

OECD Report on Base Erosion and Profit Shifting (BEPS)

Global FS Tax Newsflash
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The OECD has today released a lengthy report in relation to its Base Erosion and Profit Shifting (BEPS) work. Arising from concern by tax authorities that the tax planning activities of corporates is resulting in substantial losses in tax revenues, the report assesses the current position and considers how base erosion and profit shifting could be addressed using a collaborative solution. In the current climate of intense criticism and media scrutiny of corporate tax practices, this is a welcome re-assessment of the common principles by which taxing rights are divided between states, and one that will have widespread implications for the Financial Services sector.

Background to BEPS

The BEPS project is driven by the concerns of the tax authorities that substantial tax revenue is being lost due to planning by corporates aimed at eroding the taxable base and/or shifting profits to locations where they are subject to a more favourable tax treatment.

At the same time, there is also the more fundamental concern that the common principles by which taxing rights are shared between states have not kept pace with the changing business environment - especially given the nature of globalised business (including the ability to transact business across the internet) and the increased importance of intellectual property as a value driver.

The BEPS project has also received much political attention, including backing from the G20 and various individual governments.

The BEPS paper of 12 February 2013

The paper released today is largely a careful diagnosis of the current position. It includes a chapter on empirical evidence relating to the use of BEPS techniques, followed by a chapter on global business models that are used by corporates before moving into a more detailed analysis.

The document then proceeds to consider the key tax principles and opportunities for base erosion and profit shifting.

It notes that the jurisdiction to tax, including permanent establishment (PE) rules, have come under pressure from the development of the digital economy.

It also points out that transfer pricing already considers economically significant activities and responsibilities undertaken, assets used and risks assumed. The different treatment of debt and equity in many states is highlighted and a range of anti-avoidance techniques categorised.

How BEPS could be addressed

The paper moves on to consider how concerns on BEPS could be addressed. The report identifies the following "key pressure areas":

- international mismatches in entity and instrument characterisation including hybrid mismatch arrangements and arbitrage;
- application of treaty concepts to profits derived from the delivery of digital goods and services;
- the tax treatment of related party debt-financing, captive insurance and other intra-group financial transactions;
- transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group and

transactions between such entities that would rarely take place between independents;

- the effectiveness of anti-avoidance measures, in particular GAARs, CFC regimes, thin capitalisation rules and rules to prevent tax treaty abuse; and
- the availability of harmful preferential regimes

Next Steps for the OECD

It is acknowledged that while there is no "magic recipe" that deals with the problems raised by BEPS, it is strongly emphasised that the OECD is ideally positioned to advance a collaborative solution (which is clearly preferable to any unilateral action which could potentially make the problem worse).

In relation to specific steps identified, it is reported that a comprehensive action plan is to be developed by June 2013. The plan will:

1. identify the actions that are required to address BEPS;
2. set deadlines for actions; and
3. identify the resources and methodology that are required to implement the proposed solutions.

In response to the key pressure areas, it is stated that the action plan will include proposals to develop:

- instruments to put an end to or neutralise the effects of hybrid mismatch arrangements and arbitrage;
- improvements or clarifications to transfer pricing rules to address specific areas where the current rules produce undesirable results from a policy perspective (and it is noted that the current work on intangibles would be included in a broader reflection on transfer pricing rules);
- updated solutions to the issues related to jurisdiction to tax, in particular in the areas of digital

goods and services (and it is noted that these solutions may include a revision of treaty provisions);

- more effective anti-avoidance measures as a complement to the previous items (examples of these measures include general anti-avoidance rules, controlled foreign companies rules, limitation of benefits rules, and other anti-treaty abuse provisions);
- rules on the treatment of intra-group financial transactions, such as those related to the deductibility of payments and the application of withholding taxes; and
- solutions to counter harmful regimes more effectively, taking into account factors such as transparency and substance.

There is also a call for action from tax administrations, therefore it is highly likely the topic of BEPS will be on the agenda for the Forum of Tax Administration meeting of Tax Commissioners in Moscow in May 2013.

PwC comment

A collaborative approach

We support the OECD as the right body to look at the BEPS issue and we agree with the need for a collaborative solution to the issues that have been raised. In the current climate of intense criticism and media scrutiny of corporate tax practices, we welcome the fundamental re-assessment of the common principles by which taxing rights are divided between states.

Generally, today's OECD report is a helpful summary of the main issues raised by BEPS and it is in line with previous statements made by the OECD with respect to what they, and member tax authorities, are concerned with.

Some parts of the discussion in the document could perhaps have been a little more balanced. The discussion sets out a shopping list of concerns and states that the result of aggressive planning by corporates leads to a result which is not intended by domestic tax policy. In our

view, many of the measures referred to result from specific law enacted by many states, typically motivated by a tax competition agenda, and it does seem quite clear that these states intend the result that follows.

Therefore, whilst the essence of the paper is focused on corporate aggression in relation to tax, it also seems necessary to look at the actions of states too. This, in turn, raises the question as to whether the series of measures that are likely to result from the OECD initiative on BEPS will be acceptable to members of the OECD and other states.

Past experience of collaborative actions in this area has not always been strong. For example, the Harmful Tax Initiative seemed to falter largely due to the inability to gather a consensus amongst members of the OECD. The recent work of the OECD on permanent establishments (Article 5 of the OECD model) and on the topic of beneficial ownership also seem to reflect a lack of consensus which is leading to material concerns from businesses that the rules proposed are imprecise and extremely difficult to apply in practice.

The digital business

There is, in the report, a significant focus on intangible property and digital business. The report raises the question generally of the source:residence balance of taxing rights without committing to any particular change. There is, however, a hint that this needs to be addressed particularly in the case of digital business. The possibility of a change to the PE rules for digital business also exists.

Transfer Pricing

With regard to transfer pricing, the fundamental point raised in the report is whether too much focus is placed on legal structures (for example as reflected in contractual risk allocations) rather than on what is referred to as the "underlying reality" of an economically integrated group, which may contribute to BEPS.

This is of course, however, the entire basis of the approach of the arm's length principle. The report does not go into more detail on the extent to which this basic approach of the arm's length price should be re-considered. In our view, the most likely practical outcome of this discussion will be a re-visiting of the guidance on the circumstances in which it is legitimate to re-characterise a transaction (as contained in para 1.37 of the Transfer Pricing Guidelines).

Timing

Finally, whilst we understand the pressure for a response, we are concerned at the speed at which the OECD is proposing to address these issues. Given that what is required will involve:

- (1) the development of a range of specific solutions,
- (2) a process to check that the solutions will work in practice and not create material and unintended collateral damage and;
- (3) the building of consensus amongst states for implementation (in line with the OECD's required collaborative approach for this topic),

the overall timescale of less than six months seems extremely short and arguably more a function of political pressure in this area than reflective of the time realistically needed to develop sound policy solutions.

Certainly, recent country experiences in dealing with specific rules such as a GAAR, would indicate that this timescale is unrealistic. Our concerns on timing are exacerbated given there seems to be little clear agreement on what constitutes treaty abuse, for example, contrasting the positions of the OECD and European Commission.

The BEPS project and the re-assessment of the tax principles by which tax rights are divided between states will have widespread implications for the Financial Services industry and financial institutions should continue to follow developments.

PwC contacts

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