Base Erosion and Profit Shifting:
OECD Action Plan

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November 19, 2013

Background

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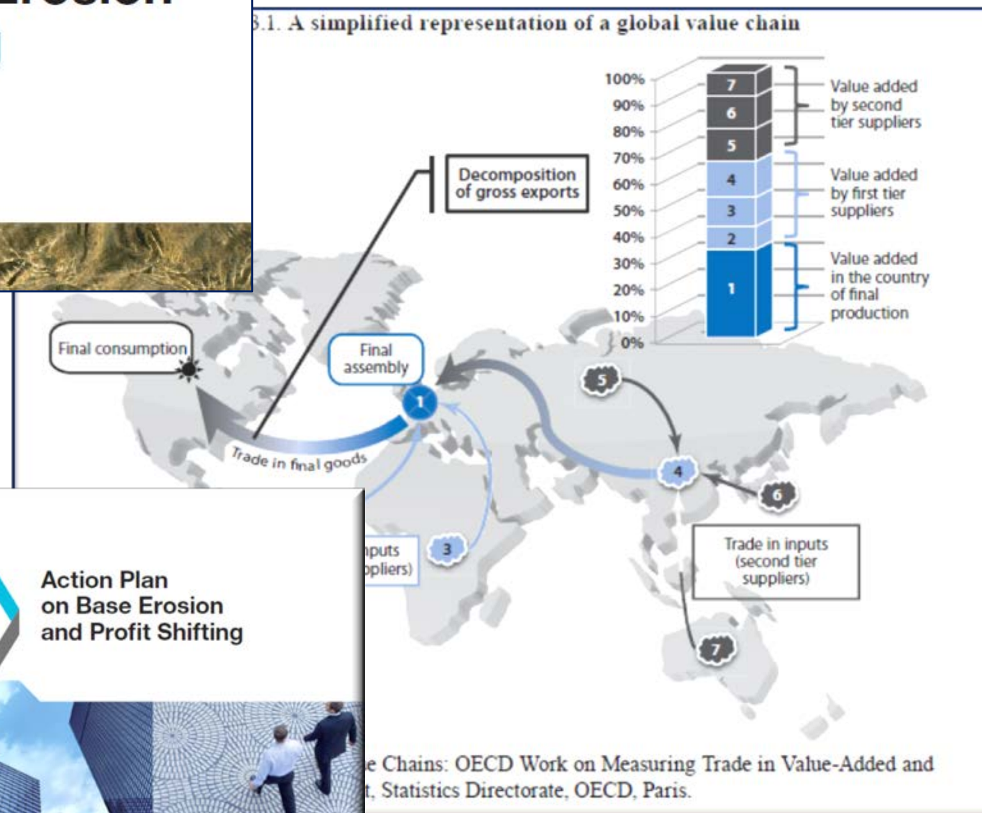
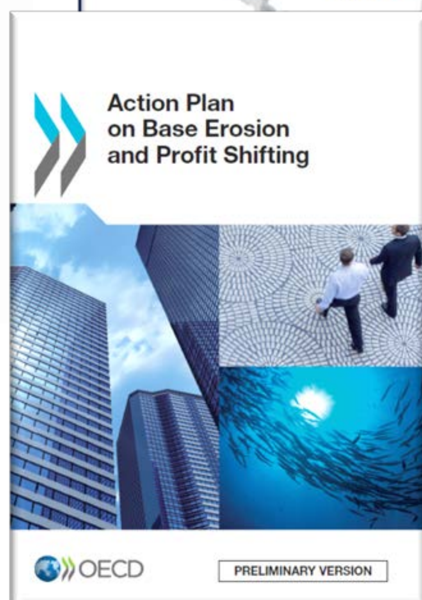
Local taxation in a global economy

tax justice network





Background

Sustained pressure for reform

- Increased global political and media attention regarding taxes
- Companies and high net worth individuals are viewed as not paying their “fair” share of tax
  - Perception that the global tax regime has not kept pace with the digital economy and other factors contributing to the erosion of the traditional tax base
  - Result – low or no overall taxation
- Perception by some that tax treaties have generally been successful in limiting double taxation but less so in fighting tax avoidance.

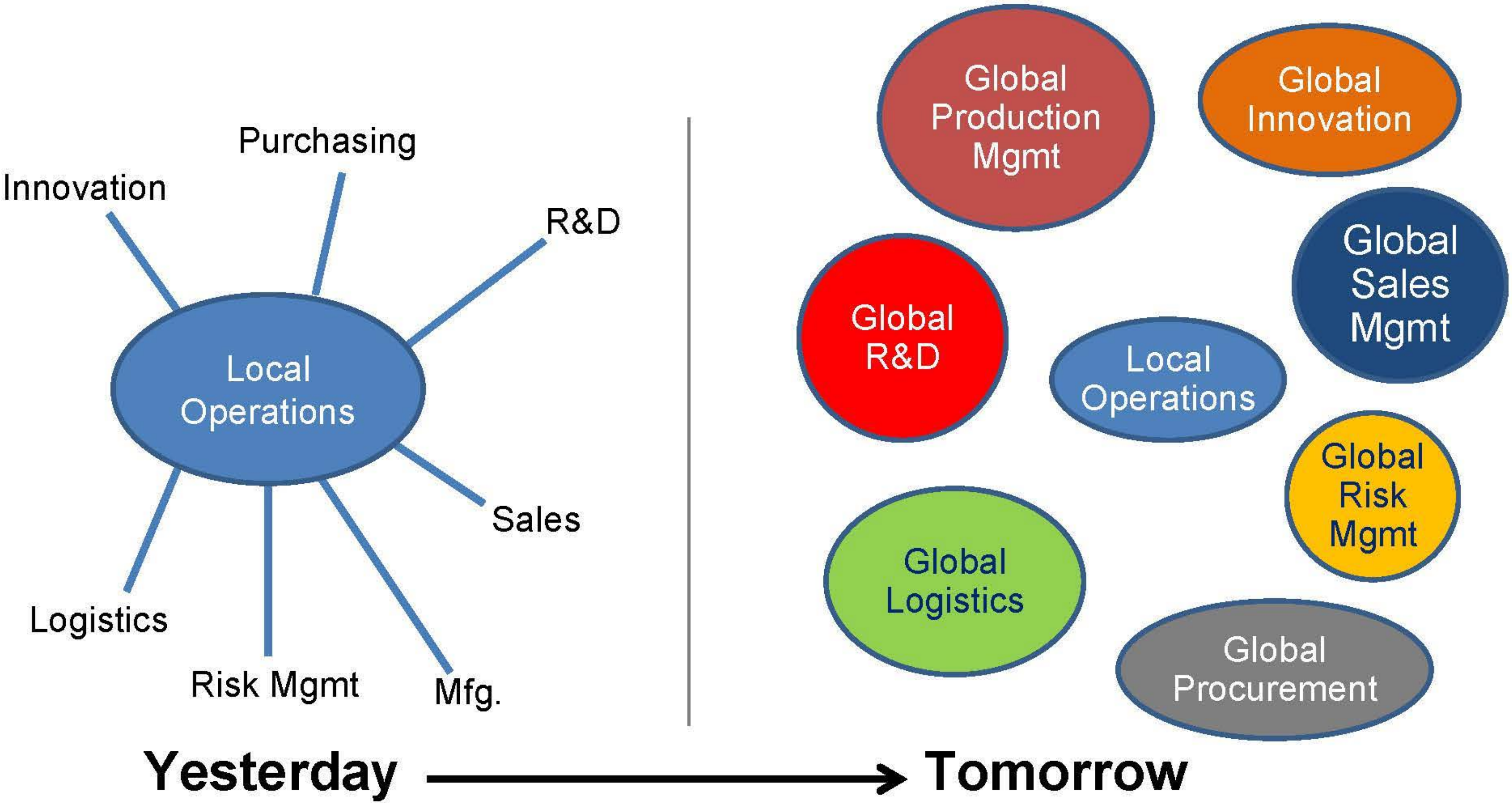
Base Erosion and Profit Shifting

What is BEPS

- BEPS generally focuses on moving profits to where they are taxed at lower rates and moving expenses to where they are relieved at higher rates
- Reduction of taxation in a foreign operating or source country either by:
  - Shifting gross profits via trading structures, or
  - Reducing net profit by increasing deductions at the level of the payer
- Low or no withholding tax at source
- Low or no taxation at the level of the recipient
  - Achieved via low-tax jurisdictions, preferential regimes, or hybrid mismatch arrangements
- No current taxation of the low-taxed profits at the level of the ultimate parent

Global Operating Structure

How should value and income be allocated?



BEPS History

Timeline

G20 leaders met

November 2012

Feb 2013

OECD released “Addressing Base Erosion and Profit Shifting”

European council meeting

May 2013

Forum of Tax Administration meeting

G8 Summit

June 2013

OECD’s Committee on Fiscal Affairs to agree action plan

July 2013

OECD’s action plan delivered to G20 Finance Ministers

September 2014

Delivery of:

- Report on digital environment
- Changes to model tax convention
- Recommendations for domestic rules
- Review of member country tax regimes
- Changes to Transfer Pricing Guidelines
- Report on international law and multilateral instrument

September 2015

Delivery of:

- Further recommendations for domestic rules
- Strategy to expand participation to non-OECD members
- Further changes to the model tax convention
- Changes to the transfer pricing guidelines
- Recommendations regarding data to be collected

December 2015

Delivery of:

- Further changes to the transfer pricing guidelines (re interest deductions)
- Revision of existing criteria regarding harmful tax regimes
- A multilateral instrument

OECD Action Plan

OECD Action Plan

Introduction

19 July 2013: OECD released its Action Plan in regard to BEPS, to coincide with the G20 Finance Leaders meeting in Moscow

The Action Plan

- Is **ambitious**: it consists of 15 specific actions “to prevent corporations from paying little or no tax”
- Is **consensus-based**: it has been “signed off” (at the political level) by all 34 OECD member countries **and** the 8 G20 countries which are not OECD members
- Has a **relatively short timetable**: all actions are to be completed by December 2015 (with many of the actions having earlier deadlines)

OECD Action Plan

Main objectives

The main overall objectives of the OECD's Action Plan are to:

- Prevent **double non-taxation** due to the gaps that exist between countries' tax rules
- Align taxation with **substance**
- Improve **transparency**

OECD Action Plan

Fundamental review of the key pillars of the international tax orthodoxy?

International tax orthodoxy: 3 key pillars

1. Separate legal entities
2. Arm's length principle (ALP)
3. ALP applied by reference to functions, assets and risks

These 3 pillars are largely unaffected by the Action Plan

OECD Action Plan

Arm’s length principle vs. formulary apportionment

Action Plan (page 20):

> “Alternative income allocation systems [i.e., alternative to the arm’s length principle], including formula based systems, are sometime suggested. However, the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries mean that, rather than seeking to replace the current transfer pricing system, <u>the best course is to directly address the flaws in the current system</u>, in particular with respect to returns related to intangible assets, risk and over-capitalization. <u>Nevertheless, special measures, either within or beyond the arm’s length principle, may be required with respect to intangible assets, risk and over-capitalization to address these flaws</u>.” [Underlining added]

OECD Action Plan

Existing international standards for source vs. residence taxation

Action Plan:

> "…This Action Plan is focused on addressing BEPS. While actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, <u>these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income</u>." [Underlining added]

Will non-OECD countries such as China and India want to independently or jointly establish their own standards for source vs. residence taxation?

15 Actions

OECD Action Plan

15 Areas under review

1. Digital economy

2. Neutralising hybrids
3. Strengthen CFC rules
4. Limit interest / Finance deductions
5. Counter harmful tax practices – substance

International coherence of corporate income taxation

6. Prevent treaty abuse
7. Prevent PE avoidance (Commissionaire)
8. Value creation – Intangibles
9. Value creation – Risk & Capital
10. Value creation – High-risk transactions

Aligning taxing rights with substance

11. Data collection / analysis
12. Disclosure (Aggressive tax planning)
13. Transfer Pricing documentation
14. Dispute resolution

Ensuring transparency and Increased certainty and predictability

15. Multilateral instrument

Swift implementation of proposed measures

OECD Action Plan

Digital economy

ACTION 1
Address the tax challenges of the digital economy

“Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterization of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT / GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.”

Previous work by the OECD on this subject did not result in significant changes to the residence/source model of taxation.

This issue has gained in importance with the public as a result of the growing interrelation between the digital and the physical economy in the delivery of goods and services

OECD Action Plan

International coherence of corporate income taxation

ACTION 2
Neutralize the effects of hybrid mismatch arrangements

"Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effect (e.g., double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; <u>(ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure</u>. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be coordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping." [Underlining added]

This work will cover both hybrid instruments and hybrid entities such as those cause by the U.S. "check-the-box" rules and would most likely imply changes to tax treaties and domestic law to neutralize hybrid mismatches.

An example of changes to tax treaties would be article IV(7) of the Canada-US treaty.

OECD Action Plan

International coherence of corporate income taxation

ACTION 3
Strengthen CFC rules

"Develop recommendations regarding the design of controlled foreign company rules. This work will be coordinated with other work as necessary."

Preamble to Action 3:

- "While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have <u>positive spillover effects in source countries</u> because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction." [Underlining added]

CFC rules vary greatly between countries and must be implemented to reach a delicate balance between preventing the deferral of tax on certain types of mobile and passive income while maintaining the competitiveness of multinational corporate groups carrying on active business.

It may prove difficult to develop a one-size-fits-all recommendation for CFC rules that would be appropriate for different national legislation.

OECD Action Plan

International coherence of corporate income taxation

ACTION 4
Limit base erosion via interest deductions and other financial payments

"Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be coordinated with the work on hybrids and CFC rules." [Underlining added]

ACTION 5
Counter harmful tax practices more effectively, taking into account transparency and substance

"Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on 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."

Will include a review of countries issuing private rulings and preferential tax regimes.

OECD Action Plan

International coherence of corporate income taxation

- Limiting BEPS through interest deductions and other financial payments has been the subject of significant attention from taxation authorities across the globe. Such limitations have been implemented in a number of ways and with varying levels of restriction including in the following ways:
  - Debt/equity ratio
  - Debt/assets ratio
  - Tax treatment of interest payment to the recipient
  - Earnings stripping limitations
  - Anti-hybrid
  - Transfer pricing rules
  - Use of proceeds of debt
  - Limitations on debt issued to finance acquisitions
- Recent global trends have been to tighten interest deduction limitation rules
- Proposals could be aimed at widening the payments and financial transactions subject to limitations.

OECD Action Plan

Aligning taxing rights with substance

ACTION 6
Prevent treaty abuse

"Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be coordinated with the work on hybrids."

On August 12, 2013, Canada released its consultation paper on treaty shopping. Canada will consider the recommendations to be issued by the OECD and is consideration domestic or tax treaty amendments to deal with treaty shopping.

ACTION 7
Prevent the artificial avoidance of PE status

"Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues."

Review fragmenting of operations of multinational groups among multiple entities to qualify for the exceptions to PE status for preparatory and ancillary activities.

OECD Action Plan

Aligning taxing rights with substance

ACTION 8, 9, 10
Assure that transfer pricing outcomes are in line with value creation

Action 8 – Intangibles

"Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements."

Action 9 – Risks and capital

"Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be coordinated with the work on interest expense deductions and other financial payments."

Action 10 – Other high-risk transactions

"Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be re-characterized; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses."

OECD Action Plan

Transparency and increased certainty and predictability

ACTION 11
Establish methodologies to collect and analyze data on BEPS and the actions to address it

"Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g., FDI and balance of payments data) and micro-level data (e.g., from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses."

ACTION 12
Require taxpayers to disclose their aggressive tax planning arrangements

"Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of "tax benefit" in order to capture such transactions. The work will be coordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations."

OECD Action Plan

Transparency and increased certainty and predictability

ACTION 13
Re-examine transfer pricing documentation

"Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's <u>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</u>." [Underlining added]

ACTION 14
Make dispute resolution mechanisms more effective

"Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases."

Canada-US tax treaty already includes mandatory arbitration provisions.

US has included mandatory arbitration in other treaties such as those with Germany, France and Belgium

OECD Action Plan

Transparency and increased certainty and predictability

- Increased transparency and disclosure may be a short-term outcome of BEPS.
- Certain disclosure requirements being considered have already been adopted in Canada, including the disclosure of aggressive tax planning at the federal level and in the province of Quebec.
- Other disclosure requirements that have been discussed include:
  - Non-mandatory statement of principles
  - Disclosure of uncertain tax positions
  - Full country-by-country reporting to tax authorities on global allocation of income of multination groups, their economic activity and taxes paid.
  - The sharing of transfer pricing documentation.
- It is generally understood that tax information and strategies of individuals and businesses is confidential and as such there is an expectation that this information sharing will likely be limited to sharing among tax authorities, not public disclosure.

OECD Action Plan

Swift implementation of proposed measures

ACTION 15
Develop a multilateral instrument

"Analyze the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and <u>the need to adapt quickly to this evolution</u>." [Underlining added]

Develop a multilateral instrument to amend existing tax treaties pursuant to proposed revisions to the OECD model convention to avoid renegotiating bilateral treaties one at a time.

Support from stakeholders

Consensus

Overall support from OECD and G20 countries

- The OECD was very pleased to announce that the Action Plan has been "signed off" by 42 countries
  - all 34 OECD member countries
  - all of the 8 G20 countries which are not OECD members: Argentina, Brazil, China, India, Indonesia, Russia, Saudi Arabia, South Africa
- The OECD was also pleased to announce that the 8 G20 / non-OECD countries will be invited to work on the 15 actions together with the OECD member countries "on an equal basis" and will be expected to associate themselves with the outcome of the BEPS Project.
- Endorsed by business groups and frequent critics of the OECD including a number of NGOs that have supported the OECD's efforts overall, but also took issue with some specific aspects.

Consensus

Canadian context

- Canada has indicated support for the BEPS action Plan in principle
- It remains to be seen what measures will be introduced in Canada
- Canada already has a very sophisticated CFC regime and a number of anti-avoidance provisions aimed at limiting BEPS

Consensus

Will it hold once implementation begins?

Will the consensus hold together when the serious work is undertaken?

- Will the inherent tensions between source vs. residence taxation emerge?
- What happens when certain countries choose not to implement proposed measures?
- What pressure will the political process place on the initiative and the implementation of recommendations?
- Will multinationals resident or operating in countries implementing new measures first be disadvantaged?
- Courts in various jurisdictions may not view similar measures in the same light.

BEPS measures implemented

Global Tax Trends

Increased enforcement of tax laws

- Substantial number of countries have significant budget deficits
- Taxing jurisdictions worldwide are becoming more aggressive with their enforcement activity to protect their tax revenues
  - Increased tax examinations
  - Increased cooperation/sharing among tax authorities
- Regulatory environment is becoming more restrictive
  - Increased governance and transparency
  - Reporting of uncertain tax positions
  - Risk rating taxpayers
  - Electronic/Real time auditing of tax filings

Global Tax Trends

Domestic legislative amendments

Many countries are changing their domestic legislation to protect their tax base

- Restricting net operating loss utilization
- Expanding CFC rules
- Modifying income tax treatment based upon “preferential” tax treatment of recipient in another country
- Moving to more substance-over-form/beneficial ownership provisions
- Restricting deductibility of interest expense
- Modifying transfer pricing rules

Global Tax Trends

Sample of independent measures already being taken

Country	Measure	Impacts
Mexico	Limits deduction of payments to related and parties and unrelated parties in preferential tax regimes	Cross border interest, rents, royalties
France	Limits deduction of low taxed related party interest expense	Low taxed financing structures
France	“Culture tax” on smartphones and tablets	Sale of hardware as consumers spend more on hardware than content
Germany	Loss of 95% exemption on hybrid dividends	Hybrid debt financing

Global Tax Trends

Sample of independent measures already being taken

Country	Measure	Impacts
China	Increased Profit allocated to location advantages following administrative guidance	Cross border transfer pricing for services and products
India	Increased profit to location advantages and R&D through administrative guidance	Cross border transfer pricing for services and R&D
Norway	Tax decision addressing location savings acknowledged that location savings may be taken into account	Cross border transfer pricing for goods and services

France Proposals to Tackle BEPS

Limitation on interest deductions and anti hybrid rules

Over the past two years, France has issued a number of proposals and enacted new tax laws aimed at curbing BEPS and countering perceived avoidance of French tax.

Proposed limitations on interest deductions/anti hybrid rules

- Deductions on intercompany interest payments allowed only if the interest income is taxable to the lender at an ETR of at least 25% of the French tax that would be payable under French tax rules.
- If lender is resident in a foreign jurisdiction, the calculation of the tax payable on the interest income must be determined as if the lender was resident in France.
- Proposed measure would apply to taxation years ending after September 25, 2013 and would apply to existing financing.
- Relates to Actions 2 and 4 of the OECD BEPS action plan.

France Proposals to Tackle BEPS (cont.)

Additional reporting requirements

Reporting requirements in addition to transfer pricing documentation

Legal entities established in France will be required to provide within a period of six months after their tax return filing deadline the following documents:

Information about the associates group :

a) A description of the business activities and changes that occurred during the period.
b) A list of key intangible assets including patents, trademarks, trade names and know-how in relation to the business;
c) A description of the TP policy of the group and the changes to it during the period;

Specific information on the legal entity:

a) A description of its business activities and changes that occurred during the period.
b) A summary of transactions with related parties, by type and amount, where the aggregate amount by type of transactions exceeds €100,000;
c) A presentation of methods used to determine transfer prices in accordance with the arm's length principle, stating the main method used and changes during the year.

Adopted on November 5, 2013 and expected to come into force shortly.

Relates to Actions 13 of the OECD BEPS action plan.

Mexico Proposals to Tackle BEPS

Payments to preferential tax regimes

Amendments to Mexico's income tax act adopted on October 31, 2013, include new limitations on the deductibility of various intercompany payments as well as certain payments to third parties. Under these rules, the following payments would not be deductible for Mexican income tax purposes:

- Payments of any kind made to a related or an unrelated individual, entity, trust, joint venture, investment fund or any other legal person subject to a preferential tax regime would have to be made on an arm's length basis; otherwise, the payment would be nondeductible for tax purposes.
- New rule not limited to interest payments which reflect the reality of global business and the importance of IP, royalties and other intercompany expenses.

Mexico Proposals to Tackle BEPS (cont.)

Anti hybrid rules

The recent amendments also include anti-hybrid rules. Under these rules, the following payments would not be deductible for Mexican income tax purposes:

- Interest, royalties or technical assistance fees paid to a foreign entity, holding or subsidiary that fall within any of the following categories would be nondeductible:
  - The foreign entity is a transparent entity (except where shareholders or members are subject to an income tax and the payment is made on arm's length terms);
  - The payment is disregarded for tax purposes in the country or territory in which the foreign entity is located; or
  - The foreign entity does not consider the payment to be taxable income.

- No deduction would be allowed for payments that are also deductible by a related party (same country or in another jurisdiction) unless the corresponding income is included in the related entities taxable income in the same or in a subsequent tax year.

Next steps for businesses

Next Steps for Businesses

Review of current tax policy

Analyze the current state and future plans in order to identify specific areas of strategic focus and impacts upon the global tax burden. Broad areas include

- Identify expenditure that provide important tax benefits to the group
- Review global operating structure to ensuring that income allocation effectively reflects business activities
- Ensure global operations and activities of each legal entity or establishment is well documented

Global planning must be aligned with business objectives

- Capital structure/debt planning in key jurisdictions
- Global intellectual property creation and deployment
- Global supply chain — location and structuring
- Global treasury
- Repatriation

Next Steps for Businesses

Prepare for change

- Understand the proposed actions of the OECD’s BEPS initiative and how they may affect the global tax position of the group.
- Consider current and proposed business plans and models in light of possible changes.
- Focus on digital delivery, permanent establishments, transfer pricing of risk and intangibles, characterization of transactions and entities, and deductibility of interest.
- Be prepared for increased compliance requirements and the disclosure of operational and tax information to foreign taxation authorities that would currently not request or even be entitled to these information’s.

Thank You.

Deloitte.