
- Ensure transfer pricing outcomes align with value creation
- Modify Controlled Foreign Corporation rules to address the high levels of mobile income in the digital economy.

Some in civil society may be disappointed with the lack of direct attack on companies operating in the digital economy. However, the nuanced and practical approach of dealing with other areas, will stand-up in the long term and avoid many unintended consequences.



HYBRIDS

The word hybrid was rarely used in English before 1850, but has been known to be used as early as 1600. It comes from the Latin hybrid which referred to the offspring of a tame sow and a wild boar. In biology, it is the result of cross breeding different entities. In linguistics, it is a word with components derived from different languages. For instance, neuroscience combines Latin and Greek. Hybrid cars use two types of fuel.

Hybrids in finance have both debt and equity characteristics. Thus a redeemable preference share has characteristics of both debt and equity. Indeed, many are legal form equity instruments which are in-substance debt.

The use of the word hybrids in international taxation is different in a nuanced way from the use of the word in finance – that is, debt and equity markets – although there is considerable overlap.

Hybrids in international taxation

Financial instrument hybrid

The essence of a hybrid in international taxation is that it is a financial instrument, arrangement or transaction that is treated differently in two jurisdictions for taxation purposes creating a permanent tax benefit. Indeed a taxation hybrid can involve the simple sale of shares if the consideration is deferred and one country recognises an in-substance interest expense and the other country does not pick-up interest income. This is still referred to as a financial instrument hybrid given the finance element involved.

Hybrid entity

Another common example of a taxation hybrid is an entity that is treated as a normal taxable or 'opaque' entity in a jurisdiction such as Australia, but is treated as a 'disregarded entity' or 'transparent' in the jurisdiction of the investor country, most commonly the United States. This has become a common structure since the late 1990s when the US introduced certain 'check-the-box' rules which gave US multinational enterprises a choice on how certain subsidiaries were treated for tax. The result was the ability to obtain a deduction in two jurisdictions if you placed debt in the hybrid entity. The language of the hybrid financial instrument was placed on the entity to form the concept of a hybrid entity, with characteristics of a transparent investor and an opaque investee even though it may be a normal Australian company. In many jurisdictions, the use of a Limited Partnership was a common hybrid entity as one jurisdiction would view the entities as 'opaque' and the other as transparent.

Proposed rules on hybrids

Hybrid	Example	Current
Deductible dividend	Redeemable Preference Shares	Deduction – No Income
Financial instrument hybrid	Deferred price share sale	Deduction – No Income
Hybrid transfer	Collateralised REPO	Deduction – No Income
Reverse hybrid	Opaque Investor/transparent Investee	Deduction – No Income
Hybrid entity	Transparent Investor/Opaque Investee	Double deductions
Double foreign tax credit	Bond Lending	Double foreign tax credits

Reverse hybrid

From this structuring, another type of hybrid developed, which paradoxically, has been referred to as a 'reverse hybrid'. The contrary nature of it, compared to a normal entity hybrid, lies in the fact that the investor country treats the entity as opaque and the investee country treats the entity as transparent. For a normal entity hybrid, it is the other way around. Rarely has this worked to produce a tax benefit when there are only two countries involved, so substantially all reverse hybrids have involved three countries. A new descriptor from the OECD has developed in relation to what has generally been referred to as 'reverse hybrids'. This is the 'imported mismatch' which reflects that a third country is imported into the structure to take advantage of the differing treatment of an entity in two jurisdictions.

Hybrid transfers

Another type of hybrid arose which emanated from both on and off-market 'loans' of shares. These 'loans' took the form of a legal sale with an agreement to buy-back. The hybrid nature of the arrangement for tax purposes is that one jurisdiction would respect the legal form – a sale and sale-back – and the other would to the substance – a loan. These have become known as hybrid transfers.

So far we have hybrid financial instruments, such as redeemable preference shares; hybrid entities which include transparent-opaque – hybrid entity arrangements; and opaque-transparent – reverse hybrid or imported mismatch arrangements; and hybrid transfers.

Other hybrid arrangements

There are two other types of arrangements that have been thrown into the international tax concept of hybrids, essentially because they produce a permanent tax benefit.

- The first is the dual resident loss company. This usually involves an entity with tax residence in two jurisdictions, one based on incorporation and the other based on central management and control or place of effective management. The entity is usually grouped with other tax positive entities so that the losses can be used in both jurisdictions.
- The second type of ancillary hybrid involves a double dip of foreign tax credits. This involves a bond being 'lent', which is legally a sale and buy-back transaction from an entity in one jurisdiction to an entity in another. Interest is paid on the bond to one party which is effectively on paid to the other in the form of a fee. The benefit arises from the fact that both parties claim full tax credits on the interest withholding tax withheld from the interest payments. This effective double dip has also been labelled as a form of hybrid in the parlance of international tax rules.

Proposed Primary Rule	Proposed Defensive Rule	Application
Deduction – Income	–	25 percent related parties and structured arrangements
No deduction – No income	Deduction – Income	25 percent related parties and structured arrangements
No deduction – No income	Deduction – Income	25 percent related parties and structured arrangements
No deduction – No income	Deduction – Income	50 percent Controlled group and structured arrangement
Deny Parent	Deny Payer	Defensive rule – 50 percent Controlled group and structured arrangements
Limit foreign tax credits	–	25 percent related parties and structured arrangements

What is being done?

On 16 September 2014, the OECD-G20 released a plan recommending countries change their domestic rules to neutralise the impact of hybrid mismatches. A mismatch is a tax outcome that lowers the aggregate tax paid by parties to the arrangement and should not generally deal with timing differences. These rules, which are structured to operate automatically rather than through the actions of revenue authorities, provide for two sets of rules: a primary rule and a defensive rule.

The concept of the defensive rule is to cater for circumstances where the other jurisdiction has not adopted the primary rule in its tax legislation. Thus, if we take a deferred price share sale agreement which is a hybrid financial instrument, the current treatment may be that the payer gets a deduction for a deemed interest expense while there is no income pick-up for the recipient. Under the primary rule, a deduction would be denied because there is no income pick-up in the recipient country. But if the jurisdiction of the entity making the payment does not have a primary rule, the secondary or defensive rule kicks in the recipient country, which will include an amount in assessable income. On this basis, there will be no double non-taxation and indeed no double taxation.

The table above outlines how this will work for six categories of hybrids dealt with by the OECD-G20 report. In some cases, the two entities involved need to be related parties based on a 25 percent ownership test. In other cases, the relationship is a 50 percent controlled group test.

Not everything has been worked out in the report. There has been a lack of consensus in four areas and further work needs to be done. Those areas are capital market transactions (such as repos), imported hybrid mismatches, hybrid regulatory capital issued intra-group by financial institutions, and the interaction of these rules with the Controlled Foreign Corporation rules which are being developed during 2015.

CHECKLIST – HYBRIDS

- [ ] Ascertain whether there are any **hybrid financial instruments** in the corporate structure.

  If so, determine the accounting treatment in particular to ascertain whether there is a latent deferred tax asset associated with the instrument that may not come to fruition.

  Ascertain the options if the OECD-G20 Action item two proposals were implemented in one or both countries. Generally (i) do nothing; (ii) unwind; or (iii) modify.

- [ ] Determine whether there are any **hybrid entities (such as disregarded entities)** in the structure (i.e. an entity that is treated as 'opaque' in one jurisdiction and 'transparent' in another). The hybrid nature of an entity may not be obvious to a non-tax person on the face of a corporate structure diagram. Consider the accounting position and options as above.

- [ ] Determine whether there are **other hybrids** and if so develop a medium term strategy for dealing with these.

COUNTERING HARMFUL TAX PRACTICES

Using concessional taxation rules to attract investment to a particular country has a long history. In the 1990s, the proliferation in concessional regimes, particularly in Europe lead to a widespread belief by Ministers and senior Treasury officials that the world was on a 'race to the bottom' with Corporate Taxation. In 1996, the OECD commissioned the Committee of Fiscal Affairs to look at what has become known as harmful tax practices.

An initial report was released in 1998, followed by four progress reports in 2000, 2001, 2004 and 2006. Work was continuing at the time of the release of the BEPS Action Plan, which reinvigorated the Forum on Harmful Tax Practices. Of the 95 regimes reviewed, 20 are still under consideration and substantially all of these relate to intangible asset regimes, such as the UK Patent Box. Of the remaining 75, 43 regimes have been considered not harmful, twelve have been amended so that they are no longer considered harmful and 20 have been abolished.

Separating acceptable concessional tax regimes from unacceptable ones is difficult. The main difficulty concerns the level of business activity required to justify the concession. This is referred to as the substantial activity requirement and has come to the fore with Patent or Innovation Box regimes. These regimes seek to attract better jobs and economic activity in the knowledge-based sector.

Traditionally and for many years, countries have encouraged R&D through tax credits or super-deductions. These include Australia, China, Netherlands, UK and the US. The concept is to give a tax concession on expenditure on R&D, usually for labour costs, but sometimes for assets.

The patent box regimes differ from this model by offering a concession at the back-end of the innovation value chain. This is achieved by providing a concessional rate on qualified IP income. Belgium, France, Hungary, Luxembourg, Netherlands, Spain and the UK have adopted this form of tax concession. Given that the regime applies at the end of the value chain, the question that arises is whether there is sufficient business activity surrounding what might be an IP transfer to a Patent Box country to warrant the concession, rather than simply undermining the tax base of other countries. This will be given further consideration by the Global Forum on Harmful Tax Practices in 2015 as part of the OECD Action Plan.

Another issue, still to be resolved is how to bring non-OECD, and now G20 countries into the fold. While there are no easy answers, considerable success has been achieved on information exchanges in recent times for some tax havens and it could be anticipated that similar progress could be made here.

CHECKLIST – PATENT BOX

- [ ] Consider the **current location of intangibles and the potential options** depending on the outcome of the review of Patent Box and related concessions. This may create opportunities in the future or render existing arrangements problematic. It is largely a matter of being alert in 2015.

Reviews undertaken on Harmful Tax Regimes by the OECD

Country	Regime	Review conclusion			
Australia	Offshore Banking Units	Not harmful			
	Conduit foreign income	Not harmful			
Austria	Holding company regime (as amended)	Not harmful			
Belgium	Holding company regime	Not harmful			
	Shipping regime	Not harmful			
	Advance Tax Ruling Practice	Not harmful			
	Distribution Centres		Amended		
	Ruling on informal capital		Amended		
	Service Centres		Amended		
	Co-ordination Centres			Abolished	
	Ruling on Foreign Sales Corporation activities			Abolished	
	Patent income deduction				Under review
Canada	International Banking Centres	Not harmful			
	International Shipping	Not harmful			
	Life insurance business regime	Not harmful			
	Non-resident owned investment corporations			Abolished	
Colombia	Foreign portfolio investment regime	Not harmful			
	Software regime				Under review
Denmark	Holding Company regime	Not harmful			
	Shipping regime	Not harmful			
Finland	Shipping regime	Not harmful			
	Aland Captive Insurance Regime			Abolished	
France	Holding company regime	Not harmful			
	Shipping regime	Not harmful			
	Headquarters regime		Amended		
	Logistics Centres		Amended		
	Reduced rate for long term capital gains licencing IP				Under review
Germany	Holding company regime	Not harmful			
	International shipping	Not harmful			
	Monitoring and Co-ordination Centres		Amended		
Greece	Holding company regime	Not harmful			
	Shipping offices	Not harmful			
	Shipping Regime (Law 27/75)	Not harmful			
	Mutual Funds/Portfolio investment companies	Not harmful			
	Offices of Foreign Companies			Abolished	
	Offshore engineering and construction				Under review
Hungary	Venture capital companies	Not harmful			
	Preferential regime for Companies Operating Abroad			Abolished	
	IP regime for royalties and capital gains				Under review
Iceland	Holding company regime	Not harmful			
	International Trading Companies			Abolished	
Ireland	Holding company regime	Not harmful			
	Shipping regime	Not harmful			
	International Financial Services Centre			Abolished	
	Shannon Airport Zone			Abolished	
Israel	Preferential company				Under review
Italy	International shipping	Not harmful			
	Trieste Financial Services and Insurance Centre			Abolished	

Reviews undertaken on Harmful Tax Regimes by the OECD (cont.)

Country	Regime	Review conclusion			
Japan	Special zones for international competitiveness	Not harmful			
	Measures for promotion of R&D	Not harmful			
Korea	Offshore activities of foreign exchange banks			Abolished	
Latvia	Shipping taxation regime	Not harmful			
	Special economic zone regime				Under review
Luxembourg	Private asset management company	Not harmful			
	Investment company in risk capital	Not harmful			
	Holding company regime (not 1929)	Not harmful			
	Provisions for fluctuations in reinsurance companies		Amended		
	Finance Branch		Amended		
	1929 Holding Company Regime			Harmful	
	Partial exemption for income and gains on certain IP				Under review
Netherlands	Holding Company Regime	Not harmful			
	Advance Pricing and Ruling Practice	Not harmful			
	International shipping	Not harmful			
	Intragroup finance activities		Amended		
	Finance Branch		Amended		
	Cost plus/Resale minus ruling		Amended		
	Ruling on Foreign Sales Corporations			Abolished	
	Risk Reserves for International Group Financing			Abolished	
	Innovation Box				Under review
Norway	International shipping	Not harmful			
Portugal	International Shipping register of Madeira	Not harmful			
	Madeira International Business Centre			Abolished	
	External branches in the Madeira International BC			Abolished	
	Partial exemption for income from certain IP				Under review
Spain	Holding Company regime	Not harmful			
	Shipping regime	Not harmful			
	Spain Basque Country and Navarra Co-ordination Centres			Abolished	
	Partial exemption for income from certain IP				Under review
	Spain – Basque Country – IP exemption				Under review
	Spain – Navarra – IP exemption				Under review
Switzerland	Holding Company regime	Not harmful			
	Service Companies		Amended		
	50/50 Practice			Abolished	
	Cantonal level – Auxiliary Company				Under review
	Cantonal level – Mixed Company				Under review
	Cantonal level – Commissionaire				Under review
	Relief for newly established or re-designed enterprises				Under review
	Canton of Nidwalden – Licence Box				Under review
Turkey	Shipping regime	Not harmful			
	Turkish free zones	Not harmful			
	Istanbul offshore banking regime			Abolished	
	Technology development zones				Under review
United Kingdom	Shipping regime	Not harmful			
	Patent Box				Under review
United States	Foreign Sales Corporation			Abolished	
	Total	**43**	**12**	**20**	**20**

TAX TREATIES

The first modern tax treaty was concluded on 22 June 1899 between Austria-Hungary and Prussia. Prior to that there were a number of limited scope treaties, an early one being an exchange of information treaty between Belgium and France in 1843 and an inheritance tax treaty between the United States and the United Kingdom in 1899.

In 1921, four professors from Rotterdam, Turin, New York and London formed what became known as the Group of Experts who produced a report in 1923 on the problems of international double taxation. This formed the basis of the 1928 League of Nations Model Tax Treaty which has had a significant influence on the tax treaties that have been agreed internationally for the past nearly 90 years.

The number of tax treaties grew relatively slowly until 1956 when the Organisation for European Economic Cooperation, the forerunner of the OECD, produced a new model treaty. At about this time it has been estimated that there were fewer than 100 treaties internationally.

In the 1960s, there was a rapid expansion of treaties signed amongst developed countries, while the 1970s saw a wave of treaties between developed countries and developing countries, with the latter seeking to attract foreign direct investment. In the 1980s, the socialist countries entered the tax treaty arena, while the 1990s saw another wave of treaties signed by former socialist economies. In the year 2000, there were about 2,000 treaties involving nearly 200 countries. Today it is about 3,000 out of a mathematical potential of about 16,000 double tax treaties.

Number of tax treaties by selected countries

Australia	44
Canada	94
China	101
France	127
Germany	98
India	85
Indonesia	71
Japan	70
New Zealand	39
Singapore	71
UK	123
USA	68

What can be said about this web of treaties?

Firstly, there are a lot of them and, it has been argued, a lot of unnecessary ones. Romania, has in excess of 80 double tax treaties including one with Namibia. Many are signed for political reasons. South Africa has 78. Seven were signed during the Apartheid era (Northern Rhodesia now Zambia in 1956, Grenada in 1960, Southern Rhodesia now Zimbabwe in 1965, Sierra Leone in 1968, Malawi in 1971, West Germany in 1973, Israel in 1978). After the demise of Apartheid, 41 treaties were signed in the 1990s and a further 30 treaties since 2000. Tax treaties in the South African context have been a political message.

Secondly, tax treaties are designed to deal with trade and investment between two countries. However, the comparative differences between treaties has meant that historically beneficial conduit paths for investment have formed. Many of those equity pathways have become super-highways. The Mauritius-India path is an example. Another is Barbados-China until a change in the treaty in 2012. The OECD-G20 Action Plan recommends the introduction of Limitations of Benefits clauses in double tax treaties to reduce the use of conduit financing routes on the basis that such routing falls outside the purpose of double tax agreements. This is discussed in the box *The Indian-Mauritius double tax agreement* below.

Thirdly, there has been significant questions raised as to whether countries undertake an appropriate cost-benefit analysis when considering entering into treaties. The OECD-G20 Action Plan recommends greater attention be given to such an analysis.

Finally, treaty networks are hard to change. It takes a considerable amount of time to negotiate changes. In response to this difficulty the OECD-G20 has proposed a multilateral instrument to swiftly modify treaties. In its report on Action Item 15 titled Developing a Multilateral Instrument to Modify Bilateral tax Treaties, it recommends holding an international conference in 2015 between the OECD and G20 with additional developing countries as equal members. The diagram below describes how the multilateral instrument works. The areas where it could be used include changes on dispute resolution, dual residence structures, hybrid mismatches and triangular issues involving permanent establishments. However, the most impactful area of change would be on treaty abuse and the insertion of limitation of benefits articles in double tax treaties.

Example of how the Multilateral Instrument works using six countries and two items of potential change...

Example of instrument	PE	LOB
Australia	✓	✓
China	✓	✓
France	✓	✓
India		✓
UK	✓	✓
USA	✓	

Example using six countries and two changes	
Number changed for PE and LOB	6
Number changed for PE only	4
Number changed for LOB only	<u>4</u>
Total number changed	14
Number not changed (US-India)	<u>1</u>
Total number of potential changes	**15**

Source: KPMG

The Indian-Mauritius double tax agreement

Mauritius is an island about 2,000km off the east coast of Africa with a population of about 1.2 million people and a land area smaller than Luxembourg. From 1710 to 1810, it was a French Colony and from 1810 to 1968, it was a British Colony. With the abolition of slavery on the island in 1835, the sugar cane planters imported a significant number of Indian indentured labourers to work the fields. There were approximately 500,000 from the 1830s through to the 1920s. It is said that more than 60 percent of the population of Mauritius is of Indian descent.

The Indian-Mauritius Double Tax Agreement was signed in 1982. Mauritius has 39 treaties and India has 85. Of the 85 treaties, 16 have clauses which limit India's ability to tax a capital gain of a non-resident with shares in an Indian company and allocate that taxing right to the jurisdiction residence country. Mauritius, however, does not tax capital gains.

This has led to Mauritius to become a major route for investment into India. In the 5 years up to, and including, 2012-13, there was approximately US$100 billion Foreign Direct Investment into India. Approximately 41 percent came from Mauritius, 12 percent from Singapore and about 6 percent each from USA, Japan, UK and the Netherlands. Cyprus, with a population of about one million people was next with 5 percent or US$5 billion.

But times are changing and the prospect of a limitation of benefits clause in the Mauritius-India treaty, together with the introduction of certain anti-avoidance measures in India in 2016, has seen new Mauritius investment in India halve between 2012-13 and 2013-14 (from about US$10 billion to US$5 billion) while new investment through Singapore has more than doubled (US$2.5 billion to US$6 billion). Mauritius has now fallen below Singapore as a source of new investment into India. The India-Singapore treaty currently has a Limitations of Benefits article.

It should also be noted that Mauritius is a major destination of Outward Direct Investment from India.

Proposed anti-treaty shopping rules

On 16 September 2014, the OECD-G20 released a report titled *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* which provides recommendations on a treaty shopping rule. There are broadly two models: a US-based Limitation of Benefits (LOB) rule and a European based rule which is referred to as a 'Principal Purpose Test' (PPT).

It is recommended that countries adopt both a LOB rule and a PPT rule. However, some flexibility is allowed to accommodate constitutional and EU restrictions. At a minimum, however, countries should adopt either a LOB or a PPT rule with a mechanism at the domestic level to deal with conduit arrangements not dealt with at the treaty level.

Limitation of benefits (LOB)

There is a 'US-based' rule which is a black letter law rule designed to ensure that there is a sufficient level of beneficial interest located in the country of the entity claiming the benefits or that no inappropriate advantage is being sought. The problem with this test is that the black letter delineations do not always produce the right outcome.

Principal purpose test (PPT)

The previous alternative test looked to whether 'one of the main purposes' of the arrangement was to obtain a treaty benefit. This test is often criticised for its uncertainty. Significant feedback suggested and that it should only operate where the dominant purpose is to obtain a treaty benefit. This has been recognised such that it has become a principal purpose test.

Further work will need to be done by the OECD and G20 to determine a 'back-up' domestic mechanism to support the situation where both tests are not adopted. Moreover, further work is being undertaken to ensure that Collective Investment Vehicles (CIV) and Non-CIV funds are not inadvertently damaged by these rules.

Australia, has accepted both tests in the past. We have a LOB test in our treaties with the US and Japan. We have a purpose based test in our treaties with the UK, Switzerland, Japan, South Africa, Norway, Finland and New Zealand.

CHECKLIST – TAX TREATIES

- ☐ Consider equity, debt and royalty chains in the international structure to ascertain whether they would stand up to **proposed changes to tax treaties**. If not, consider short and long term planning options to ensure the structure is resilient.
- ☐ Consider the potential impact on changes to the definition of permanent establishment. Does the group use **'commissionaire arrangements'** or have local representatives involved in sales, but **without the authority to conclude contracts** (which is done by the parent)? Are these arrangements likely to be effective in the long term?
- ☐ Consider the potential impact on changes to the definition of permanent establishment. Does the group rely on the fact that certain activities are considered **'preparatory and auxiliary'** and thus do not give rise to a taxable presence in a jurisdiction?

TRANSFER PRICING

There are four specific transfer pricing Action Items in the OECD-G20 Action Plan. They are:

- Intangibles (Action Item 8)
- Risks and capital (Action Item 9)
- High risk transactions (Action Item 10)
- Documentation (Action Item 13).

Four other action items have transfer pricing issues as key components. They are:

- The digital economy (Action Item 1)
- Interest deductibility (Action Item 4)
- Collecting and analysing data to ascertain the extent to which base erosion and profit shifting occurs (Action Item 11)
- Dispute resolution (Action Item 14).

This is a significant portion of the Action Plan.

Most of the reports associated with these eight items are due in September 2015. Two exceptions are transfer pricing guidelines on interest deductions which is due in December 2015 and the first phase of the work on intangibles, which was released on 16 September 2014.

Transfer pricing is at the heart of the BEPS debate. More than 60 countries have transfer pricing rules and virtually all of these are founded on the arm's length principle. This principle was originally developed in a multilateral context in 1936 with publication by the League of Nations of the draft *Convention on the Allocation of Profits and Property on International Enterprises* and has been the fundamental principle of transfer pricing ever since.

The arm's length principle asks one to look at each individual entity in a multinational enterprise and determine what the arrangements would be if that entity was dealing with other entities in the group on an arm's length basis. That is, as if an enterprise was acting on its own.

The arm's length principle is, of course, a fiction. Indeed the very success of multinational enterprises lies in the synergies, economies of scale and strategic focus of the group. The multinational enterprise is certainly not a group of entities acting as if they were on their own.

While the arm's length principle is a hypothetical position and, in some sense does not accord with economic reality, many transfer pricing experts say that it is nonetheless the best tool we have. The alternatives – which generally involve looking at the whole profit of an enterprise and allocating that profit to different jurisdictions on particular criteria – invites significant debate and difficulty about what those criteria should be.

CHECKLIST – INTANGIBLES

- [ ] Undertake a review of the location of **intangibles** and whether the return on the intangibles is in accordance with the proposed revised guidance using a functions, assets and risks analysis.

A brief history of the arm's length principle in transfer pricing

1936	First formulation of the arm's length principle in Article 6 of the League of Nations draft Convention on the Allocation of Profits and Property on International Enterprises.
1963	Arms length principle embraced in Article 9 of the OECD Model Tax Convention.
1968	US is the first country in the world to adopt comprehensive transfer pricing rules with support for three methodologies – comparable uncontrolled price, cost plus margin and resale minus margin with regulations authorising the use of other unspecified methods. Calls for safe harbours are rejected.
1979	OECD Report titled Transfer pricing and Multinational Enterprises which provided model rules for transfer pricing. Endorsement of the comparable uncontrolled price, cost plus and resale minus methodologies. The OECD was critical of the 'fourth method' which included profit comparisons and profit split methodologies. Formulatory approaches to taxation were also strongly criticised.
1980	UN adopts arm's length principle in UN Model Tax Convention.
1982	Australia introduces a transfer pricing regime into the tax legislation. Consistent with the OECD 1979 report, it is based on price and not profit.
1986	As part of a large number of tax reform measures the US introduced a rule that the return for a transferred intangible had to be commensurate with the income attached to the intangible based on actual profits obtained in the future. This was perceived to be a departure from the arm's length test and was criticised by the major trading partners of the US as creating 'super-royalties'. The underlying concern of the US was that R&D concessions in the US would diminish the tax base while the benefits would accrue offshore. These rules were substantially watered down in 1994.
1988	US White Paper on transfer pricing introduces profit based methodologies within the arm's length principles. This was referred to as the Comparable Profits Method. It was incorporated into the US regulations and quickly gained currency as a testing methodology. It contained a strong political dimension as it ensured non-US multinationals paid tax like US multinationals.
1991	The US introduces Advance Pricing Agreements.
1995	OECD Guidelines issued which in part embrace the US profit based method in the form of the Transactional Net Margin Method.
2006	Settlement of a US$3.1 billion Glaxo Smith Kline case in the US for a dispute that had lasted 14 years. This largely involved the profit allocation between the UK and the US on six products the predominant one being Zantac. The case was a watershed reflecting the very potentially huge divergence in thinking between a business and revenue authority. It also gave significant focus to the value drivers in industry and the importance of market intangibles.
2010	Updated guidance on OECD Model Convention particularly in relation to profit split and comparability issues.
2011	OECD announces two projects – one dealing with intangibles and other with simplification.
2013	Announcement of BEPS project with a four major action items dealing with transfer pricing – Intangibles, risks and capital, high risk transactions such as stewardship costs and a new template for transfer pricing reporting. The arm's length principle is subject to question.
2014	Release of Reports on Action Item 8 dealing with intangibles and Action Item 13 dealing with country-by country reporting.

The arm's length principle has evolved over time. Historically it has focused on a price. This largely involved determination of a comparable uncontrolled price or a price based on an appropriate margin either on a cost plus or a resale minus methodology.

In 1988, the United States issued a White Paper which was transformational. In this paper, a new methodology known as the 'Comparable Profits Method' came to be used to test whether amounts were being charged on an arm's length basis by focusing on objective measures of profitability known as profit level indicators. The profitability of an enterprise was tested against comparable uncontrolled enterprises having regard to the assets, functions and risks undertaken by the enterprise.

From this focus on profitability, a new method was developed which enabled one to set prices, rather than simply test them, through profitability indicia. This became known as the 'Transactional Net Margin Method' and is in common use today. It fits squarely within the arm's length principle.

However, the arm's length principle is being challenged on at least four fronts.

- Firstly, on a relatively simple level, questions are being raised as to whether apportionment methodologies would not be more appropriate in specific circumstances particularly in relation to management and stewardship costs. This is Action Item 10 and it is likely that the OECD-G20 will move towards an apportionment methodology.
- Secondly, on a deeper level, questions are also being raised as to whether the conventional functional analysis, taking into account assets and risks, produces an appropriate value allocation for a large multinational group. Consideration is being given to a value chain analysis to look at how joint roles and responsibilities create value.
- Thirdly, China in particular, but also India has thrown down the gauntlet with a concept which has become known as 'Location Specific Advantages'. These are location specific market features factors of production which present financial advantages for locating an enterprise in one location as against another. These include access to large markets, skilled labour and market premiums. While some have argued that these can be taken into account within the arm's length principle, China for instance, feels it outside such a principle, but is to be embraced nonetheless. In the Action Item 8 Guidance paper on intangibles, location savings are mentioned as factors that impact comparability and arm's length prices, but are not considered to be intangibles.
- Finally, some would argue that the focus on functions, assets and risks underlying the arm's length principle gives too much attention to risk and produces spurious results. This approach, it is argued, does not take into account the low risk nature of many activities of multinational businesses given the support provided by the group.

So a significant question is to what extent the arm's length principle will hold and to what extent there will be encroachment through allocative methodologies, new location-focused principles, and whole of value chain analyses rather than the traditional focus on functions, assets and risks. 2015 will be an important year for these answers.

Guidance on Transfer Pricing Aspects of Intangibles

On 16 September 2014, the OECD-G20 released *Guidance on Transfer Pricing Aspects of Intangibles*. Intangibles were defined as 'something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances'. This includes intangibles that are not recognised for accounting purposes.

The existence of location savings, group synergies and assembled workforce are factors that may affect comparability and arm's length prices, but are not, of themselves, treated as intangibles.

The return attributable to the intangible is allocated by compensating members of the multinational enterprise for functions performed, assets used or contributed, and risks assumed in the development, enhancement, maintenance or protection of intangibles.

When analysing risks associated with intangibles over time, the guidance distinguishes between (1) anticipated remuneration, which refers to future income expected to be derived by a multinational enterprise (MNE) group member, and (2) actual remuneration, which is income actually earned by a group member through exploitation of an intangible.

Features that may be considered in a comparability analysis include exclusivity, legal protection, geographic scope, useful life, stage of development, rights to updates and expected future benefits.

The guidance appears to endorse the use of any pricing method, depending on the facts and circumstances (including discounted cash flow valuations where traditional pricing methods are not appropriate).

COUNTRY-BY-COUNTRY REPORTING

A Report on *Transfer Pricing Documentation and Country-by-Country Reporting* on Action Item 13 of the OECD Action Plan deals with enhanced transfer pricing transparency for tax administrators.

Multinational enterprises will be required to provide relevant tax authorities with information on indicia on a country-by-country (and not an entity) basis. A three-tiered approach has been adopted.

The first tier is a Master File which will provide an overall picture of the global business, overall transfer pricing policies and the global allocation of income and economic activity of the MNE. The information required is relatively extensive and is outlined in Table 1.

Table 1: What is required to be included in the master file?

1	Organisational structure	1.1	Chart illustrating the legal and ownership structure
		1.2	Geographical location of operating entities
2	Description of MNE's businesses	2.1	Important drivers of profit for each business
		2.2	The supply chain for the 5 largest products or services by turnover
		2.3	Other products or services amounting to more than 5 percent of group turnover
		2.4	Important service arrangements between group entities other than R&D
		2.5	Capabilities of principal locations providing intra-group services
		2.6	Transfer pricing policies for allocating service costs
		2.7	Transfer pricing policies for determining prices for intra-group services
		2.8	Main geographic markets for the groups products and services
		2.9	Functional analysis of the principal contributions to value creation by each entity
		2.10	Important restructuring transactions, acquisitions and divestures during the fiscal year
3	Description of MNE's intangibles	3.1	Overall strategy for development, ownership and exploitation of intangibles
		3.2	Location of principal R&D facilities and location of R&D Management
		3.3	A list of important intangibles and which entities legally own them
		3.4	A list of important agreements – cost contribution, principal research service and licences
		3.5	Description of transfer pricing policies related to R&D and intangibles
		3.6	Important transfers of interest in intangibles including compensation
4	Description of MNE's intercompany financial activities	4.1	General description of how the group is financed
		4.2	Identification of any group member providing a central financing function
		4.3	Description of transfer pricing policies related to financing arrangements
5	Description of MNE's financial and tax positions	5.1	Annual consolidated financial statement for the fiscal year
		5.2	A list of Advanced Pricing Agreements and tax rulings relating to income allocation

The report states that 'in producing the master file, including lists of important agreements, intangibles and transactions, taxpayers should use prudent business judgement in determining the appropriate level of detail for information supplied…' Further the use of the word 'important' is common. It is said that '…information is considered important if its omission were to affect transfer pricing outcomes.'

The second tier is a local file that focuses on material transactions between the local country affiliate and associated entities in different countries. Details of what is required here are contained in Table 2.

Table 2: What is required to be included in the local file?

1	Local entity	1.1	Description of management structure of local entity
		1.2	Local organisation chart
		1.3	Description of the individuals to whom local management reports and location
		1.4	Detailed description of local businesses
		1.5	Detailed description of strategy for local businesses
		1.6	Business restructuring in the present and immediate past year impacting local entity
		1.7	Intangible transfers in the present and immediate past year impacting local entity
		1.8	Outline of key competitors
2	Controlled transactions	2.1	Description of material controlled transactions and their context involving the local entity
		2.2	Payments and receipts for each controlled transaction broken down by tax jurisdiction
		2.3	Identification of associated enterprises involved in each controlled transaction
		2.4	Copies of all material intercompany agreements concluded by the local entity
		2.5	Detailed comparability and functional analysis for each category of controlled transaction
		2.6	Indication of most appropriate transfer pricing methodology for each category
		2.7	A summary of important assumptions made in applying the methodology
		2.8	If relevant an explanation of the reasons for applying a multiyear analysis
		2.9	List and description of selected comparable uncontrolled transactions (internal or external)
		2.10	A description of comparability adjustments and their impacts
		2.11	A description of the reasons for concluding that the transactions were arm's length
		2.12	A summary of the financial information used in applying the transfer pricing methodology
		2.13	A copy of relevant unilateral, bilateral and multilateral advance pricing agreements
		2.14	A copy of other tax rulings which are relevant to the controlled transactions
3	Financial information	3.1	Annual local entity financial accounts for the fiscal year
		3.2	How the financial data used in the transfer pricing methodology ties to the accounts
		3.3	Summary schedules for comparables and their sources

The third tier is a Country-by-Country report which contains three elements. The first is an overview of ten indicia such as profit before tax and accumulated earnings which is to be completed on a country by country basis. See Table 3. The second element is a constituent entities table which looks at each entity in a jurisdiction and requests the main business activities of each entity divided into 13 components. The third element is simply the opportunity to explain the information in the other two tables. See Tables 4 and 5.

There is significant concern as to how the master file and the Country-by-Country file can be made available to various local tax administrations. The report did not include a determinative view of this mechanism. During the next several months, Working Party No. 6 of the Committee on Fiscal Affairs will undertake further work to analyse potential implementation mechanisms, with due regard to confidentiality considerations, timely reporting and other factors.

There are no materiality thresholds for Country-by-Country reporting. It is not proposed that the three-tiered reports will be publicly disclosed.

Table 3: Country-by-Country reporting – part 1 (for each fiscal year)

Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income tax paid Cash basis	Income Tax Accrued for Current year
	Unrelated	Related	Total			
For example Australia						
Brazil						
Canada						
Chile						
China						
Germany						
Ghana						
Indonesia						
Nigeria						
United Kingdom						
United States						

Table 4: Country-by-Country reporting – part 2 (for each fiscal year)

Tax Jurisdiction	Constituent entities resident in tax jurisdiction	Tax Jurisdiction or incorporation if different	R&D	Holding or managing intellectual property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or distribution
For example United States	1. US Top Co						
	2. US Fin Co						
	3. US Sales Co						
Australia	1. Aust Hold Co						
	2. Aust Sales Co						
	3. Aust Op Co						

Table 5: Country-by-Country reporting – part 3 (for each fiscal year)

Any further information that would facilitate an understanding of the above compulsory information.

	Stated Capital	Accumulated Earnings	Number of employees	Tangible assets other than cash and equivalents

Administrative Management or Support	Provision of Services to unrelated Parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding shares or other equity instruments	Dormant	Other

Major business concerns with Country-by-Country reporting

Business has expressed five major concerns with this reporting initiative.

1. That it will give rise to increased disputation as countries focus on different elements to argue for a greater share. For example, Ghana may give greater weight to the number of employees and the Netherlands to the level of share capital employed.
2. That the information may be used by jurisdictions beyond the transfer pricing analysis for which the information was created.
3. Materiality generally, and the special circumstances of smaller businesses in particular, are catered for but not so as to allow small operations in a tax jurisdiction to be excluded from the Country-by-Country report.
4. That the information may enter the public domain through a breach of confidentiality, both by revenue officials and potentially employees.
5. The cost of compliance.

CHECKLIST – REPORTING AND DOCUMENTATION ON TRANSFER PRICING

- [ ] Consider advanced preparation of a **country-by-country reporting file**. Determine what positions different revenues may adopt on reviewing such a template and put in place an international strategy for dealing with this to minimise future disputation.
- [ ] Consider what a **transfer pricing local file** may look like in all jurisdictions. What issues may arise for local tax authorities and what policies are in place for dealing with this in an effective manner?
- [ ] Consider what a **transfer pricing master file** may look like from the perspective of all jurisdictions. What issues may arise for local tax authorities and what policies are in place for dealing with this in an effective manner? Consider confidentiality and security issues.


1400
1200
1000
800
600
400
200
0

CFO/TAX CHECKLIST

	TWELVE CHECKLIST QUESTIONS FOR SENIOR EXECUTIVES AND NON-EXECUTIVE DIRECTORS		SEE PAGE
1	Ascertain whether there are any **hybrid financial instruments** in the corporate structure. If so, determine the accounting treatment in particular to ascertain whether there is a latent deferred tax asset associated with the instrument that may not come to fruition. Ascertain the options if the OECD-G20 Action Item 2 proposals were implemented in one or both countries. Generally (i) do nothing; (ii) unwind; or (iii) modify.	☐	6
2	Determine whether there are any **hybrid entities (such as disregarded entities)** in the structure (ie. an entity that is treated as 'opaque' in one jurisdiction and 'transparent' in another). The hybrid nature of an entity may not be obvious to a non-tax person on the face of a corporate structure diagram. Consider the accounting position and options as above.	☐	6
3	Determine whether there are **other hybrids** and if so develop a medium term strategy for dealing with these.	☐	6
4	Consider the **current location of intangibles and the potential options** depending on the outcome of the review of Patent Box and related concessions. This may create opportunities in the future or render existing arrangements problematic. It is largely a matter of being alert in 2015.	☐	9
5	Consider equity, debt and royalty chains in the international structure to ascertain whether they would stand up to **proposed changes to tax treaties**. If not, consider short and long term planning options to ensure the structure is resilient.	☐	12
6	Undertake a review of the location of **intangibles** and whether the return on the intangibles is in accordance with the proposed revised guidance using a functions, assets and risks analysis.	☐	15
7	Consider advanced preparation of a **country-by-country reporting file**. Determine what positions different revenues may adopt on reviewing such a template and put in place an international strategy for dealing with this to minimise future disputation.	☐	18
8	Consider what a **transfer pricing local file** may look like in all jurisdictions. What issues may arise for local tax authorities and what policies are in place for dealing with this in an effective manner?	☐	18
9	Consider what a **transfer pricing master file** may look like from the perspective of all jurisdictions. What issues may arise for local tax authorities and what policies are in place for dealing with this in an effective manner? Consider confidentiality and security issues.	☐	18
10	Consider the potential impact on changes to the definition of permanent establishment. Does the group use **'commissionaire arrangements'** or have local representatives involved in sales, but **without the authority to conclude contracts** (which is done by the parent)? Are these arrangements likely to be effective in the long term?	☐	12
11	Consider the potential impact on changes to the definition of permanent establishment. Does the group rely on the fact that certain activities are considered **'preparatory and auxiliary'** and thus do not give rise to a taxable presence in a jurisdiction.	☐	12
12	Should I or my team be seeking to **influence the outcome of the 2015 deliverables** on the OECD-G20 Action Plan? This will involve potential changes to CFC rules, financing structures using international companies, transfer pricing of finance transactions and stewardship and management costs.	☐	25

CONTACT US

Rosheen Garnon
National Managing Partner, Tax
+61 2 9335 7255
rgarnon@kpmg.com.au

David Linke
National Corporate Tax Leader
+61 2 9335 7695
davidlinke@kpmg.com.au

Grant Wardell-Johnson
Partner, Australian Tax Centre
+61 2 9335 7128
gwardelljohn@kpmg.com.au

kpmg.com.au

September 2014. NSW N12261TAX OECD