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BEPS Shifts from Talk to Action in 2015, Dominating Tax Planning, Government Legislation, and OECD's Calendar

The Organization for Economic Cooperation and Development is entering the home stretch of its massive Action Plan on Base Erosion and Profit Shifting (BEPS), with final work under the plan due in September 2015. Next up—a philosophical debate at the end of March, when a public consultation will be held on the OECD's recent transfer pricing draft on risk. The impact of the BEPS project is already far-reaching and profound, triggering changes to domestic law and regulation around the globe. Among the anticipated results of the BEPS work are the extinction of intellectual property cash boxes in zero tax rate jurisdictions.

Also contained in the Outlook section of this issue are reports on China, India, Latin America, litigation in the U.S. and Canada, prospects for amending U.S. international tax rules, and challenges facing the Internal Revenue Service as it struggles to cope with increasing demands in an age of shrinking resources.

Although the international project to combat base erosion and profit shifting (BEPS) is only half finished, the work done so far by the Organization for Economic Cooperation and Development will trigger radical changes in multinational structures in 2015 and beyond, practitioners say. Among the high-profile casualties anticipated are intellectual property cash boxes in zero-tax jurisdictions; 2015 could be the year they go away.

In interviews and public presentations, government officials and tax practitioners say that cash boxes are on the endangered species list in part because the OECD's transfer pricing discussion drafts on risk and intangibles seek to align transfer pricing outcomes with value creation. But they also are expected to become a casualty of the new country-by-country reporting template, which will flag such structures for audit scrutiny.

''Broadly, I think there is dramatically increased risk of audit and adjustment to arrangements which seek to separate economic activity from profits, where those profits are taxed at low or zero rates,'' said Ian Brimicombe, vice president of corporate finance with AstraZeneca. ''This is the focus of the OECD and individual governments through the collective action under the BEPS project—and unilateral action, such as the U.K.'s diverted profits tax.''

Sean Foley of KPMG LLP in Washington, D.C., told Bloomberg BNA that cash boxes are ''in the bull's-eye'' of tax authorities, and some corporate taxpayers will be rethinking their organizational structures as a result.

''Companies are going to be thinking very hard in 2015 as to whether they are at risk under the structures they are in, and whether those structures should be strengthened, amended or perhaps unwound,'' Foley said in an interview Jan. 9.

The OECD has not yet settled the question of how to treat entities owning intangible property with limited functional substance. But Ronald van den Brekel of Ernst & Young in Amsterdam agreed that a likely outcome of the BEPS project will be proposed rules that ''will not allow allocation of significant profit to so-called cash box entities.''

Another likely development will be greater scrutiny of related-party contracts, practitioners say. Emboldened by the discussion draft on risk released in December, auditors now will look behind the agreements to determine whether the underlying transactions align with them.

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At the same time, a number of governments are determined not to be outliers on BEPS. Switzerland, Ireland, Luxembourg, Singapore and the U.K.—through its diverted profits tax—are taking legislative action to implement some of the BEPS recommendations even though the project will not be completed for another nine months. To some observers, such efforts undermine the very purpose of the project—to arrive collectively at solutions to base erosion—but in the words of one U.S. official, the ''horse is already out of the barn'' on that point. Inevitably, despite the best efforts of the OECD to achieve consensus on the various action items, countries will pursue their own agendas.

Practitioners also pointed to another danger of the BEPS project—that it could end up producing ambiguous guidance on intangibles. If this develops, countries might assert that the new rules retain the traditional concept of the arm's-length standard, while developing countries could argue that profits should be taxed where group entities have substance, as measured by the number of employees.

What impact these changes ultimately will have on cross-border trade and investment is a question that government officials are only now beginning to consider. But one thing is certain: The result will be a much more complex tax landscape.

OECD Calendar

The OECD's BEPS project, a mandate from the Group of 20 countries, launched in July 2013 with the release of a 15-point plan for revising international tax guidelines. The project set an accelerated timeline for developing new guidance—September 2015—but in the first 18 months generated mostly talk as working groups developed a series of discussion drafts and conducted public consultations in which some of the most contentious questions were tabled for later consideration.

No new formal guidance has been adopted yet, but that will change in 2015. In the coming year, the OECD will seek to reach consensus on 10 discussion drafts. Among them are anticipated new drafts on controlled foreign corporations, cost contribution arrangements, ownership of hard-to-value intangibles, disclosure of aggressive tax planning arrangements and new data analysis to evaluate the effectiveness of the BEPS project.

The OECD held a consultation Jan. 21 on its 2014 draft addressing permanent establishment status (see the related story) and has others scheduled to discuss drafts on treaty abuse, dispute resolution, interest deductions and value-added tax.

The biggest fireworks are expected in March, when the OECD holds a two-day consultation on three transfer pricing discussion drafts released in December. One draft covers risk, recharacterization and special measures; another covers profit splits and a third draft covers commodity transactions.

These drafts relate to the September discussion draft on intangibles, much of which was grayed out when it was released because the issue has proven to be so difficult (23 *Transfer Pricing Report* 729, 10/2/14). But a philosophical showdown over the draft on risk is coming, with the U.S. and U.S.-based multinationals in one camp and developing countries in the other. At issue is the future of the arm's-length standard itself. Should it merely be tweaked? Or radically modified?

From the OECD's perspective, the point is not to weaken the arm's-length standard, but to apply it in a ''robust way,'' according to Marlies de Ruiter, head of the OECD's division on tax treaties, transfer pricing and financial transactions.

''We need to show it can take account of the realities of associated enterprises working as a group, and we are pretty sure that the arm's-length principle can do that,'' de Ruiter said in an interview Jan. 13 (See the related story).

Robert Stack, deputy assistant secretary for international tax affairs with the U.S. Department of Treasury, said recently that ''the real challenge of BEPs'' in 2015 and beyond is ''how to bring the international tax system back to a series of rules that people can live by, and abide by.''

The stakes could not be higher, he said. ''If there is a race to the bottom in corporate tax, that money disappears,'' Stack said, speaking at an international tax conference in December. ''And it doesn't magically come from someplace else. Those of us who are good world citizens, and U.S. citizens, are thinking about deficits.''

Ongoing Struggles

The OECD and G-20 member countries are still struggling with how to redesign the transfer pricing and international tax rules, according to a former U.S. Treasury official.

David Ernick was Treasury's principal staff attorney for transfer pricing matters and represented the U.S. as a delegate to OECD Working Party No. 6. He told Bloomberg BNA Jan. 12 that there is discomfort with significant profits being allocated to entities merely on the basis of contributions of capital and assumptions of risk.

''But in the real world, capital and risk-taking are entitled to compensation, so if we want to maintain the connection between economic income and taxable income, capital and risk-taking should be compensated,'' said Ernick, now with PricewaterhouseCoopers LLP in Washington.

If the OECD increases the focus on ''substance,'' meaning ''the location of employees,'' he said, there could be an unexpected impact. ''As the states have found in their experience with formulary apportionment, we may deter 'artificial' profit shifting but encourage the shifting of activity that would carry profits with it in the form of jobs and investments leaving high-tax jurisdictions,'' he said.

Thus, it is too soon to tell how the OECD and the G-20 will resolve this issue and how businesses will respond, Ernick said.

Foley told Bloomberg BNA that even if the intellectual property holding company is ''in the bull's-eye'' of tax administrators, ''I continue to think that transfer pricing and arm's-length behavior will be respected if you have assets, functions and risks in a jurisdiction—if you are doing real things there. Structures that have real substance to them will continue to pass muster in most places. The ones that lack substance are the ones that will be in trouble.''

The question will be how to define ''substance.''

According to Tom Vallone, tax director with Dell Inc., the issue of substance often ''comes around to a belly button counting exercise.''

''How many people do you have in a jurisdiction? If you have got enough, and you can wrap them around

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the right kind of job titles, you are going to be considered to have substance.''

While that approach plays well to some audiences, Vallone conceded, ''it's a bit of a head-scratcher for me because when I think where profits belong in a multinational enterprise, I would think profits belong where intellectual property is owned and where the entities that bear the risk are located.''

He added, ''I think about people as undertaking functions. And those functions are compensated in whatever way is appropriate, frequently on a cost-plus basis.''

Appropriate Test

The U.S., Stack said, does not want to see new tests that are built around body counts. The appropriate test should be about where the functions, risks and assets are located in the multinational structure, he said. Then you value them.

The U.S. is trying to manage the outcome of the BEPS work on transfer pricing ''in a way that doesn't just count belly buttons,'' the official said. ''We do not want to create a ridiculous superstructure around things that are very difficult to objectify in a meaningful way'' that results in companies moving people offshore.

Paul Morton, head of group tax for Reed Elsevier Plc in London, told Bloomberg BNA Jan. 12 that multinational companies are likely to retain their related-party entities in countries such as Switzerland, Ireland, the Netherlands, Luxembourg and Singapore ''where there are business reasons—which will often be the case.''

Patrick J. Brown, tax director of GE Power & Water, said he hopes the BEPS project will result in a more transparent international tax system, where tax competition between countries is kept within boundaries.

''I have some comfort, perhaps illusory, that the rules I face two to three years from now will not be radically different from the rules I will face two to three years later,'' he said.

Brown noted that he met the week of Dec. 8 with Swiss local government officials who ''were very candid that this tax reform is really all about making sure they are on the right side of BEPS. They want to make sure they have a competitive tax system. They feel the right way to do this is to move now.''

BEPS-Compliant

Ernick said companies must consider a multitude of factors in choosing a country of residency: the country's infrastructure, its various commercial and social laws, proximity to the marketplace, stability of the government, ''and of course its tax regime.''

Countries will be able to compete to attract business investment, Ernick said, but in the future their tax systems will have to be ''BEPS-compliant.''

''What has emerged so far is the acceptability of low tax rates and incentives that are designed to be broadly applicable to anyone who meets certain objective parameters, including that there be some form of substance to arrangements to qualify for the incentive,'' he said. ''A high rate with a lot of incentives that narrow the base seems not to be acceptable, but a regime that collects about the same amount of tax with a low rate and a broad base is perfectly fine.''

Some tax-friendly jurisdictions are likely to fare better than others post-BEPS. Vallone recalls that when he told his company's chief financial officer that zero-tax jurisdictions are going away, the CFO responded, ''What do you mean? We can't be in Singapore anymore?''

Told that the company would end up paying ''10, 15, 17.5 percent tax to somebody, or maybe even a little bit more'' by continuing its Singapore operations, Vallone said, the response was, ''I can manage that.'' The CFO, he said, wanted to remain in Singapore for a variety of reasons including talent and location.

Philosophical Debate on Risk

According to Ernick, the showdown over the draft on risk hangs on a series of arguments within the document as to why contractual allocations of risk among the separate members of a group should not be respected.

''It proposes justifications for why risks should be reordered differently from what they had been in contractual arrangements,'' he said.

To Ernick, the draft is problematic because it does not address ways to improve existing guidance on the pricing of risk.

Ernick said the proposed re-ordering could be interpreted as consistent with the existing approach to attributing profits to a PE under Article 7 of OECD Model Tax Convention. Under Article 7, risks cannot be separated from functions—or some risks may be viewed as being assumed by the multinational enterprise as a whole and allocated formulaically. This approach, he said, ''is entirely consistent with the 'single firm' paradigm established in the digital economy discussion draft.''

De Ruiter disputed that interpretation, saying the draft does not evince a new focus on the conduct of the parties versus their contracts in analyzing an entity's functions, assets and risks and its interaction with the group value chain. The draft ''sharpens the focus on conduct but it is definitely not new. More attention is given to the first and more important step of a functional analysis, which is defining what the actual transaction is that you want to price.'' (See the interview with de Ruiter and Andrew Hickman, head of the OECD's transfer pricing unit).

Ernst & Young's van den Brekel said it is important for the OECD, given its continued focus in the draft on risk and on actual conduct, functions and capabilities, ''to deal with virtual teams, and changes in roles and responsibilities.'' If the proposed guidance is accepted, he said, ''without doubt it will lead to a more subjective view on transfer pricing, and therefore also to more controversy.''

Some OECD countries, such as the Netherlands, already have amended their view of the arm's-length principle and have moved more toward the analysis of actual conduct and looking at arm's-length behavior, he said.

''For those countries, the content of the discussion draft will feel like the confirmation of their view on transfer pricing.''

However, van den Brekel noted that tax authorities in other countries still are concerned predominantly with pricing the transactions agreed by related parties, focusing more on arm's-length pricing than on arm's-length behavior.

''Therefore, the discussion draft can really be seen as a paradigm shift.''

The question can be raised, he said, whether the discussion draft on risk goes beyond the mandate of the BEPS project. From the perspective of countries that continue to analyze pricing versus behavior, he said, ''it can be seen as a substantial redesign of the arm's-length principle.''

If the proposed guidance is finalized as written, van den Brekel said, ''it will also affect a large number of taxpayers that probably are not typically seen as conducting profit shifting.''

September Draft on Intangibles

In September, the OECD issued a discussion draft on intangibles, much of which was grayed out—a reflection of the draft's controversial nature. Advisers have argued that the draft minimizes the importance of contractual risk allocation and the provision of capital.

Morton fears the BEPS project is likely to produce ambiguous guidance on intangibles because of the short time for deliverables. ''Much ambiguity and uncertainty will remain,'' he said.

Stack agreed that the danger is real. The struggle for the U.S. in 2015 will be to convince the world that an approach under which every country can look at a transaction and decide whether to tax the income ''is not a uniform approach at all.''

According to Ernick, the OECD appears to be struggling to gain consensus on how the rules for the transfer pricing of intangibles should be modified, and the discussion drafts covering transfer pricing issues are murky.

The ''million-dollar question,'' he said, is whether the arm's-length standard will retain its traditional focus on where intellectual property is owned and where entities that bear the risk are located, or whether the BEPS project will lead to new rules so that profits instead are taxed where group entities have substance in the form of a significant number of employees.

''Things are not looking good at this point for the traditional understanding of the arm's-length principle,'' he said.

Ernick pointed to a statement in the OECD BEPS draft on the digital economy issued in March 2014: ''Corporate legal structures and individual legal entities became less important and MNE groups moved closer to the economist's conception of a single firm operating in a coordinated fashion to maximise opportunities in a global economy.''

That statement, Ernick said, succinctly summarizes a conceptual paradigm based on formulary apportionment and a unitary approach to the taxation of multinational enterprises. ''That paradigm permeates the later reports on intangibles, profit splits, risks and recharacterization, country-by-country reporting and the master file.''

Ernick said all of those reports have elements that are consistent with that ''single firm'' concept, and they seem to represent a coordinated retreat from the arm's-length principle and separate-entity accounting. Formulary apportionment ''does not appear to be clearly better than the arm's-length principle, and the costs of moving to such a system would be massive.''

Unilateral BEPS Measures Although the BEPS project will not issue its final slew of reports until September 2015, some countries already are taking unilateral legislative action in order to adopt key BEPS concepts, a course of action bemoaned by companies and their advisers who believe such measures will destabilize the international tax system.

Peter Barnes of Caplin & Drysdale in Washington, D.C. said examples of BEPS measures taken by governments to date include:

- the United's Kingdom adoption of country-by-country reporting and a proposal for a new diverted profits tax effective April 1, 2015;
- Spain's adoption of new audit guidelines focusing on the digital economy and hybrid mechanisms;
- Hungary's guidance on cases of double non-taxation;
- Norway's new limits on interest deductions;
- Mexico's new requirements on treaty benefits eligibility; and
- Switzerland's focus on tax reform to address BEPS concerns.

The ''horse is out of the barn,'' said Stack when asked about the U.K. profits tax and other unilateral efforts in December. ''I don't know if the OECD ever saw itself as able to go around the world and tell ministers what laws they can pass.''

Ernick, meanwhile, lamented ''the welter of uncoordinated unilateral actions by countries around the world.'' Countries seem to be using the BEPS project as a justification to advance their domestic tax agendas, and to grab a bigger piece of corporate tax revenue for themselves, he said. The unilateral actions have covered issues from all the different BEPS work streams.

''That turbulent and rapidly-changing environment may well continue in 2015 and even accelerate, as the danger is that as soon as one country moves ahead of the OECD consensus process, others are spurred to action, not wanting to be left behind,'' Ernick said.

The project's work on hybrid mismatch arrangements is a case in point.

In its Sept. 16 explanatory statement on the seven BEPS deliverables, the OECD said jurisdictions can immediately begin to implement the draft recommendations for domestic tax legislation and tax treaty provisions to neutralize hybrid mismatch arrangements (23 *Transfer Pricing Report* S-2, 9/18/14).

A KMPG practitioner said in October that a small number of countries, including the U.K., are likely to adopt some of the recommendations on hybrids before September 2015 (23 *Transfer Pricing Report* 834, 10/29/14).

From a U.S. perspective, Ernick said, the BEPS project's work on hybrids is likely to lead to increased foreign taxes on U.S. multinational enterprises and increased claims for foreign tax credits.

''From a global perspective, it is likely to lead to more double taxation because of a lack of common implementation.''

Further, he said, the changes proposed are ''incredibly complex'' and will be difficult and costly to administer, both for taxpayers and tax authorities.

Country-by-Country Reporting

The BEPS action item with the most momentum is Action 13, calling for countries to adopt a country-by-country reporting template, master file and local file.

According to Stack and others, it already is having an impact.

''Restructurings have already begun along that line. The effect is already there.''

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Foley told Bloomberg BNA that there are indications the filing requirements will not be rolled out in 2015 and could be delayed until 2016. Nevertheless, he said, a number of companies already have begun to test the new requirements. Some have conducted a ''mock run'' of a master file, so that they will be prepared to produce reports on a real-time basis when they are due, he said.

Dell Computer is one of those companies. Vallone described a ''dry run'' in which the company took 38 of its related entities, located in Germany, Singapore and China, and asked what it would take to comply with country-by-country reporting to figure out head count, trial balance numbers and assets.

''We got our accounting folks—and it wasn't easy to ask them to help us out here on something that was so theoretical—but they did,'' Vallone said.

The exercise revealed just how much of a compliance burden the new requirements presents. For the first year of country-by-country reporting, it would take 100 staff hours per country to prepare the documentation just for those 38 entities, Vallone said. But Dell operates 380 entities in 83 countries, so the actual cost of implementation will be significantly higher.

Ernick agreed that companies are expecting compliance with country-by-country reporting to be an expensive exercise, and it is not clear if the information provided will be used productively. In fact, Internal Revenue Service Commissioner John Koskinen has expressed concerns about the impact of budget cuts on information technology at the IRS and stated that there is currently ''no capacity'' to interpret the expected flood of information from country-by-country reporting requirements (23 *Transfer Pricing Report* 1040, 12/11/14).

Reporting Mechanism

The OECD will decide in early 2015 whether countries will obtain the reporting template via the treaty network or whether each country will be able to obtain the template from the group entity operating in its jurisdiction.

Even if the BEPS project decides that the country-by-country reporting template will be provided to tax administrations via the tax treaty network, Morton said he thinks local group entities will end up having to provide the template to their local tax administrations when requested to do so.

Ernick cited the concern that tax administrations may pressure the local group entity to provide the template directly.

He noted that emerging market countries participating in the BEPS process—Argentina, Brazil, China, Colombia, India, Mexico, South Africa and Turkey—have stated that they need that information to perform risk assessment and find it challenging to obtain information on the global operations of a multinational group headquartered elsewhere. They do not have treaties with all the countries from which they would want this information, and even where they do, they may not want to go through a cumbersome process for requesting the information under the treaty, he said.

Van den Brekel said it is important for the countries participating in the BEPS project to reach consensus on the distribution mechanism because then ''there will be peer pressure not to follow a different unilateral approach. However, if no consensus will be reached, it will be very easy for countries to follow a unilateral approach.''

Another interesting question, he said, is how the countries not participating in the BEPS project will react. For these countries it would be easy to add the country-by-country reporting template and master file to their domestic requirements, ''although for some countries it will not be easy or possible to require information that is not available to the taxpayer in that country.''

Tax Competition

As the OECD works toward consensus on the discussion drafts this spring, some observers question whether the BEPS project ultimately will be able to stem the drive toward tax competition among participating countries.

Ernick noted that the OECD has already done a great deal of work on setting the boundaries for acceptable tax competition versus harmful tax competition. That work is now being refined to require a ''substantial activity'' factor in the context of preferential tax treatment for certain income arising from qualifying intellectual property, consistent with the overall focus on ''substance'' of the BEPS project, he said.

Still, countries will continue to develop tax regimes to encourage economic activity and investment consistent with the requirements for transparency and sufficient economic activity.

Barnes observed that the impulse to play off one tax system against another is not an exclusively foreign phenomenon. U.S. states have engaged in tax competition for years, and are ''not the least bit embarrassed in saying 'we won't tax you; come to me.' ''

It is ''a little bit odd,'' he said, ''that we fully accept U.S. states, including Texas, doing stuff that the BEPS exercise suggests that Luxembourg, Ireland, Switzerland, Singapore, and Bermuda cannot do.''

BY KEVIN A. BELL AND DOLORES W. GREGORY

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