

OECD publishes sweeping Action Plan on Base Erosion and Profit Shifting (BEPS)

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In brief

Today the Organisation for Economic Co-operation and Development (OECD) published an Action Plan that addresses the perceived flaws in the international tax rules that were discussed in the [OECD's February 2013 Base Erosion and Profit Shifting \(BEPS\) report](#). Today's 40-page [Action Plan](#) contains 15 separate action points or workstreams, some of which are further split into specific actions or outputs.

Unlike the typical OECD project, the G20 has driven the BEPS project, and many of its members' revenue authorities have actively participated in the development of the Action Plan. The Plan is now being presented to finance ministers at the Moscow G20 meeting before being formally submitted to the summit of the G20 leaders on September 5-6.

According to the Plan, most of the actions will take one to two (or more) years to complete. However, it may take considerably longer to fully apply these changes in practice. There are indications that the BEPS project and related developments already are leading to a material shift in the behavior of tax authorities.

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

This Action Plan calls for fundamental changes to the current mechanisms and the adoption of new consensus-based approaches, including anti-abuse provisions, designed to prevent and counter base erosion and profit shifting. These generally fall under the following three areas:

- New international standards must be designed to ensure the coherence of corporate income taxation at the international level
- A realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments
- The actions implemented to counter BEPS cannot succeed without further transparency, nor without certainty and predictability for business.

In detail

Contents of the Plan

The Action Plan lists 15 actions or workstreams with accompanying timelines. We have grouped the OECD's proposed actions into four major categories: (1) general actions on BEPS; (2) treaty actions; (3) permanent establishment (PE) and transfer pricing (TP) actions; and (4) data and transparency actions.

General actions on BEPS

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

Addressing the tax challenges of the digital economy

The first action in the Plan arguably is one of the most difficult and the recommended action — identifying possible options — is the most modest. The Plan calls for a review of different business models and a better understanding of value generation in the digital sector. It also calls for the consideration of indirect action, suggesting that the tax challenges raised by digital business may be addressed more by an indirect, not direct, tax response.

The expected output (due September 2014) is a report identifying the relevant issues raised by digital business — (including the lack of tax nexus under current rules; the attribution of value created from the generation of marketable location-relevant data; the characterization of income; the application of related source rules; and the effective collection of VAT/GST) — and possible actions to address them.

Neutralizing the effects of hybrid mismatch arrangements

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

The expected outputs (due September 2014) include changes to the Model Treaty provisions to prevent undue benefits under treaties for such hybrid arrangements (presumably countering the ability of such instruments to access treaty withholding tax reductions) and consideration of changes to domestic laws, primarily in relation to deductibility.

The work on hybrids will be coordinated with the work on interest expense deduction limitations, CFCs, and treaty shopping (see below). The Working Group will have a head start from the OECD's recent work culminating in its report on Hybrid Mismatch Arrangements, as discussed in [OECD Report on Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues](#).

Strengthening CFC rules

The Plan comments on strengthening CFC rules are brief. The Plan notes that the OECD has done no significant work in this area (presumably because it is viewed as a purely domestic issue). The indication is that the OECD wishes to see uniform CFC rules to counter BEPS in a more comprehensive manner. The Plan expressly refers to the positive "spill-over" effects of CFC rules since

taxpayers would have less incentive to shift profits into a low-tax jurisdiction.

The expected output (due September 2015) is recommendations regarding the design of CFC rules. However, the ideal of achieving uniformity in CFC rules is an ambitious goal.

Limiting base erosion via interest deductions and other financial payments

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

The expected output (due September 2015) is recommendations for best practices in the design of rules to prevent BEPS through the use of interest deductions and other financial payments. The work will evaluate different types of limitations. A second output (due December 2015) is the development of transfer pricing guidance for the pricing of related-party financial transactions.

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

Unlike the Plan's other actions, this action point concerns the actions of governments, not corporations. The discussion refers to the original 1990s OECD work on harmful tax practices, and notes that the concerns raised 15 years ago on the mobile income tax

base remain just as relevant today. The Plan states that traditional ring-fencing (a major target of the OECD's work some years ago) is less relevant now given the prevalence of across-the-board tax rate reductions on particular types of income. The [February BEPS report](#) called for solutions to counter harmful regimes more effectively, accounting for factors such as transparency and substance. The work of the Forum on Harmful Tax Practices is now to be refocused to develop more effective solutions toward this goal.

There are three expected outputs. The first (due September 2014) is a review of member country regimes. The second (due September 2015) is a strategy to expand participation in this area to non-OECD members. The third and more challenging output (due December 2015) is revised criteria on harmful tax practices.

PE and TP actions

Artificial avoidance of PE status

The Plan identifies two specific areas of OECD concern related to the PE test. The first concern is with commissionaire arrangements where the Plan suggests there may be a shift of profit from one country to another, in circumstances where there is no substantive change in the functions performed in the first country. The second concern is where MNCs artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and auxiliary activities.

Both areas will be the subject of work to address artificial avoidance of PE status. Thus, the OECD will work on amending the dependent agent test in Article 5(5) of the Model Treaty and the provisions dealing with the preparatory and auxiliary activities in Article 5(4) of the Model. The work on these issues (due September 2015)

will also address the related profit attribution issues.

Align TP outcomes with value creation

The Plan rejects the possibility for alternative income allocation systems (such as formulary apportionment) and confirms the preferred course of addressing the flaws in the current TP system. The Plan notes that in many instances the TP rules work well. However, the Plan also states that in some instances MNCs have used or misapplied the rules to separate income from the corresponding economic activity and shift the relevant income into low tax environments. The Plan notes that this most often results from transfers of intangibles and other mobile assets.

The Plan sets action points for each of three identified areas where it states that there are flaws in the current system:

- **Intangibles:** develop rules to prevent BEPS by moving intangibles amongst group members. The work will involve adopting a broad and clearly delineated definition of intangibles; ensuring appropriate allocation of profits in accordance with value creation; developing TP rules or special measures for transfers of hard-to-value intangibles; and updating the guidance on cost contribution arrangements. The work is scheduled to be completed by September 2015.
- **Risks and capital:** develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. The work will focus in particular on adopting TP rules or special measures to ensure that inappropriate returns do not

accrue to an entity solely because it has contractually assumed risks or has provided capital, implying a clear 'substance' agenda. The rules to be developed also will require alignment of returns with value creation. The work is due September 2015.

- **Other high risk transactions:** develop rules to prevent BEPS by engaging in transactions that would not realistically occur between third parties. This will require clarification of the circumstances in which transactions can be recharacterized. The Plan also requires clarification of TP methods, in particular profit splits in the context of global value chains and, as with the prior two transfer pricing actions, includes not only refining the TP rules but the possibility of adopting "special measures." The work also will aim to provide protection against common types of base-eroding payments, such as management fees and head office expenses.

Re-examine TP documentation

The Plan notes that asymmetries in information on TP between taxpayers and tax administrations potentially enhance the opportunities for BEPS – especially as a 'big picture' view of the taxpayers global value chain is often not available. The Plan also notes that differences between countries and the requirements for TP documentation lead to significant costs for business. The Plan therefore proposes to re-examine TP documentation to ensure transparency for the tax administration, bearing in mind the costs for business. The rules to be developed will include a requirement that MNCs provide all relevant governments with needed information on their global allocation of the

income, economic activity, and taxes paid among countries according to a common template. The work is due September 2014.

Treaty actions

Prevent treaty abuse

The Plan identifies a series of measures to ensure that taxpayers cannot inappropriately use bilateral treaties to generate double non-taxation for an activity.

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

The action (due September 2014) is primarily to develop best practice anti-abuse clauses for use within treaties and best practice anti-avoidance rules that jurisdictions can implement via their domestic tax systems.

Make dispute resolution mechanisms more effective

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

The action (due September 2015) is to agree on ways to resolve disputes where MAP does not work or is not applied, including the use of arbitration. The current US treaty policy is to include binding arbitration as part of the MAP process. The OECD has looked at this issue previously, resulting for example in its [Manual on Effective Mutual Agreement Procedures \(MEMAP\)](#), so the issues are well-known. The challenge remains to see whether jurisdictions can now be persuaded to do anything about them.

Develop a multilateral instrument

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

The action (due December 2015) is to analyse the tax and public international law issues related to the development of a multilateral instrument. On the basis of this analysis, interested parties will develop an instrument designed to provide an innovative approach to international tax matters.

Data and transparency

Require taxpayers to disclose their aggressive tax planning arrangements

Domestic 'disclosure initiatives' to require the reporting of arrangements largely set up to deliver a 'tax benefit' (to be widely defined) will be encouraged by reference to best practice and existing experience where jurisdictions already have such regimes. The 'modular approach' to be

recommended will mean that jurisdictions will be able to keep any existing measures, but add to them if desired. The more real-time relationships established in a number of countries, following the OECD's project on cooperative compliance as reported in [Update on OECD tax projects](#), are identified as 'useful measures' to help taxpayers with such reporting.

There will be a particular focus on international tax structures and sharing such information between jurisdictions. This is likely seeking to build on the relatively successful work of the Joint International Tax Shelter Information Centre (JITSIC) which has operated since 2004, and which has more recently included participation by the United States, United Kingdom, Canada, Australia, Japan, and China. Note that the United States has taken a lead role in cooperative efforts on data collection and analysis.

The recommendations for these reporting regimes are due September 2015.

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

The Plan notes the lack of hard evidence to quantify the amount of corporate tax revenue that governments lose because of planning aimed at eroding the tax base and/or shifting profits to locations where they are subject to a more favorable treatment. The Plan seeks to correct this and to enable analysis of the implemented actions' impact. Part of this work will require an assessment of the type of data that taxpayers are required to report to tax authorities.

The action (due September 2015) identifies the need to respect taxpayer confidentiality and to consider the administrative burden on business.

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

The G8 summit in Northern Ireland on June 17-18 resulted in some strong words on tax and transparency, although few details were provided. A number of specific tax commitments in the Lough Erne Declaration covered the following (see [Tax transparency following the G8 summit](#)):

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

While the Plan was being developed, a number of territories have been considering their own responses to BEPS. Any unilateral action makes the broad acceptance of the Plan more uncertain but all the more vital – as such unilateral action could clearly result in double taxation.

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

readiness on the part of the FTA to apply new standards and approaches in addressing issues arising out of the ongoing BEPS initiative.

In addition, the House Ways and Means Committee and the Senate Finance Committee are expected to consider the OECD Action Plan on BEPS as the House and Senate tax committees prepare for action on tax reform legislation that could result in significant changes to US international tax rules. The House Ways and Means Committee on June 13 held a hearing on tax reform issues related to international tax rules and tax havens, base erosion, and profit shifting that included testimony by OECD Center for Tax Policy and Administration Director Pascal Saint-Amans. The Senate Finance Committee on May 9 held a Members meeting to discuss tax reform options related to international competitiveness.

Observations

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

One may view the Plan as setting parameters for each action item but leaving considerable scope and flexibility for the Working Groups to formulate their recommendations. It reflects a good balance between, on the one hand, clearly identifying gaps in the current rules, the urgency of addressing those gaps, and a roadmap for each Working Group. On the other hand, it sets a responsible tone by putting forth guiding principles, including the need for clarity, predictability, and administerability for both the governments and the taxpayers, and inclusiveness in the

process (for both non-OECD countries and business).

We welcome this approach of building on, rather than abandoning, longstanding rules of international taxation. We especially welcome the statement discouraging unilateral measures noting that such measures could lead to global chaos marked by the “massive re-emergence of double taxation.” Despite the commitment to not abandon long-standing rules on international taxation, the Action Plan recommends targeted, fundamental changes to those rules.

The Plan contains a wide range of actions, some of which likely will prove easier to pursue than others. Significant challenges await in the search for solutions to the digital business issues (which perhaps explains the more modest goal of “possible actions”) and, in relation to states themselves, the development of revised criteria on harmful tax practices.

The Plan focuses on substance. This comes through in various ways – for example in the comments on the PE rule, on recharacterization, on the ownership of intellectual property, and the focus on legal contracts for risk shifting and the general comments on TP in relation to the need of aligning TP with value-creation activities.

The rejection of formulary apportionment is welcomed but the repeated reference to “special measures” to address perceived weaknesses in the transfer pricing area is disturbing.

With respect to the position of states, there likely will be gainers and losers from the reform process encapsulated in the BEPS project. This may well make the process of future work on BEPS more difficult given the importance of achieving consensus.

The success of this process relies on the BEPS workstreams addressing the action points within the framework established by the Plan.

Constructive business input (especially with the accelerated timelines) is needed to ensure that any measures developed are workable in practice, i.e., with sufficiently clear tests to permit ready compliance. This seems especially important with respect to, e.g., the changes contemplated to the PE rules, the recharacterization doctrine, and the need to prevent treaty abuse.

Companies may be pressed for more transparency by shareholders, the

media, civil society organisations, etc. Businesses will need a common approach. This will facilitate ease of compliance for business and the provision of the most informative data for regulators and the public, if such data is disclosed.

The takeaway

Taxpayers should monitor the OECD workstreams' progress, especially with regard to the OECD's specific focus areas.

Taxpayers proactively should perform internal risk assessments of their existing and planned structures, considering the increased focus on

'substance' and the potential for more transparency and public disclosure of their tax return information and allocation of profits around the world.

In addition, taxpayers should engage with domestic policy makers quickly and explain the potential impact of these changes on business, since this project is moving on a more accelerated timetable than traditional OECD projects. Since many of the Plan's changes are directed at US businesses, they might be more impacted than businesses in other countries.

Summary of the BEPS Action Plan

Action	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 analyze 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

*Some actions have multiple deadlines. The chart above reflects the latest deadline.

PwC webcast

For further information on the newly released Action Plan, please attend our webcast.

The OECD Base Erosion and Profit Shifting agenda

Tuesday July 23, 2013

9:00am EDT (US) / 2:00pm GMT / 10:00pm Japan

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Join PwC professionals as they discuss the Action Plan and considerations for multinational corporations. This one-hour webcast will cover:

- A summary of the Action Plan
- Transfer Pricing and the Arm's-Length Principle under BEPS
- Inter-relationship with other OECD projects, including intangibles and the Risk Assessment Handbook
- Permanent establishment issues
- Economic substance and other anti-avoidance issues

Let's talk

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