

Tax Policy Bulletin



OECD's Action Plan published on Base Erosion and Profit Shifting (BEPS)

19 July 2013

An Action Plan has today been published by the Organisation for Economic Cooperation and Development (OECD) with a view to addressing the perceived flaws in the international tax rules that were discussed in the OECD's February 2013 Base Erosion and Profit Shifting (BEPS) report. Today's 40 page Action Plan contains 15 separate action points or work streams, some of which are further split into specific actions or outputs.

The BEPS project has been driven by the G20, and the revenue authorities of many of its members have played an active part in the negotiations and drafting of the Action Plan. The Plan is now being presented formally to finance ministers at the Moscow G20 meeting before being remitted to the summit of the G20 leaders on 5-6 September.

Completion of the actions put forward will take one to two years, and it may take considerably longer for the impact of these changes to be fully applied in practice, although there are also indications that the BEPS project and related developments are already leading to a material shift in the behaviour of tax authorities.

Governments, revenue authorities and business will all have a material role to play over coming months if the proposed changes are to be effective.

How does the Action Plan fit in with what governments are doing?

The G8 summit in Northern Ireland on 17-18 June resulted in some strong words on tax and transparency, although there was little detail. A number of specific tax commitments in the Lough Erne Declaration covered the following (although see further our [Tax Policy Bulletin of June 2013](#)):

- automatic sharing of information,
- profit-shifting (and reporting of tax by MNCs),
- beneficial ownership of companies,
- building tax capacity in developing countries and
- reporting of income and payments by extractive companies.

At the same time as work has been going on in relation to the Action Plan, a number of territories have been assessing the nature of their own response to BEPS. There is a danger of unilateral action being discussed which makes the broad acceptance of the Plan more uncertain but all the more vital – as such unilateral action could clearly result in double taxation.

However, when Tax Commissioners from 45 countries gathered in Moscow on 16-17 May 2013 for the 8th meeting of the [Forum on Tax Administration \(FTA\)](#) they committed to coordinated action. In their final communiqué, they addressed offshore evasion, referring to leaked and shared data; increasing transparency and exchange of information, including wider adoption and use of data; increasing trust and confidence in business taxation, including refining cooperative compliance frameworks with large businesses; and improving efficiency, effectiveness and service delivery, particularly management of tax debts. The communiqué also made express reference to BEPS, and indicated a readiness on the part of the FTA to apply new standards and approaches in addressing issues arising out of the ongoing BEPS initiative.

Contents of Action Plan

The Action Plan just released lists 15 actions or work streams with accompanying timelines. For the purposes of this discussion, it seems helpful to group the OECD's proposed actions into four major categories, being (1) general actions on BEPS; (2) treaty actions; (3) permanent establishment (PE) and transfer pricing (TP) actions; and (4) data and transparency actions.

General actions on BEPS

There are five general actions directed at BEPS, being actions on: (1) the digital economy; (2) hybrid mismatch arrangements; (3) strengthening controlled foreign company (CFC) rules; (4) interest deductions and other financial payments; and (5) countering harmful tax practices.

Addressing the tax challenges of the digital economy

Technically, the first action in the Plan is arguably one of the hardest. The Plan calls for a review of different business models and a better understanding of the generation of value in the digital sector. It also notes that indirect action is to be considered and this is a hint that the tax challenges raised by digital business may be addressed more by an indirect, not direct, tax response.

The action point (to be completed within one year) is the production of an OECD report identifying the relevant issues raised by digital business (including the lack of tax nexus under current rules; the attribution of value created from the generation of marketable location-relevant data; the characterisation of income; the application of related source rules; and the effective collection of VAT/GST) and “possible actions” to address them.

Neutralising the effects of hybrid mismatch arrangements

As indicated in the Action Plan, the focus on hybrids is premised on the need to address gaps created by the interactions between domestic tax laws. The Plan states there is a need to create standards to establish international coherence in corporate income taxation. The action on hybrids in particular is explained by reference to the use of such instruments to achieve unintended double non-taxation or long-term tax deferral (e.g. by double deductions, or generating deductions without corresponding income inclusions).

The action point is multi-faceted and includes work on the Model Treaty and recommendations for domestic law change. Model Treaty provisions are to be developed to prevent undue benefits under treaties for such hybrid arrangements (presumably countering the ability of such instruments to access treaty withholding tax reductions) and various changes for domestic law are to be considered, primarily in relation to deductibility. The work on hybrids will be coordinated with the work on interest expense deduction limitations, CFCs and treaty shopping (see below). On hybrids in particular, the OECD presumably has a head start from its recent work culminating in its report on Hybrid Mismatch Arrangements, as discussed in our [April 2012 Bulletin](#).

The Action Plan calls for recommendations in relation to the Model Treaty and domestic law to be completed within one year, by September 2014.

Strengthening CFC rules

The comments in the Action Plan on the topic of strengthening CFC rules are very short. The Plan notes that the OECD has done no significant work in this area (presumably because it has been seen as a purely domestic issue). The indication is that the OECD wishes to see uniform CFC rules to counter BEPS in a more comprehensive manner. The Plan expressly refers to the positive “spill-over” effects of CFC rules due to the result that tax payers would have a much reduced incentive to shift profits into a low tax jurisdiction.

The action point is to develop recommendations regarding the design of CFC rules. The work is due to be completed within two years.

Limiting base erosion via interest deductions and other financial payments

This focus here is on the BEPS concerns from excessive deductible payments such as interest and other financial payments. The OECD concerns relate to both inbound and outbound investment scenarios. In relation to the inbound situation, the concern is with excessive interest deductions for the borrower coupled with no corresponding taxation of interest for the lender. The outbound perspective relates to the use of debt to finance the production of tax exempt or deferred income. The Plan states that rules for interest deductibility (and guarantees, derivative payments, etc) should take account of these concerns.

The action point is to develop recommendations for best practice in the design of rules to prevent BEPS through the use of interest deductions and other financial payments. The work is to evaluate different types of limitation. It is also stated that transfer pricing guidance will be developed in relation to the pricing of related party financial transactions. The work is to be completed within two years, by September 2015.

Countering harmful tax practices more effectively, taking into account transparency and substance

Unlike the other actions in the Plan, this action point is concerned with the actions of states, not corporations. The discussion in the Plan refers to the original 1990s work of the OECD on harmful tax practices, and notes that the concerns raised 15 years ago on the mobile income tax base remain just as relevant today. It is stated that traditional ring-fencing (a major target of the OECD’s work some years ago) is less relevant now given the prevalence of across-the-board tax rate reductions on particular types of income. The February BEPS report calls for solutions to counter harmful regimes more effectively, taking into account factors such as transparency and substance: the work of the Forum on Harmful Tax Practices is now to be refocused to develop more effective solutions toward this goal.

There are three major elements to the work. First, there will be a review of member country regimes, to be completed within one year. Second, a strategy is to be developed to expand participation in this area to non-OECD members. Third, and more challenging, it is proposed that revised criteria on harmful tax practices will also be developed. Both of these latter actions are intended to be completed within approximately two years.

PE and TP Actions

Artificial avoidance of PE status

The Plan identifies two specific areas which are of concern to the OECD in relation to the PE test. First, commissionaire arrangements where there may be, as the Plan notes, a shift of profit from one country to another, in circumstances where there is no substantive change in the functions performed in the first country. Second, it is noted that MNCs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and auxiliary status. Both areas are to be the subject of work to address artificial avoidance of PE status. This means that the OECD will work on amending the dependent agent test in Article 5(5) of the Model Treaty and the provisions dealing with the preparatory and auxiliary activities in Article 5(4) of the Model. It is noted that work on these issues will also address the related profit attribution issues. This work on changes to the Model Treaty is to be completed within two years.

Align TP outcomes with value creation

The Plan rejects the possibility for alternative income allocation systems (such as formulary apportionment) and confirms the preferable course is to address the flaws in the current TP system. It is noted that in many instances the TP rules work well. However, it is also stated that MNCs have in some instances used or mis-applied the rules to separate income from the corresponding economic activity and shift the relevant income into low tax environments. It is noted that this most often results from transfers from intangibles and other mobile assets. The Plan sets out action points for each of three identified areas where it is stated that there are flaws in the current system:

- Intangibles: Rules are to be developed to prevent BEPS by moving intangibles amongst group members. The work will involve adopting a broad and clearly delineated definition of intangibles; ensuring appropriate allocation of profits in accordance with value creation; developing TP rules or special measures for transfers of hard-to-value intangibles and updating the guidance on cost contribution arrangements. The work is scheduled to be completed within two years.

- **Risks and capital:** Rules are to be developed to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. The work (to be completed within two years) will focus in particular on ensuring that inappropriate returns do not accrue to an entity solely because it has contractually assumed risks or has provided capital, implying a clear ‘substance’ agenda. The rules to be developed will also require alignment of returns with value creation.
- **Other high risk transactions:** Rules will be developed to prevent BEPS by engaging in transactions which would not realistically occur between third parties. This will require clarification of the circumstances in which transactions can be recharacterised. There is also to be a clarification of TP methods, in particular profit splits, which should be applied in the context of global value chains. The work will also aim to provide protection against common types of base eroding payments, such as management fees and head office expenses. The work is to be completed within two years.

Re-examine TP documentation

The Plan notes that asymmetries in information on TP between tax payers and the tax administrations potentially enhance the opportunities for BEPS – especially as a ‘big picture’ view of the tax payers global value chain is often not available. It is also noted the differences between countries and the requirements on TP documentation lead to significant costs for business. It is therefore proposed to re-examine TP documentation to ensure transparency for the tax administration, bearing in mind the costs for business. It is specifically noted that the rules to be developed will include a requirement that MNCs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template. The work is to be completed within one year.

Treaty Actions

Prevent treaty abuse

The Plan identifies a series of measures to ensure that taxpayers cannot inappropriately use bilateral treaties to achieve a position of double non-taxation in relation to any particular activity.

At a high level, it seeks to identify whether two jurisdictions should be prepared to enter into a treaty agreement at all, in the light of the increasing number of treaties being rescinded following perceived abuse.

The action is primarily to develop within a year best practice anti-abuse clauses for use within treaties and best practice anti-avoidance rules which jurisdictions can implement via their domestic tax systems.

Make dispute resolution mechanisms more effective

Difficulties currently experienced in resolving bilateral treaty-related disputes between jurisdictions over taxing rights were highlighted in discussions between the Business and Industry Advisory Committee to the OECD (BIAC) and tax authorities during the course of the initial BEPS discussion. Many, but not all bilateral treaties include a mutual agreement procedure (MAP) based on the OECD Model Treaty and in many cases it has worked well. But even where there is a MAP article in a bilateral treaty, it often requires only that the competent authorities use their best efforts to reach agreement. Reasons for unresolved double taxation range from restrictions imposed by domestic law on the tax administration’s ability to compromise to stalemates on economic issues such as valuations.

The action, with a timeframe of two years, is to agree ways of resolving disputes where MAP does not work or is not applied. The OECD has looked at this issue previously, resulting for example in its Manual on Effective Mutual Agreement Procedures (MEMAP), so the issues are fairly well-known. The challenge remains to see whether jurisdictions can now be persuaded to do anything about them.

Develop a multilateral instrument

This action point focuses on the need for a legal basis for jurisdictions to implement many of the other action points. If it were possible to develop an instrument which overrides existing treaties or alters a number of treaties at once, that would it much easier for jurisdictions to implement necessary changes. Some helpful work has been done in this area before but there needs to be general confirmation that international law does allow it.

The action is to investigate whether it is feasible to develop an instrument of this nature and, ultimately, then to do so. There is a two year time frame for this.

Data and Transparency

Require taxpayers to disclose their aggressive tax planning arrangements

Domestic ‘disclosure initiatives’ to require the reporting of arrangements largely set up to deliver a ‘tax benefit’ (to be widely defined) will be encouraged by reference to best practice and existing experience where jurisdictions already have such regimes. The ‘modular approach’ to be recommended will mean that jurisdictions will be able to keep any existing measures, but add to them if desired. The more real-time relationships established in a number of countries, following the OECD’s project on cooperative compliance as reported in our October 2012 Bulletin, are identified as ‘useful measures’ to help taxpayers with such reporting.

There will be a particular focus on international tax schemes and sharing such information between jurisdictions. This is no doubt seeking to build on the relatively successful work of the Joint International Tax Shelter Information Centre (JITSIC) which has operated since 2004, and which has more recently included participation by the US, UK, Canada, Australia, Japan and China.

It is intended that these reporting regimes will be operating and information sharing taking place within two years.

Establish methodologies to collect and analyse data on BEPS and the actions to address it

There is recognition that there has been a lack of hard evidence to quantify the extent to which governments lose substantial corporate tax revenue because of planning aimed at eroding the taxable base and/or shifting profits to locations where they are subject to a more favourable treatment. The Plan seeks to correct this in future and also to enable analysis of the impact of the various actions which are implemented. Part of this work will require an assessment of the kind of data which taxpayers are required to report to tax authorities.

It is welcome that the action, which will take two years to deliver, identifies the need for taxpayer confidentiality to be respected and for the administrative burden on business to be considered.

Our views

The OECD's Action Plan identifies relatively comprehensively the key areas where there are current concerns relating to the international tax system. The document builds on the focal points previously identified in the BEPS report of February 2013, adding more direction and a timetable for the required work.

The Action Plan can be viewed as setting parameters for each action item but leaving considerable scope and flexibility for the Working Groups to formulate their recommendations. It reflects a good balance between, on the one hand, clearly identifying 'gaps' in the current rules, the urgency of addressing those gaps, and a roadmap for each Working Group, and, on the other hand, setting a responsible tone by putting forth guiding principles, including the need for clarity, predictability, administerability for both the governments and the taxpayers, and inclusiveness in the process (for both non-OECD countries and business).

We welcome this approach of building on, rather than abandoning, longstanding rules of international taxation and we especially welcome the statement discouraging unilateral measures on the basis such measures could lead to global chaos marked by the significant re-emergence of double taxation.

The Action Plan contains a wide range of actions and it is likely that some of these will prove easier to pursue than others. Significant challenges will be especially represented by the search for solutions to the digital business issues (which perhaps explains the more modest goal of "possible actions") and, in relation to states themselves, the development of revised criteria on harmful tax practices.

There is a very high focus on substance in the Plan and this comes through in various ways – for example in the comments on the PE rule, on recharacterisation, on the ownership of intellectual property and the focus on legal contracts for risk shifting and the general comments on TP in relation to the need of aligning TP with value creation activities.

In relation to the position of states, it seems likely that there will be gainers and losers from the process of reform encapsulated in the BEPS project and this may well make the process of future work on BEPS more difficult given the importance of achieving consensus.

It will be critical to the future success of the process that the BEPS work streams addressing these action points proceed within the framework established by the Action Plan. It will also be critical to secure constructive business input (especially with the accelerated timelines that are being pursued) to ensure that any measures developed are workable in practice – i.e. with sufficiently clear tests to permit ready compliance. This seems especially important in relation to such things as the changes contemplated to the PE rules, the recharacterisation doctrine and in relation to preventing treaty abuse.

Transparency actions may put pressure on companies from shareholders, the media, civil society organisations, etc. The most important issue for business is that a common approach is required. This will facilitate ease of compliance for business and the provision of the most informative data for regulators and the public, if such data is disclosed.

Actions

It will be important for tax payers to maintain a good awareness of the work streams carried on by the OECD and in particular the OECD's specific areas of focus.

For reasons referred to above, it will also be important that business stands ready to input into the consultation process to ensure that any rules developed can be operated at a practical level.

Given that the areas of focus of the OECD are relatively clear (particularly for example their focus on substance) it will be important to identify immediate risk areas from this agenda and address any required remediation steps. This is relevant both in connection with the current actions of the tax authorities and in relation to any future impact of the OECD work.

For our part, we will be reflecting further on the Action Plan and aiming to develop our perspectives on the action points released today – watch this space!

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