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OECD releases the final package of measures under the Base Erosion and Profit Shifting ('BEPS') Project

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Background

The final package of measures under the BEPS project for reforming the international tax system was released by the Organization for Economic Cooperation and Development ('OECD') today. This is based on the BEPS Action Plan agreed to in 2013, which identified 15 actions aimed at putting an end to international tax avoidance.

Before proceeding to summarise the key measures released today, with a view to providing context to the contents of the various measures outlined by the OECD today, it may be useful to briefly refer to the 3 fundamental pillars around which the overall BEPS plan is structured:

a) Introducing coherence in the domestic tax rules that affect cross-border activity;

b) Reinforcing substance requirement to ensure that tax is aligned with the location of economic activity and value creation; and

c) Improving transparency and certainty for businesses and governments.

India, as a part of the G-20, has been closely involved in the BEPS Project. In an Indian context, actions such as addressing the tax challenges of the digital economy, preventing treaty abuse and the artificial avoidance of Permanent Establishment (PE) status as well as transfer pricing related actions assume greater significance.

The key highlights of the final package of measures vis-à-vis each of the Actions are set out below:

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Action 1: Addressing the tax challenges of the digital economy

Several of the changes recommended as part of Action 7 dealing with the artificial avoidance of PE status were developed mindful of the need to address the specific challenges posed in the context of the digital economy. These include modifying the list of exceptions to the PE definition and dealing with artificial arrangements relating to the sales of goods or services. Work in the context of Actions dealing with transfer pricing (Actions 8, 9, 10 & 13) and Controlled Foreign Company Rules (Action 3) are also expected to help address the challenges posed by the digital economy.

The importance of collection of VAT/GST on cross-border B2C transactions is also highlighted and it is recommended that countries adopt necessary steps in this regard.

Interestingly, other options such as (i) a new rule of nexus in the form of a digital presence (ii) levy of withholding tax on certain kinds of digital payments and (iii) an equalisation levy were not recommended at this stage. However, countries may, subject to treaty obligations introduce any of the above options in their domestic laws or bilateral treaties.

Work is expected to continue on this issue and a detailed report reflecting the outcome of such work is expected by 2020.

Action 2: Neutralising the effects of hybrid mismatch arrangements

This Action is addressed towards arrangements that exploit differences in the tax treatment of entities and instruments in multiple jurisdictions to obtain tax benefits such as double non-taxation or long-term deferral.

The recommendations in this regard seek to align the tax treatment of an instrument/ entity with the treatment in the other jurisdiction without otherwise disturbing the commercial outcomes. The 'primary rule' recommends that a taxpayer should be denied a deduction for a payment if it is not includible in the income of the recipient in the other jurisdiction. Alternatively, a 'defensive rule' may be applied in the jurisdiction of the recipient requiring it to include such payment in its income.

Action 3: Designing effective CFC rules

The Report on Action 3 sets out recommendations designed to ensure that jurisdictions that choose to adopt CFC rules can effectively prevent taxpayers from shifting income to foreign subsidiaries. The recommendations deal with designing rules based on various parameters including defining a CFC, exemptions and threshold requirements, defining 'income', computing the income of a CFC, attributing income of a CFC and allowability of foreign tax credits.

Action 4: Limiting base erosion involving interest deductions and other financial payments

This Action seeks to address situations where base erosion occurs as a result of groups placing excessive third party debt in high tax countries, using intra-group loans to generate interest deductions in excess of the group's actual third party interest expense and the usage of third party or intra-group financing to generate exempt income.

The recommended approach in this regard involves 'fixed ratio rule', which allows an entity to deduct net interest expense up to a benchmark net interest to EBITDA ratio within a range of 10% to 30%. This is coupled with an optional 'group ratio' which allows an entity to deduct net interest expense up to its group's net interest to EBITDA ratio (where this is higher than the aforesaid benchmark fixed ratio).

The report also acknowledges that in view of the specific requirements of the banking and insurance sectors, further work will need to be undertaken to address similar issues in these sectors.

Action 5: Countering harmful tax practices

This Action is aimed at addressing concerns around preferential tax regimes in various jurisdictions that may be used for artificial profit shifting and which lack transparency in connection with certain rulings.

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A consensus has been evolved to strengthen preferential regimes in order to ensure alignment between taxation of profits and the substantial activities that generate them. A 'nexus based approach' has been identified (which uses expenditure as a proxy for activity) as the basis for the substantial activities test.

A framework for exchanging information in relation to rulings has also been agreed upon.

Action 6: Preventing the granting of treaty benefits in inappropriate circumstances

Addressing treaty abuse and treaty shopping is seen as one of the most important areas dealt with as part of the BEPS project. Particularly, this assumes relevance in the Indian context, mindful of the Indian Government's long stated concerns on the subject.

A three-fold approach is recommended to counter treaty abuse/shopping strategies under this Action:

a) Inclusion in tax treaties of a clear statement that treaties are entered to avoid creating opportunities for non-taxation or reduced taxation through evasion or avoidance including treaty shopping arrangements.

b) A specific anti-abuse rule in the form of a comprehensive Limitation on Benefits ('LOB') Article to be included in the OECD Model convention, which will comprise various conditions based on factors such as legal nature, ownership, general activities etc.

c) In order to address other forms of treaty abuse that would not be covered within the LOB clause, a more general anti-abuse rule based on a 'Principal Purpose Test' or a PPT rule will be included in the model convention. Under this rule, if one of the principal purposes of the transaction or arrangements is to obtain treaty benefits, the benefits would be denied unless it is established that the granting of such benefits would be in accordance with the object and purpose of the treaty.

Action 7: Preventing the artificial avoidance of PE status

This Action, together with Action 6 is designed to restore taxation in cases where cross-border income would have otherwise gone untaxed or be taxed at very low rates due to the certain provisions of tax treaties.

The approach recommended under this Action comprises of:

a) Ensuring, as a matter of policy, that activities that an intermediary exercises in a country which are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, should lead to the formation of a PE of such foreign enterprise in the country. This will cover use of commissionaire structures and similar strategies.

b) Restricting the scope of the specific exceptions in Article 5(4) only to situations that fall within the ambit of preparatory and auxiliary services.

c) Ensuring that PE status is not avoided by fragmentation of business activities / splitting up of contracts between closely related enterprises.

Actions 8 - 10: Aligning transfer pricing outcomes with value creation

The work on Action 8 to 10 of the BEPS action was targeted to ensure that the transfer pricing outcomes are aligned with the value creation. The transfer pricing rules have to be aligned with the economic activity that generated the profits.

Action 8 relates to Transfer Pricing issues of transactions involving **intangibles**. The inappropriate allocation of profits results from

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incorrect valuation of intangibles which contributes to Base Erosion and Profit shifting.

Action 9 considers **contractual allocation of risk and the resulting allocation of profits** to those risks which however did not match with the activities actually carried out by the MNE. It also speaks about the level of returns to funding by the group company and the cases where returns do not match with the activity undertaken by the funding MNE.

Action 10 relates to **re-characterization of the transaction which are used as a tool for profit extraction** and are not commercially rational for the enterprises to enter into like the management fees payment route or HO expenses and if the same is not in line with the value creation by the MNE group company.

The BEPS report has come out with the revised Transfer Pricing Guideline and would be followed by the countries which adopt OECD TP guidelines. These guidelines are devised with the objective to ensure that the operational profits are allocated to the economic activities which generate the profit.

The actual transaction has to be scrutinized to ensure that the contractual relations have to be tested with the actual conduct of the parties. The objective is to allocate profits to the enterprise which conduct the business and to also look at the commercial rationale of the transaction. Under BEPS, it can also result in disregarding the transaction or arrangement for TP purpose.

The report has come out with the methodology of valuing: 'hard to value intangible' where no reliable comparable exists, valuing corporate synergies and location savings, low value adding intra-group services, Pricing of Commodities transactions. It is provided that draft guidelines will be developed in 2016 to identify the transactions wherein Profit Split Method (PSM) will be applied.

Action 11: Measuring and Monitoring BEPS

This Action provides recommendations to ensure the availability of data and tools to monitor and evaluate the effectiveness and economic impact of the BEPS Actions going forward. Indicators such as profit rates of multinational affiliates located in low tax jurisdictions vis-à-vis average profit rates, effective tax rates of multinational companies vis-à-vis pure domestic companies, concentration of FDI etc. are prescribed in this regard.

Action 12: Mandatory disclosure rules

This Action aims at providing a framework for countries to design a disclosure regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes. The objective of such a framework is to increase transparency as well as to deter taxpayers from entering into aggressive schemes. Factors such as who is required to report, what is required to be reported, the timing of the reporting as well as the consequences of non-reporting are considered.

Action 13: Transfer pricing documentation and country by country reporting

This Action Plan provides us with a standard template for Country-by-Country (CbC) reporting of income, taxes paid and certain measures of economic activity. It recommends adoption of following 3-tiered approach to transfer pricing documentation:

a) Requirement to provide tax authorities with a high-level information regarding their global business operations and transfer pricing policies in a "master file" which will be made available to all relevant tax administrations.

b) Detailed transactional transfer pricing documentation to be provided in a "local

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file" specific to each country, identification of material related party transactions, quantum involved and taxpayers analysis regarding transfer pricing determination.

c) Preparation and filing of CbC report which consists of details such as amount of revenue earned in each jurisdiction, profit before tax in each jurisdiction, tax paid in each jurisdiction, number of employees and tangible assets in each jurisdiction, etc.

These documents taken together will require taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing risks.

The Report encourages countries to adopt CbC reporting by 1 January 2016 subject to a monetary threshold of revenues equal to or exceeding EUR 750 million. Importantly, it is also acknowledged that CbC report should not be used as a substitute for a detailed transfer pricing analysis. Also, the information in the CbC report should not be used by tax administrations to propose adjustments based on income allocation formula.

The Report states that CbC reports should be field in the jurisdiction of tax residence of ultimate parent entity and can be shared between jurisdictions through automatic exchange of information agreements. The Report further states that when the ultimate parent company is not obliged to file in its jurisdiction, a secondary mechanism involving a local filing obligation on a resident subsidiary would be accepted. Needless to say, effective implementation requires domestic law changes in many countries to align existing TP documentation requirement to the content and filing mechanisms agreed in the context of BEPS project.

Action 14: Making dispute resolution mechanisms more effective

The measures developed under this Action seek to strengthen the effectiveness and efficiency of the Mutual Agreement Procedure ('MAP') under tax treaties. The minimum standard agreed to as part of this Action is expected to:

a) Ensure that treaty obligations relating to MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner.

b) Ensure implementation of administrative processes to promote quicker resolution of treaty disputes.

c) Ensuring access to MAP by eligible taxpayers

In addition to the above, several countries have declared their commitment to provide for a mandatory binding MAP arbitration in their bilateral treaties in order to ensure that treaty related disputes will be resolved in a specified time-frame. India is not a party to such a commitment.

Action 15: Developing a multilateral instrument to modify bilateral tax treaties

This Action analyses the tax and public international law issues relating to the development of a multilateral instrument to implement the BEPS recommendations.

An ad hoc group was constituted and it began its work in May 2015 with the objective of opening the multilateral instrument for signature by 31 December 2016.

Conclusion

The release of the final package of measures under the BEPS report is undoubtedly one of the most important milestones in the history of international taxation. There is undoubtedly a long way to go in terms of implementation of the various measures recommended as part of this package. However, the entire exercise represents a significant step towards evolving an international consensus on topics that have hitherto largely been addressed at the domestic and bilateral levels.

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