OECD base erosion and profit shifting project – update on transfer pricing issues

July 2, 2013

In brief

The Organisation for Economic Co-operation and Development (OECD), on February 12, 2013, issued its initial report regarding Base Erosion and Profit-Shifting (BEPS). Since its release, there have been several discussions between the OECD working group, representatives from different tax authorities and the business. The BEPS report and the subsequent discussion has created speculation as to where the key area of focus could land. The discussions seem to have distilled the key pressure areas to control of risks and intangibles, use of hybrids, taxation of digital business, transparency agenda, inter-group financial transactions and anti-avoidance measures. The key issues are expected to be addressed by the Comprehensive Action Plan (CAP) which is due to be issued in July. We provide the highlights and our initial comments on the proceedings below.

In detail

Background

The OECD's BEPS project is endorsed by the members of the G20 and seeks to address concerns of reduced tax revenues stemming from tax planning by corporations aimed at eroding the taxable income base through shifting profits to locations where they are subject to a more favourable tax treatment.

In response to the G20 pressure the OECD issued a report targeted at multi-national enterprises in February 2013. In the report the OECD acknowledges that businesses are now operating in a more globally integrated manner than ever and the current international tax rules were developed during a time when cross border transactions were not as prominent. The report recognises that current rules also do not take into account advances in technology such as use of Ecommerce and technological development.

The report seeks to put the G20 concerns into an international commercial and taxation context and to identify the international taxation framework and principles that currently govern the areas of concern. It also aims to establish which of the international taxation principles, including the arm's length principle, is still fit for purpose and which may need to be reviewed and potentially revised. The report identifies a range of issues and symptoms that led to this erosion of profits citing taxing jurisdictions, transfer pricing, leverage and anti-avoidance as the main areas for potential reform.

The outcome of this project is currently being driven by political pressures which are also largely driven by the media/civil society agenda. Short-term and long-term actions are likely to raise questions around the current transfer pricing framework, and businesses should be considering how they can contribute to the discussion and also prepare for any action. The key areas of focus are addressed below.

Key areas of focus

Following the release of the report, the OECD has split the issues identified by the report into three separate workstreams set out below. The intention was that different workstreams are developed separately and merged into a single report before the recommendations are presented to the G20 in July 2013.

Jurisdiction to tax: residence versus source taxation, permanent establishment (PE) tests, controlled foreign company (CFC) rules;

Base erosion: hybrid mismatch arrangement, treaty abuse, interest expense, preferential regimes, mandatory disclosure rules, anti-avoidance measures, promoters penalties, making aggressive tax planning unattractive from an accounting perspective; and

Transfer pricing: status of contractual arrangements, documentation, risk allocation, intellectual property and enforcement.

Key areas of transfer pricing focus so far

Discussions and consultations so far have focused on the transfer pricing issues 'substance or contractual terms' as a starting point for intra-group pricing, taxation of the Ecommerce business and extent of disclosure and transparency. Each of the areas is discussed in turn below.

'Substance vs Contractual terms'

Pricing of intra-group transactions between related legal entities is governed by Article 9 of the OECD Model Treaty. The arm's length principle that underpins the pricing methodology states that a starting point for establishing pricing arrangements should be the contractual terms in intra-group legal agreements. Under the arm's length principle, the more functions, risks and assets are carried on, borne or owned by a legal entity, the more profits are allocated to it. It is these two features of the arm's length principle that are perceived to have encouraged the behaviour by multinationals that allocated a significant proportion of profits in favourable tax jurisdictions purely based on the terms in the intra-group legal agreements but, in some cases, without any significant economic substance in those jurisdictions. The discussions during the BEPS project have indicated that the above concerns could be addressed in two ways.

Firstly, the intra-group legal contract would remain as a starting point for intra-group pricing and the terms of intra-group agreements would be respected to the extent they reflect actual activities in and between the legal entities in question. On the other hand, contractual terms that do not reflect what is happening in business could be ignored or re-characterised to reflect actual substance in the business.

Secondly, intra-group legal agreements could be set aside and intra-group pricing would be based on the functional and risk profiles of the two entities in question. In this case an approach similar to the 2-step approach that is set out in the OECD Report on the Attribution of Profits to Permanent Establishments has been discussed during the BEPS work to date. The PE Report was prepared as guidance on attribution in intra-entity scenarios between head office and branch/permanent establishments, as governed by Article 7 of the OECD Model Treaty.

A concern with the substance based profit allocation approach is that there is not one widely shared and accepted definition of substance. As such any attempt to come up with and obtain a consensus in respect of a new definition of 'substance' for the purposes of transfer pricing would result in a significant international effort and is likely to be a lengthy process.

A discussion of Contracts vs Substance puts a sharp focus on the control and risk in relation to intangibles as set out in the OECD's draft paper on Intangibles. It also re-emphasises that the management and bearing of risk should be given special consideration, as set out in Chapter IX of the OECD Transfer Pricing Guidelines.

In terms of feedback from business and the tax authorities, there is a strong preference to retain legal contracts as a starting point to avoid undue subjectivity. This was reiterated during the BEPS discussion during the OECD International tax conference that was held in Washington on 3 and 4 June. However, a concept of substance may be attractive as an anti-abuse measure or a corroborative sense check, in particular in respect of intangibles.

Ecommerce business

The intensity of the focus on the Ecommerce business is in part driven by the negative impact the Ecommerce distribution channel has had on revenues so far and future prospects of the traditional high street retailers as well as the predicted take-up of the Ecommerce economy in the developing world.

In the international arena, there are two key concepts in the taxation of cross-border income – residence (i.e., the country where the individual or company is resident) and source (i.e., the country that is the source of income).

Ecommerce business and other technological developments have enabled businesses to arguably trade in countries without creating a taxable fixed place of business in those countries.

When the BEPS report was first issued there were three possible approaches to the taxation of digital business. The first was drafting a new, or revising the existing, definition of a PE within Article 5 of the OECD Model Convention. The second was the VAT route with sales revenues from Ecommerce sales being subject to VAT in the country of consumers. The third was a use of unitary or formulary apportionment taxation being used to establish rights to tax the Ecommerce business based on some sort of allocation key.

Certain tax authorities, such as the US, have come out strongly against creating separate rules concerning taxing rights for any particular industry. In practice, separating rules relating to the right to tax for the Ecommerce industry from other industry sectors would be difficult as an Ecommerce offering is already embedded in many sectors' business models. Based on the latest discussions in Washington, it seems that the PE route is the preferred one to address Ecommerce taxation, although it seems clear there are no easy or ready solutions.

In terms of the way forward, the French government has already put together a unilateral proposal for taxing Ecommerce businesses on the basis of 'permanent virtual establishment'. Under this proposal profits should be attributed to the virtual PE on the basis that an Ecommerce business financially benefits from the customers in the source country sharing their personal information. Given the French government is already considering unilateral action to address taxation of Ecommerce business, an international consensus on the approach to tax Ecommerce business is essential to avoid any inconsistent unilateral actions and hence create additional risk of double taxation for many multinationals.

Transparency and disclosure

Of all the proposals for the short term action plan under BEPS, an increased call for transparency and disclosure is most likely to be acceptable and feasible in the short term. Increased transparency has been called for by all stakeholders, public, media, politicians, tax authorities and NGOs. Of all the potential measures, transparency and disclosure may be the least contentious, the easiest to understand and to implement and thereby considered the most popular anti-BEPS proposal.

A debate concerning transparency has been carried on for some time. Actions and initiatives on transparency have punctuated the last decade. NGOs have been arguing strongly for the need for greater transparency. Several reports have already been issued on the impact of a lack of transparency in developing countries. So far New Zealand, Denmark and Australia have all unilaterally chosen to introduce additional disclosure requirements.

In terms of the proposals for additional disclosure and transparency, there is a range of possibilities all carrying varying implications for business. Diagram 1 on the following page shows current possibilities that are being discussed with a decreasing degree of impact from left to right.

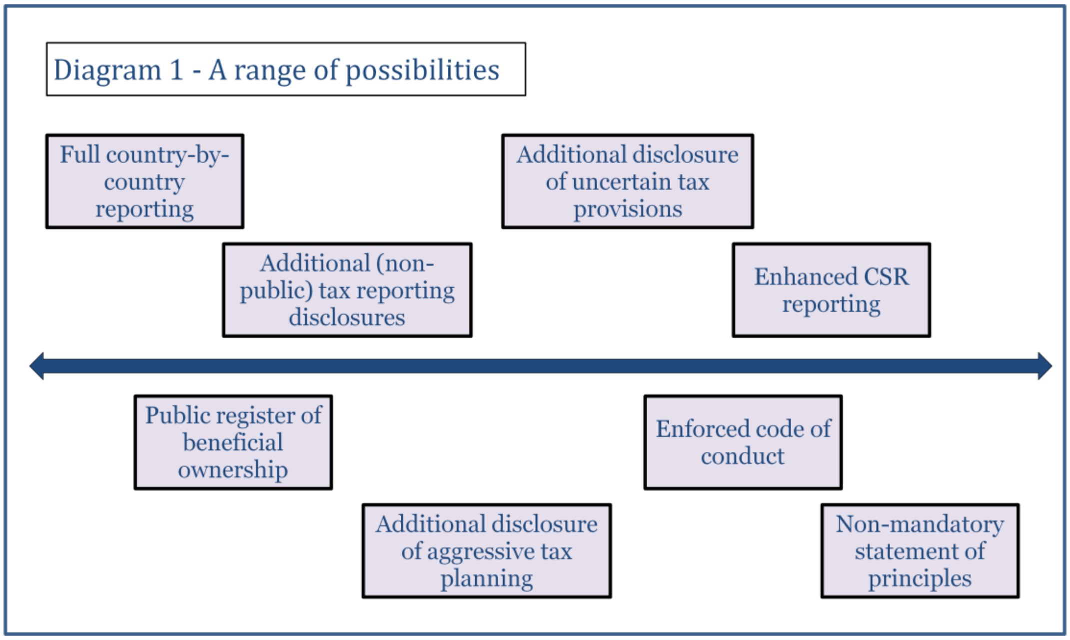
The most significant burden would be placed on business in respect of the country by country reporting proposal where extensive disclosure of audited information would be required. There are today no less than 6 different proposals on country-by-country reporting. From a practical perspective a "Lite" version of the disclosure requirements that is based on country-by-country disclosure of statutory profit is the most feasible proposal in this regard.

Other possible approaches are set out in Diagram 1.

More recently, at the summit on trade, transparency and taxation held on 17 and 18 June the G8 committed to the automatic sharing of information for tax purposes, wider tax reporting by multinational companies and greater transparency on company ownership. The Leaders Communique goes only slightly further and states "We will work to create a common template for multinationals to report to tax authorities where they make their profits and pay their taxes across the world."

The concern with the current BEPS and G8 proposals on the increase of transparency and disclosure is that each stakeholder asking for more objectives has a slightly different objective. Hence the selected proposal will need to be able to address a multitude of objectives that are not necessarily aligned.

It will be complex and costly to collect the data for the business. And lastly, there is a question of whether commercially sensitive information will be safeguarded.



Expected next steps

The OECD BEPS working group has been tasked with preparing a CAP the purpose of which is to provide countries with domestic and international instruments to better align rights to tax with real economic substance. The CAP is expected to be released in July 2013 and ahead of the G20 meeting.

It is of critical importance that an international consensus is reached in terms of agreeing the direction of the BEPS projects and any specific actions. Unless an international framework for future actions is agreed between the OECD members and support is also obtained by UN members, there is a risk of unilateral actions by individual governments. Such unilateral actions may not be helpful in comprehensively addressing the issues identified by BEPS.

An initiative has already been taken by the French government in respect of the Ecommerce business and the Australian government in respect of the wider BEPS issues. Given the initiatives by individual governments and the political pressure on the OECD BEPS working group, the speed at which the OECD is proposing to address these issues is somewhat escalated.

The latest forum for the BEPS discussion was the OECD International tax conference in Washington on June 3 and 4 where Pascal St. Amans updated the audience on the latest likely areas that would be covered by the CAP which is due to be issued in July 2013:

- Restrictive measures on the limitation of benefits clause
- Addressing the transparency agenda
- Restrictions on use of hybrids
- More uniform approach to the CFC rules
- Interest deductibility
- Control and reward of risks and intangibles
- Elimination of double taxation via the Mutual Agreement Procedure
- Taxation of digital economy

The takeaway

What does this mean for you?

While the exact proposals of BEPS remain to be announced, there are a number of factors that all businesses should be taking into consideration in the immediate short term. These include:

- Needing to stay aware of the developments under the BEPS projects, as the project is likely to lead to significant changes in the international tax and transfer pricing arena in the short to medium term.
- Identifying any situations where there is a heavy reliance on contractual structure as they may need to be reconsidered.

- Considering whether the substance and legal form of transactions are always aligned, bearing in mind that substance is very likely to become a real issue.
- Reviewing levels of reward for intra-group transactions based on the actual substance of arrangements including looking at profitability per country, to identify any potential risk spots.
- Reviewing use of low tax or 'tax haven' jurisdictions, given it is likely these will be the focus of attention in the future.

Let's talk

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