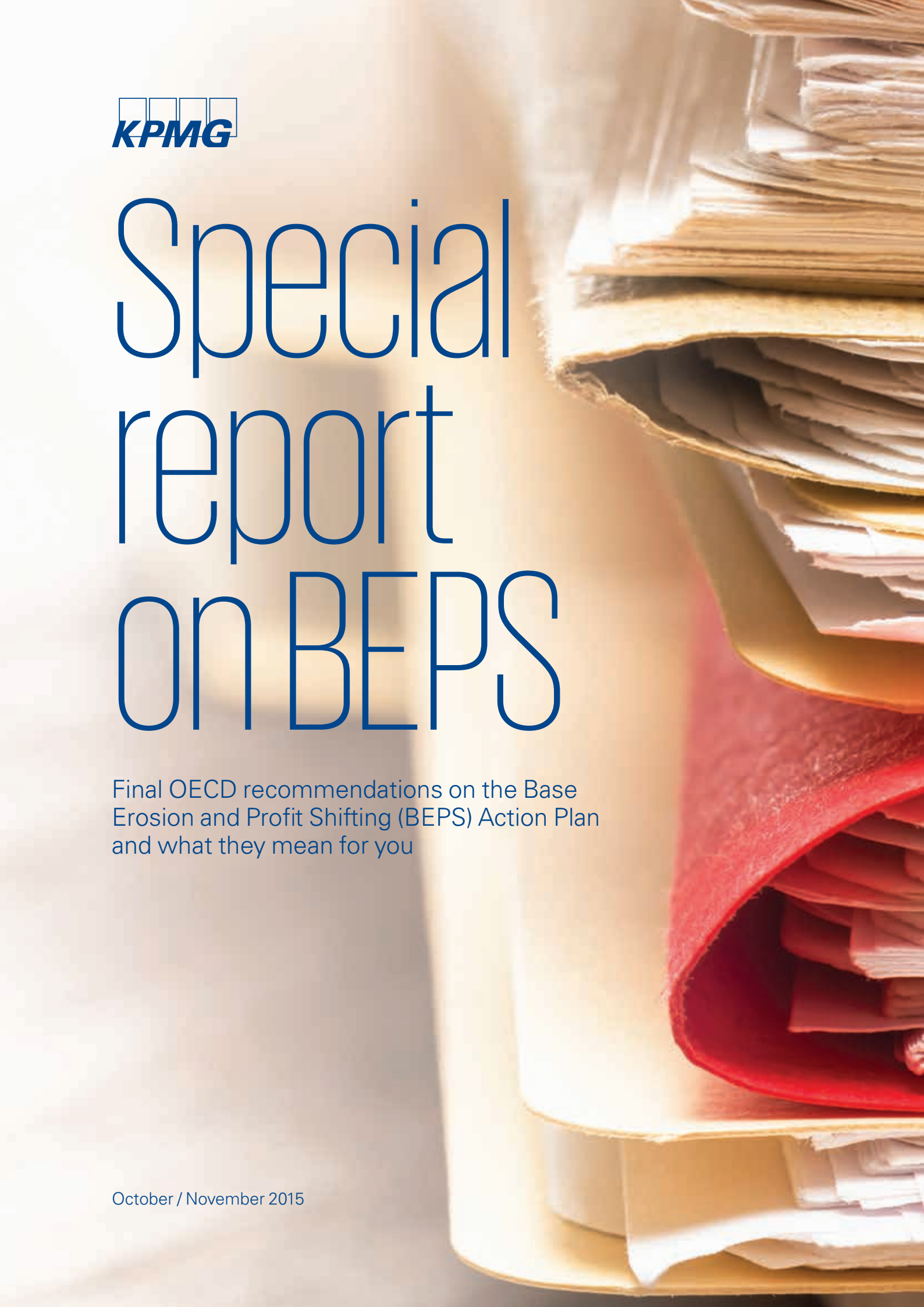
KPMG

Special report on BEPS

Final OECD recommendations on the Base Erosion and Profit Shifting (BEPS) Action Plan and what they mean for you



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Introduction

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) issued a final package of reports in connection with its Action Plan to address Base Erosion and Profit Shifting (BEPS), as well as a plan for follow-up work and a timetable for implementation. The OECD's BEPS Action Plan, which was launched in July of 2013, and endorsed by the G20, includes 15 key areas for identifying and curbing aggressive tax planning and practices, and modernizing the international tax system. The OECD delivered interim reports with respect to 7 of the 15 action items in September of 2014. Those 2014 reports have been consolidated with the remaining 2015 deliverables to produce a final set of recommendations for addressing BEPS.

Many countries have already adopted or are poised to adopt changes to their international tax systems based on the OECD recommendations. While implementation and timing will vary across borders, this final OECD release marks a crucial shift from the recommendation and consultation phase of BEPS to legislation and implementation. To help multinational organizations assess the potential impacts, tax professionals from KPMG member firms have analyzed the latest OECD recommendations and issued the following action-by-action observations.

Contents

Action 1: Addressing the Tax Challenges Raised by the Digital Economy

Introduction

Action 1 is aimed at addressing BEPS issues in the digital economy (DE). The DE presents some key features that may exacerbate BEPS concerns – mobility (intangibles, users, and business functions), reliance on data, network effects, multi-sided business models, monopoly, and volatility. The final report on the DE asserts that DE business models facilitate the artificial shifting of income, avoidance of direct tax nexus, and the avoidance of VAT. The final report concludes that work under the other BEPS Actions addresses much of the DE BEPS concern, but also sets out additional measures countries may consider. The report states that the Task Force on the Digital Economy (TFDE) will continue its work by monitoring new DE business models and the effectiveness of BEPS measures with the objective of issuing a report on its work by 2020.

- The final report expects that adoption of the permanent establishment (OECD Model Treaty Article 5) modification of Action 7 should effectively address much of the concerns with respect to direct tax nexus. Many DE business models operate through physical facilities located in market jurisdictions (e.g., e-commerce warehouses and computer server locations to address latency concerns). Action 7 modifications are expected to bring many of these businesses within the taxing rights of market jurisdictions.
- Revised transfer pricing guidance (Actions 8-10) makes it clear that legal ownership alone does not justify the right to intangibles profits – limiting the current mobility of DE profits. The TP guidelines will allocate profits to group members performing important functions, contributing important assets and controlling significant risks. Coupled with a broader definition of taxable nexus, these guidelines are expected to subject a greater share of DE profits to market country taxation.

- Subjecting DE profits to CFC taxation pursuant to the recommendation of Action 3 (Strengthening CFC Rules) is also expected to be an important factor in eliminating stateless DE income and the incentives for tax-motivated operating structures. Taking a page from U.S. legislative proposals, the final report suggests that CFC rules targeting typical DE income (e.g., royalties, sales of digital product's and digital services – similar to the foreign base company digital income proposals of the Obama Administration's 2016 Budget) or excess profits from IP-related assets (also proposed by the Obama Administration) would be effective measures to curtail DE BEPS concerns.
- Guidelines 2 (destination-based taxation of cross-border supplies) and 4 (multi-location business customers) of the OECD's International VAT/GST Guidelines should effectively address concerns of tax avoidance by VAT-exempt business customers. B2C VAT avoidance should also be addressed by adopting destination-based taxing rights that require DE suppliers to collect and remit VAT. The final report recommends adoption of simplified registration regimes to minimize compliance burdens, while also suggesting that countries may limit the recovery of input VAT under these simplified regimes. The report states that WP9 will develop implementation packages for these recommendations.
- The report concludes that data is often a 'primary input' for value creation in the DE. Nevertheless, significant uncertainty remains as to how to deal with data in the DE – should collecting data cause taxable nexus? if so, how to attribute profits from the use of data to that nexus?, and how should data-related income be characterized?
- The final report further develops alternative options addressed in its 2014 work: (1) significant economic presence nexus (nexus would be established where a non-resident has a significant economic presence evidenced by factors such as revenue from remote transactions, local domain names, localized websites, local currency payment options, number of active users in a country, online contracting and data collection); (2) withholding taxes on digital income from goods or services ordered online (tax could be a final tax or as a back-up measure to enforce net-basis taxation); and (3) 'equalization levy' (tax to equalize the tax burden on remote and domestic suppliers of similar goods and services, similar to an insurance excise taxes imposed upon foreign insurers). These measures could only be imposed through domestic legislation and are not recommended as an international standard. However, the report states that countries may wish to impose these measures to address DE BEBS concerns that those countries believe are not adequately addressed by the OECD's recommendations or as a 'stop-gap' measure until the OECD's recommendations are fully implemented.
- The final report states that the character of many forms of DE income, including cloud computing, is not addressed in the existing commentary to the OECD Model Treaty (royalties, technical services, or business profits). WP1 has a mandate to clarify the characterization of such income under current tax treaty rules. WP1's work is to be completed with full participation of Associate member countries in the BEPS process.

Observations

The final report confirms that the OECD's BEPS recommendations should only find tax nexus where a foreign enterprise has a physical presence. However, this hoped-for-outcome is significantly tempered by the TFDE's tacit approval for countries to go their own way by adopting economic nexus standards or other new DE taxes such as DE withholding tax or equalization levies. This development is particularly troubling because it presents a pathway for potentially significant double taxation of DE profits. The risk of double taxation could be fuelled by inconsistent views of how value is created within DE business models and the imposition of 'new' DE taxes and levies that are non-creditable in the resident or home-country jurisdiction. Evidencing the divergent views of members of the TFDE, the final report notes that the challenges of the DE raise important policy questions of how taxing rights of DE income should be allocated amongst resident and source countries. It is doubtful these policy issues will subside throughout the TFDE's ongoing work and may well drive future changes in the way DE income is taxed.

Action 2: Neutralize the effects of hybrid mismatch arrangements

Introduction

The aim of Action 2 is to develop model treaty provisions and recommendations for the design of domestic rules to neutralize mismatches arising from the use of hybrid instruments and entities. The OECD issued a discussion draft on 19 March 2014 and an interim report with recommendations was published on 16 September 2014, although it identified certain outstanding issues where further work was required. In line with last year's recommendations, the final report recommends the introduction of hybrid mismatch rules and certain other domestic provisions to counter hybrid arrangements, together with a proposed change to the model treaty to ensure hybrid entities are not used to obtain treaty benefits unduly. The report is a staggering 454 pages long, containing detailed guidance and numerous examples to explain how the domestic provisions are intended to operate in practice.

- The hybrid mismatch rules apply to arrangements involving a hybrid financial instrument (including a hybrid transfer) or hybrid entity (including a reverse hybrid) that cause a mismatch in tax outcomes. The rules operate to deny a tax deduction for payments made under such arrangements that are also deductible in another jurisdiction, prevent exemption for payments that are deductible for the payer and deny a deduction for a payment that is not included in ordinary income of the recipient. It should be noted that countries will be free to decide whether to apply the hybrid mismatch rules to neutralize mismatches in respect of intra-group hybrid regulatory capital instruments.
- The hybrid mismatch rules also apply to deny a deduction for payments made by a dual-resident entity where the payment would otherwise be deductible in both jurisdictions and to the extent it is not set-off against dual inclusion income (i.e. income included as ordinary income under the tax laws of both jurisdictions). In addition, the rules allow a jurisdiction to deny a deduction for a payment

in circumstances where a hybrid mismatch that arises between two other jurisdictions is "imported" into that jurisdiction (for example, through an ordinary loan), but only to the extent that the hybrid mismatch is not neutralized by one of the other jurisdictions.

– The final report recognizes the importance of consistency and co-ordination in the implementation and application of the hybrid mismatch rules to ensure the rules are effective (but do not lead to double taxation) and to minimize compliance and administrative costs. Therefore, in addition to the detailed guidance and examples, it sets out a common set of design principles and defined terms and calls for countries to exchange information relevant to the administration of the rules and to co-ordinate on the timing of the implementation of the rules. The report says that the rules should generally apply to all payments made under hybrid mismatch arrangements after the date of implementation without grandfathering of existing arrangements. Rather, the implementation date should be set far enough in advance to give taxpayers sufficient time to determine the likely impact of the rules and to restructure as necessary. It is also stated that the recommendations under Action 2 should be applied to determine an entity's total net interest expense before applying the fixed ratio rule and group ratio rule under Action 4.
– Other recommended domestic provisions include the denial of a dividend exemption for payments that are tax deductible for the payer, as well as measures to prevent hybrid transfers being used to duplicate withholding tax credits and to treat reverse hybrids as resident taxpayers where income is not brought into charge to tax in the investor jurisdiction.
– The proposed change to the model treaty involves only allowing income that is derived by or through an entity which is treated as fiscally transparent in either contracting state to be considered as income of a resident of a contracting state for the purposes of the treaty to the extent that it is treated as income of the resident for tax purposes in that state. This is a provision that is already included in a number of the US tax treaties. The report also says that countries that intend to implement the domestic provisions should consider amending their tax treaties which include an exemption method for dividends in order to eliminate double taxation to, instead, apply a credit method, either as a general rule or with respect to tax deductible dividends.

Observations

The key recommendation under this action is the introduction of domestic hybrid mismatch rules. The recommended rules contain a primary rule and a defensive rule to avoid double taxation and to ensure that the tax mismatch is eliminated even where not all jurisdictions adopt the rules. The defensive rule only applies where the other jurisdiction has not adopted the hybrid mismatch rules or, for some reason, does not apply the primary rule. The rules also operate automatically without seeking to determine which jurisdiction has lost tax. It is important to recognize that the additional rules dealing with imported mismatches serve as a "backstop" to these primary and defensive rules, by providing tertiary rules that would require third countries to deny deductions for payments to entities involved in hybrid arrangements if the relevant countries to the hybrid arrangement do not adopt (or delay the adoption of) the primary and defensive rules.

The final report acknowledges that notional interest deduction regimes do not produce the type of tax mismatch contemplated under Action 2, but says that such rules and other rules having similar effect will be considered separately in the context of the implementation of the recommendations. However, it does not explain further what options might be considered or the process through which this will be done.

Companies should review their existing intra-group financing arrangements to determine if they would be adversely impacted if the recommended rules were to be introduced by a relevant jurisdiction. For example, the UK has already announced its intention to introduce domestic rules to give effect to the OECD's recommendations on hybrid mismatch arrangements, with the rules currently expected to apply to payments made on or after 1 January 2017 and with no grandfathering of existing arrangements.

Action 3: Designing effective controlled foreign company rules

Introduction

The objective of Action 3 is to address BEPS by designing effective controlled foreign company (CFC) rules. By taxing the income of non-resident subsidiaries in the hands of the resident shareholders, robust CFC rules can prevent groups from establishing low-taxed nonresident affiliates to which they shift income which is often subject to indefinite deferral. The OECD issued a discussion draft on 3 April 2015, which provided recommendations on the key "building blocks" necessary to develop effective CFC rules for dealing with BEPS. The building blocks are intended to allow countries without CFC rules to implement recommended rules directly and countries with existing CFC rules to modify their rules to align more closely with the recommendations.

Consistent with the discussion draft, the OECD final report sets out recommendations for six building blocks: (1) rules for defining a CFC (including definition of control); (2) CFC exemptions and threshold requirements; (3) definition of CFC income; (4) rules for computing income; (5) rules for attributing income; and (6) rules to prevent or eliminate double taxation. The final report generally confirms the recommendations of the discussion draft but modifies certain aspects on some building blocks and provides more detailed guidance on others. Most significantly, regarding (3) the final report significantly revamped this income issue, makes an affirmative recommendation regarding income attribution and provides modified income attribution options.

- CFC rules should broadly define entities that are within the scope of the CFC definition so that, in addition to including corporate entities, CFC rules could also apply to certain transparent entities (partnerships, trusts) and permanent establishments (PEs) if those entities earn income that raises BEPS concerns and those concerns are not addressed in another way.
- To prevent entities from circumventing CFC rules through different tax treatment in different jurisdictions, CFC rules should include a modified hybrid mismatch rule requiring intragroup payments to a CFC to be taken into account in calculating parent company's CFC income if (1) the payment is not included in CFC income; and (2) the payment would have been included in CFC income if the parent jurisdiction had classified the entities and arrangements in the same way as the payee or payer jurisdiction.
- The CFC rules should apply both a legal and an economic control test (generally set at more than 50 percent, although countries could, if they so choose, achieve broader policy goals by setting a lower threshold) so that satisfaction of either test results in control.
- CFC rules should include a tax rate exemption that would allow companies that are subject to an effective tax rate that is sufficiently similar to the tax rate applied in the parent jurisdiction not to be subject to CFC taxation. The recommended benchmark would be no greater than 75 percent of the statutory corporate rate in the parent or shareholder jurisdiction. Whitelists could be used to simply/supplement the effective tax rate test.
- Possible approaches to defining CFC income that should be attributed to controlling shareholders are identified, including: (1) a categorical analysis (similar to the current US subpart F rules); (2) a substantive analysis (similar to many existing EU regimes); and (3) an excess profits analysis (taxing at the shareholder level returns in excess of a "normal return" earned in low tax jurisdictions)
- However defined, CFC income should be computed using the rules of the parent jurisdiction for determining income. To the extent legally permitted, jurisdictions should have a specific rule limiting the offset of CFC losses so that they can only be used against the profits of the same CFC or against the profits of other CFCs in the same jurisdiction.
- Income should be attributed only to shareholders having a minimum threshold of control, and the amount of income to be attributed to each shareholder or controlling person should be calculated by reference to both their proportion of ownership and their actual period of ownership or influence. Tax should be applied at the tax rate of the parent jurisdiction; however a second option would be to apply a "top-up tax" (the difference between the tax paid by the CFC and, for example, the rate threshold used to determine whether the CFC rules apply). In either case, a credit should be allowed for foreign taxes actually paid (including CFC tax assessed by other countries on intermediate companies).

Observations

The final report is largely unchanged from the discussion draft. In addressing "hybrid mismatches," the final report adopts the broader of two rules identified by the discussion draft in that hybrid mismatch need not give rise to a base eroding payment in order to produce CFC income. In the more general definitions of CFC income, the final report adds the notion of a broader "substantive analysis" where the discussion draft identified only the categorical approach and the excess profits approach (although it did suggest that "substance" would be relevant to certain determinations under the categorical approach). Overall, the suggestions of the final report are not dissimilar from the current US subpart F regime, although a number of its suggestions (the hybrid mismatch rule and the excess profits analysis) would extend those rules – in a manner similar to pending Administration and Congressional proposals.

Action 4: Limit base erosion via interest deductions and other financial payments

Introduction

Action 4 seeks to develop recommendations in the design of rules limiting the deductibility of interest and other financial payments made to third parties and related parties. The OECD released a discussion draft on 18 December 2014 which focused on three potential approaches – a group-wide rule, a fixed ratio rule, or a combination of those two rules. In its final report, the OECD recommends a combination approach where a fixed ratio rule is the default rule and a group ratio rule applying at a country's election. Furthermore, the OECD supplements the best practice approach with additional optional elements and targeted rules.

- Under the fixed ratio rule, an entity's deductible interest expense would be limited to a fixed ratio of the entity's earnings before interest, taxes, depreciation and amortisation (EBITDA). In lieu of EBITDA, countries could choose to apply EBIT, which represents more of a cash flow measure. These computations would be done based on tax numbers. The report recommends that the fixed ratio be between 10 percent and 30 percent. If applied as a stand-alone rule, the fixed ratio approach is recommended to apply to both multinationals and purely domestic entities.
- Under the group ratio rule, interest expenses are deductible up to the level of the net third party interest/EBITDA ratio of the group. This earnings-based group ratio rule can also be replaced by different group ratio rules, which are based on an equity or asset comparison. To prevent double taxation, countries may also apply an uplift to a group's net third party interest expense up to 10 percent.
- The recommendations treat payments of interest equivalents and expenses incurred in raising finance, including imputed interest on convertible bonds or zero-coupon bonds, the finance cost element of finance lease payments, and guarantee fees.

– The additional optional elements consist of (i) a de minimis threshold which carves-out entities with a low level of net interest, (ii) a carry forward of disallowed interest/unused interest capacity and/or carry back of disallowed interest, and (iii) an exclusion for third party interest funding certain public-benefit assets.
– The OECD recommends the targeted rules to prevent a circumvention of the general rules (fixed ratio rule and group ratio rule) as well as to address other base erosion and profit shifting risks.
– The rules are intended to apply to interest and financial payments economically equivalent to interest.

Observations

The Action 4 final recommendations are a significant change for those countries having interest limitation rules based on debt/equity ratios. A further significant change is that the earnings-based ratio also applies to third party interest. Experiences in countries having such rules has shown that this can be a threat in times of economic crisis. The status of the final report as a recommendation means that OECD member countries are not committed to adopting the final report's recommendations. There is, however, a clear expectation that member states follow the recommendations, which is intended to be monitored by the OECD. To the extent the OECD recommendations do gain traction, they will introduce significant complexity in international cash management planning. Further, even the OECD acknowledges that banking and insurance sectors may be particularly affected by these rules and that separate rules may need to be created for such industries. Unfortunately, those details remain to be developed. In addition, Action 4 requires more work regarding the detailed design and operation of the group ratio rule. The OECD expects completing the work in 2016.

Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance

Introduction

The goal of Action 5 is to identify preferential regimes, introduce compulsory spontaneous information exchange on rulings related to preferential regimes and require substantial activity for any preferential regime including IP regimes. The OECD published a report on 16 September 2014 stating that progress has been made to date by the Forum on Harmful Tax Practices (FHTP) in (i) determining the parameters within which preferential tax regimes should operate going forward, in relation to substantial activity, and (ii) in improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes.

- The FHTP will continue its work in reviewing preferential regimes (currently 43 regimes have been identified of which 16 are IP regimes).
- For IP regimes, the report agrees on the so-called 'nexus' approach which seeks to directly link IP regime benefits to the claimant company's contribution to the development of the IP in question, measured by reference to the related R&D expenditure as a proportion of total R&D expenditure, with expenditure acting as a proxy for activity. The proposal is based on a formula: eligible IP income for the IP regime = (qualifying expenditure incurred to develop the IP asset divided by overall expenditure incurred to develop the IP asset) x overall income from that IP asset.
- Qualifying expenditures must be directly connected to the IP asset and will in principle not include interest payments, building costs, acquisition costs and related party outsourcing. A 30 percent 'up-lift' for qualifying expenditures is allowed to the extent that the taxpayer has non-qualifying expenditures.
- As a transitional arrangement, the report concludes that no new entrants will be permitted in any existing IP regime not consistent with the nexus approach after 30 June 2016. Countries can allow taxpayers benefiting from an existing IP regime to keep such entitlement until 30 June 2021 at the latest.

– The report notes that a framework covering all rulings has been agreed. The framework builds on earlier OECD guidance, taking into account the Convention of Mutual Assistance in Tax Matters and the European Union's Council Directive on Administrative Cooperation in the field of taxation (2011/16/EU). The framework covers all taxpayer specific rulings, advance tax rulings, advance pricing agreements and general rulings. For countries which have the necessary legal basis, exchange of information will take place from 1 April 2016 for future rulings. For past rulings, the report confirms that rulings that have been issued on or after 1 January 2010 and were still in effect as from 1 January 2014 must be exchanged. The exchange of past rulings will need to be completed by 31 December 2016.

Observations

Existing IP regimes will have to be amended in the upcoming months to include the modified nexus approach. Also the EU Council has agreed on 9 December 2014 to endorse the OECD approach and will start monitoring EU Member States on implementation. The exchange of information on rulings runs in parallel with the EU proposal to amend Directive 2011/16/EU as regards the mandatory automatic exchange of information on cross-border advance tax rulings and advance pricing arrangements. Agreement on the final text of the EU proposal is expected shortly. The entry into force of the EU mandatory automatic exchange of cross border ATRs and APAs is expected at 1 January 2017 for all valid rulings and APAs issued, amended or renewed from 1 January 2012 onwards.

Action 6: Prevent treaty abuse

Introduction

The objectives of Action 6 are to: (i) develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances; (ii) clarify that tax treaties are not intended to be used to generate "double non-taxation"; and (iii) identify tax policy considerations for jurisdictions to consider before entering into treaties. The OECD released three discussion drafts on 14 March 2014, 21 November 2014 and 22 May 2015, as well as an agreed deliverable on 16 September 2014.

Consistent with its earlier draft recommendations, the OECD concluded in its final report that the preferred approach to preventing the granting of treaty benefits in inappropriate circumstances is to include in treaties both a limitation of benefits (LOB) article and a general anti-abuse rule in the form of a principal purpose test (PPT). The "minimum standard" required by Action 6 may also be met through the use of a PPT alone or through the use of an LOB in conjunction with other anti-abuse rules in the treaty or domestic law that address conduit arrangements.

– The final report includes draft provisions for both a U.S.-style LOB and for a "simplified" LOB, both of which are based on the 2014 deliverable and subsequent discussion drafts. The simplified LOB is expected to be paired with the PPT. Further work will be done on both the detailed and simplified LOB and Commentary during the first part of 2016, in light of changes to the U.S. model LOB, which is expected to be finalized by the end of 2015.
– The guidance on the PPT generally incorporates the guidance from the 2014 deliverable and the subsequent discussion drafts. The Commentary on the PPT includes a new example related to the splitting of contracts to avoid a permanent establishment (PE).
– The final report also confirms the specific changes recommended in the 2014 deliverable, including a provision to deny treaty benefits when payments are made to a low-taxed PE in a third jurisdiction, a minimum holding period to receive dividend withholding relief, a provision to prevent avoidance of the real property holding company provision, and a modification to the dual residence tie-breaker for entities. The recommendations also include guidance on the interaction of treaty provisions and domestic anti-abuse rules.
– Because the final recommendations include the recommendations of the 2010 report on collective investment vehicles (CIVs), no further work is anticipated on the treaty benefit of CIVs.
– The final report states that recognized pension funds will be treated as residents of the state in which they are constituted, and calls for further work on the definition of a recognized pension fund. The final report also calls for additional work to be done on the granting of treaty benefits to non-CIV funds during the first half of 2016.

Observations

The changes recommended by the final report will be incorporated into the OECD Model Tax Treaty and are expected to be included in the multilateral instrument that is being developed under Action 15 for jurisdictions to amend their bilateral treaties. The United States has announced that it will not adopt a PPT, but many other jurisdictions are expected to adopt a PPT, and many may also adopt the "simplified" LOB. A key issue therefore will be how countries choose to delineate between something that is, and is not, in accordance with the objects and purposes of the treaty. Conduit arrangements are a particular focus of attention, and are specifically targeted in the agreed commentary.

It is not clear that the simplified LOB as currently drafted is, in all cases, more taxpayer favorable than the detailed LOB, and its development should be closely monitored by taxpayers. The fact that both the detailed LOB and the simplified LOB are subject to further work results in continued uncertainty in this area.

The announcement of the further work on the treaty entitlement of pension funds and non-CIV funds is welcome. With respect to non-CIV funds, however, the final report indicates that governments continue to have significant policy concerns, so the scope of the work in the first part of 2016 is unclear.

Action 7: Prevent the artificial avoidance of PE status

Introduction

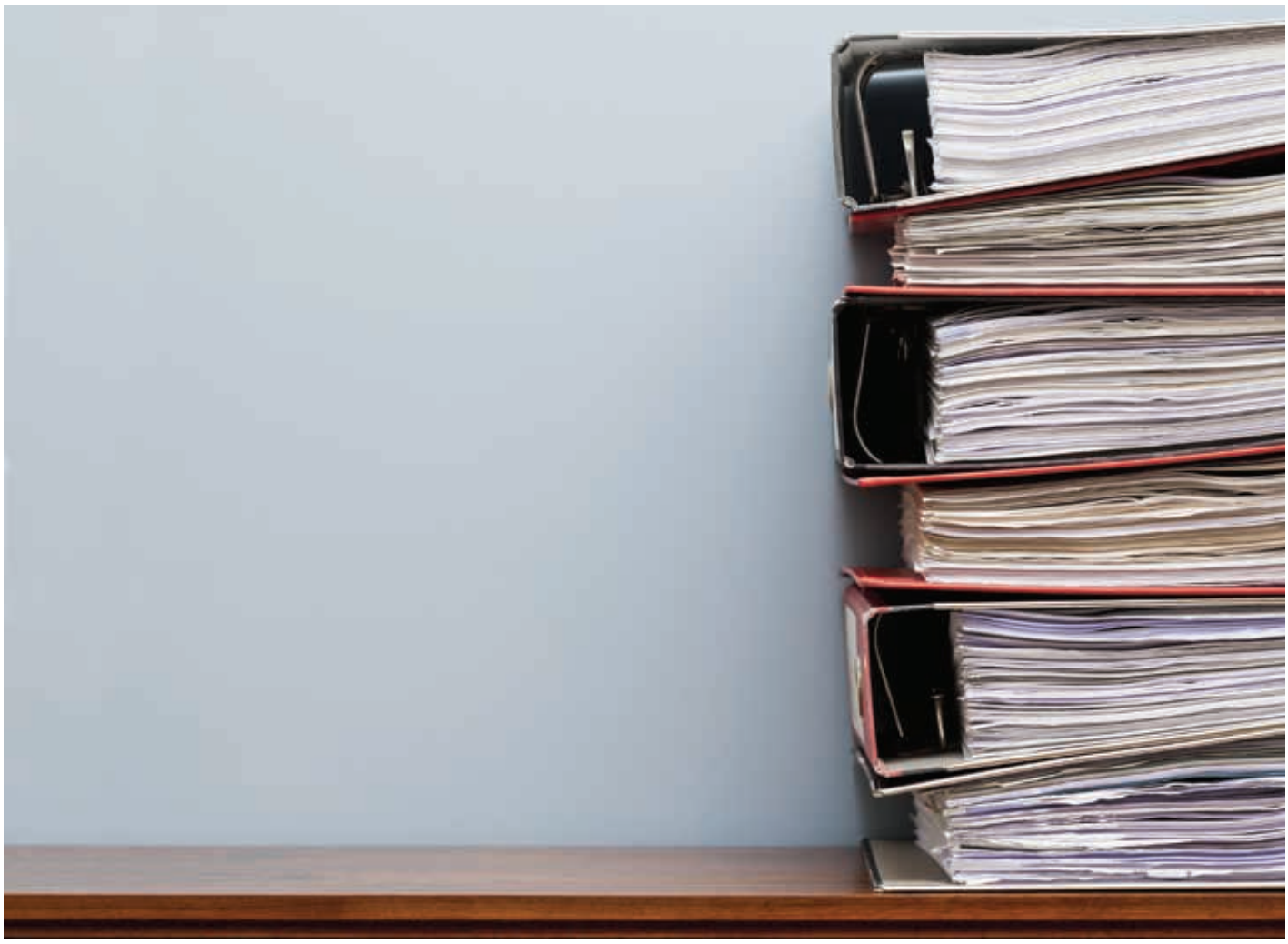
The aim of Action 7 is to develop changes to the definition of permanent establishment (PE) to prevent abuses of that threshold, including through the use of commissionaire arrangements and the specific activity exemptions to avoid PE status where core activities are involved. The OECD released an initial discussion draft on 31 October 2014 and a revised discussion draft on 15 May 2015. The revised discussion draft built on the 14 options presented in the first discussion draft and set out specific proposed changes to the PE definition in the OECD model treaty, accompanied by corresponding changes to the Commentary. In its final report, the OECD has recommended the proposed changes to the PE definition and related Commentary contained in the revised discussion draft.

- The OECD recommends an expanded scope of what is proposed to constitute a PE, focusing on the negotiation and final conclusion of contracts. An important addition to paragraph 5 is the phrase: "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise." As a result, under circumstances, also sales support and marketing type activities may constitute a PE. Furthermore, the exception for independent agents will no longer apply for companies belonging to the same group, if that person acts exclusively or almost exclusively on behalf of one or more related enterprises. The OECD re-confirms that so-called limited risk distributors cannot create an agency PE under article 5, but their profits may be affected by the work on Actions 8-10.
- The exception for preparatory and auxiliary activities (article 5, paragraph 4) will only apply if each activity meets the preparatory and auxiliary definition or, in the event of a combination of activities, they together can be seen to be preparatory and auxiliary in nature.

– A new anti-fragmentation rule seeks to deny the preparatory and auxiliary exception if the foreign enterprise or a related enterprise carries on related activities in the same jurisdiction and those activities, taken as a whole, go beyond preparatory and auxiliary. Noteworthy here is that the OECD prescribes that a resident entity can be seen as a PE in the same state.
– New rules to avoid the splitting of contracts are aimed at construction activities carried out by more than one foreign entity, each for a period of less than the threshold for construction activities (generally 12 months). Rather than changing the wording of paragraph 3, the OECD aims to deal with this under the new PPT rule to be introduced following Action 6.
– There will be no further rules for insurance companies selling in a state without having a PE in such state. Any changes should follow the general rules of the revised paragraphs 5 and 6 of article 5.

Observations

These proposed changes to the PE definition will be implemented as part of the multilateral instrument adopted under the work on Action 15. However, follow-up work on profit attribution rules in relation to PEs still has to be concluded before the end of 2016, which is the deadline for negotiation of the multilateral instrument.



Develop rules to prevent BEPS by:

Action 8: moving intangibles among group members;

Action 9: transferring risks among, or allocating excessive capital to, group members;

Action 10: engaging in transactions which would not, or would only very rarely, occur between third parties

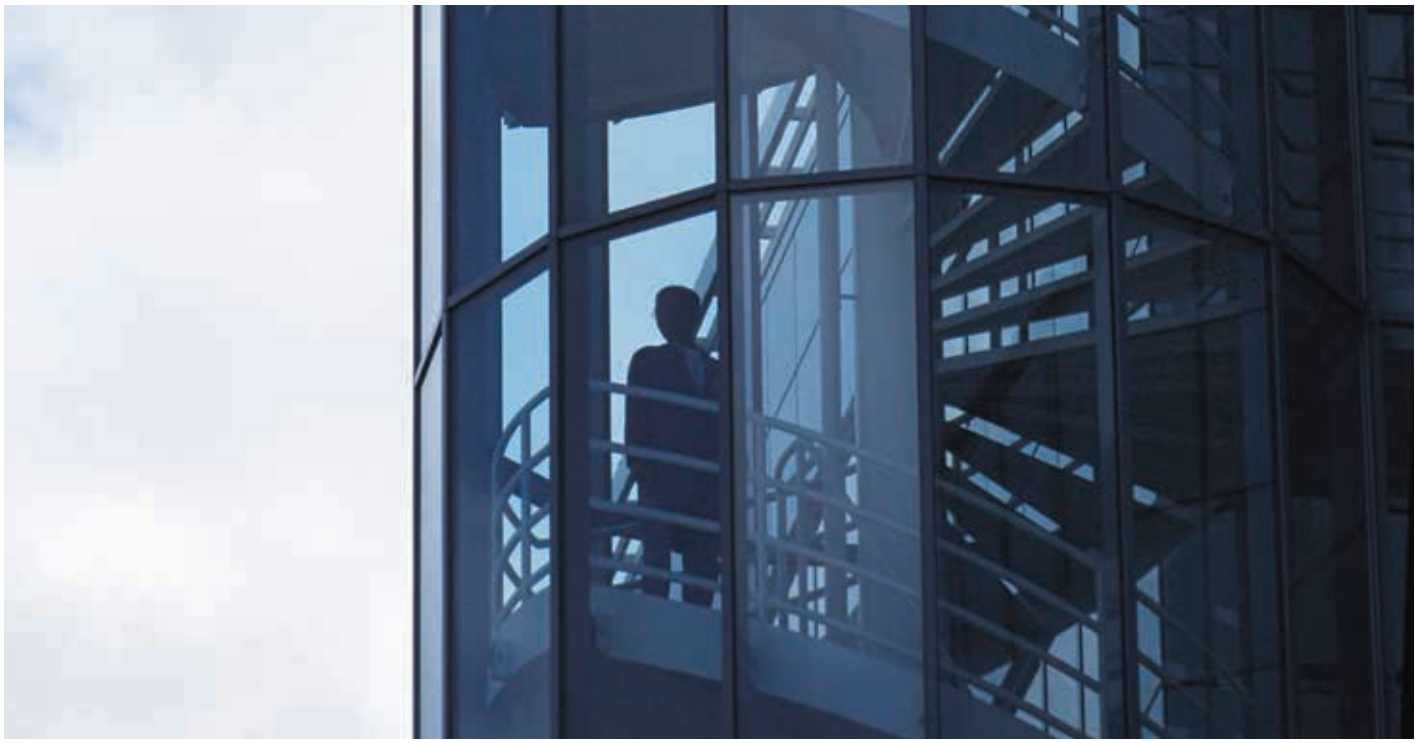
Introduction

Actions 8, 9, and 10 of the BEPS Action Plan relate to a number of closely related topics. These include the development of: (i) rules to prevent BEPS by moving intangibles among group members; (ii) rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members, which will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital and to require alignment of returns with value creation; and (iii) rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties.

Under these Action Items, the OECD released more discussion drafts than any of the other Action Items. Specifically, the OECD released the following deliverables under Actions 8, 9, and 10: i) initial report on intangibles – September 2014, which followed after two discussion drafts; ii) discussion draft on low value-adding intra-group services – November 2014); iii) discussion draft on risk, recharacterization, and special measures ("RRSM") – December 2014; iv) discussion draft on intra-group commodity transactions – December 2014 ; v) discussion draft on profit splits in global value chains – December 2014; vi) discussion draft on cost contribution arrangements ("CCAs") – April 2015; and vii) discussion draft on hard-to-value intangibles ("HTVI") – June 2015.

On October 5, 2015, the OECD released final guidance under Actions 8, 9, and 10 in one report. The guidance takes the form of amendments to various chapters of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines). The report covers risk and recharacterization (Chapter I of the OECD Guidelines), intra-group commodity transactions (Chapter II of the OECD Guidelines), intangibles including HTVI (Chapter VI of the OECD Guidelines), services including low value-adding intra-group services (Chapter VII of the OECD Guidelines), and cost contribution arrangements (Chapter VIII of the OECD Guidelines). The following describes the key points relevant in the Actions 8-10 report:

- Chapter I – addresses the capacity to assume and control risk, the relationship between contractual arrangements and conduct, as well as the return for low functioning or "cash box" companies. It also sets out the circumstances in which transactions that lack commercial rationality can be disregarded. Given these changes and the outputs from other actions no special measures were ultimately considered to be needed. It also contains guidance on the treatment of location savings and other market features, assembled workforce and group synergies.
- Chapter II – additions to address intra-group commodity transactions. Addresses applicable methods (generally the Comparable Uncontrolled Price ("CUP") method) and the application of the methods (e.g., economically relevant characteristics) to commodity transactions.
- Chapter VI – clarifies the definition of intangibles and HTVI, discusses ownership of intangibles and transactions involving development, enhancement, maintenance, protection and exploitation ("DEPME") of intangibles. The report provides supplemental guidance for determining arm's length conditions in intangible transactions.
- Chapter VII – provides guidance regarding intra-group services transactions and an elective simplified method or safe harbor for low value-adding services.
- Chapter VIII – defines CCAs, addresses the value of contributions to CCAs and addresses the substance of CCA participants. As expected, this guidance accords with the principles in Chapters I and VI to ensure that CCAs cannot be used to circumvent the new guidance relating to intangibles and risk.



Observations

As expected from the OECD comments at the July 2015 Public Consultation, the RRSM (i.e., Chapter 1 of the OECD Guidelines) guidance has changed significantly from the discussion draft. In the final report, the OECD recommends beginning with the contractual arrangement and review it against the conduct of the parties. The final report provides guidance on risk, the control over risk, the financial capacity to assume risk, and removes content from the discussion draft regarding moral hazard. The guidance also makes it clear that non-routine profits are attributable to entities with substantive decision-making functions (in contrast "cash boxes" could only receive a risk free rate of return for funding). The new guidance also provides a theoretical framework/road map which taxpayers can follow to ensure that their ex ante allocations of risk are respected by the tax authorities. In order to increase the chances of success, taxpayers should give careful consideration to their ex ante allocation of risk on a risk-by-risk basis, should ensure that this allocation is reflected in the written contracts and that the conduct of the parties is consistent with the new OECD guidance (especially in relation to control of risks) and that the conduct remains aligned with the contractual term over its life. Attention also needs to be given to ensuring that transfer pricing documentation described under Action 13 is also wholly consistent with the approach taken on risk. The revised Chapter I makes specific reference to information likely to be included in the master file and local files as relevant to analysis of risks and their attribution. Consideration should be given to discussion of important risk allocations in the master file where the overall context of the business is presented, to support the position taken; furthermore risk allocations impacting local entities will need to be consistently documented in the local file.

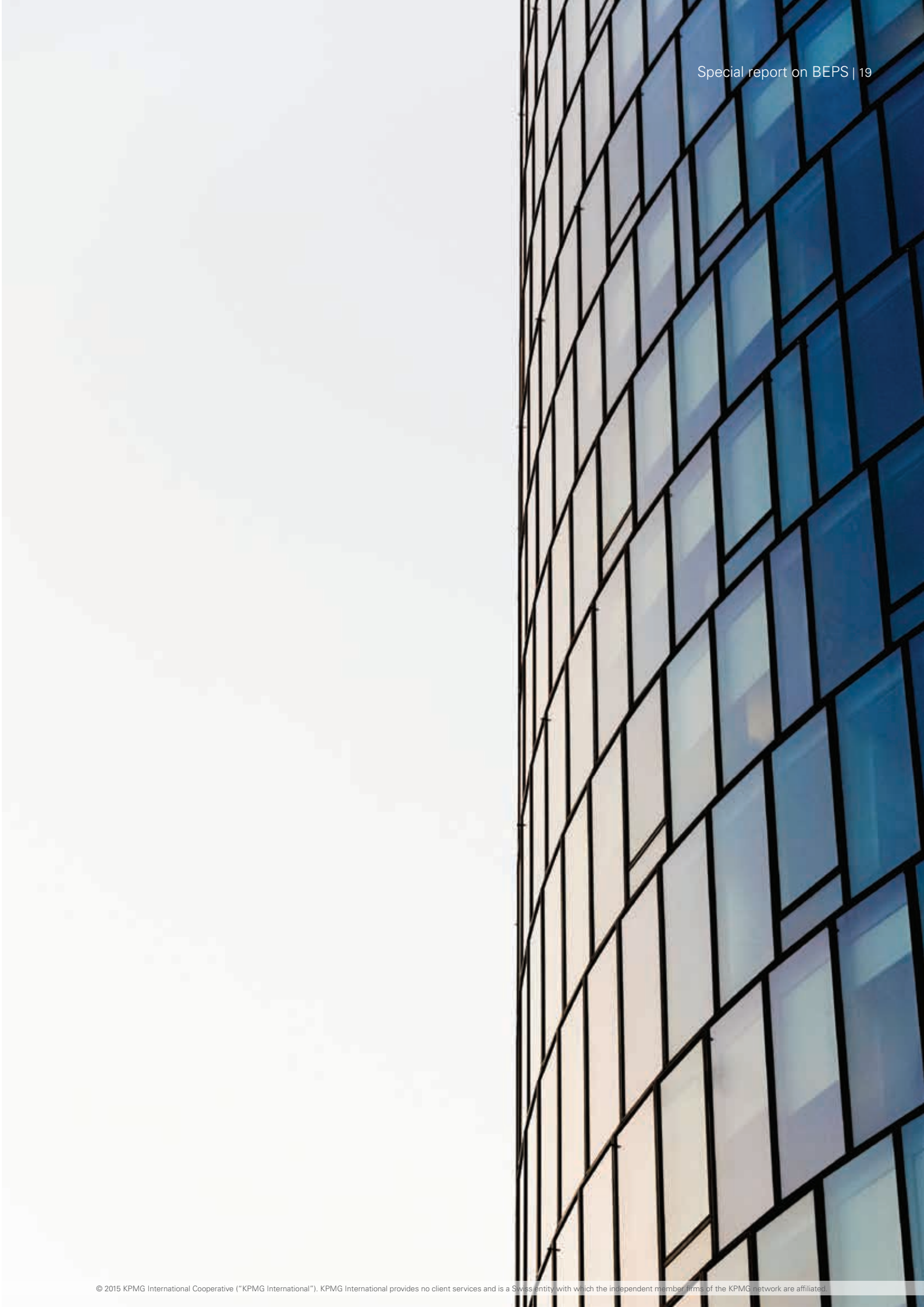
The intangible guidance in the revised Chapter VI remains largely unchanged from the September 2014 report, other than finalizing the previously provisional Section B. However, guidance on HTVI previously issued only as a discussion draft is now incorporated. Importantly, this HTVI guidance covers situations when tax administrations can use ex post evidence when evaluating ex ante pricing arrangements (corresponding to the U.S. commensurate with income approach). The final HTVI section include expanded limitations on the use of ex post evidence relative to the discussion draft.

The CCA guidance in Chapter VIII has been modified to reflect the new Chapter I, Chapter V (i.e., transfer pricing documentation as described under Action 13) , and Chapter VI guidance including HTVI. The final report still requires the contributions to be based on their arm's length value rather than on their cost, except for low value-adding services, and it now makes a distinction between contributions of pre-existing value and current contributions.

The final guidance on intra-group commodity transactions is an improvement on the earlier draft as its states more clearly that the CUP is generally an appropriate method for commodity transactions (in contrast to the "sixth method" favored by some developing countries) and provides practical guidance on what economically relevant characteristics might need to be adjusted for to ensure comparability. It also makes clearer that tax authorities can only impute the pricing date for a commodity transaction (usually the shipment date) when the taxpayer has not provided reliable evidence of the actual pricing date. These changes should significantly reduce the risk of tax authorities recharacterizing the terms and conditions of commodity transactions provided they are comprehensively documented.

As expected, the guidance on low value-adding intra-group services did not change significantly from the discussion draft. The main changes to the low value-adding intra-group services guidance include OECD recommendations that: (i) tax administrations may adopt a threshold for which if beyond the simplified method would not be allowed (the OECD does not set a specific threshold and it is up to local countries in the legislation to do so)); and (ii) the markup under the simplified approach is equal to 5 percent (as opposed to 2 to 5 percent in the discussion draft) except for on pass-through costs.

The OECD has said that as part of the follow-up work after October 2015 it will complete guidance on profits splits and financial transactions, provide implementation guidance on low value-adding services and HTVI, and will develop a transfer pricing toolkit for low income countries.



Action 11: Establish methodologies to collect and analyze data on BEPS and the actions to address it

Introduction

The BEPS Action Plan states that improving the availability and analysis of data on BEPS is critical, including monitoring the implementation of the Action Plan. In relation to the scope of Action 11, the Action Plan provides for the following: *Establish methodologies to collect and analyze data on BEPS and the actions to address it. Specifically to: Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses.* The OECD released one discussion draft under Action 11 in October 2014.

– The final report includes an assessment of the existing data sources relevant for BEPS analysis. In particular, the report assesses the existing data sources relevant for analysis of BEPS and BEPS countermeasures, describes the potential criteria for evaluating available data for BEPS research (e.g., coverage/representativeness, level of detail, timeliness), and highlights the challenges and limitations of currently available data for BEPS analysis.

– The report introduces six indicators to assist in tracking the scale and economic impact of BEPS over time, as well as two additional indicators that may be constructed in the future with better data. The proposed indicators aim to identify disconnects between financial and real economic activities, profit rate differentials within top global MNEs, tax rate differentials between MNEs and comparable non-MNEs, and profit shifting through intangibles and interest.
– The report also provides a survey of the current literature and research that measures the scale and economic impact of BEPS and BEPS countermeasures.
– The final report also includes a set of recommendations aimed at better data and tools for monitoring BEPS in the future. The list of recommendations includes, but is not limited to, a new Corporate Tax Statistics publication (which among other information would include aggregated and anonymized statistical analyses based on the data collected under the Action 13 CbyC Report) and periodic reports on the estimated revenue impacts of proposed and enacted BEPS countermeasures.

Observations

While there is a large and growing body of evidence on the existence of BEPS, measuring the scale and economic impact of BEPS has been challenging given the complexity of BEPS and current data limitations. Nevertheless, this report proposes six indicators which, when taken together, may provide general indications of BEPS – particularly when measured over time. The report also suggests potential future indicators – based on new data that will be available by way of Actions 5, 12, and 13 – that could provide further insights into the scale and economic impact of BEPS. While this report does not suggest any changes to countries' local legislation, it does outline a number of best practices in the areas of data collection and analysis, and offer some specific recommendations for better measurement in the future. With the amount of effort that the OECD and many countries have put into the OECD BEPS Action Plan, it highly likely that this area will be further developed in years to come.

Action 12: Require taxpayers to disclose their aggressive tax planning arrangements

Introduction

The goal of Action 12 is to design mandatory disclosure rules for perceived aggressive or abusive tax planning. The OECD published a discussion draft on 31 March 2015 in which it outlined the main objectives and design principles of any mandatory disclosure regime. The OECD final report provides a modular framework that enables countries without mandatory disclosure rules to design a regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes and their users.

- The report recommends the adoption of rules on the mandatory disclosure of aggressive tax planning arrangements by tax advisors (also called promoters in the report) and taxpayers.
- Such rules should include specific and generic hallmarks, such as a confidentiality clause and contingent fees, to determine whether a scheme is deemed aggressive and therefore reportable.
- The report recommends developing hallmarks that focus on the type of cross-border BEPS outcome that causes concern.
- Sanctions, especially pecuniary penalties, for non-compliance are also recommended.

Observations

BEPS Action 12 recommendations are general in nature, do not represent a minimum standard and leave countries free to choose whether or not to introduce a mandatory disclosure regime. The report mentions that both mandatory disclosure and co-operative compliance are intended to improve transparency, risk assessment and ultimately taxpayer compliance. It remains to be seen whether the recommendations will lead to rules that strike an appropriate balance between proportionality and effectiveness for both taxpayers and tax administrators.

Action 13: Re-examine transfer pricing documentation

Introduction

Action 13 recognizes that enhancing transparency for tax administrations by providing them with adequate information to conduct transfer pricing risk assessments and examinations is an essential part of tackling the BEPS problem. The OECD released three deliverables under Action 13: (i) Guidance on Transfer Pricing Documentation and Country-by-Country ("CbyC") Reporting - September 2014; (ii) Guidance on the Implementation of Transfer Pricing Documentation and CbyC Reporting– February 2015); and (iii) CbyC Reporting Implementation Package – June 2015.

- The OECD recommended a three-tiered approach to documentation that includes preparing a master file, local file and CbyC report.
- The master file is intended to provide a "blueprint" of the MNE group containing standardized information relevant for the MNE group. The local file provides additional detail on the operations and transactions relevant to that jurisdiction and the economic analyses of the intercompany transactions. Finally, the CbyC report contains summary data by jurisdiction including revenue, income, taxes, and indicators of economic activity.
- The OECD has recommended that i) the CbyC report be required for MNE groups with annual consolidated group revenue of more than €750 million; ii) will begin for MNE's fiscal year beginning on or after January 1, 2016; iii) will be filed by the ultimate parent company of the MNE in its jurisdiction (or by a surrogate parent entity); and iv) is due one year after the fiscal year end of the parent company.
- The master file and local file will be filed locally with the tax jurisdictions requiring the reports.

Observations

The final Action 13 deliverable has not changed from the guidance in the three reports prepared in late 2014 and early 2015, except for the addition of an Executive Summary. As described above in Actions 8-10, the OECD added several cross references in the final Actions 8-10 report to Action 13. Thus it will be critical for MNEs to present a coherent story starting with the contractual arrangements, the actual conduct of the parties and the write-ups of such in the transfer pricing documentation. There is still a certain ambiguity to certain some items, especially as it relates to the CbyC report and even to some extent the master file that may have many MNEs interpreting the guidance differently. Throughout the past several months, we have seen approximately 14-16 countries indicate their intent to adopt CbyC reporting, with Australia leading the way with a bill introduced to Parliament. We expect to see many more countries implementing CbyC reporting in the coming months. Master file and local file has experienced a slightly slower adoption (i.e., approximately 7 countries have indicated their intent to adopt master file and local file), with some countries opting to keep their current transfer pricing documentation requirements. Many MNEs have already started preparing their master files and CbyC reports, given the additional time and burden that these requirements are expected to take.

Action 14: Make dispute resolution mechanisms more effective

Introduction

The aim of Action 14 is to improve the effectiveness of the mutual agreement procedure (MAP) in resolving treaty-related disputes. The OECD released a discussion draft on 18 December 2014 in which the OECD attempted to identify comprehensively the obstacles that prevent countries from resolving disputes through MAP and to develop possible measures to address those obstacles. The final report reflects a commitment by all countries to adhere to a minimum standard for the resolution of treaty related disputes, and establish and submit to a monitoring mechanism to ensure that the commitments embodied in the minimum standard are fulfilled. In addition, the final report identifies best practices which are complementary to the minimum standard, but are not part of it. Finally, the final report notes that while currently there is no consensus among all OECD and G-20 Countries on the adoption of mandatory binding arbitration, a significant group of countries has committed to adopt and implement mandatory binding arbitration.

- The minimum standards and best practices identified in the report are informed by three general objectives: (1) treaty obligations are implemented in good faith and cases resolved in a timely manner; (2) administrative processes prevent disputes and promote their timely resolution; and (3) treaty eligible taxpayers can access MAP.
- Minimum Standards – The final report identifies 17 specific measures that comprise the minimum standard and are intended to be responsive to each of the stated objectives. These elements and the objective to which they relate include: (1) *Good Faith*: provide access to MAP in transfer pricing cases, provide access to MAP with respect to treaty or domestic law general anti-treaty abuse rules, resolve MAP cases within an average of 24 months, commit to membership in the Forum on Tax Administration (FTA), report MAP statistics in a complete and timely manner, agree to peer review of compliance with minimum standards in the FTA, and provide Transparency regarding reasons for rejecting arbitration; (2) *Administrative Procedures*: publish clear and easily accessible guidance and procedures for accessing and

using MAP, publish MAP profiles on shared public platform, ensure that staff in charge of MAP is authorized to resolve cases, should not use revenue or audit adjustment based performance measures for competent authority functions, ensure adequate resources provided to the MAP function, and clarify that audit settlements do no preclude access to MAP; and (3) *Access to MAP*: inform both competent authorities of MAP requests and allow for both to provide views on whether the request should be accepted or rejected, identify in published guidance the specific information and documentation necessary to be submitted to request MAP, and include in tax treaties that agreements will be implemented notwithstanding domestic law time limits, or accept alternative provisions that limit the time for making certain adjustments to avoid late adjustments for which MAP relief is unavailable.

- Best Practices – In addition to the specific minimum standard, the final report identifies 11 best practices. The best practices are not considered part of the minimum standard because they have a subjective or qualitative character that is not readily monitored or evaluated, or because not all OECD and G20 countries are willing to commit to them at this stage.
- Monitoring Mechanism – Detailed terms of reference and an assessment methodology to monitor the implementation of the minimum standard will be developed in the context of the OECD/G20 BEPS project in 2016.
- Mandatory Binding Arbitration – The following countries declared a commitment to provide for mandatory binding arbitration in their bilateral treaties: Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

Observations

The establishment of and full commitment to a minimum standard to strengthen the effectiveness of MAP coupled with monitoring and peer review is an important step forward in improving current challenges. Given the anticipated increase in controversy as a result of changes in law adopted in some countries, it is not clear that these measures will be sufficient to address all concerns. In this regard, the commitment by 20 countries to binding arbitration is a welcome development. Gaining broader commitment to the use of binding arbitration would provide greater certainty and mitigate concerns.

Action 15: Develop a Multilateral Instrument

Introduction

The purpose of Action 15 is to streamline the implementation of tax treaty-related BEPS measures through a multilateral instrument (MLI) to amend existing bilateral tax treaties. The OECD issued a report on 18 September 2014 in which it concluded that a MLI is desirable and feasible and would be negotiated through an international conference open to G20 countries, OECD members and other interested countries. On 6 February 2015, the OECD published a mandate with respect to the process for developing the MLI. On 27 May 2015, an ad hoc group was established to develop the MLI. The ad hoc group was open to all interested countries on an equal footing. To date there are 90 countries participating. The ad hoc group has agreed on a number of procedural issues so that the substantive work can begin on 5-6 November 2015. The OECD's final report reiterates the conclusions and mandate contained in its earlier publications on Action 15.

- To date there are 90 countries participating in the development of the MLI.
- Participation in the development of the MLI is voluntary and does not entail any commitments to sign the instrument once it has been finalized.

Observations

While there is precedence for a multilateral instrument (the Convention on Mutual Administrative Assistance in Tax Matters is signed by 66 countries), the MLI contemplated by Action 15 is a significantly more complicated undertaking, particularly with 90 countries participating in its development. Questions remain as to whether the instrument will offer a menu of options for participating countries, or will incorporate a fixed set of provisions with a few options. In addition, it is unclear what the relevance of the MLI will be with respect to jurisdictions between which an income tax treaty is not currently in effect. If the work on the MLI is successful, ratification of the instrument by the signatories will have the effect of amending pre-existing bilateral agreements between signatories and thus putting into law the treaty related aspects of the BEPS Action Plan without the need for separate bilateral negotiations.

Contacts

Willem Jan Paardekooper
International Tax
KPMG Meijburg & Co
T: +31 8890 91471
E: paardekooper.willemjan@kpmg.com

Brett Weaver
International Tax
KPMG in the US
T: +1 206 913 6697
E: baweaver@kpmg.com

Robin Walduck
International Tax
KPMG in the UK
T: +44 20 7311 1816
E: robin.walduck@kpmg.com.uk

Franz Prinz zu Hohenlohe
International Tax
KPMG in Germany
T: +49 89 9282 1186
E: franzhohenlohe@kpmg.com

Grant Wardell-Johnson
International Tax
KPMG in Australia
T: +61 2 9335 7128
E: gwardelljohn@kpmg.com.au

Chris Xing
International Tax
KPMG in China
T: +85 2297 88965
E: christopher.xing@kpmg.com

Vinod Kalloe
International Tax
KPMG Meijburg & Co.
T: +31 8890 91657
E: kalloe.vinod@kpmg.com

Stephen Blough
Global Transfer Pricing Services
KPMG in the US
T: +1 202 533 3108
E: sblough@kpmg.com

Clark Chandler
Global Transfer Pricing Services
KPMG in the US
T: +1 202 533 3186
E: cjchandler@kpmg.com

John Neighbour
Global Transfer Pricing Services
KPMG in the UK
T: +44 20 7311 2252
E: john.neighbour@kpmg.co.uk

Montserrat Trapé
Global Transfer Pricing Services
KPMG in Spain
T: +34 93 253 2936
E: mtrape@kpmg.es

Manal Corwin
International Tax
KPMG in the US
T: +1 202 533 3127
E: mcorwin@kpmg.com

kpmg.com/socialmedia

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