Global Tax Update
BEPS Special Edition | September 2015

JONES DAY

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BEPS Likely to Have Significant Impact on International Tax Rules

Welcome to this special edition of Jones Day's *Global Tax Update*.

Almost two years ago, the Organisation for Economic Co-operation and Development launched a radical and far-reaching review of the international tax system. The project's name, BEPS (base erosion and profit shifting), provides a good insight into its objectives: it is nothing less than an attempt by the OECD to proof the international tax system against what is perceived as widespread tax avoidance by multinational enterprises.

Because of its wide-reaching nature, the work of the BEPS project was split into 15 action groups dealing with such diverse topics as the digital economy, hard to value intangibles and hybrid mismatches. In this special edition of Jones Day's *Global Tax Update* newsletter, Jones Day tax lawyers provide summaries of the seven action groups of the BEPS project that have already reported. You can access these reports by clicking on the links at right on this page. The other eight action groups are due to report at the end of September 2015, and a further edition of the BEPS special edition will be published as soon as possible after that.

Even though the BEPS project has not ended, there is no mistaking that it will likely have a profound impact on the international tax system. Some countries have already started implementing their own versions of the BEPS recommendations. In its 2015 Finance Act, the UK introduced the diverted profits tax, a new tax which aims to counter

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arrangements in which MNEs ensure that their presence in the UK falls short of constituting a permanent establishment and therefore escape UK tax. The new rules are wide and despite what may first appear, are likely to catch situations which are not currently contemplated. They also seek, very deliberately, to be UK tax treaty "proof".

In other countries, reaction to BEPS has been more circumspect. In a letter to the US treasury, published at the end of June, US Senate Finance Committee Chairman, Orrin Hatch, and Chairman of the US House Ways and Means Committee, Paul Ryan, warned that in their view, some of the BEPS project proposals would adversely affect US companies and urged the US treasury to consult more widely before agreeing to certain of the measures suggested by the BEPS project.

The implementation of BEPS proposals is itself an interesting subject. There is no doubt that measures need to be implemented at the local level, but the fact that certain jurisdictions have already implemented certain BEPS recommendations means that, contrary to what certain individuals had feared (or perhaps hoped), it is unlikely that failure to implement by one country will stall the BEPS project. In addition, there are a number of rapidly growing economies which are not part of the BEPS project that may well decide to use the BEPS recommendations as a blueprint for their domestic rules, whether or not they are finally implemented by the members of the BEPS project. In short, BEPS is going to have a significant impact on international tax rules.

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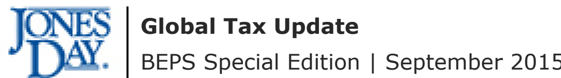

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Addressing the Tax Challenges of the Digital Economy: BEPS Action 1

On 16 September 2014, the OECD released the report on the tax challenges of the digital economy (the "Report") under its Action Plan on Base Erosion and Profit Shifting ("BEPS").

The Report recognises that because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. As a result, the Report concludes that the tax challenge and BEPS concerns raised by the digital economy are better addressed by analysing existing structures adopted by multinational enterprises, focusing on the key features of the digital economy and determining which features raise or exacerbate tax challenges or BEPS concerns.

Digital Economy: Key Features and BEPS Opportunities

The Report identifies certain key features of the new business models emerged in the digital economy that can exacerbate BEPS risks: mobility, with respect to intangibles (on which the digital economy relies heavily), users, and business functions (resulting from a decreased need for local personnel to perform functions as well as flexibility to choose location of server or other resources); the massive use of data; network effects; the spread of multi-sided business models; tendency toward monopoly or oligopoly; and volatility due to lower barriers to entry into markets and rapidly evolving technology.

The Report acknowledges that structures that can be used to implement business models in the digital economy highlight existing opportunities to achieve BEPS to reduce or eliminate tax in jurisdictions across the whole supply chain, including market and ultimate parent company countries. For example, the importance of intangibles, combined with the mobility of the same for tax purposes under existing rules, generates substantial BEPS opportunities in the area of direct taxes. The centralisation of infrastructure at a distance from a market jurisdiction and the sales of goods and services into that market from a remote location, together with the ability to conduct substantial activity with minimal use of personnel, generates potential opportunities to achieve BEPS by fragmenting physical operations to avoid taxation. Some key features of the digital economy also increase risks of BEPS in the context of indirect taxation, in particular in relation to remote supplies to VAT exempt businesses.

Tackling BEPS in the Digital Economy

The Report recognises that many of the BEPS concerns apply equally to the digital and conventional economy, and it anticipates that the work on other Actions of the BEPS

Action Plan will address some of the BEPS concerns raised by the digital economy. These include, *inter alia*:

1. Action 7 (Prevent the Artificial Avoidance of PE Status), which should ensure that core activities cannot inappropriately benefit from the exceptions to PE status and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status.
2. Actions 8, 9, and 10 (Ensure that Transfer Pricing Outcomes are in line with Value Creation), which should have the goal of reflecting the value of intangibles if they are transferred intra-group and to align income from intangibles with the economic activity that generates it. Further, they should provide clearer guidance on the application of transfer pricing methods, including profit splits in the context of the global value chain.
3. Action 3 (Strengthen CFC Rules), which should take into consideration the possible need to adapt CFC rules to the digital economy.
4. International VAT/GST Guidelines on place of taxation of B2B supplies of services and intangibles, which should minimise BEPS opportunities for supplies of remotely delivered services made to exempt businesses.

Broader Tax Challenges Raised by the Digital Economy

The Report identifies four main broader tax challenges raised by the digital economy:

1. **Nexus**. The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence to carry on business raises questions as to whether the current rules are appropriate.
2. **Data**. The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, and of how to characterise for tax purposes a person's or entity's supply of data in a transaction, for example, as a free supply of a good, as a barter transaction or some other way.
3. **Characterisation**. The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models, particularly in relation to cloud computing.
4. **VAT Collection**. Cross-border trade in both goods and services creates challenges for VAT systems, particularly where such goods and services are acquired by private consumers from suppliers abroad.

Potential Options to Address Broader Tax Challenges

The Report provides an overview of the potential options to address these broader tax challenges. They include:

1. Modification to the exemptions from PE status for activities that were previously preparatory and auxiliary in the context of conventional business models which may have become core functions of certain businesses.
2. Creation of a new nexus for fully dematerialised digital activities based on a significant digital presence. To address administrative concerns, certain minimum thresholds, based on the number of contacts, users, and levels of consumption in the market country, would be considered.
3. Replacement of the existing concept of PE with a significant presence test to reflect the relationships and interaction with customers located in a certain market country.
4. Creation of a withholding tax on digital transactions to be levied by the financial institution involved in payments.
5. Introduction of a bandwidth-tax-based or "Bit" tax on the number of bytes used by websites (creditable against corporate income tax).

6. Establishment of lower thresholds for imports of low-valued goods and requiring non-resident suppliers of remote B2C supplies to register and account for VAT purposes in the jurisdiction of the consumers.

In this regard, on 18 December 2014, the OECD released a discussion draft of guidelines concerning (i) the place of taxation of B2C supplies of services and intangibles, and (ii) provisions to support the application of these guidelines in practice.

Finally, the Report recognises that further work is required to evaluate the impact of the BEPS Project on the digital economy, focusing on nexus, data, multi-sided business models, characterisation, and potential options to address the tax challenges of the digital economy. A supplementary report is expected by the end of 2015.

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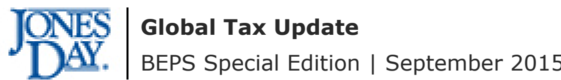

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GLOBAL TAX UPDATE

Hybrid Mismatches and the OECD Proposal: BEPS Action 2

Hybrid mismatch arrangements can be used to achieve double non-taxation including long-term deferral. The OECD report on Action 2 of the 15 BEPS Actions, titled "Neutralising the Effects of Hybrid Mismatch Arrangements", published in September 2014 (the "Report"), comprises two parts—Part I, which provides recommendations with respect to domestic law provisions, and Part II, which relates to treaty provisions.

The principal targets of the Report are tax mismatches resulting from: (i) arrangements involving tax deductions for expenses (normally interest) with no corresponding taxation of the receipt (deduction/no-inclusion or "D/NI"), or (ii) a tax deduction for the same expense in two or more jurisdictions (double deduction or "DD"). These arrangements typically involve a hybrid entity: opaque (e.g., a company) in one jurisdiction, transparent (e.g., a partnership or branch) in another; or a hybrid instrument; debt in one jurisdiction, equity in another. The Report also considers indirect hybrid mismatches where a mismatch arrangement is imported into a third jurisdiction.

Recommendation

BEPS Action 2 will be implemented based on the extent of the present mismatch. This is determined by comparing the tax treatment of the payment under the laws of each jurisdiction. D/NI mismatches occur where a proportion of payment deductible in one jurisdiction does not correspond to the proportion of ordinary income in another. DD mismatches occur where all or part of a payment is also deductible in another jurisdiction. Whilst differences in payments can give rise to mismatches by way of fluctuating foreign currency, they will not give rise to a D/NI outcome. Unilateral, equitable tax deductions will also fail to produce a mismatch because they are economically closer to a tax exemption. Hybrid mismatch rules should not be applied to entities where tax concerns are not raised. The OECD proposals in the Report are mechanical, and there is no need to show purpose.

Scope

The Report states that the hybrid mismatch rules are designed to:

- neutralise mismatches in tax treatments without changing the tax characterisation and commercial outcome of the arrangement or instrument;
- be comprehensive;
- apply automatically;
- avoid double taxation through rule co-ordination;
- minimise disruption to existing domestic law;

- be clear and transparent in their operation;
- provide sufficient flexibility to allow for implementation in each jurisdiction;
- be workable for taxpayers and keep compliance costs to a minimum; and
- be easy for tax authorities to administer.

The Report also states that jurisdictions should co-operate on measures to ensure recommendations are implemented and applied consistently and effectively. These measures include:

- developing agreed guidance on the recommendations;
- co-ordinating the implementation of the recommendations (including time);
- developing transitional rules (with no assumed grandfathering of existing arrangements);
- reviewing the effective and consistent implementation of the recommendations;
- exchanging information on the jurisdiction as treatment of hybrid financial instruments and hybrid entities;
- endeavouring to make relevant information available to taxpayers; and
- considering the interaction of the recommendations with other BEPS Actions including Action 3 (CFC rules) and Action 4 (Interest).

The Report limits the scope of the application of the recommended rules to specifically stated circumstances; most of the rules would apply only to hybrid arrangements involving related persons and members of the same controlled group or to certain "structured arrangements". "Structured arrangement" is defined as any arrangement where the hybrid characteristic is priced into the terms of the arrangement, or the facts and circumstances of the arrangement indicate that it has been designed to accomplish a hybrid mismatch.

The Report provides a nonexhaustive list of facts and circumstances that indicate the existence of a structured arrangement:

- an arrangement that is designed to create, or is part of a plan to create, a hybrid mismatch;
- an arrangement that incorporates the terms, steps or transactions used to create a hybrid mismatch;
- an arrangement that is marketed, in whole or in part, as a tax advantaged product where some or all of the tax advantage derives from the hybrid mismatch;
- an arrangement that is primarily marketed at taxpayers in the jurisdiction where the hybrid mismatch arises;
- an arrangement that contains features that alter the terms of the arrangement, including the return if the hybrid mismatch is no longer available; and/or
- an arrangement that would produce a negative return absent the hybrid mismatch.

The taxpayer will not be regarded as a party to a structured arrangement when neither the taxpayer nor any member of the same control group could reasonably be expected to know there is a hybrid mismatch and did not share any of the tax benefit resulting from such mismatch. (There is no suggestion in the Report of a possibility for jurisdictions to provide safe harbours to taxpayers.)

Two persons would be related if they were in the same control group or if one person has a 25 percent or greater investment in the second person or if a third person holds a 25 percent or greater investment in both. (In the earlier OECD discussion draft, the relationship threshold reported was 10 percent rather than 25 percent). Two persons would also be in the same control group if:

- they are consolidated for accounting purposes;
- the first person has an investment in a second person who grants the former effective control, or a third person has such an investment in the first two;
- the first person has a 50 percent or greater investment in the second person, or a third person has a 50 percent or greater investment in both; or

- the two persons can be regarded as associates of enterprises under Article 9 of the OECD Model Tax Convention. The person will be regarded as holding the investment if it directly or indirectly holds a percentage of voting rights or value in the equity of another person.

There are also rules regarding acting together, so that a person who acts together with another person in respect of ownership or control of any voting or equity rights or interest will be treated as owning the other person's rights or interest. Acting together will be deemed to happen if: (i) the persons are members of the same family; (ii) the person regularly acts in agreement with another person's wishes; (iii) the two persons have entered into an agreement that materially impacts the value or control of the assets or the ownership or control of such rights or (iv) the interests are managed by the same personal group or person. In the case of a collective investment vehicle, the presumption of acting together can be rebutted if, based on the terms and circumstances of an investment arrangement, it can be demonstrated to the satisfaction of the relevant tax authority that no such conduct is involved.

Part I of the Report—Recommendations for the Design of Domestic Rules

Part I illustrates situations where a D/NI outcome may be achieved by using both hybrid instruments and hybrid entities, but the Report refers only to hybrid entities when analysing a D/D outcome. The Report also makes recommendations in respect of payments that produce indirect D/NI outcomes.

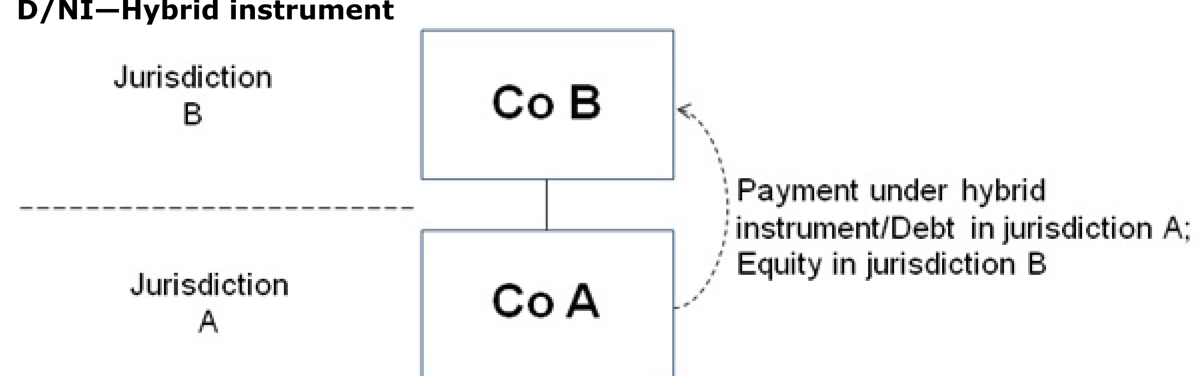
The Report proposes a primary rule or "response" in each situation that determines which jurisdiction should first counteract the mismatch and, usually, a secondary rule or "defensive" rule which applies if the primary jurisdiction does not counteract.

The recommendations are summarised in the in the report as:

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
D/NI	Hybrid financial instrument	No dividend exemption for deductible payments Proportionate limitation of with-holding tax credits	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
	Disregarded pay-ment made by a hybrid		Deny payer deduction	Include as ordinary income	Controlled group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime Restricting tax transparency of intermedi-ate entities where non-resident investors treat the entity as opaque	Deny payer deduction	-	Controlled group and structured arrangements
DD	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response, defen-sive rule applies to controlled group and structured arrangements
	Deductible pay-ment made by dual resident		Deny resident deduction	-	No limitation on response.
Indirect D/NI	Imported mismatch arrangements		Deny payer deduction	-	Members of con-trolled group and structured arrangements

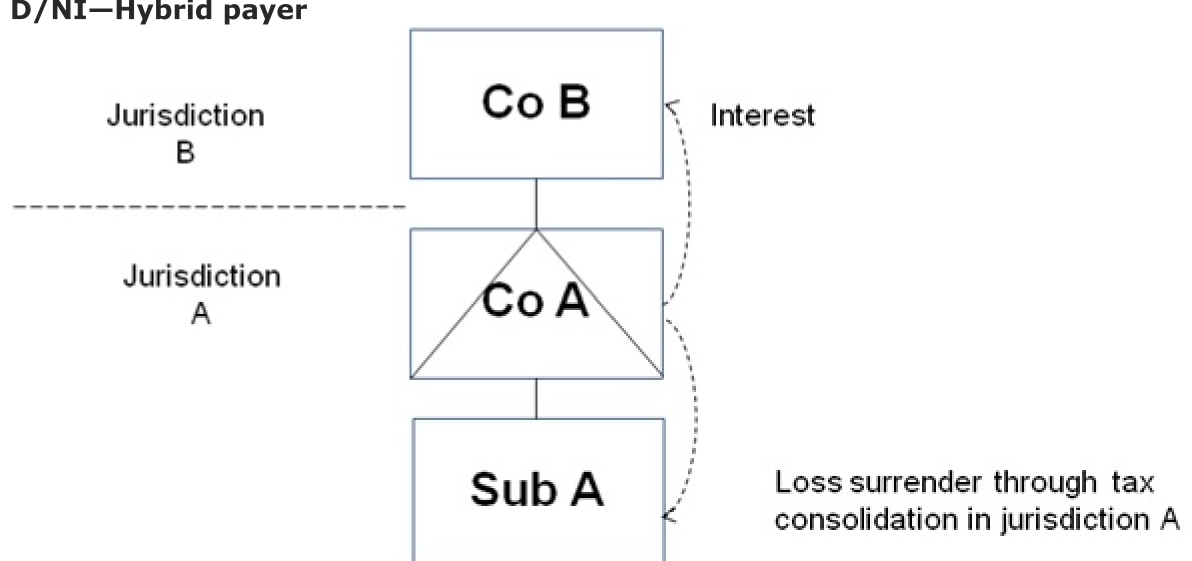
Examples

D/NI—Hybrid instrument



- Primary rule: Deny deduction for interest in Company A in jurisdiction A
- Defensive rule: Include interest as ordinary income of Company B in jurisdiction B

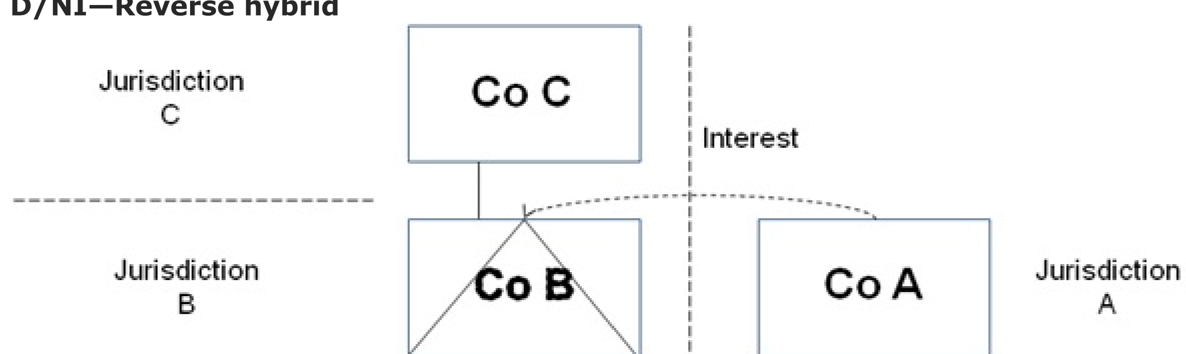
D/NI—Hybrid payer



Company B owns Company A. Company A is hybrid entity disregarded in jurisdiction B. Loan between B and A is disregarded in jurisdiction B so loan interest is N/I. Loan interest is deductible by Company A in jurisdiction A and Company A can surrender the tax benefit of its interest deduction to Sub A to shelter Sub A's profits.

- Primary rule: Deny deduction for interest in Company A in jurisdiction A
- Defensive rule: Include interest as ordinary income in Company B in jurisdiction B

D/NI—Reverse hybrid



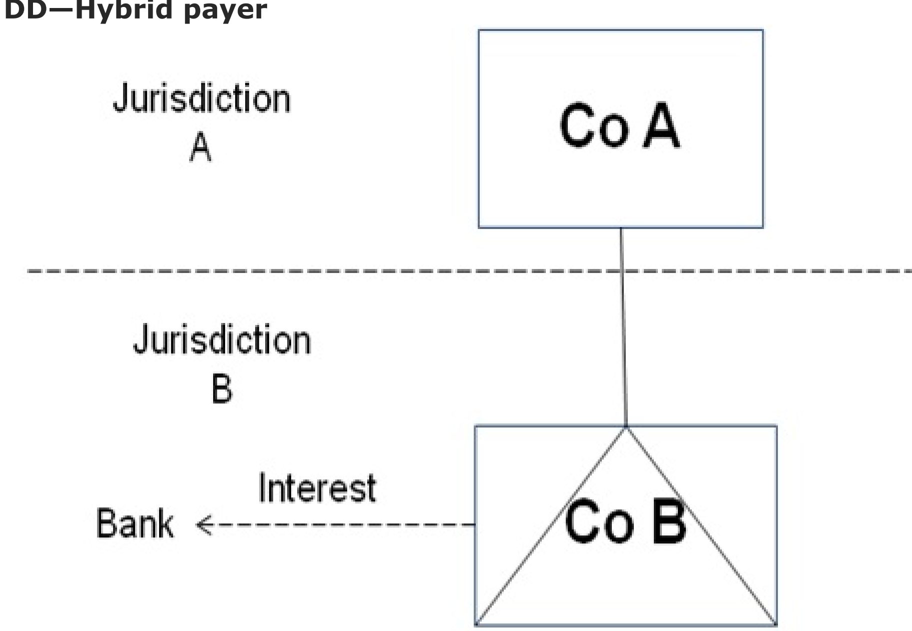
Company A pays interest to Company B. Interest is deductible for Company A in jurisdiction A.

Company B is not taxed on receipt of interest in jurisdiction B because it is a transparent entity in jurisdiction B and jurisdiction B regards Company B's income as being taxable in jurisdiction C

Company B is seen as opaque by jurisdiction C so jurisdiction C regards Company B's income as being taxable in jurisdiction B—N/I interest.

- Primary rule: Deny deduction in Company A
- Defensive rule: Not necessary as there are recommendations made in the Report regarding CFC and offshore investment regimes

DD—Hybrid payer



Company B is disregarded in jurisdiction A. Payment of interest by Company B is regarded as a deductible payment by Company A in jurisdiction A. Payment is also deductible in jurisdiction B by Company B.

- Primary rule: Deny deduction in A
- Secondary rule: Deny deduction in B
- DD payment by dual resident: Deny deduction to the extent it exceeds dual inclusion income
- No limitation in scope of primary rules but secondary rule applies only if parties are in the same control group or payment made under structured arrangements to which Company B is a party.

Indirect D/NI—Imported mismatch

- Interest deduction in jurisdiction C for Company C
- Neutral in jurisdiction A for Company A; receives interest from Company C and pays interest to Company B
- Outcome is deduction for Company C in jurisdiction C but not taxable as exempt dividend received by Company B in jurisdiction B

The Report recommends that jurisdictions should introduce legislation so that a reverse hybrid is treated as a resident taxpayer in the jurisdiction in which it is established (i) if it is not otherwise within the charge to tax on income in that jurisdiction and (ii) the accrued income of a nonresident investor in the same control group as the reverse hybrid is not within the charge to tax under the laws of the investor jurisdiction.

- Primary rule: Deny deduction in Company A
- Defensive rule: Include as ordinary income in Company B
- Backstop: Deny deduction in Company C

Part II of the Report—Recommendation on Treaty Issues

Part II examines treaty issues with recommendations on changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities are not used to obtain treaty

benefits. The recommendations also address treaty issues that may arise from the recommended domestic law changes. Part II generally reflects the proposals in the discussion drafts.

The first recommendation is to amend Article 4(3) of the OECD Model Tax Convention (part of the work on Action 6 Treaty Abuse) so that treaty residence of a dual resident entity can be determined mutually by the competent authorities of the relevant jurisdictions determining where effective control is exercised. In the absence of an agreement, the dual resident entity cannot claim treaty benefits from either of the jurisdictions involved except as agreed by the competent authorities. The Report states that this is not enough to effectively mitigate BEPS concerns with dual resident entities, however, since the entity could be resident in one state under the treaty but resident in the other state under domestic law. This could enable foreign losses to be shifted to another resident company under its domestic law group relief system and get claim treaty protection against taxation of foreign profits. The Report concludes that the solution must be to change domestic law so that a resident of one state under a double tax treaty is denied domestic residence in the other state (as is currently the case in the UK and Canada).

The second recommendation addresses the use of transparent entities to benefit from treaty provisions. The Report recommends an amendment to Article 1(2) of the Model Tax Convention to include a rule on fiscally transparent entities whereby income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of one of the contracting states will be considered to be income of a resident only to the extent that the income is treated for the purposes of taxation by that state as the income of a resident of that state.

The Report suggests that the OECD commentary on transparent entities should be widened from just a consideration of partnerships to other noncorporate entities.

Finally, Part II considers the interaction between Part I and tax treaties.

The primary response to the mismatch—the denial of deduction for a payment to the extent it gives rise to D/NI—raises questions as to whether tax treaties would permit such a denial. Deductibility issues, however, are often matters of domestic law. (Article 7 the OECD Model Treaty—Business Policies).

Defensive rule: If the payer jurisdiction cannot neutralise the mismatch, then the payee will require such payment to be included as ordinary income to the extent it gives rise to D/NI. Two recommendations were also given as to the elimination of double taxation, including preventing a dividend exemption and restricting relief in proportion to the net taxable income. Again, this is largely a matter of domestic law.

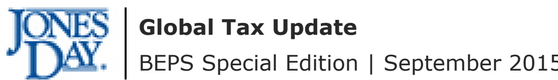
Exemption method (Article 23A) and Credit Method (Article 23B): In the case of dividends, the credit method applies even where the exemption method applies to other income. It is acknowledged, however, that a number of bilateral tax treaties depart from this provision. The Report emphasises that the credit method should be followed.

Article 23B (the credit method) advocates that relief should be restricted in proportion to the net taxable income provided under an arrangement. Double non-taxation may still occur, however, where treaty or domestic law departs from the credit method provision.

Anti-discrimination: The Report concludes that the recommendations do not appear to raise any issue of discrimination based on nationality. The rules solely govern taxation regarding an establishment's business.

Next Steps

The final OECD Report and commentary are due in September 2015.



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Countering Harmful Tax Practices: BEPS Action 5

Past Progress and Prospects

Harmful tax practices (e.g., tax havens, preferential tax regimes, tax rulings) are characterised by the propensity to erode tax bases of other countries which allegedly leads to an undesirable race-to-the-bottom on taxation rates. Action 5 of the OECD Action Plan on Base Erosion and Profit Shifting ("BEPS"), therefore, addresses the detecting and coordinated countering of such harmful tax practices, with a renewed focus on transparency and substance requirements.

Background

In 1998, the OECD Committee on Fiscal Affairs published a report on Harmful Tax Competition ("1998 Report"), with the purpose of developing a better understanding of harmful tax practices around the world. In total, 12 factors were set out in order to determine whether a preferential tax regime could be harmful.

The four key factors are: (i) no or low effective tax rates on movable sources of income, (ii) ring-fenced from the domestic economy, (iii) a lack of transparency and (iv) no effective exchange of information.

Eight other, indicative factors are: (i) an artificial definition of the tax base, (ii) no adherence to international transfer pricing principles, (iii) an exemption for foreign sources of income, (iv) negotiable tax rate, (v) secrecy provisions, (vi) wide network of tax treaties, (vii) promotion of the preferential regime and (viii) encouragement of operations that are purely tax driven.

Also, the creation of the Forum on Harmful Tax Practices ("Forum"), operating under the auspices of the Committee on Fiscal Affairs, was first proposed in this 1998 Report. The 1998 Report was followed by subsequent publications describing the progress that had been made and the steps that needed to be taken next.

BEPS Action 5

In 2013, the work around harmful tax practices was revived with the 15-point BEPS Action Plan. Action 5 of this Action Plan commits the Forum to:

Revamp the work on harmful tax practices with a priority on (i) *improving transparency*, including compulsory spontaneous exchange on rulings related to preferential regimes,

and (ii) *requiring substantial activity for any preferential regime*. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework. (numbering and emphasis added)

The Forum is expected to deliver the following outputs, in three steps:

Review of member and associate countries, by September 2014. In a 2014 interim report on Action 5 (the "2014 Report") the Forum presented a review of preferential regimes in OECD member and associate countries. The criteria from the 1998 Report were applied, as well as the newly developed substantial activity factor with regard to intangible regimes (see below). From the 2014 Report it should be understood that the monitoring of preferential regimes is an ongoing activity.

Strategy to involve non-OECD member/associate countries, by September 2015. In order to avoid non-OECD countries or non-associated countries enjoying a competitive advantage, these other countries should be involved and take up commitments as well. The outcomes of the efforts undertaken by the Forum to achieve this global level playing field will be published in September 2015.

Revision of existing criteria, by December 2015. Even though the deadline is only set in December 2015, much progress has already been made with regard to the revision of the 1998 criteria and the development of a new framework to detect harmful tax practices. The focus is put on requiring substantial activity for benefitting from preferential regimes and making tax-payer specific rulings more transparent.

Substantial Activity Requirement in IP Regimes. So far the substantial activity requirement has only been addressed in the context of IP regimes or so-called patent box systems. The main goal is to align taxation (benefits) with substance, which makes it crucial as to how substantial activity is defined. The Forum considers the 'nexus approach' the most appropriate: the tax benefits for income from IP rights only apply to the extent the taxpayer incurred the expenditures to develop this IP right. In other words, the amount of qualified expenditures incurred by the taxpayer in relation to the total expenditures incurred is considered to represent substantial activity and is used to calculate the tax benefit:

$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{overall income from IP asset} = \text{income receiving benefits}$$

(*see* 2014 Report, p. 30)

While all expenditures for activities undertaken by unrelated third parties continue to qualify as incurred expenditures, expenditures for activities of related parties are not. The costs for acquiring IP are not qualifying expenditures, while they are included in the overall expenditures.

In the aftermath of the 2014 Report a modified nexus approach was proposed by the UK and Germany. This modified nexus approach reserves the right for corporations using existing preferential intellectual property regimes to still include in the qualifying expenditures the costs incurred by related parties (such as subsidiaries) or the acquisition of IP rights, it being understood however that such up-lift can be no more than 30 percent of the regular qualifying expenditures. Moreover, it is agreed that no new taxpayers can join any existing regime the moment a new regime is put into place, and neither can new IP assets owned by existing taxpayers benefit from such tax system going forward (relevant end-date will be no later than 30 June 2016). The final abolition date of the old regime would be 30 June 2021.

Improving Transparency Through Compulsory Spontaneous Exchange. With

regard to improved transparency, the 2014 Report provides an extensive framework for the spontaneous exchange of country by country tax-payer specific rulings. First, the rulings to which such spontaneous exchange applies are identified. Several criteria are developed, some of which are identical to criteria to detect general preferential regimes. The information on the tax-payer specific ruling should be shared with all the affected countries at the latest within three months after the ruling has become available to the competent authority. The legal basis for this spontaneous exchange will be reported on in the progress report of 2015.

Next Steps

With deadlines approaching in September and December 2015, new interim reports are awaited to gain an overview of the progress made by the Forum on the three outputs it is expected to deliver. With regard to the substantial activity requirement and the modified nexus approach in particular, more details about transitional regimes, reporting requirements, practical methodologies for identifying qualifying expenditures and guidance on the definition of qualifying IP assets are expected. Concerning the compulsory spontaneous exchange of rulings an outline of the application and implementation of the developed framework are expected to come out relatively soon.

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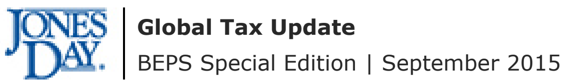
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Treaty Abuse: BEPS Action 6

Action 6 (Treaty Abuse) is a key element of the OECD's BEPS Project. Action 6 targets, in summary, "treaty shopping", i.e., where a person in country A, which is not, in principle, eligible to benefit from a given tax treaty with country B, invests through an entity in country C to benefit from the treaty. More generally, Action 6 intends to prevent the granting of treaty benefits in inappropriate circumstances.

The Original Action 6 Proposals

The original Action 6 proposal (published in September 2014) contained two approaches to the treaty shopping issue (either or both approaches could have been included in the treaties).

One approach was based on the so-called "principal purpose test" ("PPT") where the treaty benefit would be denied if it was viewed as one of the principal purposes of the relevant transaction; the second approach was a "limitation on benefits" rule ("LOB"), following essentially the typical clause included in treaties signed by the US, i.e., that only certain defined tax residents are eligible to the treaty benefit.

Each approach was criticised for its supposed weakness: the PPT was viewed as creating too many uncertainties for the market (i.e., subjectivity test), and the LOB was viewed as lacking flexibility and reflecting US domestic policy concerns. The inclusion of both approaches was a way to compromise and progress on the matter.

The Revised Proposal

Following extensive consultation and discussion, a new draft was released (May 2015) and a simplified LOB version was proposed to be used in combination with the PPT (as an alternative to the full LOB).

The simplified LOB would cover: individuals, governments, publicly traded entities, entities 50 percent or more beneficially owned by the above persons, active business, derivative benefits (i.e., entities owned 75 percent or more by equivalent beneficiaries) and competent authority discretionary relief (the relief being available where there are clear non-tax reasons, a potentially difficult hurdle, although the authorities are asked to deal "expeditiously" with the requests).

The idea behind a simplified LOB is that it may be more easily included in a "multilateral instrument", and the OECD members would then fine-tune it in their bilateral negotiations

for their respective treaties. Also, a simplified LOB should be simpler than a full one, to the extent that the PPT could take care of the remaining complexities (e.g., no base erosion test would be needed, since the PPT should exclude the relevant arrangements; also, the intermediary entities may be looked through if the relevant contracting states so decide). Still there are questions as to whether the LOB (even in its simplified format) and the PPT should be tied together, or whether the contracting states should be free to use the method they prefer.

Although the simplified LOB is supposed to be more practical for a number of situations, it is still not helpful for certain vehicles (e.g., securitisation entities) as they would need to be able to identify their beneficial owners (which is, generally, not practical).

For the regulated collective investment vehicles ("CIV"), it was concluded that the flexible findings of the 2010 OECD Report, "The granting of Treaty Benefits with respect to the income of collective investment vehicles", remain relevant (the practical implementation of the 2010 Report being facilitated if the recommendations in the TRACE project (Treaty Relief and Compliance Enhancement) are also implemented). There are still doubts as to whether the proposed language, in respect of CIVs, provides enough strong support for the implementation of the 2010 Report, and to what extent the TRACE project should be part of the implementation package.

While it is generally recognised that at least certain non-CIV funds, such as the securitisation entities, do carry an economic importance, certain member states still feel that non-CIV funds may be used for treaty shopping purposes. Thus, the non-CIV funds may, ultimately, have to rely on the discretionary relief. The situation of the non-CIV funds (which is also problematic under the PPT) may continue to be discussed after September 2015 and beyond as part of the "multilateral instrument" efforts up to December 2016.

For pension funds, it is proposed that they should qualify for the relevant treaty where 90 percent of their beneficiaries are residents of either contracting state, or of a third state if they are entitled to a treaty between the source state and such third state and would be subject to the same or lower WHT rates.

Further Developments

Regarding the PPT, and the related uncertainties, it has been proposed that four new examples be added to provide illustrations on the application of the rule. However, these examples may be viewed as being fairly simplistic, with the consequence that they do not necessarily provide actual guidance. It has been suggested that further examples should be added, including in respect of CIVs (i.e., they should not be challenged on the basis of the PPT given that their first and foremost reason for existence is not tax). It is also suggested that more effort should be put into finding a less subjective criterion for PPT purposes. Separately, it is proposed that advisory panels be formed within the states to advise on the application of the PPT. It has been also suggested that the non-application of the LOB rules should be viewed as a positive factor for the PPT analysis.

Separately, the US Delegate to the Action 6 Working Party has made a proposal to exclude from treaty relief entities benefitting from a "special tax regime" (i.e., regimes resulting in a low effective tax rate), with certain exceptions such as pension funds, charities, etc. The proposal comes very late in the process, and it does raise various issues in terms of combination with the other proposed rules. There is also a question as to whether the point should not be dealt with under other BEPS actions (e.g., Action 5 on harmful tax practices).

A final version of Action 6 is due to be released in September 2015.
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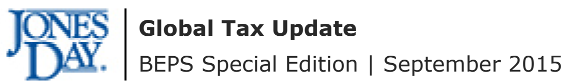

Intangible Assets: BEPS Action 8

The taxation of transactions involving intangible assets (either by licence of use or directly by their transmission) is possibly the OECD's biggest concern on transfer pricing and international tax at the moment. Action Group 8 was tasked with developing guidance on the transfer pricing aspects of intangibles.

Definition

According to the OECD guidelines, the term "intangible" refers to those non-physical or financial assets to be disposed of or controlled for use in commercial activities, transfer or whose use should be compensated as if it occurs between nonrelated parties.

Action Plan 8 develops standards to prevent BEPS as a result of intragroup transfer of intangibles with the following implications:

- Adopt a comprehensive and clear definition of "intangible".
- Ensure that the benefits associated with the transfer and use of intangible assets are properly allocated according to value creation.
- Develop transfer pricing rules or special measures for the transfer of difficult-to-value intangibles.
- Provide updated guidance in cost contribution agreements.

Special Measures Under Consideration

Alongside revised guidance on transfer pricing and intangibles, the following special measures will be considered:

- **Difficult-to-value IP**. Provide tax administration with authority to apply rules based on real results ("according with income" standards)
- **Financial returns**. Limit the return of entities that provide only financing services. Treat such entities as lenders rather than equity investors.
- **Mandatory sharing of benefits.** Apply quotas/profit split to capital gains of certain transfers of difficult-to-value IP.
- **Capitalisation**. Implement Article 7 on attribution of profit to subsidiaries regulations (asset and risk allocation through the "Significant People Function" for situations involving excessive capitalisation of low-function entities).

Key Issues Addressed in the Revised Guidance

OECD has also provided guidance in relation to intangibles, brief details of which are set forth below:

Chapter I

- **Location savings**. Should not be considered an intangible, but prices should be based on comparable transaction in the local market. When such comparable cannot be identified, comparability adjustments may be necessary.
- **Uniquely assembled workforce**. Transfers should not necessarily require a payment, but any know-how, saving time and associated costs (or any detrimental effects) should be reflected in the price according to the "arm's length" principle.
- **Synergies**. Compensation is appropriate only when there is "a deliberately concerted action of the group" which provides material advantages. The benefits should be allocated based on the contribution to the creation of synergy savings.

Chapter VI

- Intangibles continue to be classified either as "marketing" or "trading" intangibles, although it is clear that the classification of an intangible does not affect the required analysis level of transfer pricing.
- A functional analysis must be performed in order to understand how an intangible interacts with other functions, assets and risks of MNEs; therefore an analysis made from a single perspective cannot reliably value a transaction involving an intangible.
- Legal ownership alone does not confer any right to retain ultimately any return on the intangible. Also, the intangible's financing developed in isolation is likely to result in a level of return on financing other than "return on equity".
- It is possible that a dealer could increase the value of an intangible, in which case the nature of the costs and the substance of the (future) rights of the relevant part should be reviewed.
- In general, no payment should be made simply for using the trademark of the group. Any consideration paid should reflect the functions, assets and risks assumed by the user of the trademark in the improving value of the trademark in their jurisdiction.

Intangibles Developed by Employees

In relation to intangibles developed by the employees themselves, the following should be taken into account:

- Design and control of marketing and research programs.
- Priorities setting and management for creative companies, including determining the course of a "blue-sky" investigation or a basic research.
- Control over strategic decisions in relation to development of intangibles.
- Significant decisions on the defence and protection of intangibles.
- Management and control of budgets.
- Quality control of functions undertaken by others.

Studies

The studies are focusing on the following issues:

- **Intangibles based in workforce**: Comments on the organised workforce, consideration of the right to use intangible assets of temporary employees.
- **Developed IP against acquired IP**: New distinction between "intangible internally developed" and "intangible fully developed and currently exploitable".
- **Ex ante analysis**: The new definition includes a distinction between ex ante and ex post.
- **Important functions**: New list of important functions to be done/controlled by the owner.
- **Price analysis:** Potential for using an analysis not based on comparable (profit split, valuations, etc.) in the absence of comparable observations.

Tax Authority Activities

Areas in which more tax authority activity is expected include:

- Rates of input and output royalty payments.
- Price of franchise rights in which the business model is well established.
- Existence of royalties for the group name.
- Level of local marketing expenses incurred by distributors.
- Valuation of intangibles transferred within the group.
- Group's synergies captured by a centralised entity.
- Return level where the owner of intangible outsources a significant part of this development activity to related parties.
- Comparability where "local market characteristics" influencing prices are observed.
- Movements of workforce—groups and individuals who could transfer know-how.

Conclusions

The application of these regulations must overlap with a multitude of domestic tax regulations by governments that obviously seek greater economic and tax efficiency of investments globally. In view of the results of the action plan, it is clear that the OECD is not seeking a radical change in the rules governing international taxation but pursues the inclusion of numerous modifications and adjustments which may have a significant impact on the taxation of multinational companies. Further developments may be forthcoming, as the reports issued to date contain a reference to the future evolution of the outstanding areas and are, therefore, preliminary.

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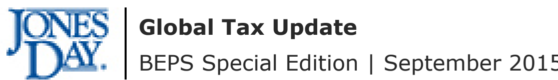

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Country-by-Country Reporting and Global Master Files: BEPS Action 13

The OECD's recent recommendations[1] with respect to transfer pricing documentation and country-by-country reporting may have the most significant impact on multinational enterprises ("MNEs") of all of the OECD's BEPS proposals. The adoption of these recommendations, without consensus on effective dispute resolution, is likely to alter the transfer pricing practices of many MNEs and may even impact their business models in the face of increased transfer pricing and nexus (permanent establishment) disputes.

What Must Be Reported?

The OECD recommends a three-tiered standardised reporting structure for MNEs with at least EUR 750 million of annual revenues, consisting of an annual country-by-country report ("CbC Report"), along with a global master file ("Global Master File") and local transfer pricing files ("Local Files"). The new reporting requirements would be effective with respect to 2016 and the first reports would thus have to be filed in 2017.

CbC Report. The OECD has published a model template for the CbC Report, which consists of three tables. The first table is an overview per jurisdiction (i.e., not per entity) of (i) the revenues, specifying both related-party and unrelated-party revenues, including service, royalty and interest income, (ii) the profits before tax, (iii) the income tax paid on a cash basis, (iv) the income tax accrued for the current year, (v) the stated capital, (vi) the accumulated earnings, (vii) the number of FTEs and (viii) the tangible assets (other than cash and cash equivalents). The second table is a list of constituent entities of the MNE per tax jurisdiction, including taxable branches and permanent establishments, and a designation of each such entity's main business activities, by ticking specific boxes. The third table allows, but does not require, the MNE to provide more information with respect to the compulsory information of tables 1 and 2.

Global Master File. The Global Master File is intended to be a "blueprint" of the MNE, or if justified, its separate business lines. It should include (i) an organisational structure chart, (ii) a description of the business, including the capabilities of the principal locations of the MNE and a brief functional analysis describing the principal contributions to value creation by individual entities within the group, (iii) an overview of the main intangibles of the MNE and of the intercompany arrangements relating to those intangibles, (iv) an overview of the financing structure of the MNE and its internal financing arrangements, (v) the consolidated financial statements of the MNE, even if the MNE is not obliged to prepare such statements, but does so only for internal management purposes and (vi) a list of existing tax rulings and advance pricing agreements "relating to the allocation of income among countries".

Where to File and Exchange of Information

The OECD recommends that the Global Master File and Local File be submitted with the local tax administration of all relevant jurisdictions and that the CbC Report be filed in the jurisdiction of the ultimate parent company or, if such jurisdiction fails to exchange the CbC Report with foreign tax administrations on undue grounds, a secondary jurisdiction. The CbC Report should then be shared automatically by the tax administration of the filing jurisdiction with foreign tax administrations based on competent authority agreements included in (i) the Multilateral Convention on Administrative Assistance in Tax Matters, (ii) bilateral tax treaties or (iii) Tax Information Exchange Agreements, provided that certain conditions are satisfied by the foreign tax administration. Unfortunately, the automatic exchange of information, as proposed by the OECD, is not subject to the condition that the other country submit to mandatory binding arbitration to effectively resolve disputes.

MNE Concerns

Pyrrhic Victory for Arm's-Length Standard. The agreement on CbC Reports and Global Master Files is a compromise between those pushing for unitary taxation with formulary apportionment and transfer pricing advocates. Even though the latter appear to have won the debate as the arm's-length standard remains, this may prove to be a Pyrrhic victory due to the acceptance of reporting standards and criteria that can easily be reconciled to a unitary taxation formula.

Inappropriate Use. The CbC Report is intended to be used by tax administrations to assess transfer pricing and BEPS risks, so that they can better allocate their audit resources and target their audit enquiries. The OECD notes specifically that jurisdictions should not propose adjustments to the income of a taxpayer on the basis of an income allocation formula based on the data from the CbC Report and that any such adjustments should be conceded promptly in any Mutual Agreement Procedure in the event of a transfer pricing dispute. It is questionable, however, if these intended safeguards indeed provide sufficient comfort to MNEs, as (i) they do not protect against transfer pricing adjustments that, although not based on formulary apportionment, are clearly tainted by such approach, and (ii) in many instances, the competent authority of the home jurisdiction of the MNE may not be a party to such transfer pricing dispute and may therefore not have a place at the table or much leverage in a Mutual Agreement Procedure.

Increase of Transfer Pricing and PE Disputes. There is consensus within the OECD that profits should be taxed where economic activities generating the profits are performed and where value is being created. In practice, however, tax administrations have differing views on what this means. In the absence of an effective dispute resolution mechanism, this is a significant concern to MNEs. The new reporting requirements will significantly increase this concern, because tax administrations of individual countries can be tempted to construe the data in the CbC Reports and Global Master Files to fit their particular perspective. This is undoubtedly going to result in more transfer pricing disputes globally and, possibly, disputes about the existence of taxable branches or permanent establishments.

No Mandatory Binding Arbitration. The OECD's work on Action 14 regarding dispute resolution is not progressing at the same pace as Action 13 and certain other actions. Unfortunately, there is no consensus within the OECD with respect to what would constitute an effective dispute resolution mechanism. According to the OECD, only 20 countries have expressed a willingness to adopt mandatory binding arbitration. Once the proposed measures of Action 13 enter into force, MNEs will thus be subjected to additional reporting requirements and the sharing of CbC Reports with governments that reject mandatory binding arbitration in the event of disputes.

Confidentiality. The CbC Reports and Global Master Files can include highly sensitive

competitive information about the MNEs. The OECD recommends that tax administrations implement legal and systematic safeguards to ensure that no sensitive competitive business information from the CbC Reports will be leaked, that all information included in the CbC Reports will remain confidential and that the tax administration of the home jurisdiction is allowed to refuse to share CbC Reports if those safeguards are not met. Recent leaks of confidential governmental information and naming and shaming in the press may not give much comfort to MNEs that confidentiality of their information will be guaranteed.

No Way Back Even Without the United States

Despite concerns expressed by MNEs, practitioners, academics and politicians,[2] the consensus reached so far means that MNEs will be confronted with these new reporting requirements, even if their home jurisdiction ultimately decides not to endorse Action 13. Many countries are likely to require MNEs to submit a CbC Report and Global Master File in their jurisdiction, regardless of whether such MNE is required to produce these reports in its home jurisdiction. It is of no surprise that some of the jurisdictions that were very quick to endorse CbC reporting are also the jurisdictions that pose most of the above-described concerns.

Next Step: Public CbC Reporting (EU Commission Proposal)

On 17 June 2015, the European Commission launched a public consultation on corporate tax transparency in the European Union. The consultation aims to assess if country-by-country reporting should become public and is scheduled to close on 9 September 2015. Given the keenness of the European Commission to respond to the public sentiment regarding the tax affairs of MNEs and the country-by-country precedents for financial institutions and large extractive and logging industries under the EU Capital Requirements Directive, EU Accounting Directive and EU Transparency Directive, MNEs should get prepared for this possible next step, which would clearly aggravate all of the above concerns.

Recommendations

Dry Run. MNEs that have not done so already should conduct a dry run and prepare a draft CbC Report and Global Master File to learn from the reports' contents. Adverse findings can then still be corrected, underlying documentation and transfer pricing can be improved and the MNE can even decide to restructure its business model, all in anticipation of the tax administration's review.

Review Existing Local Reporting Practices. Some of the most relevant data in the CbC Report are likely to come from the financial statements of individual subsidiaries. Until recently, local financial reporting requirements did not receive much attention from MNEs, but choices made when drawing up these financial statements can turn out to appear very relevant when data from the local filings is transposed to the CbC Reports.

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[1] *See* the September 2014 report "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting", the February 2015 guidance note "Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting" and the June 2015 report "Country-by-Country Reporting Implementation Package".

[2] *See* the letters by Senate Finance Committee Chairman Orrin Hatch (R-Utah) and House Ways and Means Committee Chairman Paul Ryan (R-Wis.) to the Secretary of the Treasury of 9 June 2015 and 27 August 2015.

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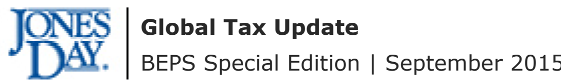

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GLOBAL TAX UPDATE

Developing a Multilateral Instrument to Modify Bilateral Tax Treaties: BEPS Action 15

The Report on Action 15 of the BEPS action plan (the "Report") was released in September 2014. The goal of Action 15 is to streamline and simplify the implementation of the other BEPS-related measures. The Report explores the technical and political issues which are to be considered under public international law and international tax law. The OECD Report concludes that a multilateral instrument is feasible and desirable. It proposes a mandate to hold a conference aiming to develop such multilateral instrument.

Proposals on Multilateral Instruments

The Report recognised that more than 3,000 bilateral tax treaties exist which vary widely in their details. Updating them requires substantial resources and time since every single tax treaty would need to be renegotiated. The Report concludes that a multilateral instrument simplifies this updating process. It describes the benefits of a multilateral instrument, which are:

- addressing treaty-based BEPS issues while respecting sovereign autonomy;
- providing flexibility, respecting bilateral relations, and a targeted scope; and
- facilitating speedy action and innovation.

Purpose of a Multilateral Instrument

A multilateral instrument will modify a limited number of provisions common in most bilateral tax treaties. Tax treaties which do not have such provisions would be amended by the provisions designed to counter BEPS. It is not intended to draft a new complete tax treaty like the existing model tax convention or to replace it. Only the provisions related to the other BEPS actions are intended to be addressed, such as:

- Dual residence structures
- Hybrid mismatch arrangements
- Triangular cases involving permanent establishments in third states
- Treaty abuse
- Transfer pricing

Only time will tell whether the multilateral instrument has an effect on future amendments to the OECD model tax convention. Currently, this is not intended.

The Report further suggests that the multilateral instrument be accompanied by an explanatory report. Such explanatory report is intended to achieve a common understanding and interpretation of the new provisions of the multilateral instrument. It

will further create a level of clarity and predictability of the tax treatment of cross-border activities.

The multilateral instrument will be binding only between the parties which have ratified it. This will have the result that a state may amend some of its tax treaties by the multilateral instrument but other tax treaties will not be affected and remain in force as they were negotiated earlier. The Report discusses the possibility that a multilateral instrument would allow states to make reservations as to individual provisions in line with practice on other international conventions. This clearly shows that international taxation will not become easier since the particular treaty position of the relevant state will need to be verified.

Technical Issues

The Report acknowledges that technical hurdles need to be resolved. Since a multilateral instrument will coexist with many bilateral treaties, potential conflicts may result. Such conflicts may be variations:

- in scope between similar provisions of existing tax treaties; or
- in wording of similar provisions of existing tax treaties

The first relates to the interaction between the new multilateral provision and an existing bilateral provision which both cover the same subject matter. Such cases raise the question as to whether the existing provisions should remain fully or partly in force in parallel to the multilateral provision. The Report suggests to address this issue by "compatibility" or "primacy" clause. The second potential conflict relates to a situation where an existing treaty uses the same terminology as the multilateral instrument but incorporates a different concept. However, the Report believes that this may be resolved by using own defined terms when necessary.

Implementation

Like existing tax treaties a multilateral instrument would be governed by international law and would be legally binding on the parties which have ratified it. The implementation will follow established international procedures of negotiation and ratification, thereby respecting domestic procedures pursuant to national law. The relationship between parties to a bilateral tax treaty which are not parties to a multilateral instrument are not affected.

Annex A to the Report describes how the multilateral instrument can resolve the technical issues like the compatibility of bilateral tax treaties concluded after the entry into force the multilateral instrument; the relationship between parties to the multilateral instrument and third parties; the entry into force of the multilateral instrument; the consistency of the interpretation and implementation and the level of commitment of a given state. All these issues have been dealt with in other international agreements the relevant provisions of which are listed as examples of how to resolve such technical issues. It further lists examples of opt-in or opt-out clauses and choice of alternative provisions.

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