Special report

The OECD's Action Plan on Base Erosion and Profit Shifting

On 19 July, the OECD published its *Action plan on base erosion and profit shifting*, produced at the request of the G20 in response to growing public disquiet on the perceived avoidance of tax by some multinationals. This report provides: an overview of developments; a Q&A on the key issues; the 15 action points; and further reaction from tax experts.

BEPS is a critical issue for 'all parties', says OECD

- **Action plan marks 'a turning point in the history of international tax co-operation', says OECD secretary general Angel Gurría.**
- **KPMG notes 'a potential seismic shift in the international tax landscape'.**
- **Campaigners call for UN tax committee to be strengthened.**

G20 finance ministers meeting in Moscow last weekend endorsed the OECD's 'ambitious and comprehensive' action plan to address base erosion and profit shifting (BEPS). 'Tax avoidance, harmful practices and aggressive tax planning have to be tackled,' ministers said in a communiqué (see lexisurl.com/yTIIy).

The effective taxation of 'mobile income' was a key challenge, they said. 'Profits should be taxed where functions driving the profits are performed and where value is created. In order to minimise BEPS, we call on member countries to examine how our own domestic laws contribute to BEPS and to ensure that international and our own tax rules do not allow or encourage multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions.'

The scale of the OECD's report and its ambitions for change represented 'a potential seismic shift in the international tax landscape', KPMG said. The chancellor, George Osborne, said the report was 'a major step forward towards a global tax system that is fair and fit for purpose for the modern economy'.

'Global roadmap'

The OECD observed that national tax laws have not kept pace with the globalisation of corporations and the digital economy, leaving 'gaps that can be exploited by multinational corporations to artificially reduce their taxes'. The digital economy offered 'a borderless world of products and services that too often do not fall within the tax regime of any specific country, leaving loopholes that allow profits to go untaxed'.

The action plan (see lexisurl.com/fDLLr) offered a 'global roadmap' to allow governments to collect the tax revenue they need and give businesses the certainty they need to invest and grow. Fifteen specific actions (see page 12) would give governments 'domestic and international instruments to prevent corporations from paying little or no taxes'.

OECD secretary general Angel Gurría said the plan would be rolled out over two years. It marked a 'turning point in the history of international tax cooperation'.

'A tense situation'

The OECD's report warned that while globalisation had benefited domestic economies, it had also opened up opportunities for multinationals to 'greatly minimise' their tax burden. 'This has led to a tense situation in which citizens have become more sensitive to tax fairness issues. It has become a critical issue for all parties', the report said.

Many governments were having to cope with less revenue. 'BEPS undermines the integrity of the tax system, as the public, press and some taxpayers deem reported low corporate tax rates to be unfair.' Lack of revenue in developing countries 'leads to critical under-funding of public investment that could help promote economic growth'.

The OECD said individuals were having to bear a greater share of the tax burden; multinationals themselves faced 'significant reputational risk' and those that failed to take advantage of legal opportunities to reduce tax liabilities could be put at a competitive disadvantage. Companies operating only in domestic markets 'have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax'.

'Commitment'

'We think that it is time to come together to make this plan work,' said **ICAEW** chief executive **Michael Izza**. The ICAEW would look to work closely with the UK government and the OECD.

Bill Dodwell, head of tax policy at **Deloitte**, described the plan as 'the most significant potential change to international taxation for decades'. The plan 'identifies the challenge of taxing the emerging digital economy, but recognises there is currently no consensus. This is problematic and a key hurdle for the OECD to overcome', he said. 'Businesses should also expect to see more imminent changes in connection with hybrid instruments and entities and the tax deductibility of interest'.

Richard Collier, tax partner at **PwC**, said the OECD plan amounted to a 'full-scale review' and could herald 'the biggest reform of global taxation in a lifetime'. Tougher tests to assess taxable presence and the substance of business activities in a particular country were likely. Change would not happen overnight, but it was in everyone's interest to reform the system. The plan's success would depend on 'continued commitment and effort by governments and business'.

Chris Morgan, head of tax policy at **KPMG** in the UK, said the OECD's proposals were 'ambitious and welcome'. It was 'widely recognised' that international tax rules need updating to take account of modern business practices. The action plan created a roadmap that should help companies to plan their future tax strategies, he said. KPMG noted that the action plan 'emphatically rejects the introduction of unitary taxation or formulary apportionment'. Consideration would be given to measures which may 'go beyond the arm's length principle' in dealing with intangibles, risk and capital allocation. 'What is being considered is probably a wider use of profit split methods as opposed to relying on comparable transactions.'

The **Tax Justice Network**, however, said unitary taxation was 'more politically feasible than the OECD's approach, if governments are serious about taxing multinational corporations'.

Developing countries

In a joint statement, **Christian Aid**, **Oxfam** and the **Global Alliance for Tax Justice**, a new campaigning body, warned that, while the OECD action plan was a step forward, it 'fails developing countries'. **Alex Prats**, principal economic justice adviser at Christian Aid, said the OECD expected the UN committee of experts on international cooperation in tax matters to help facilitate the contribution of developing countries to the reform process. But this would only happen if there was a firm commitment to strengthen that committee, he said.

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Adviser Q&A on the key issues

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What is the background to the action plan?

The OECD has been considering base erosion and profit shifting (BEPS) for a number of years. As tax planning by multinationals has become more sophisticated, gaps between domestic tax systems have become more apparent. In addition, the development of the digital economy has meant that businesses are more mobile than before. The OECD is keen that the OECD Model Tax Convention adequately deals with these gaps to ensure that multinationals do not benefit from double non-taxation.

Recent media pressure has also led the G20 to request that the OECD considers BEPS in more detail.

What does the action plan propose?

The action plan proposes to:

- review the application of existing international tax rules to the digital economy (i.e. online businesses);
- develop treaty anti-avoidance provisions to deal with hybrid entities and hybrid instruments;
- develop recommendations for countries to deal with controlled foreign companies, interest deductibility, treaty abuse and hybrids;
- improve information exchange, including spontaneous exchange in some cases;
- improve dispute resolution mechanisms;
- broaden the definition of permanent establishment, with particular focus on commissionaires;
- amend the transfer pricing rules, including broadening the definition of intangibles, and documentation requirements;
- develop recommendations for reporting business restructuring and tax planning arrangements; and
- develop a multilateral instrument under which countries can implement the action plan proposals.

The action plan does *not* propose any radical change. For example, formulary apportionment of profits is specifically excluded. Instead, the action plan relies on amending and strengthening existing mechanisms such as transfer pricing, controlled foreign company and permanent establishment rules.

What is the impact on the UK?

The UK already has the framework in place around which the action plan is built. UK tax legislation specifically incorporates the OECD Transfer Pricing Guidelines, and HMRC states that it follows the commentary to the OECD Model Tax Convention when interpreting other areas of legislation. Any changes made to these will therefore automatically be dealt with in the UK.

However, if changes were made to information exchange and improved dispute resolution, this would require amendment to UK domestic legislation and/or double tax agreements.

How innovative is action point 15 (to develop a multilateral instrument to implement changes)?

There are already a number of multilateral European agreements in relation to mutual assistance and information exchange.

Although HMRC has previously worked with the US and Australian tax authorities on data collection, any new multilateral agreements would have a much wider scope.

It is questionable as to how effective a multilateral agreement on (say) transfer pricing or permanent establishment would be. These matters are largely dealt with under domestic law in the first instance, and a multilateral agreement is likely to be more useful to a taxpayer company seeking relief under a multilateral competent authority process.

If the agreement is intended to ensure that the action plan is applied consistently, countries will still need to agree the underlying principles. We have seen with proposals for a common consolidated corporate tax base (CCCTB) that even with a framework in place (the European Union, in the case of CCCTB), no change can be made unless countries can agree.

How well has the action plan been received?

The action plan has been favourably received by government, and has been endorsed by the G20, which includes the UK. Business reaction has also been generally positive; the CBI, for example, has issued a statement supporting the action plan.

Many tax campaigners had hoped that the OECD would come out in support of formulary apportionment. However, such a radical shift from the current system of transfer pricing and treaties was never likely.

How realistic is the 18 to 24 month timeframe to implement the plan?

It is very unlikely that the action plan will be implemented in this timeframe. More minor changes to the definition of permanent establishment (due to be implemented in 2012) have been discussed in various forms since 2006, and the formal process of consultation began in 2012.

Most of the changes proposed in the action plan are likely to take at least two years to implement.

What are the next steps?

The next steps are for the OECD to produce recommendations, or propose amendments to the OECD Model Tax Convention and Transfer Pricing Guidelines.

Depending on the outcome of these recommendations and changes, OECD member states may then need to amend domestic legislation.

Do you think the action plan will achieve the stated aspirations of the G8/G20?

The action plan deals with some genuine issues in the Transfer Pricing Guidelines and Model Tax Convention, which have not been updated to deal with modern business structures.

The proposed anti-avoidance and information exchange rules will prevent some of the more abusive structures. However, no radical changes are proposed and it is unlikely that the tax base will be fundamentally shifted.

In particular, companies will still be taxed where their functions, assets and risks are located, and not where their customers are located. The action plan proposes a greater focus on customer-generated intangibles, such as information about customers, but it remains to be seen how significant an impact this will have.

Interviewed by Natalie Coope and Robert O'Hare, Lexis®PSL Tax.

The 15 action points in the OECD's report

Action point	Description	Expected output	Deadline
Addressing the digital economy			
1. Address the tax challenges of the digital economy.	Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.	Report identifying issues raised by the digital economy and possible actions to address them.	Sept 2014
Establishing international coherence of corporate income taxation			
2. Neutralise the effects of hybrid mismatch arrangements.	Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on coordination or tie-breaker rules, if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be coordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.	Changes to the Model Tax Convention. Recommendations regarding the design of domestic rules.	Sept 2014 Sept 2015
3. Strengthen CFC rules.	Develop recommendations regarding the design of controlled foreign corporation rules. This work will be coordinated with other work as necessary.	Recommendations regarding the design of domestic rules.	Sept 2015
4. Limit base erosion via interest deductions and other financial payments.	Develop recommendations regarding best practice in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be coordinated with the work on hybrids and CFC rules.	Recommendations regarding the design of domestic rules. Changes to the Transfer Pricing Guidelines.	Sept 2015 Dec 2015
5. Counter harmful tax practices more effectively, taking into account transparency and substance.	Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.	Finalise review of member country regimes. Strategy to expand participation to non-OECD members. Revision of existing criteria.	Sept 2014 Sept 2015 Dec 2015.
Restoring the full effects and benefits of international standards			
6. Prevent treaty abuse.	Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be coordinated with the work on hybrids.	Changes to the Model Tax Convention. Recommendations regarding the design of domestic rules.	Sept 2014 Sept 2014
7. Prevent the artificial avoidance of PE status.	Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.	Changes to the Model Tax Convention.	Sept 2015

Action point	Description	Expected output	Deadline
8. Ensure that transfer pricing outcomes are in line with value creation / intangibles.	Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.	Changes to the Transfer Pricing Guidelines and possibly to the Model Tax Convention. Changes to the Transfer Pricing Guidelines and possibly to the Model Tax Convention.	Sept 2014 Sept 2015
9. Ensure that transfer pricing outcomes are in line with value creation / risks and capital.	Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be coordinated with the work on interest expense deductions and other financial payments.	Changes to the Transfer Pricing Guidelines and possibly to the Model Tax Convention.	Sept 2015
10. Ensure that transfer pricing outcomes are in line with value creation / other high-risk transactions.	Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.	Changes to the Transfer Pricing Guidelines and possibly to the Model Tax Convention.	Sept 2015
Ensuring transparency while promoting increased certainty and predictability			
11. Establish methodologies to collect and analyse data on BEPS and the actions to address it.	Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses.	Recommendations regarding data to be collected and methodologies to analyse them.	Sept 2015
12. Require taxpayers to disclose their aggressive tax planning arrangements.	Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of 'tax benefit' in order to capture such transactions. The work will be coordinated with the work on cooperative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations.	Recommendations regarding the design of domestic rules.	Sept 2015
13. Reexamine transfer pricing documentation.	Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's 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.	Changes to Transfer Pricing Guidelines and recommendations regarding the design of domestic rules.	Sept 2014
14. Make dispute resolution mechanisms more effective.	Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.	Changes to the Model Tax Convention.	Sept 2015
From agreed policies to tax rules: the need for a swift implementation of the measures			
15. Develop a multilateral instrument.	Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution.	Report identifying relevant public international law and tax issues. Develop a multilateral instrument.	Sept 2014 Dec 2015

Source: OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, http://dx.doi.org/10.1787/9789264202719-en

An in-house perspective

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Despite the somewhat negative view of corporate behaviour, the action plan is sensible, well targeted and appropriately ambitious.

At first glance the OECD action plan on BEPS conveys a somewhat negative view of corporate behaviour. It notes that the global integration of multinational enterprises has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers and continues: 'These developments have been exacerbated by the increasing sophistication of tax planners in identifying and exploiting the legal arbitrage opportunities and the boundaries of acceptable tax planning, thus providing MNEs with more confidence in taking aggressive tax positions ... These developments have opened up opportunities for MNEs to greatly minimise their tax burden. This has led to a tense situation in which citizens have become more sensitive to tax fairness issues.' This is clearly one view of the issues which the general public and, perhaps, politicians will recognise. But there are many large corporates which have not engaged in aggressive planning and which are much more concerned with how to operate the current tax system correctly in the light of their international business models. For most, this will be the real focus of the work that lies ahead.

Once past these somewhat negative notes, the action plan is sensible, well targeted and appropriately ambitious in terms of scope and speed. The principle of coherence is highlighted; it is a worthy ambition to ensure that there is neither double taxation nor double non-taxation. From a business point of view, coherence might be expressed slightly differently, in that all business income should be taxed once and all business expenditure should be deducted once. Many businesses will welcome the clear signal that formulary apportionment is not to be pursued. This is because of 'the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries'. The best course is to directly address the flaws in the current system, although the action plan suggests that 'special measures within or beyond the arm's length principle may be required with respect to intangible assets, risk and over-capitalisation to address these flaws'. The OECD should tread extremely carefully in moving beyond the arm's length standard. Business would generally argue that this is the bedrock of transfer pricing and not to be departed from lightly. The emphasis on multilateral consensus and action is welcome, as is the proposal to make multilateral dispute resolution more effective. This recognises the great importance of minimising uncertainty for business.

Of the 15 actions in the plan, the first may prove to be the most difficult. This is to address the tax challenges of the digital economy. There are various ideas, particularly from France, to recognise a digital permanent establishment where customers download products or services, and to tax the harvesting of useful data from customers; and how to characterise income derived from new digital business models. None of these have been fully thought through yet and so far there seem to be few workable ideas on the table. This is an area where it will be critical for business and tax policy makers to work together. An OECD technical advisory group would work well in order to draw directly on business experience.

This will be a busy two years, but there is a once in a lifetime opportunity to bring the international tax system into the 21st century, and it seems that there is a great deal of goodwill and energy available to make this happen.

Revisiting permanent establishment rules

Alison Lobb
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Action 7 identifies that the time has come to update the international rules defining whether or not a permanent establishment exists, not least because of the nature and dynamism of modern businesses.

The definition of permanent establishment (PE) in article 5 of the OECD Model Tax Convention has been widely adopted in treaties, with little variation, to define when a PE exists. As well as providing for primary taxing rights to a country with a PE, it also offers administrative savings in determining where there is not a PE. Article 5 does not cover services PEs nor 'virtual PEs' in the digital context.

Article 5 does, however, define a 'fixed place of business' PE and a 'dependent agent' PE, and in the BEPS context there are potential issues with both of these. There are several specific activity exemptions from creating a fixed place of business PE (even though there would be one without an exemption). These include, for example, the use of facilities and the maintenance of a stock of goods where these are solely for the purpose of storage, display or delivery, or activities that are 'preparatory or auxiliary'. Such exemptions made sense historically, for example when goods arrived in bonded warehouses by ship; but for some modern centralised businesses, a key value driver is the ability to despatch goods to the customer speedily and efficiently in-market, even though the sale may be concluded elsewhere.

The dependent agent PE concept has been the subject of dispute in recent years, in particular in relation to 'commissionaire' arrangements. Commissionaires are a legal construct, found in many civil law countries, where the commissionaire (sales agent) does not bind the principal to the end customer. The issue is whether the commissionaire creates a dependent agent PE of the principal in the country of the commissionaire. Several European Supreme Court decisions have confirmed that article 5 requires a principal to be legally bound to the customer for there to be a dependent agent PE. It is clear that tax authorities do not like commissionaire arrangements, and therefore changes here are not surprising.

For businesses, PEs remain a challenge, applying to third party situations as well as within groups. Ensuring tax compliance with potential permanent establishments can be a headache in modern dynamic businesses, as there is no minimum time requirement for creating a PE under these headings (in contrast to construction projects). Tax disputes commonly arise where one country alleges a PE and claims significant profits attributed to it. Clear definitions, with appropriate de minimus time limits, would be helpful progress whilst addressing the wider BEPS issues.

The UK's competitive position

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A key issue for the UK will be deciding on its negotiating stance as the BEPS project moves forward. While some compromises are inevitable, if multilateral progress is to be made, it is important that HM Treasury does not inadvertently cede UK competitive advantage.

Actions 4 and 5 indicate where particular pressure points are likely to arise. Action 4 identifies a need to 'prevent base erosion through the use of interest expense' and action 5 says that it will 'take a holistic approach to evaluate preferential tax regimes'. The UK has a relatively generous regime for interest deduction, and this was the subject of lengthy debate during the reform of the taxation of foreign profits. Early in that debate, the possibility of restricting interest relief (possibly along the lines of the US interest allocation rules) was mooted, but rejected on the grounds of complexity. The final package represents a mainly territorial system, with anti-avoidance rules including the debt cap to prevent excessive deductions. The UK CFC rules are the final piece of that package, with profits attributable to UK economic activity being fully taxed, together with amounts artificially diverted from the UK. Overall, the regime is a balanced and competitive set of rules, which makes the UK an attractive location for holding company activity.

Any move to restrict interest deductibility would impose significant compliance burdens and reduce UK competitiveness, and it is to be hoped that HM Treasury will resist any pressure in this area. However, it is less clear that the finance company partial exemption (FCPE) measures in the CFC rules will survive: it is more difficult to justify this incentive on policy grounds, particularly if there is a general move to abolish other preferential financing regimes throughout the OECD. Measures by third countries to restrict interest deductibility where the income is favourably taxed under regimes such as FCPE may also curtail the benefits available.

> **Any move to restrict interest deductibility would … reduce UK competitiveness**

Elsewhere in the BEPS action plan, one strongly positive proposal is action 14, which recognises the need to ensure certainty and predictability for business. It is likely that mutual agreement procedures will be strengthened, and we may see a move towards more use of international arbitration and dispute resolution, perhaps using international mediation centres such as Qatar for the resolution of cross-border disputes.