BEPS: Why Malaysian corporates should care

BY AUROBINDO PONNIAH

BEPS, or base erosion and profit shifting, has been the buzzword among multinational companies (MNCs) and international tax practitioners for the last couple of years. While Malaysian corporates and tax professionals have had their hands full with the lead-up to, and introduction of, the Goods and Services Tax (GST) earlier this year, BEPS continued evolving and came of age early this month.

BEPS, in its current form, can be traced to the economic crisis of 2007/08. This crisis has exposed a number of fault lines in the global financial system leading to unprecedented intervention by governments to prop up financial markets and stimulate national economies.

The financial burden of this intervention, which led to increased budget deficits, is still being felt to this day. Countries realised that they needed to expand their revenue base in order to fund or narrow national deficits, and this in turn, led to the question of whether or not MNCs were paying their "fair" share of tax.

In questioning the global tax structures of MNCs, countries began to look at existing tax rules, which are seen to allow an erosion of the tax base and shifting of profits to low-tax jurisdictions. This perception of base erosion and profit shifting being linked to international tax planning structures led many governments, including those of the G20, to put BEPS firmly on their agenda. In 2012, the G20 asked the Organisation for Economic Cooperation and Development (OECD) to research and report on the issue.

The OECD issued its report in February 2013 and identified six key pressure areas, namely (i) arbitrage opportunities caused by hybrids and mismatches in tax systems; (ii) the digital economy; (iii) intragroup financing; (iv) transfer pricing issues; (v) the effectiveness of tax anti-avoidance rules; and (vi) the role of preferential tax regimes. The G20 accepted the findings and asked the OECD to come up with a comprehensive action plan to address the perceived flaws in the international tax rules.

The OECD spent the last couple of years working on the BEPS action plan project and on Oct 5 this year, released its final recommendations. The OECD's final recommendations were endorsed by the G20 finance ministers during a meeting on Oct 8 in Lima, Peru, and the ministers also agreed to put forward the recommendations for discussion at the upcoming G20 heads of state summit in November.

The BEPS Action Plan

The BEPS recommendations consist of 15 action points which, among others, cover:

- taxation of the digital economy or e-commerce activities;
- the use of hybrid instruments (for example, convertible preference shares) and hybrid entities (for example, partnerships) to leverage mismatches in laws;
- the design of controlled foreign company rules (that is, rules designed to prevent shifting of income to foreign subsidiaries);
- placing limitations on deductions for interest and other financial payments;
- mandatory disclosure of aggressive tax planning structures;
- aligning transfer pricing outcomes with value creation (that is, to ensure profits are allocated to where the economic activity which produced the profits is located);
- revised standards on transfer pricing documentation (that is, MNCs are to provide reports on all their subsidiaries and this information will be shared with affected tax authorities);
- measures to prevent the abusive use of tax treaties as well as increased substance and transparency when dealing with preferential tax regimes; and
- changes to prevent the artificial avoidance of a permanent establishment (that is, a tax concept which refers to a fixed place of business which could result in a tax liability in a particular jurisdiction).

Unfortunately, there is a sense of complacency among Malaysian corporate taxpayers as to the potential impact of BEPS. When the issue is raised, most Malaysian MNC directors usually remember chuckling over a cup of coffee a few years ago, while reading the news on their iPads, of American CEOs being grilled by Senate and Parliamentary committees. BEPS is often seen as an issue that will only impact G20 or OECD countries, neither of which Malaysia is a member of.

This would be a seriously flawed assumption. The OECD, from day one, recognised that it had to have the cooperation of as many countries as possible in order for the BEPS project to succeed. To this end, the OECD engaged many non-G20/OECD member countries, getting their participation in technical working groups and involving them in shaping the action points. The Inland Revenue Board of Malaysia (IRBM), which has cooperated with the OECD for many years, has been engaged by the OECD and actively participated in the BEPS discussions.

Now, even if consensus is not reached by countries participating in the BEPS project, the genie is out of the bottle. Tax authorities, including those in Malaysia, will be emboldened by much of the BEPS findings and will seek to challenge the legitimacy of tax planning structures used by MNCs. Some countries are expected to take it a step further and make unilateral changes to their domestic legislation.

This can be seen by the UK's introduction of the Diverted Profits Tax for example. The actions taken by the authorities in other countries, whether unilaterally or as part of a wider BEPS reform, will have an impact on Malaysian MNCs as their operations in that jurisdiction will likely be subject to these new rules.

BEPS and Malaysian corporates

The question which Malaysian MNCs should be asking is not if BEPS will affect them, but when. Malaysian MNCs, when reviewing their international tax structures, will likely see significant impact in a number of areas, including restrictions on the use of tax treaties, increased transfer pricing reporting and documentation requirements, broader permanent establishment risks and challenges, restrictions on interest/financial payments and increased disputes with tax authorities.

Should some of the main BEPS actions be adopted in Malaysia, we could see restrictions placed on the tax treatment of debt and financing of operations/investments by way of counteraction rules for hybrid instruments/entities. The rules will serve to limit the tax deduction for interest expenses incurred in certain circumstances.

Coupled with other possible anti-avoidance measures such as thin capitalisation rules (which is applicable to companies when their capital is made up of a greater proportion of debt than equity), the impact on intragroup financing structures could be substantial.

The use of Malaysia's tax treaty network to structure outward or inbound investments is also likely to come under scrutiny as will intermediate jurisdictions used to structure investments for tax reasons. Such structures are expected to be disregarded with the introduction of rules to ensure that lowering the instance of tax was not the primary driver.

Another BEPS measure that will in all likelihood be adopted by the IRBM is transfer pricing documentation and country-by-country reporting. This will require affected MNCs to prepare additional transfer pricing documentation for the IRBM — standard documentation detailing revenue, profits, taxes paid, and so on, for each country the MNC does business in.

Foreign tax authorities, using information exchange agreements, will be able to access this information from the IRBM. Likewise, the IRBM will be able to use the same agreements to access reciprocal information on foreign MNCs conducting business in Malaysia. Under the OECD's recommendations, this measure is expected to go live on Jan 1, 2016, which is barely three months away.

Malaysian MNCs must accept the fact that there has been a seismic shift in the way international tax rules work and pro-actively start to review their tax policies to manage any associated risks. A number of major foreign MNCs, though not explicitly citing BEPS, have already reviewed their internal tax policies and taken preventative measures, which will likely increase the cost of doing business. These companies recognise that it is a small price to pay to manage their tax and reputational risks.

Coming so close on the heels of GST, Malaysian corporates can be forgiven for being anxious about having to deal with another tax issue but as the author Margaret Mitchell said, "Death, taxes and childbirth. There's never a convenient time for any of them!" E

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