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# What's your BEPS action plan?

**Get legal counsel in the loop**

**Global Legal Services Network**

KPMG International

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With the tax affairs of multinational companies making headlines, and the publication of the final recommendations for the global project to address base erosion and profit shifting (BEPS), the tax functions at many companies are now examining the potential implications of BEPS for their corporate group. But tax is not the whole picture. In considering the implications of BEPS for a group's legal entities, contracts and arrangements, one cannot ignore the legal implications, and many general counsel and legal functions are not yet in the loop. Given the complexity that restructurings aimed at ensuring BEPS compliance may create — from tax and legal standpoints alike — consideration of potential legal issues should be integral to all BEPS-related impact assessments and any proposed actions that result.

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# OECD BEPS Action Plan

The Organisation for Economic Co-operation and Development (OECD) BEPS Action Plan, introduced in 2013, set out 15 specific action points to ensure international tax rules are fit for an increasingly globalized, digitized business world and to deter international companies from unfairly organizing their business arrangements in order to minimize their tax bills. On 5 October 2015, the OECD published its final recommendations, and these have since been approved by the finance ministers of the G20 nations. These will be used by national Governments as the basis for new domestic legislation, aimed at implementing the Plan's action points. In some cases, the OECD proposes new minimum standards, whereas in others, national Governments will have discretion and greater flexibility as to whether and how to implement proposed changes.

In the UK, we are already seeing concrete results in terms of near final legislation at the national level. Enough information is now available on some action points for companies and their advisors to begin mapping out the potential tax and legal implications of BEPS and think about how these changes could affect their business arrangements.

## Integrated response required

As countries put in place new domestic tax legislation in response to the BEPS recommendations, many existing corporate structures and contractual arrangements may need to be revised — or unwound and replaced entirely — to ensure they reflect the recommendations. Tax law changes may also necessitate, for example, new intra-group financing arrangements, corporate registrations of branches and companies in overseas jurisdictions to increase substance, or the transfer of intellectual property to realign ownership with the entity and the jurisdiction in which the intellectual property was developed. Ideally, these responses will be formed with legal advice from integrated teams working alongside tax and other advisers who together have a well-rounded understanding of the BEPS Action Plan and its tax, legal and other implications for global businesses.

Transfer pricing is an area where a combination of tax and legal skill is particularly critical. Tax professionals focus on whether the intercompany pricing arrangements are appropriate and whether the functions, assets and risk assumed by the parties to the arrangement support the allocation of profits across jurisdictions. Legal professionals focus on ensuring that the intercompany documentation is sufficiently robust (through inclusion of appropriate representations, warranties and covenants, for example) and determining the legal character of existing undocumented intercompany arrangements (including the appropriate governing law of an undocumented arrangement). Both perspectives are crucial to the success of any transfer pricing policies and processes.

## Charting your road map for BEPS compliance

Throughout this article, we'll explore three specific BEPS Action Plan items with implications from a legal perspective. The purpose of these examples is to illustrate the types of legal issues that may arise from the Plan and the steps that companies can take now and in the following few months to ensure that they are best placed to react quickly to the OECD's final recommendations as national Governments adopt implementing domestic legislation. Companies that are not yet looking into the potential tax and legal consequences of BEPS could be caught short by the need to unwind or alter complex corporate structures within compressed timeframes — and the longer they delay, the more difficult this will be.

# Action 2

## Neutralizing hybrid arrangements

Action Point 2 aims to neutralize the benefits of hybrid instruments, entities and arrangements. The OECD's final deliverable on the topic recommends specific re-designed model treaty provisions and domestic rules to achieve this goal.

A 'hybrid' instrument, entity or arrangement is treated differently in one tax jurisdiction from another, opening opportunities for taxpayers to obtain a tax benefit by virtue of the differing treatment. Such benefits may take the form of two tax deductions for one expense, or a deduction in one country without a corresponding income inclusion in another. The OECD expressly stated in its BEPS Action Plan that these arrangements "harm competition, economic efficiency, transparency and fairness."

Prior to the publication of the OECD's final guidance, the UK government had already announced plans to implement domestic legislation to tackle hybrid mismatches. This legislation will apply to payments made on or after 1 January 2017. No transitional period will be allowed, so affected taxpayers need to deal with their hybrid arrangements before then.

Companies in certain industries need to await further details before taking any action. For example, banks and insurers do not yet know how the OECD's final recommendations will affect hybrid regulatory capital instruments. These industries are already subject to significant governance and regulation, and whether they will be carved out from the legislative changes is not yet known. The OECD's final guidance has left it in the hands of individual national Governments to determine whether and how to apply the hybrid mismatch rules to hybrid regulatory capital instruments.

On the other hand, certain US financing arrangements commonly used by multinationals have been specifically referred to by the OECD in discussion draft documents as falling foul of the proposed model treaty changes.

Many groups are already reviewing or restructuring their US financing arrangements to be consistent with the proposed BEPS changes, working with their tax advisers to plan the most appropriate approach. In these cases, legal counsel with specialized knowledge of corporate restructuring and intragroup financing can help:

- examine transaction bibles and legal documents produced in relation to hybrid structures to confirm the terms of the existing arrangements and ensure they reflect the arrangements' reality (in respect to the terms and amount of borrowing, for example);
- determine the legal terms of any undocumented arrangements (including the appropriate governing law) and put in place documents for these arrangements as soon as possible;
- advise on the optimal route to unwind any structures from a legal perspective;
- advise on potential rationalization of the US group after the unwinding;
- provide legal input on how each step in the restructuring should be implemented;
- produce the legal documentation required to effect the implementation itself; and
- ensure that sufficient flexibility is built into the new legal structure to support any further restructuring, should BEPS related changes be implemented by certain jurisdictions in an unforeseen manner.

# Action 5

## Countering harmful tax practices — focus on patent box regimes

Action Point 5 aims to counter harmful tax practices with a priority on improving transparency and exchange of information between countries and requiring substantial business activity in a jurisdiction for access to its preferential tax regime.

In this area, the OECD has focused in on preferential intellectual property (IP) tax regimes (such as the UK patent box), which provide tax benefits for IP held within a jurisdiction. The OECD is concerned about cases where tax benefits arise, even though the IP itself was developed and originated in another jurisdiction.

For example, the UK's patent box regime allows qualifying companies to pay corporation tax on certain income from relevant IP at an effective rate of 10 percent. Germany and other EU member states have previously asserted that the UK's regime allows entities to benefit even where the links to the related research and development (R&D) activity are minimal. As a result, the UK has already agreed to implement a new IP regime from June 2016 that will follow the 'modified nexus' approach that complies with the OECD's Action 5 recommendations. The UK's existing patent box will be closed to new entrants as of June 2016 and abolished by June 2021. HMRC is currently consulting on how the patent box will be modified to comply with Action 5 and requesting views on the design of the modified patent box.

Ireland is also set to introduce a Knowledge Development Box (KDB) under which income qualifying for relief will be taxed at 6.25 percent. The Department of Finance in Ireland has taken a policy decision to design the KDB in line with the views of the EU and the OECD. The Minister for Finance confirmed that the KDB regime will follow the 'modified nexus' approach endorsed by the OECD by linking the relief under the KDB to the proportion of qualifying R&D expenditure being carried on by the company in Ireland for that innovation. While the introduction of the KDB may be a positive addition to Ireland's corporation tax offering, its impact is expected to be limited for multinational groups who typically undertake R&D activities globally.

Patent box regimes can apply to income from a broad range of IP, including:

— assets that can be identified for legal purposes and assigned or licensed separately from goodwill;

— assets that derive from advances in conducting R&D; and

— assets that have legally defined ownership interests that are not necessarily registered or disclosed.

However, the OECD's Action 5 proposals could restrict the benefits of these regimes to income from 'patents and similar rights' only. To prepare for this possibility, legal counsel's advice is needed to assess:

— which of their IP assets would continue to qualify for a patent box regime's benefits;

— whether IP assets should be registered to ensure they fall within a particular regime's scope; and

— which transfer pricing methods should be used to ensure certain income that is embedded in goods and services relating to IP assets qualifies for the regime.

# Action 7

## Preventing artificial avoidance of permanent establishment status

Action Point 7 aims to broaden the definition of permanent establishment (PE) to prevent the artificial avoidance of PE status. This action point focuses on groups that replace local subsidiaries with commissionaire and other arrangements that allow income to escape taxation in the relevant jurisdiction.

A number of high profile multinational US technology companies formerly used structures whereby a UK subsidiary undertook marketing and other activities in the UK but actual contracts for customer sales were entered into between UK customers and an offshore entity, causing the UK customer business to be (primarily) taxed outside of the country.

The UK has already sought to tackle such behavior with its Diverted Profits Tax (DPT), which took effect from 1 April 2015. The DPT applies where a non-UK company has avoided a UK taxable PE in circumstances where it has UK customers and where UK companies make excessive payments to foreign related companies that do not have the necessary substance. The 25 percent DPT is a separate tax from the usual 20 percent corporation tax.

DPT has caused some uncertainty. Some companies have opted to establish formal tax and legal structures in the UK to ensure they pay the 20 percent corporation tax, rather than risk falling within a DPT charge.

It also remains to be seen how DPT and the OECD's expanded PE definition will interact. Such concerns are spurring some companies to re-examine their global operations and whether they have a taxable PE in the jurisdictions in which they operate or do business. These companies are working with their legal counsel to:

— ensure that agency arrangements are well documented and, where needed, re-negotiate the contracts' terms that could cause a PE to arise, by specifying what activities an agent undertakes;

— undertake cross-jurisdictional feasibility assessments as to whether and how the company's presence in different jurisdictions triggers a taxable PE or a requirement to register a corporate legal presence, and determine what legal structures are available in those jurisdictions; and

— formalize their presence in jurisdictions through company incorporation or branch registration where needed.

# Assessing your readiness for BEPS — key questions

In the short-term, the swelling wave of international tax changes means companies need to analyze how specific new provisions and prohibitions may affect their current arrangements and restructure them as needed. Over the longer term, companies need to institute governance procedures to monitor evolving operating models and determine the most efficient, BEPS-compliant way of operating in the future, as well as complying with the ever growing transparency and disclosure requirements.

The following questions and considerations should act as a starting point for managing the changes to come:

— Has your company undertaken the legal due diligence it needs to act quickly, for example, by assembling relevant agreements and reviewing them for potential complications (e.g., problematic change of control terms)?

— Are legal arrangements, including the terms of intragroup loans, supported by properly executed contracts? Are the terms of those contracts (e.g., interest rates, service charges) being honored?

— Have you identified all hybrid instruments, entities and arrangements in use across your organization and put plans in motion to alter, unwind and/or replace these arrangements, where necessary, with more sustainable arrangements that reflect the OECD's recommendations?

— Have you determined whether your IP assets would qualify or continue to qualify for patent box regimes and whether action related to those assets is needed to ensure any benefits are secured?

— Have you examined the potential impact of a broadened PE definition and developed responses or alternative plans as needed?

— Do you have operations in overseas jurisdictions but no formal tax and legal registrations there? Have you assessed whether a more formal presence is required in those jurisdictions?

— Does your company have processes and systems in place to gather information for new BEPS-related disclosures (e.g., transfer pricing, country-by-country tax reporting) and present it to governments in the right form?

— Have you set protocols for regular communication of BEPS-related developments among tax and legal professionals, management, directors and other affected groups in your organization?

— Do your tax and legal teams regularly meet with company's directors to brief them on proposed restructurings and document the substantive business reasons for these and other BEPS-related decisions?

At a minimum, consider having tax and legal professionals with specialized knowledge of the BEPS agenda undertake feasibility work now to ensure you clearly understand the possible impact on your intragroup arrangements and group structures — and the underlying legal documents that are in place throughout the company. This global review will help put your company in the best position to manage the impact of BEPS-related changes as national Governments look to implement the OECD's final recommendations over the coming months.

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