Expert Q&A on the OECD's BEPS Project

The Organisation for Economic Co-operation and Development's (OECD's) Base Erosion and Profit Shifting (BEPS) Project is an initiative aimed at reducing double non-taxation arising in the context of cross-border transactions. In October 2015, the OECD published reports on 15 separate action items to address BEPS (BEPS reports). G20 leaders endorsed the BEPS reports in November 2015. Although the BEPS reports are said to be final and to represent a consensus, several of the BEPS reports set out areas of follow-up work, and often countries may choose from several options. Practical Law asked *Eric Wang* and *Andrew Thomson* of *Sullivan & Cromwell LLP* to discuss the key action items addressed in the BEPS reports.

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Why is BEPS a concern?

BEPS refers generally to tax planning strategies that shift profits to low- or no-tax jurisdictions (where little or no economic activity takes place) at the expense of higher-tax jurisdictions (where the economic activity takes place or consumers reside). For a multinational enterprise (MNE) that successfully implements a profit shifting strategy, the result can be little or no overall corporate tax being paid for certain activities.

What do the BEPS reports address?

The 15 action items cover a wide range of approaches to ending double non-taxation. Broadly, the action items seek to:

- Align taxing rights with economic and value-adding activity.
- Eliminate gaps arising from different tax treatment in different countries.
- Prevent treaty abuse.
- Provide transparency to tax authorities.

To align taxing rights with economic activity, the BEPS reports include revised guidance on transfer pricing, changes to the definition of "permanent establishment" (PE) in the OECD model tax treaty, and recommendations on harmful tax practices (that is, preferential tax regimes for mobile activities). One BEPS report addresses gaps caused by hybrid mismatch arrangements (where an entity or instrument is treated differently in two or more tax jurisdictions). Several BEPS reports contain measures to improve transparency, most notably country-by-country (CbC) reporting.

The OECD is also working on a multilateral tax treaty to speed up the process of implementing some of the recommendations that would otherwise need to be reflected in bilateral treaties (either in changes to existing treaties or the negotiation of new ones).

How will the various BEPS Project recommendations be implemented?

The recommendations in the BEPS reports are not legally binding and will be implemented in different ways. Some have been or will be implemented simply through changes to OECD guidance (for example, the revised guidance on transfer pricing). Some will require changes to bilateral tax treaties (and the aim of the multilateral treaty is to facilitate these changes). Others (for example, the recommendations on hybrid arrangements and CbC reporting) will require domestic law implementation. How these changes are made will depend on the jurisdiction.

The BEPS reports also reflect different levels of consensus among participating countries, with BEPS reports setting forth minimum standards reflecting the most consensus (for example, the BEPS reports addressing harmful tax practices and CbC reporting). There is some level of expectation that recommendations requiring changes to domestic law will be implemented by the countries that have been most actively involved in reaching the consensus reflected in the final BEPS reports (that is, OECD and G20 countries). This does not mean, however, that they will all apply the same rules.

What has been the US response to the BEPS Project?

There is no single US response. This is because President Obama (and his administration), Congress generally, each of the political parties, and even individual Congressmen and Senators have somewhat differing views. However, the overall response has mostly been negative.

The general view is that MNEs with a US parent company will need to pay disproportionately more non-US tax as a result of the BEPS Project and, therefore, the US government's tax collections will be reduced. So far the only concrete step taken by the US to implement any of the BEPS recommendations is a proposal to implement CbC reporting through administrative regulations.

What has been the EU response to the BEPS Project?

The EU has supported the BEPS Project more enthusiastically than the US. Member states like France, Germany, and the UK have supported the project from the beginning. For the self-standing EU institutions, the European Commission, and the Parliament, the solution to the BEPS problem is naturally more EU harmonization.

The EU is expected to implement many of the BEPS recommendations and the European Commission announced on January 28, 2016 its own anti-tax-avoidance package. The package includes a:

- Proposal for an anti-tax-avoidance directive.
- Proposed revision to the existing cooperation directive to require CbC reporting in the EU and exchange of reports between relevant EU tax authorities.
- Recommendation on reinforcement of member state tax treaties against aggressive tax planning.

The anti-tax-avoidance directive contains six measures, three of which overlap with OECD action items (limitations on interest deductions, a controlled foreign corporation (CFC) regime, and a rule for dealing with hybrid mismatches). However, the anti-tax-avoidance directive goes beyond the BEPS reports both in the detail of those rules and by including a general anti-abuse rule, an exit tax (for transfers of assets out of a member state or changes in tax residence), and a "switch-over clause." The switch-over clause would deny exemptions from corporate tax for dividends, gains on shares, or the income of PEs where the PE or investee company was established in a low-tax jurisdiction outside the EU.

What has been the UK response to the BEPS Project?

As noted above, the UK has been a strong supporter of the BEPS Project. The government has already published draft legislation to:

- Require CbC reporting.
- Address hybrid mismatch arrangements in line with the BEPS Project recommendations.
- Change the UK's patent box provisions to apply the substantive requirements of the BEPS report on harmful tax practices.

The UK has also carried out a consultation on changes to the UK's interest deductibility rules (which are currently relatively generous) to bring them in line with the recommendations in the BEPS reports on limiting base erosion involving interest deductions.

How is the emphasis on transparency reflected in the BEPS Project recommendations?

One of the key aims of the OECD is to create greater transparency for tax authorities. Transparency allows countries to take quicker and better-informed defensive measures against BEPS strategies deployed by MNEs and to push back against practices in other jurisdictions that facilitate BEPS. Three BEPS reports relate to transparency.

One key plank of the BEPS report on harmful tax practices is transparency of tax rulings between tax authorities. A framework has been agreed to for tax authorities to exchange six categories of taxpayer-specific rulings on an automatic basis. These categories cover areas that are susceptible to BEPS (for example, rulings related to preferential tax regimes). The aim is for tax authorities to receive information on tax rulings that are susceptible to BEPS quickly so that they can decide whether countermeasures are needed.

A second BEPS report provides a framework for countries without mandatory disclosure rules to obtain early information on aggressive or abusive tax planning schemes. It suggests requiring promoters and taxpayers to disclose the use of potential tax avoidance schemes to relevant tax authorities.

A third BEPS report, on transfer pricing documentation, adds CbC reporting of specified tax and financial information to the master file and local file already produced in many jurisdictions. On January 27, 2016, 31 OECD and G20 member countries signed a Multilateral Competent Authority Agreement, which provides for the automatic exchange of CbC reports. The US has not yet signed this agreement.

How has the EU responded to the transparency aspects of the BEPS Project?

The EU has already amended the existing cooperation directive to require member states to exchange information on advance cross-border tax rulings and advance pricing arrangements (except those in relation to individuals and businesses with group-wide annual turnover of less than EUR40 million). However, this does not fully implement the BEPS Project recommendations on exchange of tax rulings, since it only covers exchanges between EU tax authorities. The potential use of tax rulings to grant preferential treatment to certain taxpayers is currently under the spotlight in the EU. The Directorate-General for Competition of the European Commission has been investigating several rulings under its powers to regulate the provision of state aid.

In addition, as mentioned above, the European Commission's anti-tax-avoidance package includes proposed revisions to the cooperation directive to require CbC reporting in the EU and the exchange of reports between relevant EU tax authorities.

Which MNEs will be subject to CbC reporting and what information will be disclosed?

The BEPS Project recommendation on CbC reporting would require MNEs with at least EUR750 million in annual revenue (or the equivalent in domestic currency) to provide the MNE's parent entity's tax authority with certain financial and tax information on an annual basis for each tax jurisdiction in which it does business. This information includes income tax paid and accrued, revenues from related and unrelated parties, and headcount.

The BEPS report suggests that CbC reports should be shared with other relevant tax authorities through an automatic exchange of information. Several non-governmental organizations advocated making the CbC reports public, but the OECD did not adopt that suggestion.

Has the US adopted rules on CbC reporting?

On December 21, 2015, the IRS and Treasury Department issued proposed regulations requiring CbC reporting based on the OECD model legislation. The proposed regulations would generally require a CbC report to be filed with the IRS by a US company that is the ultimate parent entity (generally, the parent entity that consolidates accounts under US GAAP with its domestic and foreign subsidiaries) of an MNE group that had revenues of $850 million or more for the preceding annual account period. The proposed CbC report would include the ultimate parent entity and its constituent entities (generally those entities that are required to consolidate their accounts with the ultimate parent entity). The proposed CbC report is essentially identical to the OECD model.

The regulations are proposed to apply for taxable years beginning on or after the date when the final regulations are published. As a result, the US will not require CbC reports for tax years beginning on January 1, 2016, which is the date recommended by the OECD and which will be applied in many other jurisdictions. Some of those jurisdictions, including France, have introduced rules requiring local subsidiaries of a foreign-parented MNE to file CbC reports locally if they are not shared by the parent jurisdiction. (This would also be required throughout the EU under the rules proposed by the European Commission.) Therefore, currently, US-parented MNEs may need to produce CbC reports under foreign law before the US rules apply.

How will the BEPS Project's emphasis on transparency affect taxpayers?

Most MNEs are expecting two somewhat separate impacts.

First, there is a possibility of more disputes with tax authorities, particularly if there are two or more jurisdictions asserting taxing rights over the same income on differing theories (for example, by reference to the location of customers, sales teams, manufacturing, or intellectual property development).

Second, a number of MNEs are concerned about some portion of the CbC reporting information being made public, whether legally or illegally. The complex tax analyses that go into determining how income is taxed in multiple countries where products are manufactured and shipped through a number of different countries is very difficult to explain to an MNE's consumers. It is clear that the US government will resist sharing CbC reporting information in circumstances where it is expected to be made public, but how other countries and MNEs without a US parent company will react is still unclear.

Will the BEPS Project recommendations on transfer pricing lead to significant changes in transfer pricing rules?

With the exception of changes to transfer pricing documentation, it is hoped that the transfer pricing recommendations will not lead to significant changes in the US or to companies established in the US. The arm's length principle, which forms the basis of the transfer pricing regime, has been left largely untouched by the OECD, with only minor updates to strengthen the OECD's guidance in relation to specific areas, for example, transactions involving intangibles.

However, as the OECD's focus has been on furnishing tax authorities with all the relevant transfer pricing documentation to cut down on BEPS, it is expected that there will be increased transfer pricing tax disputes. In addition, given the categories of information that are expected to be shared under the CbC reporting rules, there is an expectation that some jurisdictions will want to assert a level of tax based on sales or other factors in its jurisdiction, and will therefore do so directly or deploy aggressive arm's length theories to reach that result.

What are the BEPS Project recommendations on hybrid entities and instruments?

A hybrid mismatch is an arrangement that exploits differences between tax jurisdictions, often through the use of a hybrid entity or instrument. A hybrid entity is an entity that is treated differently under the rules of different tax jurisdictions (for example, a partnership which may be treated as a taxable entity in one jurisdiction and transparent in another). Similarly, a hybrid instrument is one that is characterized differently by two tax jurisdictions (for example, an instrument that is considered debt in one country and equity in another).

The BEPS report on hybrid mismatch arrangements sets out recommendations to neutralize the tax effects of these mismatches in two ways. First, the BEPS report recommends changes to domestic law and sets forth a series of linking rules that aim to align the tax treatment of a hybrid entity or instrument with the treatment in the counterparty's jurisdiction (for example, by denying the payer an interest deduction when the recipient is not subject to tax on the interest). Second, the BEPS report recommends changes to tax treaties and aims to ensure that the benefits of tax treaties are only granted in appropriate cases to the income of hybrid entities.

The recommendations aim to put an end to, among other things, multiple deductions for a single expense, and deductions in one country without corresponding taxation in another. The recommendations are also intended to neutralize hybrid mismatch effects of what is commonly known as check the box planning.

How will the BEPS report on hybrid mismatch arrangements affect international tax planning?

While the full impact will depend on how each country implements these recommendations, and on what changes are made to treaties, it is expected that it will become more difficult to aggressively "interest strip" from high-tax jurisdictions (meaning to strip income from an entity located in a high-tax jurisdiction through interest payments made to an entity located in a low-tax jurisdiction). Many MNEs have already begun to wind down their use of hybrid structures.

The effects on US planning remain unclear. Currently, many US MNEs focus their international tax planning on reducing non-US tax and deferring US tax on income earned outside the US. With respect to deferral, a critical aspect is using hybrid entities to ensure that non-US income is treated as active, and that the royalties or interest used to reduce non-US tax are ignored for US tax purposes.

However, to the extent that higher non-US taxes must be paid as a result of the BEPS Project recommendations, US MNEs may decide that deferral is unnecessary because high-taxed non-US income can be repatriated for only a small amount of additional US tax (under the US foreign tax credit system). To maximize this effect, some US MNEs may seek to restructure their non-US businesses to keep previously low-taxed non-US income offshore while repatriating future high-taxed non-US income that will bring along foreign tax credits.

Who will oversee the implementation of the BEPS Project recommendations?

The OECD and G20 countries have agreed to monitor the implementation of the BEPS Project recommendations. This will consist of reports describing what countries have done to implement the recommendations and adhere to the minimum standards. The OECD has indicated that there will need to be some form of peer review, so that no country or jurisdiction gains unfair competitive advantages.

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