

BEPS: Current Reality and Planning in Anticipation

The authors reflect on the progress so far of the OECD BEPS initiative, and consider how multinational groups could be planning in anticipation of the changes that may come out of the process.

1. The OECD BEPS Project

1.1. The BEPS report and the BEPS action plan

In February 2013, the OECD published a report summarizing its findings regarding the phenomenon of base erosion and profit shifting.¹ Although the report presented nothing substantively new (and even struggled to present significant empirical evidence to support the existence of BEPS), it concluded that an action plan should be drawn up by the OECD in order to suggest concrete ways in which BEPS could be combated and to provide information for further discussion and debate on the subject.

The action plan was duly published in July 2013. It contained an extensive list of topics for review and potential overhaul, most of which were foreshadowed in the earlier BEPS report. However, the action plan articulated the topics and proposals more clearly and contained a timetable for the envisaged reform.

The action plan was organized around 15 specific action points, which are shown in Table 1:²

1.2. OECD progress in implementing the BEPS action plan

The OECD has already begun to turn out work products for several reform areas identified in the action plan. These include the creation of an OECD task force on the digital economy; engagement with developing nations in September 2013 to discuss BEPS; the October 2013 consultation on identifying strategies that allegedly result in the artificial avoidance of “permanent establishment” status; and the November 2013 request for input regarding the tax challenges of the digital economy.

Most notable, however, are the OECD’s efforts in the transfer pricing sphere. Since the action plan was published, the OECD has issued several important transfer pricing documents, a number of which relate to previously ongoing initiatives that have been wrapped into the BEPS project. These include a white paper on transfer pricing documentation (which surveyed the current state of affairs regarding transfer pricing documentation and considered how the requirements could be simplified and improved); a revised discussion draft on the transfer pricing aspects of intangibles; and a memorandum on transfer pricing documentation and country-by-country reporting. A public consultation was held in November 2013 on transfer pricing matters, at which these documents were discussed and debated with stakeholders.

Table 1

Action point	Description	Deadline
1	Address the tax challenges of the digital economy	September 2014
2	Neutralize the effects of hybrid mismatch arrangements	September 2014
3	Strengthen CFC rules	September 2015
4	Limit base erosion via interest deductions and other financial payments	December 2015
5	Counter harmful tax practices more effectively, taking into account transparency and substance	December 2015
6	Prevent treaty abuse	September 2014
7	Prevent the artificial avoidance of PE status	September 2015
8	Assure that transfer pricing outcomes are in line with value creation: intangibles	September 2015
9	Assure that transfer pricing outcomes are in line with value creation: risks and capital	September 2015
10	Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions	September 2015
11	Establish methodologies to collect and analyse data on BEPS and the actions to address it	September 2015
12	Require taxpayers to disclose their aggressive tax planning arrangements	September 2015
13	Re-examine transfer pricing documentation	September 2014
14	Make dispute resolution mechanisms more effective	September 2015
15	Develop a multilateral instrument	December 2015

* McDermott Will and Emery, Houston and London, respectively.

1. OECD, *Addressing Base Erosion and Profit Shifting – Report: 2013* (OECD, 2013), International Organizations’ Documentation IBFD.
2. For a more detailed discussion, see C. Lowell and M. Herrington, *A Call to Rewrite the Fundamentals of International Taxation: The OECD BEPS Action Plan*, 20 Intl. Transfer Pricing J. 6 (2013), Journals IBFD.

Several of the proposed deadlines from the action plan (including the deadline for confirming changes to the OECD transfer pricing guidelines on intangibles) fall within the next nine months, with the remainder spread over the period to December 2015.

1.3. What taxpayers can expect from the BEPS project

The authors are of the view that the BEPS project is unlikely to lead to the kind of seismic changes that the OECD action plan calls for. Fundamentally, this is because effecting such a far-reaching reform of fundamental international tax principles would require a coordinated and simultaneous approach by all countries.

Even if the practical issues in implementing such a project could be overcome, it is by no means certain that the political willpower or appetite really exists for such an overhaul. While politicians in many countries continue openly to criticize BEPS and multinationals' supply chain planning, the fact remains that countries commonly utilize tax policy-making to encourage inward investment from overseas investors and facilitate credit export neutrality for their domestic taxpayers. A cynic might describe the continuing complaints about BEPS from such countries as hypocritical.

Countries are therefore ultimately always likely to prefer to retain sovereignty in setting their own tax policies, and so multilateral coordinated action in the form envisaged by the BEPS action plan is, in the authors' view, plainly unrealistic. Some changes will come, however, and even though they are unlikely to be as earth-shattering as those proposed in the BEPS action plan, they will be significant.

1.4. Non-transfer pricing specific changes

Outside the transfer pricing sphere, the authors expect the BEPS action plan to be the catalyst for some important changes, including:

- a broader definition of a “permanent establishment” (possibly incorporating place-of-consumption concepts from indirect taxes like VAT, and possibly with specific rules for digital businesses);
- enhanced information exchange. This will increasingly move in the direction of automatic exchange. This area is already evolving rapidly, in no small part due to the proliferation over the past 12 months of intergovernmental agreements with the United States relating to FATCA and also due to the actions of the European Commission, which has been spearheading a campaign within the European Union for enhanced information sharing between tax administrations and greater cooperation in the fight against perceived abusive tax practices;
- possible further developments were, in the authors' view, also foreshadowed by the UK government's announcement in October 2013 that it would be creating a register of beneficial ownership of domestic corporations, with the intention of ensuring transparency of ultimate economic ownership. The United Kingdom has also been at the forefront of developing new automatic information exchange agreements based on FATCA, which in late 2013 it extended to cover the UK Crown Dependencies and British Overseas Territories (Anguilla, Bermuda, the British Virgin Islands, the Cayman Islands, Gibraltar, the Isle of Man, Montserrat, and the Turks and Caicos

Islands) and which are likely to inform further developments in standardized forms of automatic information exchange agreements;

- limited country-by-country reporting. The authors expect some form of country-by-country reporting to come in due course, most likely with the parent company of a multinational group submitting a (standardized) OECD report template to its domestic tax administration. That report would then be shared with overseas tax administrations under the terms of existing double taxation treaties. Quite how this will apply to US corporations is unclear, however, as the US government has openly rejected the concept of country-by-country reporting (at least in the context of public reporting);
- it seems appropriate to the authors that any such requirement have a trigger-mechanism so that the burdensome reporting is applicable only to groups as to which there is likely to be base erosion potential. This could be done via an overall effective tax rate test, home country clearance procedures (via APA or similar processes that exist in many countries) or otherwise; and
- enhanced international cooperation in the collection of taxes. The authors expect it to be increasingly easy for countries to enforce tax claims against non-residents before the non-resident's domestic court system. Progress already continues to be made in this area with the increasing number of countries signing up to the Convention on Mutual Administrative Assistance in Tax Matters (developed jointly by the OECD and the Council of Europe in 1988 and amended by Protocol in 2010). All G20 countries (including China) have signed the convention, and even countries like Luxembourg and Switzerland have now signed. Many other countries have also committed to sign the convention in the coming months.

The authors also anticipate some significant inroads into the principles of international taxation by virtue of the BEPS project. This is likely to take the form of various miscellaneous changes, such as in relation to a broader permanent establishment definition. Important changes will continue to emerge in the transfer pricing sphere, due largely to the rise in power of developing nations such as China and the growth in importance of the UN transfer pricing manual. These nations tend to apply different transfer pricing methodologies than those of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations— for example, arguing that: returns should be allocated to “local market advantages” (such as location savings and market premium); formula apportionment should be used; and foreign intangibles are often overvalued at the expense of undervaluing local intangibles.

In this regard, it is notable that these concepts are being embraced by the OECD as it seeks to encourage such countries to come under its umbrella. For example, in the OECD revised discussion draft on intangibles there are suggestions that it may be legitimate to allocate a return to

location savings, utilize profit split methodologies, value certain intangibles via traditional financial valuation models (such as discounted cash flow), treat “goodwill” as an intangible and so on.

Indeed, country-by-country reporting can also be viewed as a BRICS³ concession: in transfer pricing disputes with source countries, it is common for the source country to insist on being able to examine the global financial results of the group (or at least of the affiliate entity involved). This is intended to enable the source country to check whether a greater share of the group’s profits should be allocated to the functions and risks performed in the source country. Certain countries could of course also utilize country-by-country reporting to achieve formulary apportionment (as opposed to using the reports purely as risk assessment tools).

1.5. Transfer pricing specific changes

From a transfer pricing perspective, the changes that the authors expect the BEPS action plan to lead to include:

- an increased reliance on two-sided (profit split) transfer pricing methodologies in order to confirm that a transaction is in accordance with the arm’s length principle;
- increased reliance on (and need for) APA and MAP procedures, perhaps streamlined to facilitate efficiency in the country-by-country reporting context;
- increasing awareness, and understanding, of transfer pricing within tax administrations. Many countries are now beginning to view transfer pricing adjustments as a revenue-generating tool and are building their transfer pricing capabilities. As disputes arise and are settled, tax administrations will build their practical experience of dealing with transfer pricing. Cross-border sharing of expertise and transfer pricing know-how, which is also becoming increasingly common between tax administrations, will also contribute to this trend;
- the development of country-specific “comparable” data, and sharing of databases between tax administrations. The use of such “secret” comparables (as opposed to comparables available in the public domain such as via OSIRIS) is and will likely remain highly contentious for taxpayers. However, it seems likely that developing nations in particular will regard this as a way in which to build their transfer pricing resources quickly (as has happened in many countries over the years, including Japan, Canada and Australia). Indeed, it may facilitate the replacement of the bespoke comparables adjustments that many source states use (for example, geographic adjustments in China) in an effort to bridge the gap between the non-availability of domestic market comparables and the wealth of information available in respect of more mature markets;
- progress on the simplification of transfer pricing documentation. The OECD held a public consultation on

transfer pricing matters in November 2013, where its white paper on transfer pricing documentation was discussed with business representatives. The authors were encouraged to hear the OECD’s recommending common approaches on master files and local country files, explicitly recognizing that transfer pricing documentation needs to be simple for business and accepting that the information generated by such documentation often needs to be used more effectively by tax administrations (there being a need for better use of information rather than a greater volume of information);

- reaffirmation of the arm’s length principle over unitary taxation/global formulary apportionment methodologies. The OECD strongly favours the retention of the arm’s length principle and intends to find solutions to perceived transfer pricing problems (e.g. in relation to intangibles) within the arm’s length principle wherever possible. Notwithstanding therefore the statements in the BEPS action plan about the possibility of the adoption of “special measures” in certain circumstances, the authors think this is unlikely to come to pass; and
- the finalization of the OECD revised transfer pricing guidance on intangibles (which the OECD has already committed to delivering by September 2014). Given the tenor of the 2013 revised discussion draft, the authors think it almost inevitable that the final guidance will place some (possibly undue) emphasis on the importance of allocating rewards to functions instead of to legal ownership and risk taking.

2. How Taxpayers Can Approach the BEPS Project

The authors submit that multinational groups should view the BEPS project as an opportunity. As noted, changes will inevitably flow from the project. Indeed, in some cases changes have already started to happen – for example, Ireland introduced a narrow rule at the end of 2013 to clamp down on so-called “nowhere companies” (by providing that a company incorporated in Ireland will also be tax resident in Ireland if it is managed and controlled in a country that tests tax residence by reference to the place of incorporation (e.g. the United States)).

The reality is that the international tax landscape is and will continue for the foreseeable future to be a patchwork of overlapping domestic tax regimes. This means that gaps and frictions between each regime will continue to exist, which will either fail to successfully tackle BEPS or will in fact create or exacerbate it.

A multinational group could therefore approach the BEPS project as a twofold process: (i) by assessing the possible impact of BEPS on its effective tax rate and (ii) by monitoring developments in BEPS to ensure that opportunities are seized as they present themselves. The first process is essentially defensive, whilst the second is evolutionary in nature.

.....
3. Brazil, Russia, India, China and South Africa.

2.1. Effective tax rate analysis

A group might approach the effective tax rate assessment in the following way:

- revisiting its effective tax rate plan and checking its global effective tax rate;
- establishing a simplified spreadsheet version of the effective tax rate plan and evaluating the likely impact of the outcomes of the BEPS action plan on each element; and
- segregating the elements that are material to the effective tax rate plan.

For those elements that are identified as being both material to the group's effective tax rate planning and possible targets of the BEPS action plan, the group could then begin a process of evaluating the steps that could be taken (to the extent consistent with its wider planning) in order to preserve its global effective tax rate and also develop alternative contingency paradigms.

This could be the same kind of process that is regularly used in major transfer pricing cases such as APAs and competent authority procedures, and the outcome of the plans could then be taken into account as business decisions need to be made over time.

2.2. Monitoring BEPS developments

In addition to considering the effect of BEPS on its existing effective tax rate, a multinational group should also be monitoring the concrete developments arising from the BEPS initiative as they evolve. Over time, such groups are likely to notice opportunities presenting themselves as the project rolls on. Where possible, groups could then incorporate these opportunities into their effective tax rate planning and utilize BEPS as an opportunity to actually improve their overall tax position.

In this vein, it is (in the authors' view) critical for multinational groups to actively participate in the BEPS process and in wider global dialogues on international tax matters. This should, as a minimum, be by way of participation in requests for feedback on topics such as the OECD revised intangibles guidance, but ideally should also include participation in discussions via business representative bodies such as BIAC.⁴ Only by having a seat at the table and making its voice heard can a group hope to drive the BEPS project in a direction that is beneficial to it.

3. Conclusion

The BEPS action plan has already begun to drive changes in the international tax rules, and 2014 is likely to see further changes and more concrete proposals from the OECD for reform as the BEPS project reaches its halfway point.

Individual countries such as Ireland are taking isolated steps to address perceived abusive practices. In the likely absence of a coordinated and simultaneous multilateral response from all countries to the BEPS action plan, the authors believe it is likely that increasing numbers of countries will be making changes to their own regimes to protect their respective domestic tax regimes.

As was true many generations ago when international tax principles, via treaty and domestic law, initially emerged, the current process is likely to present opportunities for multinational groups to review their effective tax rate planning and ensure that they proactively evolve in line with the BEPS process as the latter unfolds.

.....
4. Business and Industry Advisory Committee.