

Introduction

- On 5 October, the OECD released the final deliverables of their Base Erosion and Profit Shifting (BEPS) Action Plan
- This represents one of the most significant changes to the international corporate tax landscape since the League of Nations proposed the first bilateral tax treaty in 1928
- The OECD estimates that global revenue losses from BEPS are up to USD 240 billion annually, and they hope that these proposals will go some way to addressing this tax gap
- For the majority of Actions, these documents conclude the discussion and recommendation phase and mark the start of the implementation and practical delivery phase. This implementation phase will include a mandate for monitoring and supporting implementation
- Multinationals will need to fundamentally rethink how they view taxes in a post-BEPS world, and governments will have to think about how they balance their ambition to attract business activity through offering an attractive corporate tax system against the need to keep a more level global playing field
- In this document we summarise the key proposals, and provide our initial view on how the recommendations may translate into implementation actions and who may be most affected

Action 1: Digital Economy

October 2015 Deliverable? Yes

Key OECD proposals

- For direct tax no specific new digital taxes or permanent establishment rules are recommended. The OECD expects Digital Economy to be tackled by other Actions but leaves the door open to countries to implement domestic rules if they consider them inadequate or creating a time lag. Monitoring will continue with a further report in 2020
- For indirect taxes, a shift to collecting tax in the jurisdiction of consumption is recommended. For B2B this generally means a recharge or self assessment. For B2C remote suppliers of digital services will need to register and account for VAT in the country of residence of their customer
- A new Low Value Import Report provides options for tax authorities to tax more low value e-commerce transactions by shifting VAT obligations to the vendor/intermediary

KPMG's view

- Taxing B2C supplies of both digital services and low value e-commerce in the country of residence of the consumer will place a greater compliance burden on vendors in the global digital economy and potentially increase the cost to consumers
- It is disappointing that the report effectively encourages countries to tackle digital BEPS challenges unilaterally which will lead to global uncertainty and inconsistency

Action 2: Hybrid mismatch arrangements

October 2015 Deliverable? Yes

Key OECD proposals

- Recommendation for the introduction of domestic hybrid mismatch rules to neutralise the effect of hybrid instruments and entities
- Other recommended domestic provisions include the denial of a dividend exemption for tax deductible payments and measures to prevent hybrid transfers being used to duplicate withholding tax credits
- Proposed change to the OECD model treaty to ensure hybrid entities are not used to obtain treaty benefits unduly

KPMG's view

- The hybrid mismatch rules operate automatically and contain a primary response and a defensive rule to avoid double taxation and to ensure that the mismatch is eliminated even where not all jurisdictions adopt the rules. It is noted that countries will be free to decide whether to apply the rules to mismatches in respect of intra-group hybrid regulatory capital instruments
- Companies with existing intra-group financing arrangements will need to assess the impact if the recommended rules were to be introduced by a relevant jurisdiction. In this regard, the UK has already announced its intention to introduce domestic rules to give effect to the OECD's recommendations on hybrids from 1 January 2017

Action 3: CFC Rules

October 2015 Deliverable? Yes

Key OECD proposals

- As with the earlier discussion draft, the final recommendations are in the form of "building blocks" that are considered necessary for the design of effective CFC rules. The six building blocks include the definition of a CFC and of CFC income and the attribution of CFC income
- The recommendations are not minimum standards, but they are designed to ensure that countries which choose to implement them will have CFC rules that effectively prevent taxpayers from shifting income into foreign subsidiaries

KPMG's view

- The OECD clearly recognises the need for flexibility in this area, as the design of CFC rules in different countries reflect differing policy objectives, in particular depending on whether they have a worldwide or territorial tax system or whether they are EU members
- The definition of CFC income is one of the key building blocks, but is an area where there are clearly differing views. A non-exhaustive list of approaches (e.g. substance and excess profits analysis) has been included to accommodate those differing views

Action 4: Interest deductions

October 2015 Deliverable? Yes

Key OECD proposals

- Recommendation of Fixed Ratio Rule (FRR) of tax relief for net interest of 10% to 30% of EBITDA, applied to net (including third party) interest at an entity level
- A Group Ratio Rule (GRR) would enable groups that are more highly leveraged with third party debt to apply the worldwide ratio rather than the country's FRR (possible 10% uplift to prevent double taxation)
- Alternatives to the GRR include an "equity escape" rule or no GRR provided the FRR is applied to both multinational and domestic groups
- Suggested further options: a de minimis threshold, public benefit exemption, carry forward of disallowed interest expense and/or unused interest capacity, and other targeted anti-avoidance rules

KPMG's view

- The recommendations are in line with our expectations, and most countries are expected to select a FRR in the range of 20% to 30% of EBITDA
- The GRR, if adopted, is likely to be of more benefit to largely domestic groups
- Implementation is key: some countries that have restrictions on interest deductions may be reluctant or slow to change these if they believe they are already effective
- This Action will affect all international investors, with some more acutely affected e.g. Infrastructure, PE, Real Estate and other "highly leveraged" groups. Banking and Insurance sectors must wait for more further work to be completed in 2016

Action 5: Harmful tax practices

October 2015 Deliverable? Yes

Key OECD proposals

- Introduction of the Nexus principle to link benefits under preferential IP "Box" regimes to a claimant's proportionate contribution to R&D activities underpinning the income
- New Nexus based regimes to be introduced from July 2016 with use of current regimes permitted in certain circumstances until June 2021 under grandfathering provisions
- Introduction of compulsory spontaneous exchange of information on certain rulings from April 2016. Applies to past rulings, and new entrants to IP boxes post February 2015
- All IP regimes will require change to reflect Nexus principle and non-IP regimes will be reviewed to ensure in line with new substance requirements

KPMG's view

- The Nexus principle will introduce considerable complexity to IP "Box" regimes and, for many taxpayers, is likely to restrict overall benefits, particularly those groups operating multiple R&D centres on a global basis
- Taxpayers should be aware that information will be exchanged spontaneously in relation to certain rulings including on preferential regimes, unilateral transfer pricing and PEs

Action 6: Treaty abuse

October 2015 Deliverable? Yes

Key OECD proposals

- As a minimum standard, to counter treaty shopping countries will include one of the following types of rules: (1) A combined approach of both a Principal Purposes Test ("PPT") and Limitation on Benefits ("LOB") rule in tax treaties; (2) A PPT rule alone in tax treaties; or (3) An LOB in tax treaties supplemented by domestic anti-conduit financing legislation
- Suggested specific anti-abuse rules for transactions seeking to prevent source taxation of immovable property, low taxed PEs, holding periods for short term dividend transfer transactions, dual resident companies
- Still to be finalised in early 2016 is the recommended wording for the LOB clause (pending the finalisation of the US new model tax treaty) and the treaty entitlement of non-CIVs

KPMG's view

- We welcome the OECD's recognition of the need for flexibility
- The deferral in finalising the LOB provisions to align them with the US model treaty seems sensible, despite this involving a degree of residual uncertainty
- Whilst there is recognition of the importance of non-CIV funds and their treaty entitlement, the lack of clarity for such funds is unhelpful (although understandable, given the deferral of finalisation of the LOB provision)

Action 7: Definition of PE

October 2015 Deliverable? Yes

Key OECD proposals

- Revised proposals to change the PE definition would result in a significant extension to the definition of a PE
- The circumstances in which a "dependent agent" PE can be created will be significantly widened - for example, it will extend to situations where a person "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise"
- The list of excepted activities will be subject to an overriding precondition that they be "preparatory or auxiliary" in nature
- A new anti-fragmentation rule will be introduced, applying where complementary functions that are part of a cohesive business operation are carried on by the same or a closely related enterprise

KPMG's view

- The proposed changes to the definition of PE are far reaching, and will need to be considered by every multinational
- The scope of some of the changes (in particular relating to "dependent agents") has been slightly narrowed compared to earlier proposals. However, the final proposals remain inherently less precise than the current PE definition and so will generate significant uncertainty for business

Actions 8-10: IP and TP outcomes

October 2015 Deliverable? Yes

Key OECD proposals

- Legal ownership of an intangible does not of itself provide a right to all (or even any) of the return generated from its exploitation. Instead those returns accrue to the entities which carry out DEMPE functions - development, enhancement, maintenance, protection and exploitation - in relation to that intangible
- The new guidelines emphasise the need to accurately delineate a transaction so that the conduct of parties will replace contractual arrangements where they are incomplete or out of line with the conduct. Transactions can be disregarded for TP purposes where they lack commercial rationality
- Return for risk is allocated to the party which controls it and has the financial capacity to assume it. An entity only providing capital will be entitled to no more than a risk free return
- Enhanced rules on how to apply the CUP (comparable uncontrolled price) methodology to commodity transactions
- A safe harbour for low value adding services recommended, with a light touch benefits test and prescribed net cost plus margin of 5%
- Changes to the rules on Cost Contribution Arrangements to align them with the other TP outcomes

Actions 8-10: IP and TP outcomes (cont.)

KPMG's view

- Other than some clarification of continuing to recognise contractual terms where they align with conduct and the significance of the financial capacity to assume risk there is little change from the previous discussion drafts and the recommendations are consistent with the overall evolution of the tax treatment of intangibles, risks and capital
- These recommendations cement the importance of underlying substance and value creation over legal ownership/funding
- Whilst there is some clarification for business as a result of these recommendations (e.g. proposed safe harbours), overall we expect there to be an increase in disputes which will be time consuming and costly
- The majority of multinationals will be affected, with some sectors more acutely impacted (for example, financial services are affected by the Action 9 recommendations)

Action 11: BEPS data

October 2015 Deliverable? Yes

Key OECD proposals

- The OECD finds six indicators that it has studied point to BEPS activity costing governments between USD 100 billion and USD 240 billion a year in lost tax revenues
- The recommendations cover data to be collected by governments and methodologies to analyse data, and also the consistent presentation of data
- Improved data and analysis tools are intended to lead to better identification of any BEPS taking place and the impact of the actions taken to address BEPS

KPMG's view

- The recommendations set out are in line with our expectations
- It is difficult to assess the success of the proposed tools in monitoring BEPS until Actions are implemented more widely in a variety of jurisdictions

Action 12: Mandatory disclosure rules

October 2015 Deliverable? Yes

Key OECD proposals

- Recommendations do not represent a minimum standard and it is for countries to determine whether or not to introduce a mandatory disclosure regime
- The report recommends a modular approach to disclosure targeting features of aggressive transactions, specific domestic risk areas and cross-border BEPS outcomes of concern
- It acknowledges any implementation must be balanced with country specific needs and existing compliance and disclosure initiatives
- The report also includes information on how mandatory disclosure contributes towards enhanced transparency between tax administrations

KPMG's view

- The recommendations are in line with our expectations. The key will be in carefully targeted implementation to balance harvesting relevant information with avoiding unnecessary disclosures
- The recommendations appear heavily influenced by the UK disclosure rules and whilst they may be relatively simple to assimilate into the UK regime it is unclear how they will translate into other tax systems

Action 13: TP documentation and CbCR

October 2015 Deliverable? No

Key OECD proposals

- The three papers previously released have been consolidated to create the text of new Chapter V of the OECD Guidelines (i.e. there are no new materials published aside from the Executive Summary)
- Work continues at a local country level on the domestic implementation of the OECD recommendations in respect of Master File, Local File and Country by Country Reporting (CbCR)

KPMG's view

- Countries are already announcing new legislation to implement all three elements of Action 13
- The basis of preparation and definitions need to be tested and refined by multinationals, with transfer pricing documentation being an important tool with which they can manage their transfer pricing risk and put their CbCR data in context
- Multinationals need to have a transfer pricing documentation strategy to coordinate the content and preparation and make sure that the three elements consistently explain the group's business model
- Many tax authorities are asking for transfer pricing documentation to be submitted alongside tax returns. Transfer pricing documentation will become part of the annual tax compliance cycle

Action 14: Dispute resolution

October 2015 Deliverable? Yes

Key OECD proposals

- A strong political commitment to a minimum standard of treaty dispute resolution mechanisms and the creation of an effective monitoring mechanism to ensure progress is made
- A rapid expansion of binding mandatory arbitration amongst 20 countries through the multilateral instrument

KPMG's view

- The proposals are welcome and present an opportunity for progress to be made. However much depends on how the recommendations are implemented in practice to deliver both widespread access to Mutual Agreement Procedure (MAP) and effective dispute resolution.
- The degree of political commitment from all participating countries – but critically from those where the greatest improvements arguably need to be made (for example, India, China, Brazil) – will be key to the successful implementation of the recommendations

Action 15: Multilateral instrument

October 2015 Deliverable? No

Key OECD proposals

- No further announcements provided. The final report simply attaches the 2014 Report on the desirability and feasibility of a multilateral instrument (MLI) and the mandate for an ad hoc group to develop it
- The inaugural meeting of the Action 15 ad hoc group is to be held on 5 and 6 November 2015, to start the substantive work in developing the MLI
- Work will continue throughout 2016 to conclude the MLI and open it for signature by December 2016

KPMG's view

- The MLI could affect over 3,000 bilateral agreements so it is important that we have clarity over how it will work as soon as possible
- So far, about 90 countries are participating in the ad hoc group, including now the US

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