OECD Releases Finalized Proposals on Key Tax Base Erosion Concerns

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On September 16, 2014, the Organization for Economic Cooperation and Development (OECD) released its 2014 deliverables on the Base Erosion and Profit-Shifting (BEPS) project. The BEPS project, an ambitious and wide-ranging effort by the OECD's Centre for Tax Policy and Administration (CPTA), is aimed at combating tax avoidance strategies in which global businesses minimize their overall tax burden by moving profits into taxpayer-friendly jurisdictions and exploiting differences in the tax laws and treaties of countries around the world. The OECD began its efforts in 2013 at the behest of the G-20 group of nations, which had come to understand that any serious effort to prevent these tax avoidance strategies would require centralized, coordinated planning and study.

On the same day, the BEPS committee heads hosted a Paris-based webcast to present the most significant aspects of these reports. The panel described the primary purpose of the BEPS project as "realign[ing] the location of profit with the location of value creation" and emphasized that the reports were crafted to conform closely to that goal.

There is no question that the OECD is approaching these issues with great resolve. The BEPS project will likely lead to significant, taxpayer-adverse changes to the domestic laws and treaty instruments of developed and developing nations alike. Indeed, CPTA Director and project head Pascal Saint-Amans believes that change is already afoot. In a recent interview with the Wall Street Journal, Saint-Amans remarked that the Centre's work is "having an impact already even though it hasn't [yet] come into force." He also cautioned against some of the aggressive tax planning currently taking place, warning that even though the BEPS project is not yet complete, "[i]t is difficult to sell your scheme to a company that knows th[ese avoidance opportunities] will be over in a few years."

Some governments have not waited for the OECD's final verdicts on these issues before toughening their domestic tax laws in light of the problems it has identified. Earlier this year, for instance, the Republic of Ireland's Department of Finance solicited official input on whether the country should alter its domestic tax rules to prevent the "double-Irish" avoidance structure currently employed by Google, Pfizer, Apple and other multinationals.

These preemptive moves are cause for concern. They raise the question of whether BEPS is helping to harmonize transfer pricing and other international tax rules or is, conversely, leading to the deterioration of a long-standing and effective consensus in these areas.

The 2014 deliverables included final reports and recommendations regarding seven of the fifteen Action items identified at the beginning of the BEPS project. The remaining eight items are due to be addressed in reports to be completed in 2015. During its webcast presentation, the panel discussed the highlights of the seven reports:

Action 1: The Digital Economy

The final report on this item concludes that it is not possible to "ring-fence" the digital economy from the broader economy for tax purposes. It describes a number of new digital business models, explaining that some of them pose significant BEPS risks. However, the report refrains from providing or endorsing any concrete measures to deal with the problems it identifies, with the webcast panel noting that it is intended merely to "clarify debate" on the issues.

Legislative options discussed in the report include modifying the nexus or Permanent Establishment rules to better reflect the borderless and geographically-transient nature of today's digital economy. A possible withholding tax on digital transactions is also discussed and evaluated. This proposal has proven controversial amongst international businesses, some of whom have expressed concerns regarding the high compliance costs, administrability issues, and economic distortions that might arise if such a tax were implemented into law.

Action 2: Hybrid Mismatch Arrangements

This report is focused on identifying and eliminating certain cross-border tax arbitrage opportunities. It addresses situations in which, for example, parties to an international financial instrument exploit inconsistent tax characterizations of the instrument in their respective countries; if the issuer's home jurisdiction characterizes the instrument as debt but the holder's jurisdiction treats it as representing an equity relationship, the issuer may be able to deduct interest payments without corresponding income inclusions by the holder. These kinds of opportunities can also arise when jurisdictions differ as to whether a business entity should be taxed on a transparent or pass-through basis.

The webcast panel noted that the report's final recommendations were intended to eliminate these mismatch opportunities without affecting other commercial or regulatory considerations. Moreover, the report tries to avoid general anti-abuse or purpose-based draft laws, instead crafting its draft provisions to be as rule-like and "automatic" as possible.

According to the webcast panel, participating nations have reached consensus regarding:

- the desirability of "linking rules" — domestic law provisions that make specific reference to the law of the counterparty jurisdiction;
- "scope," or a minimum related-party threshold before the mismatch rules would become applicable to a transaction or business structure;
- the necessity of "secondary rules," which would be triggered if one counterparty's home law failed to adequately eliminate the mismatch opportunity; and

- stopgap measures to avoid unintended double or otherwise excessive taxation of global businesses.

The report sets out a number of draft rules intended to address the above concerns. Further work is planned on a number of technically complex areas such as repo financing transactions, and more study is required to ensure that these recommendations are consistent with other elements of the broader BEPS project.

Action 5: Harmful Tax Competition

This aspect of the BEPS project, which the report describes as still at an "interim" stage, is aimed at combating certain so-called harmful tax practices of governments. It focuses on low-tax or otherwise taxpayer-friendly jurisdictions and regimes.

The report released on September 16th discusses a controversial "substantial activity" rule that would limit the ability of multinational businesses to locate income-generating intangible assets in tax-favorable jurisdictions. It notes that this rule is still in an interim and early-stage form, due in part to concerns expressed by businesses that it would hamper their flexibility in allocating assets to the countries where they can be most effectively and productively used. Also proposed is a compulsory information-exchange mechanism that would apply among taxing authorities. With respect to this proposal, the report notes that it has been difficult to strike a satisfactory balance between the need for cooperation and information exchange, on the one hand, and respect for the confidentiality of taxpayer information, on the other. Some taxing authorities also worry that this kind of exchange mechanism would overwhelm them with raw and unfiltered data. Finally, the report provides a list of nations whose taxing systems are under review for harmful or questionable tax laws or lax enforcement.

Action 6: Preventing Tax Treaty Abuse

This report expresses the unequivocal consensus among OECD member nations that tax treaties should not be used to achieve double non-taxation or to further tax avoidance objectives. It proposes that language to this effect be inserted into the preamble of the OECD Model Tax Convention.

In previous discussion drafts, there had been high-level agreement that countries should include a "Limitation On Benefits" clause in their bilateral tax treaties. However, there was less consensus as to whether that clause should take the form of a U.S.-style LOB clause (containing specific thresholds for beneficial ownership of resident entities or minimum levels of "substantial" business activity), or a more general, purposive, U.K.-style LOB clause.

The final report ducks this debate by adopting a "minimum standard" approach. Under this approach, either a U.S.-style or U.K.-style LOB clause is sufficient to prevent the most serious forms of treaty abuse. Thus, the report gives member nations broad discretion to choose either the general or specific form of the clause (or both) depending on the details of relationships with other countries.

Action 8: Guidance on Transfer Pricing and Intangible Assets

This report deals with the problem of applying transfer-pricing principles to intangible assets, including patents, trademarks, proprietary know-how, and others. The report contains final guidance to member governments as to some of the issues studied and interim guidance as to other, more complex issues.

Chapter 1 of the OECD Transfer Pricing Guidelines has now been expanded to discuss issues such as location savings and group synergies. In addition, a revised Chapter VI of the Guidelines reflects this report's final guidance on identifying intangibles and on implementing the arm's length principle to intangible assets. Chapter VI now discusses issues such as comparability principles in intangibles transactions and valuation techniques for hard-to-value intangibles.

Guidance on the "appropriate" allocation of income to intangible assets remains in interim form. There has been significant disagreement among OECD members countries as to whether (and to what extent) core economic factors such as risk-bearing, use and exploitation of assets or financial capital, or functions performed should supersede "mere" legal ownership and contractual arrangements for the purpose of gauging compliance with transfer pricing rules. There are also complex and technical coordination issues to be worked out among the various transfer pricing Action Items (8-10), and further work is apparently required to ensure that these final reports do not conflict with one another.

Finally, the report identifies areas in need of further study, which include so-called "excessive" capitalization of business entities as well as the problem of "cash-box" owners of intangibles carrying out little or no business activity.

Action 13: Transfer Pricing Documentation and Country-by-Country Reporting

This report lays out a specific plan to coordinate and harmonize the reporting and documentation requirements of multinational businesses with respect to transfer pricing. It provides for a three-tiered approach to reporting, where a multinational would be required to keep:

- a "Master File" (containing a high-level overview of the overall group's business);
- a "Local File" for each of the group's constituent entities (containing detailed information on specific intragroup transactions in which that entity is involved); and
- a "Country-by-Country report" (including details on aggregate, jurisdiction-wide information on allocation of income, taxes paid, business functions and economic activity, etc.).

The OECD's thinking remains in flux with respect to the mechanics of filing this information. The report provides that the Local File would be presented only to the jurisdiction in which a given entity operates or is tax resident. However, there is disagreement regarding how extensively the Master File and the Country-by-Country report should be filed and disseminated. Some countries have expressed particular concern that requiring

businesses to file the Country-by-Country report to large numbers of taxing jurisdictions would provide a roadmap for the most aggressive among them to assert taxing power over these businesses' global operations on a disproportionate or otherwise inappropriate basis. Some companies also worry that widespread dissemination of the report may raise a "weak link" problem with respect to taxpayer confidentiality; if even one taxing authority is lax as to the confidentiality or security of the Country-by-Country file, this sensitive and proprietary information could leak into the public domain.

According to the report, concerns of this kind have led the OECD to put off specific proposals on filing and disseminating the Master File and the Country-by-County report until at least 2015. The report also states that these filing mechanics will be subject to ongoing revision even after the completion of the BEPS project, with a view to "continuously improving th[eir] operation." Our own view is that some country (or countries) likely will require companies to file the report locally, and to make the reports public.

Action 15: Developing a Multilateral Legal Instrument

There is now consensus that a multilateral tax treaty or convention is indeed feasible. In January 2015, the OECD's Committee on Fiscal Affairs will begin steps to coordinate this logistically challenging task.

During the webcast presentation, the BEPS project committee heads stated that these finalized recommendations will be presented to the governments of member nations for approval, political endorsement, and legislative implementation. Those in the international tax planning community hope that governments wait to enact new domestic legislation until all of the BEPS Action Items, including the reports due in 2015, are complete; many of the proposals contained in the recently-issued reports interact with issues to be addressed in the 2015 reports. Rushing to implement these proposals may lead to inconsistencies with the recommendations set to be finalized later. However, countries need not wait until the BEPS project is complete before incorporating its proposals into their domestic tax laws. As noted, it has already spurred some governments to crack down on perceived loopholes or abuses in the tax planning realm. As such, the BEPS project is already affecting the tax planning strategies of a number of multinational enterprises. As the BEPS project nears completion, international businesses should be alert to the possibility of imminent and significant legislative reform in these areas.

For more information concerning this Alert, please contact a member of Caplin & Drysdale's International Tax/Transfer Pricing Group.

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