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B.E.P.S. RETROSPECTIVE: THE GLOBAL APPROACH TO COMBATTING BASE EROSION AND PROFIT SHIFTING IN 2014

Insights Special Edition

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EDITORS' NOTE

The O.E.C.D.'s attack on B.E.P.S. has been a work in progress since its announcement. B.E.P.S. proposals have been enacted into law by some countries while challenged by others, most notably the United States. With the turn of the year, we thought it appropriate to publish a retrospective of B.E.P.S. developments in 2014 as recorded in *Insights* by members of Ruchelman P.L.L.C.

This commemorative edition includes the following articles published in 2014 and 2015:

- **The O.E.C.D. Announces Global Standard for Automatic Exchange of Information.** In February 2014, the O.E.C.D.'s global model standard for automatic exchange of information reporting was released. The standard essentially adopted F.A.T.C.A. and is noteworthy in the context of F.A.T.C.A.'s application to foreign trusts.

- **U.S.-Based Pushback on B.E.P.S.** While the U.S. broadly agrees that the issues addressed by the B.E.P.S. project should be remedied, it disagrees that the best solution contains a multilateral framework, and U.S. lawmakers and regulators have publicly expressed doubt about the progress and effectiveness of the B.E.P.S. project. Has the O.E.C.D. created a miracle in Washington by bringing both political parties, two branches of government, and U.S. industry into alignment on tax policy?

- **The O.E.C.D.'s Approach to B.E.P.S. Concerns Raised by the Digital Economy.** The O.E.C.D. public discussion draft on Action 1, published in March 2014, provides a detailed introduction to the digital economy and proposes that rules to prevent B.E.P.S. should be consistent with counterparts in the traditional economy.

- **Action Item 1: The O.E.C.D.'s Approach to the Tax Challenges of the Digital Economy.** With the aim of ensuring that taxation follows economic activities and the creation of value (and not the other way around), the final report on Action Item 1 addresses the unique tax challenges arising from the digital economy.

- **O.E.C.D. Discussion Drafts Issued Regarding B.E.P.S. Action 2 – Neutralizing the Effects of Hybrid Mismatch Arrangements.** Two public discussion drafts issued in March 2014 address hybrid mismatch arrangements designed to exploit a difference in the characterization of an entity or an arrangement under the laws of two or more tax jurisdictions.

- **Action Item 2: Neutralizing the Effects of Hybrid Mismatch Arrangements.** On the heels of the March discussion drafts, the O.E.C.D. released the initial components of its plan to neutralize tax deficits resulting from hybrid mismatch arrangements.

- **B.E.P.S. Action 4: Limit Base Erosion via Interest Payments and Other Financial Payments.** Action 4 of the B.E.P.S. Action Plan focuses on best practices in the design of rules to prevent base erosion and profit shifting using interest and other financial pay¬ments economically equivalent to interest.

- **Action Item 5: Countering Harmful Tax Practices More Effectively.** Since the 1998 publication of its report Harmful Tax Competition: An Emerging Global Issue, the O.E.C.D. has endeavored to enhance its approach to identifying and combatting harmful tax practices. Modifications to the existing standard are found in the discussion draft on Action Item 5.

- **Action Item 6: Attacking Treaty Shopping.** Action Item 6 addresses abuse of treaties, particularly focusing on treaty shopping as one of the most important sources of B.E.P.S. The approach adopted in the discussion draft amends the O.E.C.D. Model Convention.

- **Action Item 8: Changes to the Transfer Pricing Rules in Relation to Intangibles – Phase 1.** Unlike some of the other B.E.P.S Action Items, Action Item 8 has a basis in existing O.E.C.D. rules. Modifications to existing guidelines are provided in the discussion draft.

- **B.E.P.S. Actions 8, 9 & 10: Assuring that Transfer Pricing Outcomes are in Line with Value Creation.** The discussion draft under Actions 8, 9, and 10 introduces revisions to Chapter I of the O.E.C.D.'s transfer pricing guide¬lines, guidance on risk and recharacterization is¬sues, and special measures to ensure that transfer pricing outcomes are in line with value creation.

- **B.E.P.S. Action 10: Part I – The Profit Split in the Context of Global Value Chains.** The discussion draft regarding taxation of global value chains aims to assure that transfer pricing outcomes are in line with value creation. It suggests the use of the profit split method in certain circumstances in lieu of a one-sided transfer pricing methodology.

- **B.E.P.S. Action 10: Part II – The Transfer Pricing Aspects of Cross-Border Commodity Transactions.** The discussion draft on transfer pricing issues arising from commodities transactions seeks to create clear guidance on the application of transfer pricing rules. It identifies issues and invites commentary on the O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

- **Action Item 13: Guidance on Transfer Pricing Documentation and Country-By-Country Reporting.** Action Item 13 develops rules regarding transfer pricing documentation to enhance transparency for tax administrations, taking into consideration the compliance costs for multinationals.

- **B.E.P.S. Action 14: Make Dispute Resolution Mechanisms More Effective.** While most of the Action Items focus on taxpayer abuse, Action 14 focuses on sub rosa attempts of tax authorities to undermine treaty-based dispute resolution procedures.

- **Action Item 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties.** Implementation of many of the B.E.P.S. Action Items would require amending or otherwise modifying international tax treaties. B.E.P.S. Action Item 15 recommends the development of a multilateral instrument to enable countries to easily implement measures developed through the B.E.P.S. initiative and to amend existing treaties.

We hope you enjoy this issue.

-The Editors

THE O.E.C.D. ANNOUNCES GLOBAL STANDARD FOR AUTOMATIC EXCHANGE OF INFORMATION

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Tags
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As we noted in our prior issue, the Leaders of the G-20 Summit endorsed automatic exchange of information reporting to combat tax evasion in September 2013.[1]

In particular, they stated that:

> We commend the progress recently achieved in the area of tax transparency and we fully endorse the OECD proposal for a truly global model for multilateral and bilateral automatic exchange of information. Calling on all other jurisdictions to join us by the earliest possible date, we are committed to automatic exchange of information as the new global standard, which must ensure confidentiality and the proper use of information exchanged, and we fully support the OECD work with G20 countries aimed at presenting such a new single global standard for automatic exchange of information by February 2014 and to finalizing technical modalities of effective automatic exchange by mid-2014. In parallel, we expect to begin to exchange information automatically on tax matters among G20 members by the end of 2015.[2]

On February 13, 2014, the Organisation for Economic Co-Operation and Development ("O.E.C.D.") announced a global standard for automatic exchange of financial account information. Over 40 countries made a joint statement and committed to an early adoption of this standard. On February 23, 2014, the G-20 finance ministers and central bank governors endorsed the proposal.[3]

The O.E.C.D. global model standard is based on the following key drivers:

- A common standard on information reporting, due diligence and exchange of information;
- A legal and operational basis for the exchange of information, including confidentiality and protections against misuse of information gathered through this process; and
- Common or compatible technical solutions.[4]

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1 See "Non-Resident Alien Interest Reporting Rules Upheld" for coverage of the September 2013 G-20 Summit.

2 See "G20 Leaders' Declaration," para. 51, September 2013.

3 See O.E.C.D. (2014), "Standard for Automatic Exchange of Financial Account Information (Common Reporting Standard)."

4 The Global Standard Model does not address them, and they are expected to be addressed by mid-2014.

Essentially, the O.E.C.D. global model standard has adopted F.A.T.C.A. (and its intergovernmental agreement approach) for information reporting purposes. In particular:

- Financial institutions subject to reporting include depository and custodial institutions, investment entities, and specified insurance companies, unless they present a low risk of being used for evading tax.
- Reportable accounts include accounts held by individuals and entities (which includes trusts and foundations), and the standard includes a requirement to look through passive entities to report on the relevant controlling persons. In addition, accounts held by passive nonfinancial entities must also be reported, if they have as one or more of their controlling persons one of the above-listed individuals or entities.
- The financial information to be disclosed with respect to reportable accounts includes interest, dividends, account balances, income from certain insurance products, sales proceeds from financial assets, and other income generated with respect to assets held in the account or payments made with respect to the account.
- The required information will be exchanged within nine months after the end of the year to which the reported information relates. The currency in which the reported amounts are expressed must be stated. The competent authorities of the countries party to an agreement will settle on the data transmission method. The internal tax laws of the country exchanging the information will apply to determine the character and amount of payments made with respect to a reportable account.
- Due diligence procedures distinguish between pre-existing and new accounts and high value and low value accounts.
  - Due diligence for pre-existing individual accounts are based either on an "indicia" search or on enhanced due diligence procedures requiring a paper search and actual knowledge test of the relationship manager. For new individual accounts the standard contemplates self-certification.
  - For entity accounts, financial Institutions are required to determine: (a) whether the entity itself is a reportable person, which can generally be done on the basis of available information (A.M.L./K.Y.C. procedures) and if not, a self-certification would be needed; and (b) whether the entity is a passive non-financial entity and, if so, the residency of controlling persons. Pre-existing entity accounts below 250,000 U.S.D. (or local currency equivalent) are not subject to review.

"What was once initially intensely resisted by much of the world is now being emphatically endorsed as a global standard."

What was once initially intensely resisted by much of the world is now being emphatically endorsed as a global standard. Even though political leaders cannot agree on many things, one thing can be said if this approach is adopted on a worldwide basis: raising revenue without raising taxes is politically tenable.

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U.S.-BASED PUSHBACK ON B.E.P.S.

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Tags
Arm's Length
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Return on Capital
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Transfer Pricing
Tax Reform
Treaty Abuse
Value Creation

INTRODUCTION

> In addition to the aggressive actions by some foreign countries to levy more taxes on U.S. taxpayers before a consensus has been reached, the process established by the O.E.C.D. raises serious questions about the ability of the United States to fully participate in the negotiations.
>
> Ultimately, we believe that the best way for the United States to address the potential problem of B.E.P.S. is to enact comprehensive tax reforms that lower the corporate rate to a more internationally competitive level and modernize the badly outdated and uncompetitive U.S. international tax structure.

So say Representative Dave Camp (R) and Senator Orrin Hatch (R), two leading Republican voices in Congress, on the O.E.C.D.'s B.E.P.S. project.

Does this somewhat direct expression of skepticism represent nothing more than U.S. political party politicking or a unified U.S. government position that in fact might be one supported by U.S. multinational corporations? The thought of the two political parties, the Administration and U.S. industry agreeing on a major political/economic issue presents an interesting, if unlikely, scenario. This article will explore that scenario.

OVERVIEW OF B.E.P.S./WHY B.E.P.S.?/WHY NOW?

Base erosion and profit shifting ("B.E.P.S.") refers to tax planning strategies that exploit gaps and mismatches in tax rules in order to make profits "disappear" for tax purposes or to shift profits to locations where there is little or no real activity and the taxes are low. This results in little or no overall corporate tax being paid.[1]

The B.E.P.S. Action Plan sets forth 15 actions to improve, in the words of the O.E.C.D., "coherence, substance and transparency" and to address tax gaps arising from the digital economy. The Action Plan calls for a multilateral instrument that countries can use to implement the measures developed in the course of the work by the O.E.C.D. The Action Plan was released in July of 2013. In September 2013, the leaders of the G20 countries meeting in St. Petersburg endorsed the Action Plan. The O.E.C.D. is set to deliver final guidance in September on several of those items, including intangible property and documentation. From a macro-economic viewpoint, B.E.P.S. is based on the following self-serving paradigms.

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[1] See "BEPS - Frequently Asked Questions."

The O.E.C.D. is convinced that:

- There is tax rate arbitraging being done by multinational corporations that use transfer pricing to shift income to low tax jurisdictions and expenses to high tax jurisdictions.
- There is shifting of intangible property and resulting royalties and license fee income to low tax jurisdictions. This is a primary goal of multinational corporations given the rise of information technology and other knowledge-intensive industries that exploit intangible assets currently owned by companies or potentially developed in the future.
- National governments aid and abet tax avoidance by cutting corporate tax rates (*e.g.*, E.U. countries) or creating tax regimes designed solely to attract foreign investors (*e.g.*, U.S. portfolio debt and patent box legislation in several E.U. countries). A complicating factor here is the potential reaction of emerging markets and developing countries considering their own form of international tax competition.

The specific B.E.P.S. Action Plan items operate within these paradigms to address the perceived areas of concern.

Four actions in the B.E.P.S. Action Plan (Actions 2, 3, 4, and 5) focus on ensuring that tax deductible payments by one person will result in income inclusions for the recipients so that double non-taxation is avoided.

In the area of transfer pricing, the O.E.C.D. seeks to address issues such as returns related to over-capitalization, risk, and intangible assets. It is important to note that the O.E.C.D. is considering special rules, either within or beyond the arm's length principle, to correct these issues. Five actions in the B.E.P.S. Action Plan focus on aligning taxing rights with substance in order to ensure that tangible economic substance exists for an entity, as evidenced by office space, tangible assets, and employees (Actions 6, 7, 8, 9, and 10).

The Action Plan also outlines certain procedures to improve transparency, such as:

- Improved data collection and analysis regarding the impact of B.E.P.S.;
- Taxpayers' disclosure about tax planning strategies; and
- Less burdensome and more targeted transfer pricing documentation.

Four actions in the B.E.P.S. Action Plan focus on improving transparency (actions 11, 12, 13, and 14).

U.S.-BASED CONCERNS REGARDING THE B.E.P.S. ACTION PLAN

The U.S. Government's main goal is to prevent other countries from taxing what it views as "its" tax base through B.E.P.S. While the U.S. government policy makers appear to broadly agree with the O.E.C.D. that the issues addressed by B.E.P.S. should be remedied, they seem to disagree that a multilateral framework is the best solution for addressing these problems. The following discussion reviews the B.E.P.S. Action Plans and notes U.S. pushback on certain aspects. The pushback has taken the form of proposed alternatives, comments, and an expressed view to reserve judgment on implementation to a later time. The U.S. business community likewise is concerned. This reflects recent intense scrutiny of U.S. multinational corporations' tax affairs by certain E.U. countries.

ACTION 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 characterization 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 business models in this sector.

Comments

The Digital Economy Task Force ("D.E.T.F.") was established in September of 2013 under the leadership of Thomson Reuters. The goals of the D.E.T.F. are "to educate the public and work collaboratively across stakeholder groups, including government agencies, law enforcement, corporations, academia, public and non-profit agencies, as well as key industry players." The D.E.T.F. seeks an approach that "will be a balanced view of both the advantages and disadvantages surrounding the digital economy."

There is little support among members of the D.E.T.F. for adopting a "virtual" permanent establishment. The concern is whether there will be a mistaken emphasis on attributing the revenue rather than a cogent approach to attributing the deductions to a "significant digital presence."

Tax Executive Institute ("T.E.I.") is the principal worldwide organization of in-house corporate tax executives with chapters in Europe, North America, and Asia representing over 3,000 of the largest companies in the world. T.E.I. issued comments on Action Plan 1 in April.

T.E.I. agrees that it is not correct to arbitrarily label enterprises "digital" or "non-digital" as the case may be. However, T.E.I. opposes options set forth in Section VII, including modifications to the permanent establishment exemptions, a new nexus standard based on significant digital presence, a virtual permanent establishment, and creation of a withholding tax regime on digital transactions.

These options are all generally unworkable as far as T.E.I. is concerned. They are not aligned with either G20's statement that profits should be taxed where they are located, nor other B.E.P.S. Action Plans themselves, such as Action Plan 7 on Permanent Establishments; 8, 9, and 10 on Transfer Pricing; 2 on Hybrids; 4 on Base Erosion; and 6 on Treaty abuse. T.E.I. notes that digital businesses face similar issues in moving assets across jurisdictional lines as do traditional businesses.

Digital business assets constituting intangible property, technical expertise, and similar intangible assets often present more complex cross border tax issues than are encountered when more traditional tangible assets are transferred. Improper initiatives relative to the taxation of digital businesses could very easily result in the taxation of these enterprises multiple times with regard to the same transaction.

Other measures noted in the Action 1 Discussion Draft would aim to restore taxation in both the market country and the country of the ultimate multinational parent. T.E.I. notes that many of these measures are designed to address low effective tax rates which are the result of deliberate tax policies of the O.E.C.D.'s Member States. T.E.I. concludes that most of the tax issues identified by the O.E.C.D. with respect to the digital economy could be addressed by proper application of existing international tax principles.

"Improper initiatives relative to the taxation of digital businesses could very easily result in the taxation of these enterprises multiple times with regard to the same transaction."

ACTION 2: Neutralize the effects of hybrid mismatch arrangements

> Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralize 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 co-ordination 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.

Comment

The main debate with respect to the hybrid mismatch arrangements is whether the O.E.C.D. will adopt a top-down approach to curb some types of hybrid arrangements (which could apply to any debt instrument that is held cross-border) or instead use a bottom-up approach, which would only apply to instruments held between related parties (including parties acting in concert as well as hybrid financial instruments entered into as part of a structured arrangement).

The I.R.S. has expressed disagreement with the top down approach, contending that it would be largely unworkable, requiring testing for exceptions in all cases. It is also concerned with practical issues such as effective administration of the recommended action plan. While the goals are specific, the remedy is vague and application of vague remedies in different countries can easily result in multiple adjustments that reach conflicting results – all countries involved in the cross border transaction assert primary jurisdiction to impose tax. This should be compared to a belief that is shared by multiple countries that wide latitude must exist for application of enforcement mechanisms. The I.R.S. is attempting to have the topic of controlled foreign corporations ("C.F.C.'s") included in the draft on hybrid arrangements.

The I.R.S. also has expressed disagreement with a proposal under the hybrid discussion draft that would reduce the required ownership between companies to 10% in order for the entities to be considered to be related. Again, the I.R.S. believes that this would lead to an increased burden on effective administration. The I.R.S. will attempt to raise the threshold in future discussions. Discussions on this point have gravitated to a higher threshold, generally 25%, with perhaps 50% in certain cases.

ACTION 3: Strengthen C.F.C. rules

> Develop recommendations regarding the design of controlled foreign company rules. This work will be coordinated with other work as necessary.

Comments

The work in this area is consistent with current U.S. international tax reform proposals that generally seek to broaden the non-U.S. source income tax base of multinational corporations.

In November of 2013, the "Baucus Discussion Draft" was released by Senator Baucus under the auspices of the Senate Finance Committee. The Discussion Draft is notable in its attempt to address in an entirely U.S. context many of the same international tax issues addressed by the O.E.C.D. in B.E.P.S. Action Plans 2 (Hybrid Mismatch Arrangements), 3 (Strengthening CFC Rules), 4 (Limit Base Erosion via Interest Deductions and Other Financial Payments), and 8, 9, and 10 (Transfer Pricing).

With respect to C.F.C. rules the Baucus Discussion Draft would replace the current U.S. deferral system with a statutory scheme referred to as "Option Y" or an alternative proposal referred to as "Option Z." Either one could replace the concept of deferring non-U.S. source income with a system under which all income of foreign subsidiaries of U.S. companies would either be taxed currently at a certain minimum rate or be permanently exempt. Both options would result in subjecting a greater portion of C.F.C. income to U.S. taxation on a current basis.

A tax reform proposal was also released by the House Ways and Means Committee's Chairman Camp in February 2014 ("the Camp Draft Plan"), which would similarly broaden the corporate tax base and prevent base erosion. However, the Camp Draft Plan would take a different approach than the Baucus Discussion Draft, by proposing an essentially territorial tax system through a 95% dividends received deduction. Like the Baucus Discussion Draft, the Camp Draft Plan would expand Subpart F income by creating a new category of Subpart F income (foreign base company intangible income). It would also impose a one-time retroactive tax on previously untaxed foreign earnings, albeit at a lower rate. Unlike the Baucus Discussion Draft, which does not commit to any particular corporate tax rate, the Camp Draft Plan would lower the corporate tax rate to 25%.

ACTION 4: Limit base erosion via interest deductions and other financial payments

> Develop recommendations regarding best practices 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.

Comment

Action Plan 4 raises issues regarding the application of transfer pricing principles to the level of debt and the rate of interest payable. It also questions the freedom of enterprises to determine the amounts of funding that can be raised through the issuance debt and equity that appears on a balance sheet.

I.R.S. and Treasury note that it is a basic tenet of the arm's length principle endorsed by the Action Plan (at least, in principle) that the tax treatment within a country should essentially be the same whether payments are made to a foreign group entity or to a third party. I.R.S. and Treasury also believe that a natural extension of this view, market dynamics of capitalization, and interest costs should control deductions claimed for interest rather than the tax exposure faced by the lender. Under this view, the taxable status of the lender simply is not relevant.

Having said this, Action Plan 4 may align nicely with current U.S. tax laws restricting interest deductions found in the I.R.C. 163(j) earnings stripping rules, as well as legislative proposals from both Congress (Rep. Camp) and the Administration regarding thin capitalization and deferral of interest deductions attributable to un-repatriated earnings.

ACTION 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.

Comment

In an early statement on point (June 2013 at the O.E.C.D. International Tax Conference in Washington D.C.), Robert Stack, U.S. Treasury Deputy Assistant Secretary for International Tax Affairs, Office of Tax Policy, stated in general that the B.E.P.S.

Action Plans face both technical and political challenges. From the U.S. standpoint, B.E.P.S. should focus on addressing the stripping of income from higher-tax jurisdictions into low-tax or no-tax jurisdictions rather than on a fundamental reexamination of residence and source country taxation. Mr. Stack stated that the actions of both companies and governments should be examined, and he admitted that the U.S. "check the box" regulations have weakened the U.S. C.F.C. rules.

ACTION 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.

Comment

Action 6 seeks to prevent treaty abuse and develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances

"The I.R.S. indicates that the U.S. will not join any multilateral treaty that has a main purpose test."

The U.S. is currently reflecting on its own limitations on benefits ("L.O.B.") article, some of which is unpopular with other countries. Some countries are requesting arbitration or a mutual agreement procedure in the event that U.S. denies treaty benefits under an L.O.B. provision. Countries are also concerned that some legitimate transactions are being caught inadvertently by the L.O.B article. The I.R.S. accepts the basic merit of these comments.

The I.R.S. disagrees with the idea that a general avoidance rule is declared if one of the main purposes of a transaction is a tax benefit. In fact, the I.R.S. indicates that the U.S. will not join any multilateral treaty that has a main purpose test. If enacted, the U.S. will reserve judgment on the model treaty due to a "main purpose test."

ACTION 7: Prevent the artificial avoidance of permanent establishment status

> Develop changes to the definition of permanent establishment to prevent the artificial avoidance of permanent establishment 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.

Comment

Action Plan 7 seeks to develop changes to the definition of permanent establishment. The I.R.S. wishes to curtail some of the exceptions to permanent establishment status for preparatory and auxiliary activities so that specific kinds of activities are no longer considered auxiliary but are deemed to be core. The I.R.S. believes that the examples used by the O.E.C.D. to help identify core versus auxiliary activities primarily targets U.S. companies.

ACTIONS 8, 9, 10: Assure that transfer pricing outcomes are in line with value creation

Action 8: 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.

Comment

A working party is currently debating the second prong of Action 8, which calls on countries to ensure that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation. The U.S. indicates that while it may not agree with the current proposed measures, they will be addressed at a later time.

The U.S. believes that measures to analyze difficult-to-value intangibles could instead be remedied by the Internal Revenue Code ("Code") or special legislation. However, the I.R.S. has signaled that some measure should be taken to address the situation of offshore entities owning intangible property which is subject to zero tax.

The I.R.S. proposes assessing difficult-to-value intangibles using a contingent payment regime that measures value based on actual returns. Thus, it advocates a commensurate-with-income standard where the U.S. parent transfers an intangible out of the U.S. at an extremely low price. Under that approach, a tax authority could assert that when extremely low valuation was demonstrated at the time an intangible left the country after which the value became extremely high, the earlier valuation could be adjusted retroactively to the time of export from the U.S. This is the method that applies under Code §482.

The I.R.S. also fears that B.E.P.S. is focusing on territories that have a zero-tax regime, such as Bermuda, but is ignoring low tax regimes such as Ireland. However, the I.R.S. acknowledges analyzing a low-tax jurisdiction is more difficult compared to analyzing a no-tax jurisdiction.

The I.R.S. is confident that it will succeed in recalibrating the intangibles discussion draft. Specifically, it is confident in revising the rule for identifying the member of a multinational group that should be entitled to the returns on intangible property.

Note that the I.R.S. does not favor retroactive application of whichever action plan is proposed. Those that have already valued and "exported" intellectual property would continue to be protected.

Action 9: 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.

Comment

Action 9 seeks to address the problem of transferring risk among or allocating excessive capital to group members.

The I.R.S. opinion on cash is that the party having capital is entitled to an arm's length return for its use. According to the I.R.S., the debate should rather be about whether an equity return or a debt return is proper in the circumstances. The important goal according to the I.R.S. is that cash-box entities should file a return. Other countries argue that members of a multinational group are linked. For that reason, an arm's length cap is appropriate on the profits attributable to capital.

With respect to debt incurred between related parties, the I.R.S. is concerned with base erosion but maintains the view that this problem should not be addressed through B.E.P.S. Nonetheless, an arm's length rule could be applied in certain intercompany loans. For example, it could be applied when an intercompany loan carries an excessive rate of interest charged or when the amount of debt is excessive and should be recharacterized as equity. In these circumstances, a facts and circumstance test should be used to determine the allowable interest rate and the status of the instrument issued in connection with the transfer of funds. In general, the I.R.S. disapproves of a view that a transaction is illegitimate merely because there is a lack of comparable transactions among independent parties.

Action 10: 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 re-characterized; (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.

Comment

B.E.P.S. Acton Plans 9 and 10 have been consolidated, with a September 2015 deadline in mind. Both task the B.E.P.S. project with changing the O.E.C.D. transfer pricing guidelines and possibly the O.E.C.D. Model Tax Convention Action 9 is directed to preventing "arbitrary profit shifting" when group members transfer risks internally or allocate excessive capital to other group members. Action 10 is directed to preventing groups from engaging in transactions that wouldn't, or would only very rarely, occur between third parties.

In July, the new head of the O.E.C.D. transfer pricing unit, Andrew Hickman, addressed a Transfer Pricing Conference sponsored by the National Association for Business Economics. He defined the foregoing Action Plan tasks in terms of analysis of risk and recharacterization. The unanswered question at this time is the extent to which taxation authorities would be required to accept the facts and circumstances presented by taxpayers so that authorities could not demand that taxpayers change their specific facts and circumstances.

At the same conference, Deputy Assistant Treasury Secretary Robert Stack stated that the U.S. would focus its efforts to ensure that (i) the current arm's length standard is clearly articulated and (ii) profits are attributable to the place of economic activities. Deputy Assistant Secretary Stack enunciated the U.S. position in the following language:

- The place of economic activities is where the assets, functions, and risks of the multinational are located;
- The U.S. must further ensure that any special measures agreed to at the O.E.C.D. are firmly anchored in these principles; and
- Legal and contractual relationships are ignored in determining intercompany prices only in unusual circumstances.

Deputy Assistant Secretary Stack reiterated the U.S. position that the arm's length standard is the best tool available to deal with the difficult issue of pricing among affiliates of a multinational group. He noted that the worldwide concern with the arm's length standard emanates in large part from worldwide dissatisfaction with the very low effective tax rates reported by major U.S. multinational companies. Tension exists among countries as to the relative value of activities performed within their borders in the product supply chain. This creates an environment in which the blunt-instruments approach of the B.E.P.S. transfer pricing Action Plans has gained traction. Nonetheless, the U.S. intends to steadfastly avoid turning long-standing transfer pricing principles into a series of vague concepts easily manipulated by countries to serve their revenue needs at the expense of the U.S. tax base and U.S. multinational groups.

The U.S. concern with the B.E.P.S. transfer pricing Action Plans reflects current events. Within the last decade, the O.E.C.D. reaffirmed its commitment to the arm's length principle in its *O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, as amended on July 22, 2010. The O.E.C.D. has also expressly rejected a so-called formulary approach within the context of its transfer pricing guidance. In contrast to that position, the B.E.P.S. transfer pricing Action Plan principle challenges the arm's length principal. The B.E.P.S. Action Plan notes certain "flaws" in the arm's length principle, and contemplates "special measures, either within or beyond the arm's length principle," in order to address issues with respect to "intangible assets, risk and over-capitalization."

Needless to say, Action Plans 9 and 10 have turned the transfer pricing world on its head; at least one I.R.S. official cautions that we are on the verge of international tax chaos. The B.E.P.S. transfer pricing project team is on record that "the arm's-length principle is 'not something that is carved in stone,'" and if 'we come to the point where we recognize that there is a limit to what we can do with the arm's-length principle, we may need special measures—either inside, or even outside, the arm's-length principle—to really address these situations." In this context, it is felt that the O.E.C.D. may approve new transfer pricing rules inconsistent with the arm's length principle.

The U.S. position is that a move away from the arm's length principle would abandon a sound, tested theoretical basis including transfer pricing precedents. This would thereby substantially increase the risk of double taxation. Experience under the arm's length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations. This shared understanding is of great practical value in achieving the objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation. Policy makers at the I.R.S. and the Treasury Department recognize that improvements to the international transfer pricing regime can be achieved. However, prior experience with the arm's length standard should be drawn on to effect changes to it.

A former Director of the I.R.S. Office of Transfer Pricing, Samuel Maruca, was quoted recently as saying "B.E.P.S. could lead to international chaos if not managed well." The issue has apparently come to a head with respect to consideration of the Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles. The O.E.C.D. position is seen by the U.S. as a departure from a traditional arm's length analysis of functions and risks and more towards a formulary approach. The O.E.C.D. position places less emphasis on ownership and contractual assumptions of risk and more emphasis on the location of individuals performing what are considered to be important functions in the concept to customer chain. This approach, combined with the new proposed country-by-country reporting template intended to act as a transfer pricing risk tool, raises the specter of a multinational equivalent of formulary apportionment so common in the U.S. among state income tax systems.

ACTION 11: Establish methodologies to collect and analyze data on B.E.P.S. 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 confidence.

Comment

A decision is yet to be made as to how multinational companies will share their country-by-country reporting templates with tax authorities. The working party is considering whether a U.S. multinational would give its template to the I.R.S. so the government can share it under the relevant U.S. treaty, which is subject to confidentiality rules, or follow some other process for sharing the information. The I.R.S. prefers the treaty approach but believes that the issue will not be addressed in 2014.

In general, the I.R.S. believes that most reporting requirements can be fulfilled by existing U.S. Law (Code §6038); however, it has refrained from passing judgment on this measure until it reviews the final draft of the B.E.P.S. reporting template.

ACTION 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 co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations.

Comment

The information returns used in the U.S. for international tax compliance and reporting are under consideration as a template for worldwide tax transparency to track how profits are moved around the globe. Form 5471 (*Information Return of U.S. Persons With Respect to Certain Foreign Corporations*) gathers significant legal and commercial information with respect to C.F.C.'s that may not be generally available to tax administrations around the world. Form 5471 is being considered by the G20 nations and the O.E.C.D. as the model for the type of information that may be requested by other countries. The form requires reporting by U.S. citizens or residents, domestic corporations, domestic partnerships, and certain estates and trusts of assets held in foreign corporations in which a direct or indirect ownership percentage of at least 10% exists. The requirements affect a broad range of other individuals and businesses, including U.S. citizens or residents who are officers and directors of these corporations.

Supplementing the Form 5471 are other information gathering forms such as:

- Form 8938 (*Statement of Specified Foreign Financial Assets*), implementing I.R.C. §6038D;
- Form 1120, Schedule UTP (*Uncertain Tax Position Statement*), which addresses the likelihood that certain positions taken on the tax return are correct; and
- FINCEN Form 114, the electronic successor to Form TD F90-22.1.

Thus, the work being done in conjunction with Action Plan 12 is generally seen as consistent with U.S. concepts of ongoing informational reporting.

ACTION 13: Re-examine 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.

Comment

The key issue with Action Plan 13 has been the country-by-country reporting aspect of transfer pricing documentation. The U.S. corporate community has argued that this should not be undertaken for various commercial/legal reasons involving risks in disclosing proprietary business information. The Treasury has resisted country-by-country reporting in the past. However, with support from the G8 and G20 leaders the exercise has become not a "whether to" but a "how to" exercise.

Under the B.E.P.S. Action Plan, the information that is gathered is only to be used by tax administrations for purposes of risk assessment and should not take the place of a transfer pricing analysis. The I.R.S. is confident in its ability to conduct robust transfer pricing audits under the new Transfer Pricing Roadmap procedures, announced in February 2014. Accordingly, the I.R.S. and Treasury see Action Plan 13 as a secondary source of information. This is apparently consistent with the views of the O.E.C.D. working party dealing with Action Plan 13.

Action Plan 13 has been the subject of comments regarding several practical information reporting issues raised by industry. Examples include:

- Appropriate depreciation methods;
- Reporting for groups within a country on an aggregate basis rather than a separate legal entity basis;
- Reporting of inter-group transactions in the master file only;
- Disclosure of share capital and accumulated earnings; and
- Taxes being reported when and as paid, rather than accrued.

Many fear that Action Plan 13 may be become bogged down in detail of financial reporting, trying to balance the risk of inappropriate or illegal access to company proprietary information.

ACTION 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.

Comment

Action Plan 14 is the O.E.C.D.'s idea of a taxpayer-friendly initiative, which it feels should be welcomed by taxpayers. The Action Plan focuses on:

- Access to Mutual Agreement Procedure ("M.A.P.");
- Arbitration;
- Multilateral M.A.P.'s & Advance Pricing Agreements ("A.P.A.'s");

- Adjustment issues, including timing for corresponding adjustments, self-initiated adjustments, and secondary adjustments;
- Interest and Penalties;
- Hybrid Entities; and
- Legal status of a mutual agreement.

This approach generally aligns with the I.R.S. approach as set forth in Notice 2013-78, issued in November 2013, which proposed updated guidance related to requesting U.S. Competent Authority with a view to "improve clarity, readability, and organization." The Notice also intended to reflect I.R.S. structural changes that have occurred since 2006.

On behalf of the U.S. corporate community, T.E.I. commented on Notice 2013-78 in March of 2014. Comments made by T.E.I. were that:

- Opening the Competent Authority process to taxpayer initiated adjustments was welcomed;
- Competent Authority-initiated M.A.P. cases and the required inclusion of M.A.P. issues that are not a part of the taxpayer's request for assistance elicited concerns and questions;
- Provision of all information to both Competent Authorities is overreaching, particularly where the information may not be relevant to a given Competent Authority; and
- The interplay between the foreign tax credit rules, that mandate the exhaustion of all remedies under the laws of the foreign country before a foreign tax is creditable, and the denial of U.S. Competent Authority assistance in an M.A.P. case raise fears that a U.S.-based group will be required to challenge a foreign-initiated adjustment in instances where the I.R.S. will not provide assistance through an M.A.P. case.

ACTION 15: Develop a multilateral instrument

> Analyze 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.

Comment

Deputy Assistant Secretary Robert Stack has expressed concerns regarding the implementation of this B.E.P.S. Action Plan in the United States. Action Plan 15 was criticized in connection with its call for the development of a multilateral instrument. It was characterized as an idea that is not well-defined in terms of its process and substance with little opportunity of implementation.

CONCLUSION

B.E.P.S. Action items 1, 2, 5, 6, 8, 13 and 15 currently have a September 2014 target delivery date. The O.E.C.D. expects to present final reports at the G20 Finance Ministers Meeting. Draft reports for many of these action items were released in February and March, and related comments have been collected. The O.E.C.D. has admitted that it is working at a frantic pace to deliver the final reports by the target date in order to pre-empt the development of unilateral B.E.P.S. legislation and regulation in O.E.C.D. and G20 member nations.

In light of the quickly approaching target delivery dates, U.S. lawmakers and regulators have publicly expressed doubt about the progress and effectiveness of the project. The statements noted at the beginning of this article were joint statements released by Senate Finance Committee Ranking Minority Member Orrin Hatch and House of Representatives Ways and Means Committee Chairman Dave Camp in late June 2014. They focused on the time frame and progress of the implementation of the B.E.P.S. Action Plan as well as concerns that the plan is being used by other member nations to increase the taxes collected on U.S. corporations. According to Messrs. Hatch and Camp, the September 2014 deadline for implementation of the seven early action items is extremely ambitious, which limits the ability to review, analyze and comment on the rules being proposed. Accordingly, Messrs. Hatch and Camp believe the process raises serious questions about the ability of the United States to fully participate in the negotiations. Nevertheless, comprehensive U.S. Federal income tax reform has been suggested to lower the corporate income tax rate to a level which is internationally competitive and to modernize the U.S. international tax system.

Deputy Assistant Secretary Stack has expressed general concern regarding the implementation of the B.E.P.S. Action Plans in the United States.

Congress, the Administration, and the corporate community share several basic views regarding B.E.P.S.:

- There are areas of international tax law that are the province of the U.S. and should be managed without the layering on top of a newly created set of rules and principles;
- The basic tenet of transfer pricing, the arm's length standard, should remain a cornerstone of international tax; and
- U.S. international tax reform is urgently needed to compliment B.E.P.S. Action Plans and to protect U.S. economic interests.

As with many overriding issues and ideas, the devil is in the details. Action other than rhetoric seems to be missing. The only thing that is certain is that the saga will continue.

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THE O.E.C.D.'S APPROACH TO B.E.P.S. CONCERNS RAISED BY THE DIGITAL ECONOMY

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Tags
B.E.P.S.
Digital Economy
O.E.C.D.

On March 24, 2014, ten days after the O.E.C.D. released its public discussion draft on prevention of treaty abuse,[1] a second public discussion draft was released, addressing the tax challenges of the digital economy (the "Discussion Draft").[2]

The Discussion Draft emphasizes the concept that the digital economy should not be ring-fenced and separated from the rest of the economy, given its relationship to the latter. It provides a detailed introduction to the digital economy, including its history, components, operations, and different actors. Surprisingly, it does not propose any groundbreaking approaches to addressing the base erosion and profit shifting ("B.E.P.S.") challenges encountered in the digital economy. It simply reflects an approach that is consistent with the fight against B.E.P.S. – seeking to determine where economic activity takes place in the digital economy in order to best achieve taxation in a non-abusive fashion.

The Discussion Draft singles out six factors that characterize the digital economy in light of B.E.P.S. concerns:

1. Mobility of all facets of the digital economy, including the intangibles used, the users themselves, and the business functions carried on by various players in the business model;
2. Reliance on data;
3. Network effects;
4. Use of multi-sided business models;
5. Tendency towards monopoly or oligopoly; and
6. Volatility.

The Discussion Draft addresses traditional B.E.P.S. concerns relating to direct and indirect taxation. These include the avoidance of a taxable presence in the market place, the avoidance of withholding taxes through treaty-shopping, the minimization of tax in intermediate countries, the minimization of tax in the ultimate parent's home jurisdiction, and cross-border acquisitions by V.A.T. exempt purchasers. The Discussion Draft reiterates the O.E.C.D.'s stated goal in the B.E.P.S. project – that is, to ensure that taxation takes place at least once, preferably at the location of economic activities. This is particularly difficult to determine with respect to the digital economy, since the different actors, components, and users are generally spread over multiple jurisdictions.

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1 See Client Alert March 18, 2014 Re: O.E.C.D. Public Discussion Draft on Preventing Treaty Abuse.

2 See Public Discussion Draft BEPS Action 1: Address the Tax Challenges of the Digital Economy.

With that in mind, the Discussion Draft proposes, *inter alia*, the following approaches to achieve appropriate taxation:

- Revisiting the Treaty definition of permanent establishment ("P.E.") with a focus on the various exemptions for specific activities: These exemptions were drafted so as to avoid preparatory or auxiliary activities from giving rise to taxation. However, when applied to the digital economy, these preparatory or auxiliary activities may well constitute a core element of the given digital business.

- Creation of a two-step nexus test based on an entity's "significant digital presence" to evaluate whether P.E. exists: A preliminary set of factors would determine whether a given activity is fully dematerialized – that is, in broad terms, no physical presence exists in a country and no physical object is furnished to the customer. Once this determination is made, a second set of factors would establish whether an enterprise engaged in a fully dematerialized activity has a significant digital presence, in which case specific methods have been followed to reach a class of users or consumers in a particular country. As an alternative to this two-step test, the Discussion Draft proposes the use of personal data to reach a conclusion as to the presence of a P.E.

"The Discussion Draft addresses traditional B.E.P.S. concerns relating to direct and indirect taxation."

- Referring to the work of the Business Profits TAG, three alternative approaches to P.E. thresholds: (i) "virtual fixed place of business," (ii) "virtual agency PE," and (iii) "on-site business presence PE."

- Creation of a withholding tax on digital cross-border transactions: This would be achieved by requiring the financial institution involved in online payment to withhold the required tax.

- With regard to V.A.T., a review of the exemption for low-valued goods: The Discussion Draft highlights the increased flow of cross-border acquisitions of low valued goods generated by the digital economy and correlated decrease in V.A.T. revenue.

- With regard to Business-to Consumer ("B2C") transactions in the V.A.T. field, the most viable option is described as one under which the foreign supplier collects the V.A.T. and remits it to the jurisdiction of consumption: This should be coupled with simplified registration regimes and thresholds, as well as with an international cooperation mechanism between jurisdictions.

Another challenge addressed by the Discussion Draft involves the methods for attributing value to the collection of digital data. This refers to the practice whereby sophisticated tracking techniques allows digital merchants to identify items of interest for a specific group of consumers (such as French teenage girls living in Paris who respond to clothing advertisements) and the data is then sold to merchants and used to target specific items to that category of consumer. The Discussion Draft also raises questions concerning the character of certain income flows related to the digital economy, such as payments for cloud computing. Do they constitute payments for services, royalty payments or business profits?

The Discussion Draft mostly refers to other actions of the 2013 B.E.P.S. Action Plan to effectively address the B.E.P.S. concerns raised by the digital economy. It refers specifically to Action 2 (Neutralize the Effects of Hybrid Mismatch Arrangements), Action 4 (Limit Base Erosion via Interest Deductions and Other Financial

Payments), Action 5 (Counter Harmful Tax Practices More Effectively), Action 6 (Prevent Treaty Abuse), Action 7 (Prevent the Artificial Avoidance of PE Status), and Actions 8-10 (Assure that transfer pricing outcomes are in line with value creation). Regarding consumption taxes, the Discussion Draft refers to Guidelines 2 and 4 of the O.E.C.D.'s "Guidelines on place of taxation for B2B supplies of services and intangibles." In addition, the Discussion Draft examines the importance of C.F.C. legislation and takes the position that C.F.C. regimes should address the taxation of income generally earned in the digital economy.

Comments on the Discussion Draft could be submitted electronically until April 14, and submitters wishing to speak in support of their comments were required indicate their intention to do so by April 7.

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ACTION ITEM 1: THE O.E.C.D.'S APPROACH TO THE TAX CHALLENGES OF THE DIGITAL ECONOMY

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The O.E.C.D.'s Action Plan adopted in Saint Petersburg in 2013 aims at tracking where economic activities generating taxable profits are performed and where value is created. It aims at ensuring that taxation follows the economic activities and the creation of value and not the other way around. Action Item 1 of the Action Plan (the "Action 1 Deliverable") focuses on the tax challenges of the digital economy. Along with the 2014 Deliverable on Action 15 (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties), the Action 1 Deliverable is a final report.

The Action 1 Deliverable published on September 16, 2014 mainly reiterates the March 2014 Public Discussion Draft on Action 1 (click here to access our article on the 2014 Public Discussion Draft). It restates that, while B.E.P.S. is exacerbated in the digital economy space, the digital economy cannot be ring-fenced from other sectors of the economy for B.E.P.S. purposes because the digital economy is an ever growing portion of the entire economy. The Action 1 Deliverable thus refers to other Actions to address common B.E.P.S. issues that are not specific to the digital economy. Action Item 1 also refers to the O.E.C.D.'s International V.A.T./G.S.T. Guidelines with regard to V.A.T. issues raised by the digital economy. Although the Action 1 Deliverable adds relatively little to the previously published Public Discussion Draft on Action Item 1, the benefit of a set of uniformly accepted rules should not be understated. With European countries struggling to raise tax revenue in order to close budget gaps, the risk of adverse unilateral action by one or more countries is real. During a symposium held in Rome at the beginning of the month, certain European countries, and especially Italy, pushed for unilateral action with regard to the taxation of the digital economy.[1] If that action proceeds to enactment, digital tax chaos could be encountered.

Like the Public Discussion Draft, the Action 1 Deliverable gives an extensive explanation of the evolution of the digital economy, its key features, and the ensuing B.E.P.S. opportunities arising from the conduct of a digital business. It restates the previously identified traditional B.E.P.S. concerns relating to direct and indirect taxation. These include the avoidance of a taxable presence in the market place, the avoidance of withholding taxes through treaty-shopping, the minimization of tax in intermediate countries, the minimization of tax in the ultimate parent's home jurisdiction, and cross-border acquisitions by purchasers that are exempt from V.A.T.

The Action 1 Deliverable lays out how B.E.P.S. issues arising in the digital economy can be addressed. It emphasizes restoring taxation at the level of the market jurisdiction and the jurisdiction of the parent company, which is referred to as the restoration of taxation on stateless income. In an attempt to illustrate that no ring-fenced approach should be chosen, Action Item 1 refers to Action Items 2 through 10 of the B.E.P.S. Action Plan for solutions. Action Item 1 also raises B.E.P.S. issues with

1 "Profiles of Fiscal Policy and Markets for Digital Services and E-Commerce," Rome, October 6, 2014.

"The Action 1 Deliverable … emphasizes restoring taxation at the level of the market jurisdiction and the jurisdiction of the parent company."

regard to consumption taxes and refers to the Guidelines 2 and 4 of the O.E.C.D.'s "Guidelines on place of taxation for business-to-business (B2B) supplies of services and intangibles."

Chapter 7 of the Action 1 Deliverable delves deeper into the challenges raised by the digital economy and isolates the following broad categories that constitute the main B.E.P.S. challenges:

- Nexus (reduced physical presence and related nexus issues),
- Data (characterization and attribution of value),
- Characterization of payments made, and
- Administrative challenges (identification by the taxing authorities of economic activities, extent of activities, collecting and verifying information regarding the offshore entity, difficulty of identifying the location of customers).

The Action 1 Deliverable lists the following potential options to address these tax challenges and points out that some of the solutions will apply to several overlapping challenges:

- <u>Modifications to the exemptions from permanent establishment ("P.E.") status</u>. This would entail re-assessing the exemptions from P.E. status contained in paragraph 4 of Article 5 of the O.E.C.D. Model Tax Convention in light of the evolution of the digital economy. Certain preparatory and auxiliary activities in the article constitute the core functions for certain digital businesses. Among the options under consideration are the elimination of the entire paragraph, the elimination of only certain subparagraphs, or the addition of a condition that the exemptions are only available when the activity conducted is preparatory and auxiliary in nature.
- <u>New nexus based on significant digital presence</u>. Business ventures engaged in "Fully dematerialized digital activities" would have a taxable nexus in another country if a "significant digital presence" is maintained in that country. Action Item 1 provides a list of elements that would determine whether an activity is a fully dematerialized digital activity. These include the dedication of the core business to digital goods or services, the fact that contracts are generally concluded remotely via the internet or the telephone, the prevalence of online payments, etc.

  Once engaged in a fully dematerialized activity, nexus in a specific jurisdiction would exist should the enterprise have a significant digital presence in that jurisdiction. For this purpose, a "significant digital presence" could be deemed to exist, *inter alia*, in one of the following scenarios: significant number of contracts signed with tax residents of a particular jurisdiction; wide use or consumption of digital goods or services in a particular jurisdiction; substantial payments made to the enterprise by clients located in a particular jurisdiction; the fact that a branch located in the other jurisdiction offers secondary functions that are strongly related to the core business of the enterprise with regard to clients of that other jurisdiction.

- Replacement of the P.E. concept with a significant presence test. This would include some level of physical presence and an ongoing relationship with a customer base in the country of physical presence.

- Creation of a withholding tax on digital transactions. The financial institutions involved with payments for goods or services would be required to withhold the tax, so as to avoid withholding of this tax by customers of the foreign digital goods and services provider.

- Introduction of a "Bit" tax. This tax would be based on bandwidth usage of a website. The number of bytes used by a website would be taken into consideration in calculating the tax, as would the turnover of the enterprise. The tax would be progressive and creditable against corporate income tax.

- Several solutions with regard to consumption tax.

In sum, the Action 1 Deliverable principally restates the previously published Public Discussion Draft on Action Item 1. The noticeable differences relate to length and the inclusion of examples of typical tax planning structures in the digital economy. It defers to other Deliverables when addressing the tax challenges of the digital economy.

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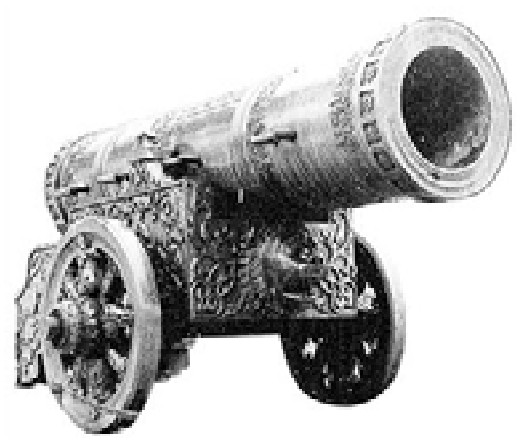

O.E.C.D. DISCUSSION DRAFTS ISSUED REGARDING B.E.P.S. ACTION 2 – NEUTRALIZING HYBRID MISMATCH ARRANGEMENTS

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Tags
B.E.P.S.
O.E.C.D
Double Deduction

INTRODUCTION

On March 19, 2014, the O.E.C.D. issued two discussion drafts proposing steps to neutralize abusive tax planning through hybrid mismatch arrangements. One report proposed changes in domestic law;[1] the second proposed changes to the O.E.C.D. Model Tax Convention.[2]

The discussion drafts reflect the O.E.C.D.'s attempt to bring "zero-sum game" concepts to global tax planning. In a zero-sum game, transactions between two or more parties must always equal zero (*i.e.*, if one party to a transaction recognizes positive income of "X" and pays tax on that amount, the other party or parties generally must recognize negative income of the same amount, thereby reducing tax to the extent permitted under law). Seen from the viewpoint of the government, tax revenue is neither increased nor decreased on a macro basis if timing differences are disregarded.

If all transactions are conducted within one jurisdiction, the government is the ultimate decision maker as to the exceptions to the zero-sum analysis. For policy reasons, a government may decide to make an exception to a zero-sum game result by allowing the party reporting positive income to be taxed at preferential rates or not at all, while allowing the party reporting negative income to fully deduct its payment. But, when transactions cross borders and involve related parties, taxpayers have a say in what is taxed and what is not taxed.

From a global tax revenue perspective, the transaction can move from a zero-sum to a double negative sum in a way that is fully compliant with the laws of each country. Tax advisers receive bonuses when these results are achieved and investors applaud. The O.E.C.D. views this as abusive and proposes changes in domestic law and income tax treaties to end the practice.

DOMESTIC LAW PROPOSALS

Hybrid mismatch arrangements incorporate techniques that exploit a difference in the characterization of an entity or an arrangement under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes. The B.E.P.S. Action Plan calls for the adoption of domestic rules that are designed to put an end to these arrangements.

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1 See "Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Law)."

2 See "Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)."

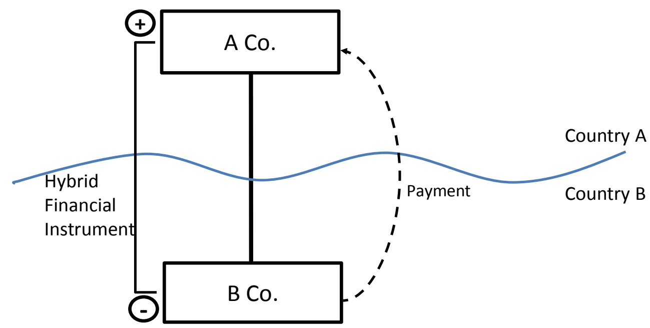
Three mismatch arrangements are targeted by the proposal. They are: (a) hybrid financial instrument, (b) hybrid entity payments, and (c) reverse hybrid and imported mismatch arrangements. Those advisers who regularly plan for cross-border mergers, acquisitions, and financings should be familiar with each planning technique.

Hybrid Financial Instruments

These are transactions where a payment is made under a financial instrument. The payor claims a deduction in its jurisdiction of residence, but payment is not subject to withholding tax, and the related recipient is treated in its jurisdiction of residence as if no taxable income is received.

"Hybrid mismatch arrangements incorporate techniques that exploit a difference in the characterization of an entity or an arrangement under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes."

A simplified mismatch arrangement is illustrated by the following diagram:



In the illustration, B Co. (an entity resident in Country B) issues a hybrid financial instrument to A Co. (an entity resident in Country A). The instrument is treated as debt for the purposes of Country B law, and Country B grants a deduction for interest payments made under the instrument, while Country A law grants some form of tax relief (an exemption, exclusion, indirect tax credit, etc.) in relation to the interest payments received under that instrument. Hence, the zero-sum game result is disrupted.

The mismatch may be due to any of several reasons. Most commonly the financial instrument is treated by the issuer as debt (which is a claim against the issuer) and by the holder as equity (which is an investment in the issuer). This difference in characterization can result in a payment that is treated as a deductible by the issuer and a dividend by the recipient. If the recipient is entitled to a dividends-received deduction or the dividend corresponds with the entity's foreign tax credit planning, no tax is imposed on the recipient or it may reduce tax otherwise due on global income through the maximization of credits. Again, implicit in the proposal is the exemption from withholding tax allowed when payment is made.

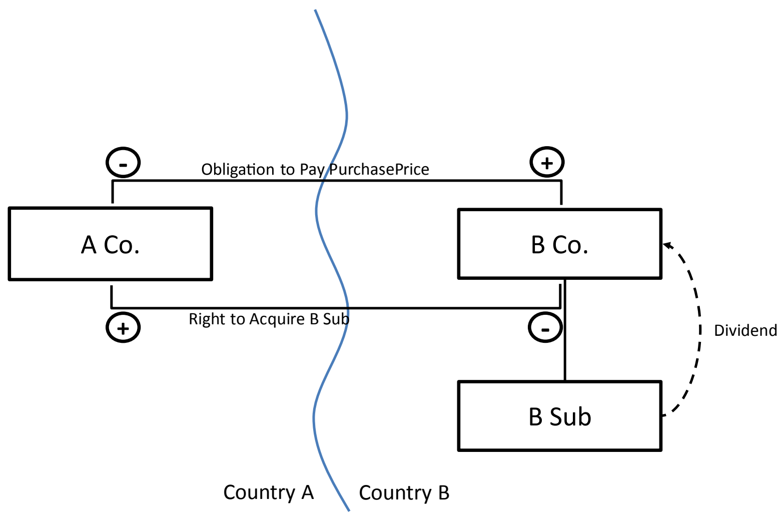
Other planning techniques may result in the mismatch of tax outcomes. These techniques may result from specific differences in the tax treatment of a particular payment made under the instrument. Examples include:

- A subscription or sale of shares with a deferred purchase price component that is treated as giving rise to a deductible expense for the share subscriber and a non-taxable receipt for the share issuer;
- A deduction claimed by an issuer for the premium paid on converting a mandatory convertible note, while the holder of the note treats the premium as an exempt gain;

- An issuer that claims a deduction for the value of an embedded option in an optional convertible note, while the holder ignores the value of the option component (or gives it a lower value than the issuer);

- An issuer that bifurcates an interest-free shareholder loan into its equity and debt components and then accrues the equity component over the life of the loan, while the holder treats the entire amount as a loan for the principal sum.

Hybrid transfers are often cast as collateralized loan arrangements or derivative transactions where the counterparties to the same arrangement are located in different jurisdictions and each treats itself as the owner of the loan collateral or the subject matter of the derivative. A typical example is a sale and repurchase arrangement (generally referred to as a "repo") where the terms of the repo make it the economic equivalent of a collateralized loan. Nonetheless, one jurisdiction treats the arrangement in accordance with its form (a sale and a repurchase of the asset), while the counterparty jurisdiction taxes the arrangement in accordance with its economic substance (a loan with the asset serving as collateral). This is illustrated in the following diagram:



In the example, a company in Country A (A Co.) owns a subsidiary (B Sub). A Co. sells the shares of B Sub (or a class of shares in B Sub) to B Co. under an arrangement that calls upon A Co. (or an affiliate) to acquire those shares at a future date for an agreed price. Between the sale and repurchase, B Sub earns income, pays tax, and makes distributions on the shares to B Co.

Country B taxes the arrangement in accordance with its form. Accordingly, B Co. is treated as the owner of the B Sub shares and entitled to receive and retain the dividends paid by B Sub during the life of the repo. Country B will typically grant a credit, exclusion, exemption or some other tax relief to B Co. on the dividends received. B Co. also treats the transfer of the shares back to A Co. as a genuine sale of shares and may exempt any gain on disposal under an equity participation exemption or a general exclusion for capital gains.

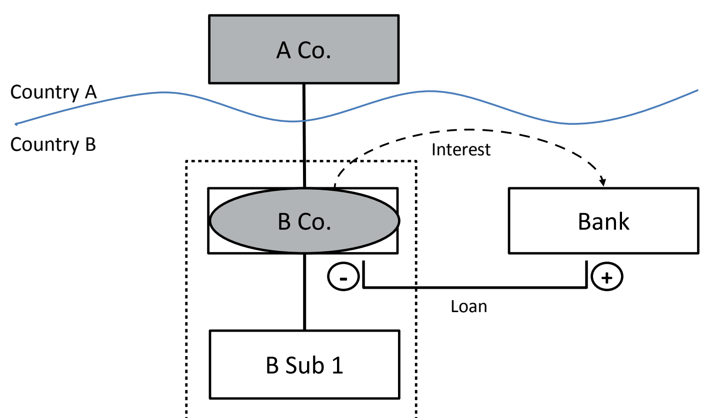
In accordance with its economic substance, for Country A tax purposes, the transaction is treated as a loan by B Co. to A Co. that is secured through a pledge of shares in B Sub and effected through a temporary transfer of legal title. A Co. is thus regarded as being the owner of the B Sub shares with the corresponding entitlement to B Sub dividends during the life of the repo.

Because Country A treats A Co. as the owner of B Sub shares, it requires A Co. to include in its income the amount of any dividends paid by B Sub to B Co. However the income tax on dividends will generally be sheltered by a credit, exclusion, or other tax relief applicable to those dividends under the laws of Country A. The net cost of the repo to A Co. is treated as a deductible financing cost. This cost includes the dividends treated as economically derived by A Co. (which are paid to and retained by B Co. from B Sub), but for Country A purposes, they are treated as paid by A Co. to B Co. during the life of the repo. Because Country A treats A Co. as having paid the amount of the dividend across to B Co., Country A grants a deduction for the amount of the dividend paid to and retained by B Co.

The discussion draft proposes to neutralize the tax benefit under the foregoing mismatches through the adoption of a linking rule that would seek to align the tax outcomes for the payor and the recipient under a financial instrument. The primary response would be to deny the payor a deduction for payments made under the hybrid financial instrument. In the event the payor is located in a jurisdiction that does not apply the primary rule, the payment would be included in the income of the recipient when computing tax in its country of residence. In addition, the dividends-received deduction that applies to a corporate recipient of a dividend would not apply to payments that are deductible for the payor. Payments under hybrid instruments would be included within this rule.

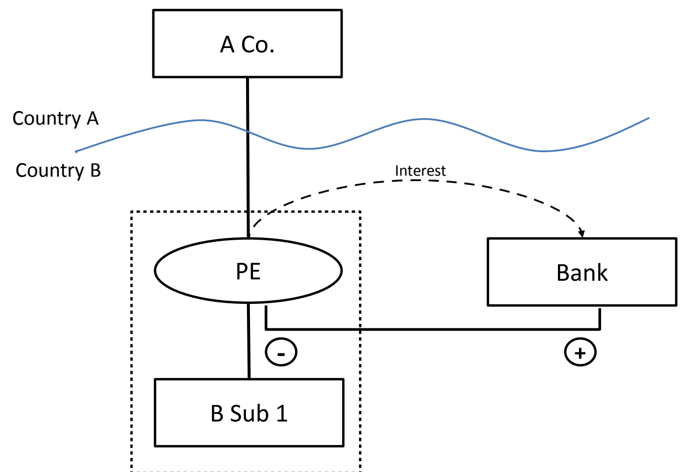
Hybrid Entity Payments

These are transactions where differences in the characterization of the hybrid payor result in either (a) a deductible payment being disregarded in the country of residence of the recipient or (b) the allowance of a deduction in another jurisdiction so that the payment is deducted twice, each time offsetting income taxed separately in one, but not both, jurisdictions. The most common double deduction hybrid technique involves the use of a hybrid subsidiary that is treated as transparent under the laws of the investor's tax jurisdiction and opaque under the laws of the jurisdiction where it is established or operates. An opaque entity is treated as an entity, but is entitled to benefits under an income tax treaty. This hybrid treatment can result in the same item of expenditure incurred by the hybrid being deductible under the laws of both the investor and subsidiary jurisdictions, as illustrated in the following diagram:



In this example, A Co. holds all the shares of a foreign subsidiary (B Co.). B Co. is a hybrid entity that is disregarded for Country A tax purposes. B Co. borrows from a bank and pays interest on the loan. B Co. derives no other income. Because B Co. is disregarded, A Co. is treated as the borrower under the loan for the purposes of Country A's tax laws. The arrangement therefore gives rise to an interest deduction under the laws of both Country B and Country A. B Co. is consolidated, for tax purposes, with its operating subsidiary B Sub 1, which allows it to surrender the tax benefit of the interest deduction to B Sub 1. The ability to "surrender" the tax benefit through the consolidation regime allows the two deductions for the interest expense to be set-off against separate income arising in Country A and Country B.

The same structure can be used without involving a hybrid entity, provided the subsidiary jurisdiction allows permanent establishments to consolidate for tax purposes with other resident companies. The diagram below illustrates this structure:



If the consolidation regime in Country B treats the permanent establishment (PE) as if it were a local entity and permits the permanent establishment to "surrender" the tax benefit of the deduction to B Sub 1, the result is the same as in the preceding illustration. The equivalent interest expense can be set-off against separate income arising in Country A and Country B.

The double deduction outcome raises base erosion issues only when interest expense deduction is eligible to be set-off against income that is not subject to tax in the other jurisdiction. This effect can be demonstrated by assuming, in the above example, that B Co. (or PE) derives no income. In such a case the interest expense that is deemed to arise in Country A might then be set-off against A Co.'s in-country income, thus reducing the amount of tax payable under Country A law. It can also be surrendered to B Sub 1, allowing it to be used against income taxable only in Country B.

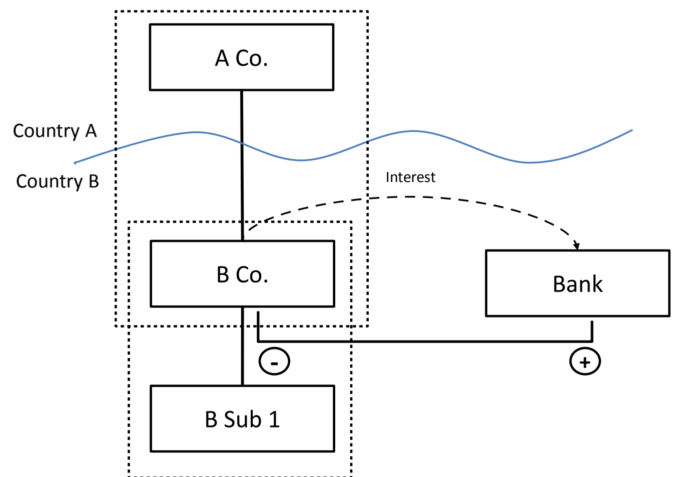
According to the discussion draft, the double deduction opportunity gives rise to tax policy concerns, from the perspective of the investor jurisdiction, for the following reasons:

- The hybrid entity is usually structured so that it never generates a net profit; this ensures that there is never sufficient dual inclusion income to eliminate the mismatch generated by the duplicate deduction.

- In the event the hybrid entity does begin to generate surplus dual inclusion income, the investor can simply restructure its holdings in the hybrid entity to prevent the surplus income from being included under the laws of the investor jurisdiction.

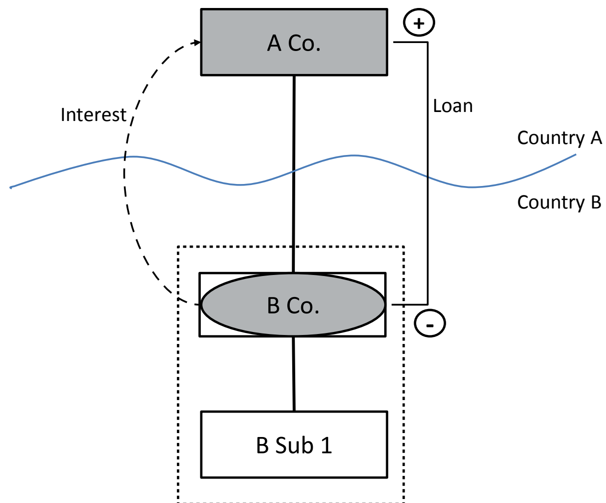
- The loss surrender mechanism in the subsidiary jurisdiction can be used to make the mismatch in tax outcomes permanent. The surrendering of surplus deductions to non-hybrid entities means that the deduction will no longer be available to reduce any dual inclusion income that may be derived by the hybrid entity in the current or any subsequent period. Thus, any dual inclusion income derived by the hybrid in a subsequent period will be subject to tax under the laws of the subsidiary jurisdiction (Country B in the above examples) at the full rate, and such tax will be fully creditable under the laws of the investor jurisdiction (Country A in the above examples). The effect of the loss surrender under the consolidation regime therefore allows for each deduction to be set-off permanently against "other income," permanently eroding the tax base of the investor jurisdiction.

A similar hybrid effect can be achieved by orchestrating a structure where the entity, while not hybrid, is a member of more than one tax consolidation group. This is illustrated in the following diagram:



In the example, A Co. (a company incorporated and tax resident in Country A) holds all the shares in B Co. (a company incorporated in Country B but tax resident in both Country A and Country B). B Co. owns all the shares in B Sub 1 (a company incorporated and tax resident in Country B). B Co. is consolidated, for tax purposes, with both A Co. (under Country A law) and B Sub 1 (under B Country law). B Co. borrows from a bank and pays interest on the loan. B Co. derives no other income. Because B Co. is resident in both Country A and Country B, it is subject to tax on its worldwide income in both jurisdictions on a net basis and can surrender any net loss under the tax consolidation regimes of both countries to other resident companies. The ability to "surrender" the tax benefit through the consolidation regime in both countries allows the two deductions for the interest expense to be set-off against separate income arising in Country A and Country B.

The same basic hybrid technique can be used to engineer a deduction for a payment in the jurisdiction of residence of the payor without any income recognized in the jurisdiction of residence of the recipient. An example involves a payment made by a hybrid entity to its investor that is deductible under the laws of the payor's jurisdiction but disregarded under the laws of the investor's jurisdiction. This is illustrated in the following diagram:



Tax benefits are derived because B Co. is treated as transparent under the laws of Country A. Because A Co. is the only shareholder in B Co., Country A simply disregards the separate existence of B Co. Disregarding B Co. means that the loan and the accompanying interest on the loan are ignored under the laws of Country A. In many cases, the funds lent from A Co. to B Co. are sourced from external borrowing by A Co. The arrangement therefore gives rise to an interest deduction under the laws of Country B but no corresponding inclusion under the laws of Country A. This deduction is then eligible to be offset against the income of B Sub 1 under the group consolidation regime. The ability to surrender the loss through the consolidation regime allows the deduction to be set-off against separate income arising under Country B law, producing a double deduction when funds are externally sourced by A Co.

"The double deduction rule isolates the hybrid element in the structure by identifying a deductible payment made by a hybrid in the subsidiary jurisdiction."

The discussion draft proposes to address the hybrid payment issue through a linking rule that focuses only on whether the payment gives rise to a deduction in the subsidiary jurisdiction that could be offset against dual inclusion income. The rule would also have a primary/secondary structure so as to require application in one jurisdiction rather than both.

The double deduction rule isolates the hybrid element in the structure by identifying a deductible payment made by a hybrid in the subsidiary jurisdiction. This is referred to as the "hybrid payment." It also identifies the corresponding "duplicate deduction" generated in the jurisdiction of the investor. The primary recommendation is that the duplicate deduction cannot be claimed in the investor jurisdiction to the extent it exceeds the claimant's dual inclusion income, which is income that is brought into account for tax purposes under the laws of both jurisdictions. A secondary recommendation applies to the hybrid in the subsidiary jurisdiction to prevent the hybrid claiming the benefit of a hybrid payment against non-dual inclusion income if the primary rule does not apply. For both rules, excess deductions can be carried forward by a taxpayer and offset against future dual inclusion income.

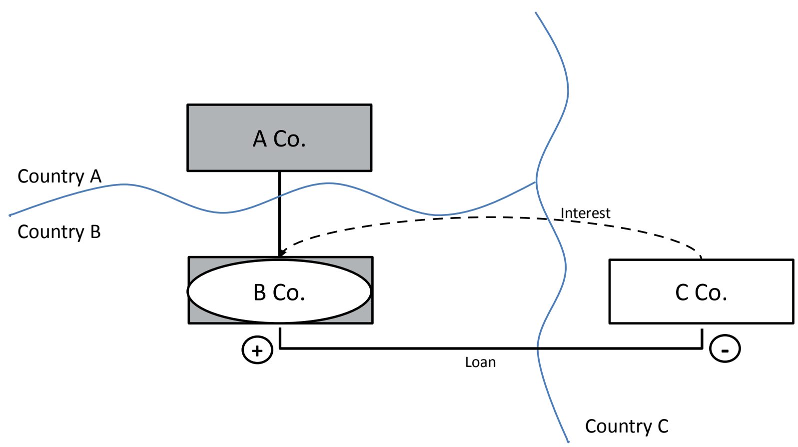
In order to prevent stranded losses, the discussion draft recommends that excess duplicate deductions should be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the deduction cannot be set-off against the income of any person under the laws of the other jurisdiction.

The deduction/non-inclusion rule defines a disregarded payment as one that is made cross-border to a related party where the tax treatment of the payor results in the payment being disregarded under the laws of the jurisdiction in which the recipient is resident. The deduction that is generated by a disregarded hybrid payment cannot exceed the taxpayer's dual inclusion income. As a secondary rule, the recipient would be required to include the excess deductions in income.

Reverse Hybrid and Imported Mismatches

Two arrangements are targeted by these rules. The first is an arrangement where differences in the characterization of the intermediary result in the payment being disregarded in both the intermediary jurisdiction and the investor's jurisdiction (reverse hybrids). The second is an arrangement where the intermediary is party to a separate hybrid mismatch arrangement, and the payment is set-off against a deduction arising under that arrangement (imported mismatches).

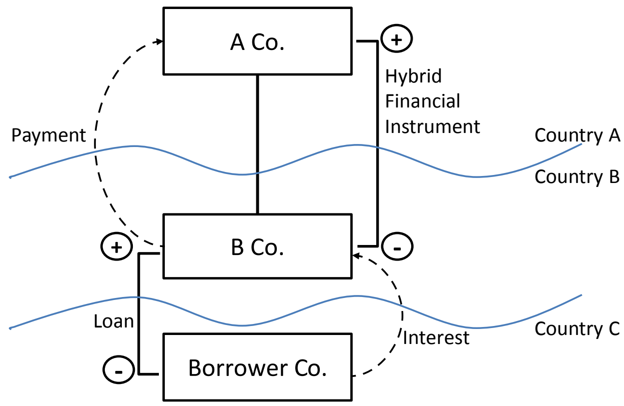
In the reverse hybrid arrangement, the hybrid is treated as opaque by its foreign owner and transparent under the jurisdiction where it is established. This is illustrated by the following diagram:



A Co. is a company resident in Country A, the investor jurisdiction. It owns all of the shares in B Co., a foreign subsidiary established under the laws of Country B, the intermediary jurisdiction. B Co. is treated as transparent for tax purposes under the laws of Country B but is regarded as a separate taxable entity under the laws of Country A. C Co., a company resident in Country C, the payor jurisdiction, borrows money from B Co. and makes interest payments under the loan. The payment is deductible under the laws of the payor jurisdiction, Country C, but is not included in income under the laws of either the investor or the intermediary jurisdiction because neither such jurisdiction treats the payment as income of a resident. Instead, each country treats the income as being derived by a resident of the other jurisdiction. This assumes that A Co. does not maintain a taxable presence in the intermediary jurisdiction. If it did (*e.g.*, to enable B Co. to act as a dependent agent), Country B might impose tax.

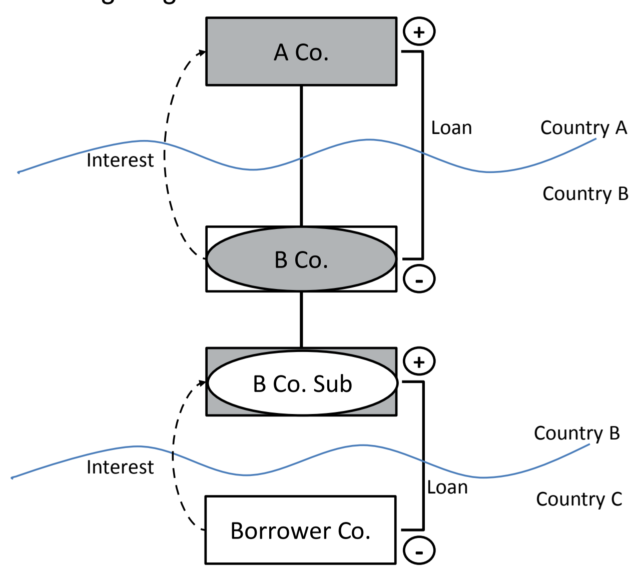
The mechanics of reverse hybrid structures also make it difficult for any party to the arrangement to know the nature and extent of the mismatch unless the arrangement is implemented within the confines of a controlled group. Reverse hybrids mismatches can arise in the context of widely-held investment vehicles that admit offshore investors.

In the imported mismatch system, a hybrid instrument is used to reduce or eliminate the income in the intermediary jurisdiction. The intermediary company then lends funds raised with the hybrid instrument in return for a note from a borrower in a third country. The following diagram illustrates the fact pattern:



B Co. is a wholly-owned subsidiary of A Co. A Co. lends money to B Co. in return for the issuance of a hybrid financial instrument. The payments are structured to be exempt from tax under the laws of Country A, while being deductible under the laws of Country B. Borrower Co. borrows money from B Co. Interest payable under the loan is deductible under the laws Country C (the jurisdiction of residence of Borrower Co.) and is included in income by B Co. under Country B law. The result of this structure is that interest is deductible in Country C, but ultimately is not deductible in Country A. Country B's tax revenue is unaffected as income is offset by deductions.

A similar result can be achieved through the use of a series of hybrid entities, as illustrated in the following diagram:



In the structure, A Co., a Country A resident, establishes a wholly-owned subsidiary B Co., a resident of Country B. B Co. is a hybrid that is treated as transparent under the laws of Country A. B Co. forms a wholly-owned subsidiary B Co. Sub. B Co. Sub is a “reverse hybrid” entity from the perspective of Country A. It is treated as transparent for tax purposes under the laws of Country B but as a separate taxable entity under the laws of Country A.

A Co. lends money to B Co. B Co. uses the money to acquire equity in B Co. Sub. B Co. Sub lends money to Borrower Co., an unrelated entity resident in Country C. Because Country A disregards the separate existence of B Co., it ignores the loan and the interest on the loan. This part of the structure therefore gives rise to an interest deduction under the laws of Country B but no corresponding inclusion under the laws of Country A. Interest payable under the loan between Borrower Co. and B Co. Sub is deductible under the laws of Country C and is included in income under Country B law. Country B treats B Co. Sub as a transparent entity and will include its income in B Co.’s income. However, the income will be offset by the interest deduction under the loan arrangement between A Co. and B Co.

The net result of this structure is that Borrower Co. has a deduction, the income and expense of B Co. and B Co. Sub eliminate tax in Country B, and A Co. has no taxable income.

The discussion drafts propose the following rules to address the foregoing perceived abuses. In respect of imported mismatch arrangements other than reverse hybrids, comprehensive hybrid mismatch rules in the investor or the intermediary jurisdiction should be adopted that would be sufficient to prevent imported mismatches being structured through those jurisdictions. It proposes that all countries adopt the same set of hybrid mismatch rules. This approach ensures that the arrangement is neutralized in the jurisdiction where the hybrid technique is deployed, and there would be no resulting mismatch that could be exported into a third jurisdiction. A comprehensive solution where all countries establish the same set of hybrid mismatch rules will also generate compliance and administration efficiencies and certainty of outcomes for taxpayers.

To address reverse hybrid structures and provide measures designed to protect the payor jurisdiction from imported mismatches, the discussion draft makes two recommendations. The first is the adoption of rules that require income of, or payments to, a reverse hybrid to be included in income under the laws of the investor jurisdiction. It would be supported by the adoption of rules requiring income of, or payments to, a reverse hybrid to be included under the laws of the intermediary jurisdiction, if not included under the laws of the investor jurisdiction. The second recommendation is the adoption of rules that would allow the payor jurisdiction to deny the deduction for payments made to an offshore structure including an imported mismatch structure or reverse hybrid where the parties to the mismatch are members of the same controlled group or the payor has incurred the expense as part of an avoidance arrangement.

TREATY ISSUES

To supplement the detailed discussion draft of proposed changes to domestic law, a discussion draft was also published regarding changes in the O.E.C.D. Model Tax Convention.

The discussion draft proposes to change the Article 4 (Resident) paragraph (3) of the O.E.C.D. Model Tax Convention to address some of the B.E.P.S. concerns related to dual-resident entities. It will provide a revised method of allocating tax residence by adopting a case-by-case method, instead of the current place of effective management. In essence, it will likely prevent any single rule or approach from being controlling in all circumstances. Certainty of result is given second position to prevention of abuse.

"In essence, it will likely prevent any single rule or approach from being controlling in all circumstances. Certainty of result is given second position to prevention of abuse."

Paragraph 3 of Article 4 would be modified to read as follows:

> Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, *the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident* for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. *In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.* [Emphasis supplied.]

The discussion draft acknowledges that the revision will not address all B.E.P.S. concerns related to dual-resident entities. Thus, an entity could be a resident of a given State under that State's domestic law while, at the same time, being a resident of another State under a tax treaty concluded by the first State. This would allow that entity to benefit from the advantages applicable to residents under domestic law – for example, being able to shift its foreign losses to another resident company under a group relief system – without being subject to reciprocal obligations regarding global taxation – it could claim treaty protection against taxation of its foreign profits. The draft suggests that countries adopt domestic legislation providing that an entity considered to be a resident of another State under a tax treaty will be deemed not to be a resident under domestic law.

The 1999 O.E.C.D. report on The Application of the OECD Model Tax Convention to Partnerships (the "Partnership Report") contains an extensive analysis of the application of treaty provisions to partnerships, including situations where there is a mismatch in the tax treatment of the partnership.[3] The discussion draft proposes to expand the scope of the Partnership Report to other transparent entities. Thus it proposes to modify Article 1 (Persons Covered) by inserting a new paragraph 2, providing as follows:

> For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

The new text would be supported by the adoption of additional commentary. An example in the proposed commentary explains how the provision would be applied:

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3 O.E.C.D. (1999), The Application of the OECD Model Tax Convention to Partnerships, Issues in International Taxation, No. 6, O.E.C.D. Publishing, Paris.

> State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.

The proposed commentary explains that the reference to "income derived by or through an entity or arrangement" is to be given a broad meaning. It is intended to cover any income that is earned by or through an entity or arrangement, regardless of (a) the view taken by each Contracting State as to who derives that income for domestic tax purposes and (b) whether or not that entity or arrangement has legal personality or constitutes a person. It would cover income of any partnership or trust that one or both of the Contracting States treats as wholly or partly fiscally transparent. It does not matter where the entity or arrangement is established. The paragraph applies to an entity established in a third State to the extent that, under the domestic tax law of one of the Contracting States, the entity is treated as wholly or partly fiscally transparent and income of that entity is attributed to a resident of that State.

In the case of an entity or arrangement which is treated as partly fiscally transparent under the domestic law of one of the Contracting States, only part of the income of the entity or arrangement might be taxed at the level of the persons who have an interest in that entity or arrangement, as described in the preceding paragraph, whilst the rest would remain taxable at the level of the entity or arrangement. This provision is intended to apply to (a) trusts that are fiscally transparent when distributions are made from current income and (b) a separate taxpayer for accumulated income. To the extent that the trust qualifies as a resident of a Contracting State, the provision will ensure that the benefits of the treaty will also apply to the share of the income that is taxed at the trust level by the jurisdiction of residence.

The proposed paragraph does not prejudge whether the transparent entity or its members are the beneficial owners of the income. Thus, for example, a fiscally transparent partnership that receives dividends as an agent or nominee for a person who is not a partner does not preclude the State of source from considering that neither the partnership nor the partners are the beneficial owners of the dividend. The fact that the dividend may be considered as income of a resident of a Contracting State under the domestic law of that State is not controlling on the tax treatment of the source State.

CONCLUSION

The discussion draft on hybrid entities is an ambitious attempt to limit tax planning that has existed for decades. Whether it can be implemented universally remains an open question.

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ACTION ITEM 2: NEUTRALIZING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

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Tags
Double deductions
Dual Inclusion Income
Double Non-taxation
Hybrid Entities
Hybrid Instruments
Hybrid Mismatches
Imported Hybrid Mismatches

On the heels of the discussion drafts issued in March, the Organization for Economic Cooperation and Development ("O.E.C.D.") released the initial components of its plan to fight base erosion and profit shifting (the "B.E.P.S. Action Plan"). Action Item 2 addresses the effects of hybrid mismatch arrangements and proposes plans to neutralize the tax deficits caused.

These responses aim to tackle the following issues created by the hybrid mismatch arrangements:[1]

- Reduction in overall tax revenue,
- Unfair advantage given to multinational taxpayers with access to sophisticated tax-planning expertise, and
- Increased expense often incurred in setting up hybrid arrangements compared to domestic structures.

This article introduces the different hybrid arrangements, looks at the proposed changes in both domestic law and international tax treaties, and discusses the ripple effect this could have if implemented.

INTRODUCTION

A hybrid mismatch arrangement is one that exploits a difference in the way an entity or instrument is taxed under different jurisdictions to yield a mismatch in total tax liability incurred by the parties.[2] The two possible mismatches that could result are either a "double deduction" ("DD") or a deduction that is not offset in any jurisdiction by ordinary income ("D/NI"). These mismatches are brought about by the different interpretations afforded to the entities and transactions in relevant jurisdictions. The root cause of the hybrid mismatch is that an entity may be a "hybrid entity" and an instrument may be a "hybrid instrument." Understanding the different hybrid arrangements is instrumental to understanding the plan proposed by the O.E.C.D.

Hybrid Financial Instruments

A hybrid financial instrument is an instrument that can be construed as either a debt instrument or a class of equity such as preferred shares, depending on the rules in force in a country. The transaction using the instrument involves two or more

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1 IFA, "Hybrid Mismatch Arrangements," February 21, 2013.

2 OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, pg. 29, #41.

countries having different rules in effect, and the terms of the instrument are sufficient to bring about such a mismatch in tax outcomes.[3]

The most common example of this is a debt/equity instrument: a loan from an entity ("A") in Country A to an entity ("B") in Country B where A treats the instrument as equity and B treats it as debt:

- B is granted a deduction on interest payments because the loan is treated as debt.
- A isn't taxed or offered tax relief such as an exemption or an indirect foreign credit – meaning that taxes paid by the borrower in Country B may offset tax owed by A on the receipt of income from countries outside A – in connection with the interest received from B. This presumes that A is a 10% or greater shareholder of B.

Determining whether an instrument is debt or equity can have a significant impact on tax consequences for the borrower and the lender. Well advised companies can negate home-country tax through the foreign taxes paid by subsidiaries when dividends from the subsidiaries are received. If the subsidiary can reduce its own tax with a deduction because the dividend is afforded interest treatment, a D/NI result is achieved. The U.S. has been dealing with tricky debt-equity cases for years; the three most exemplary cases being *PepsiCo* (2012),[4] *Dixie Dairies* (1980),[5] and *Monon Railroad* (1970):[6]

- The court in *Monon Railroad* held that an instrument constituted debt notwithstanding a long maturity term and contingent timing for interest payments.
- The *Dixie Dairies* case established a list of thirteen factors used to determine whether an instrument constitutes a debt or equity.[7]
- The *PepsiCo* case is the most recent case to deal with the issue. PepsiCo was a Dutch L.L.C. wholly owned by the PepsiCo Inc. in the U.S. PepsiCo Inc. wanted to treat the agreement between the two companies as debt in the Netherlands and equity in the U.S. for a double tax exemption. The court applied the Dixie Dairies factors to determine that the instrument should be treated as equity for U.S. federal income tax purposes.

Despite the fact that all thirteen *Dixie Dairies* factors were applied, two seemed to hold more weight than the others. The first was the degree of certainty regarding repayment of principal and payment of interest, as of the date of issue. As certainty wanes, the instrument begins to look more and more like equity. A second factor was whether the funds were used to acquire core capital assets of the business. If so, the advanced funds are characterized more as equity than debt. On the other hand, if the capital is used for day-to-day expenses, it would weigh towards debt.[8]

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3 Neutralising the Effects of Hybrid Mismatch Arrangements, p. 30.

4 *Pepsico Puerto Rico, Inc. v. Commissioner*, T.C. Memo 2012-269.

5 *Dixie Dairies Corp. v. Commr.*, 74 T.C. 476 (1980).

6 *Monon Railroad v. Commr.*, 55 T.C. 345 (1970).

7 See AICPA: "Debt vs. Equity in the Tax Court."

8 Joe Dalton, "Has PepsiCo's US Tax Court win revealed 'super factor' in deciding debt vs equity cases?," International Tax Review, October 4, 2012.

Note that in all cases the U.S. acknowledges that no single factor is controlling and the importance of the two factors could be different if other circumstances were to exist.

This was also seen in *Hewlett-Packard* (2012),[9] a case involving a put option between a U.S. taxpayer and a foreign corporation. The put option was to all the shares of a Dutch entity in which the U.S. taxpayer was a minority shareholder and the foreign corporation held significantly more shares. The U.S. taxpayer was entitled to put the shares of the Dutch entity to the foreign corporation on specified dates in return for the fair market value on that date. The U.S. taxpayer held certain enforcement rights against the Dutch entity, presumably to force a redemption of its shares by the Dutch entity. The court held that the option instrument was, in substance, debt. According to the court, the key to this determination is primarily the taxpayer's actual intent, as revealed by the circumstances and conditions of the transaction.

Luxembourg offers two such hybrid planning options regarding instruments. One is the Convertible Preferred Equity Certificate ("C.P.E.C."), which is structured to be debt in Luxembourg but equity in the U.S. Another planning option is a profit participating loan which also has the same effect – it is treated as debt in Luxembourg and equity in the U.S.[10] Luxembourg's cooperation, or lack thereof, is what makes it difficult for the I.R.S. to fight the D/NI outcome. If Luxembourg were to decide that payments on these instruments are not deductible, the D/NI treatment would disappear. The lender would not enjoy the tax "kicker" that enhances interest income.

Action Item 2 aligns the treatment of cross-border payments so that they are treated as a financing expense by the issuer's jurisdiction and ordinary income in the jurisdiction of the holder.[11]

Hybrid Transfer

A hybrid transfer is a collateralized loan arrangement or a derivative transaction in which each of the counterparties are in different jurisdictions and each treats itself as the owner of the loan collateral.[12]

This is clearly seen in sale and repurchase arrangements: A sells its shares in B2 to B with an agreement to repurchase later down the line. A treats the transaction as a collateralized borrowing and any dividends paid to B are treated by A as an interest cost. B treats the transaction as the purchase of participation. Consequently, the dividends B receives from B2 are exempt. A D/NI result is achieved as A's deduction is not matched by the recognition of taxable income by B.

Action Item 2 proposes to neutralize the tax benefit through the following recommendation: Jurisdictions that relieve economic double taxation by offering a dividend exemption for amounts paid by a foreign payor should limit the benefit when the dividend is paid by a company resident in a foreign jurisdiction and is deductible for the payor in that other jurisdiction.

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9 Hewlett-Packard Company v. Commr., T.C. Memo 2012-135.

10 Jasper L. (Jack) Cummings, Jr. and Edward Tanenbaum, "Convertivble Preferre Equity Certificates," Alston & Bird Tax Blog, July 13, 2011.

11 OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 31.

12 OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 34.

Hybrid Entity Payments

Hybrid entity payments create a D/NI situation where the entity is transparent in the payee jurisdiction but not under the laws of the payor jurisdiction.

An entity is transparent with regard to an income item or expense if the laws of a relevant country provide that the entity should be treated as an extension of its sole shareholder. To illustrate: A owns all the shares in B, an entity that is treated as a branch or an extension of A for purposes of Country A tax. In other words, it is a disregarded entity for tax purposes in Country A. In Country B, B is a taxpayer. A makes a loan to B and receives interest income.

For purposes of computing A's taxable income in Country A, the interest is disregarded – A cannot pay interest to itself.

"Action Item 2 proposes to neutralize the tax benefit of the foregoing mismatches through the adoption of a linking rule that would seek to align the tax outcomes for the payor and the recipient under a financial instrument."

For purposes of computing B's taxable income in Country B, the interest is recognized as an item of income and expense for tax purposes. The interest payment is deductible. Implicit in this example is the absence of an obligation imposed on B under the laws of Country B to collect withholding tax on the interest payment. Either Country B's domestic law does not provide for withholding tax on interest or an income tax treaty between Country A and Country B exempts the interest income of A from tax in Country B.

Action Item 2 proposes to neutralize the tax benefit of the foregoing mismatches through the adoption of a linking rule that would seek to align the tax outcomes for the payor and the recipient under a financial instrument. The primary response would be to deny the payor a deduction for payments made under the hybrid financial instrument. If a deduction is allowed in the payor's residence jurisdiction, the recipient's jurisdiction would treat the recipient as fully taxable income. The rule does not apply to payments that are fully taxable in both jurisdictions or to mismatches in the recognition of income and expense in the payor's and payee's jurisdictions of residence.

Reverse Hybrids

Reverse hybrid entity payments occur where the entity is transparent in the payee jurisdiction but not under the laws of jurisdictions relevant to the payor.[13] In other words, when looking from the subsidiary up to the shareholder/payee, the subsidiary is transparent in its resident jurisdiction (*i.e.*, it is viewed as a part of the shareholder/payee). However, in the payee's jurisdiction, the foreign subsidiary is opaque, meaning it is recognized as an entity that qualifies for benefits because of the payee's status as an owner.[14]

To illustrate: A is the shareholder/payee and B is the subsidiary/payor. B is transparent under the tax laws of Country B but opaque in Country A. B makes a loan to an unrelated entity ("C") and pays interest on the money borrowed:

- The payment is deductible for C under the laws of Country C.
- Owing to the way the loan is structured or booked, in country A, the loan is viewed as income of B.

[13] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 45.

[14] See "Comments Concerning Proposed Regulations Under Section 894(c) Relating to Payments Made by Domestic Reverse Hybrid Entities," p. 3.

- Also due to the way the loan is structured or booked, in country B, the loan is viewed as income of A.

Thus, neither Country A nor Country B treats the interest as income of a resident. Each set of laws attributes the income to a resident of another country.

The response recommended in Action Item 2 is to neutralize the effect of hybrid mismatches that arise under payments made to reverse hybrids through the adoption of a linking rule that denies a deduction for such payments to the extent they give rise to a D/NI outcome. The proposed adoption of an offshore investment regime for C.F.C.'s would call for taxation on a current basis of income accrued through offshore investment structures to occur in the shareholder's jurisdiction.[15]

Indirect Hybrid Mismatches

Hybrid mismatches can be imported into a jurisdiction of choice through the use of straightforward financial instruments such as loans.

To illustrate: An entity ("A") is a resident of Country A. It intends to make a loan to a related party ("C"), resident in Country C. Instead of making a direct loan to C, it lends money to its subsidiary ("B") pursuant to a hybrid instrument that is viewed to be debt under the tax laws of B's resident jurisdiction, but equity under the tax laws of Country A. B enters into a straightforward lending transaction with C. The ultimate result is a deduction for C and no offsetting of income to B – because of the back-to-back funding transaction with A, which is respected as debt – and no offsetting of income to A – because of the hybrid nature of the loan to B. In substance, the hybrid nature of a parent-subsidiary loan can be extended to a transaction with an unrelated party.

The response of Action Item 2 is to apply the hybrid mismatch rule discussed above in the jurisdiction of residence of C. Again, the effect of timing differences would be ignored. The rule would apply to situations in which all participants are related parties – A, B, and C are in the same group – and situations involving unrelated parties – A and B are related, but C is not – that are acting in concert pursuant to an overall arrangement.

PROPOSAL

To date, the provisions of U.S. tax law that deal with hybrid mismatch include Code §894, §909, and several income tax treaties that exclude income from hybrid transactions from treaty coverage. Code §894, when applicable, prevents taxpayers from taking advantage of withholding tax reductions through tax treaties when the claim for relief is made by the ultimate investor acting through the hybrid entity. It denies treaty benefits to the ultimate investor if the tax laws of its country of residence treat the hybrid entity as a recognized entity.[16] Section 909 'splitter' rules don't allow foreign credits without a corresponding income inclusion.[17] Paragraph 7 (a) of Article 4 (Residence) of the Canada-U.S. Income Tax Treaty extends the

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15 OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 47.

16 Jeffrey Rubinger, "Tax Planning for 'Inbound' Licensing of Intellectual Property," May 12, 2011, slide 8.

17 IFA, "Hybrid Mismatch Arrangements," February 21, 2013, slide 32.

rule to business profits. Paragraph 3 of Article 4 Residence of the France-U.S. Income Tax Treaty ignores the hybrid nature of a third-country instrument used by a U.S. company if the third country has not concluded an agreement containing an exchange or information provision. However, none of these measures have been proven to be thorough enough, and therefore, the O.E.C.D. has put forward Action Item 2.

For a rule to effectively address the mismatches and tackle them head-on, it has to be comprehensive and automatic. However, it must also be coordinated enough to avoid a D/NI result, as well as double taxation on the same item of income. The rule must be clear and workable in eliminating the mismatch. The planned response is two-pronged: changes to domestic law in member states and treaty applications.

Domestic Law

Action Item 2 recommends adoption of a linking rule that aligns tax consequences for payors and payees under the hybrid arrangements. This rule has been discussed above and focuses on a two-step response:

- A more offensive, primary response that denies the deductions to the payors;
- And where the payor is in a jurisdiction that doesn't apply the primary rule, the payee jurisdiction should apply a defensive rule that would require the deductible payments to be included in ordinary income.

These mismatch rules would apply to related parties of structured arrangements.

"All cases of dual treaty residence would be solved on a case-by-case basis by the Competent Authorities, rather than on the basis of the current rule that is self-applied."

O.E.C.D. Model Tax Convention

In addition to changes in domestic law, Action Item 2 encourages countries to co-operate by sharing data and following the prescribed treatment for dealing with hybrids:

- Collaboratively determine the tax residency of the entity in question to properly determine the tax consequence.[18] This means that all cases of dual treaty residence would be solved on a case-by-case basis by the Competent Authorities, rather than on the basis of the current rule that is self-applied. In the absence of an agreement by the Competent Authorities, the entity would not be entitled to any relief or exemption from tax provided by treaty.
- The income of wholly- or partly-transparent entities would be considered to be income of a resident of a State only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.[19]
- Individuals and entities should be taxed appropriately.

Scope

The linking rule cannot be limitless and should not apply to transactions where the hybrid result is a coincidence. Therefore, the O.E.C.D. recommends applying the rule only to mismatches arising between related parties who may be acting in concert.

[18] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 81.

[19] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 86.

“Action Item 2 basically requires one country to check another’s decisions before imposing its own taxes.”

A related party is a person who acts together with another person in respect of ownership, control, voting rights, or equity if he or she has an owning or controlling interest. In addition, family members, managing parties, and a person acting in accordance the wishes of another, are all treated as if they were acting together.

THE BALANCING ACT

By their very nature, hybrid mismatch arrangements are cross border transactions that manipulate facts in order to find ways to diminish the overall tax liability of the participants. The planned approach is an ambitious one; one that depends on the co-operation of other countries.

Action Item 2 basically requires one country to check another’s decisions before imposing its own taxes. However, the procedures that are proposed under Action Item 13, related to intangible transfer pricing, may also be applicable to hybrid instruments. If all transactions are open to all tax authorities, the opportunity to “play” the system is reduced.

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B.E.P.S. ACTION 4: LIMIT BASE EROSION VIA INTEREST PAYMENTS AND OTHER FINANCIAL PAYMENTS

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Tags
Action 4
Financial Payments
Interest Equivalents
Interest Expense
Over Leveraged
Recharacterization
Related Party Debt
Thin Capitalization
Third-party Debt

Action 4 of the B.E.P.S. Action Plan focuses on best practices in the design of rules to prevent base erosion and profit shifting using interest and other financial payments economically equivalent to interest. Its stated goal is described in the following Action:

> Develop recommendations regarding best practices 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.

On December 18, 2014, the O.E.C.D. issued a discussion draft regarding Action 4 (the "Discussion Draft").[1] The Discussion Draft stresses the need to address base erosion and profit shifting using deductible payments such as interest that can give rise to double non-taxation in both inbound and outbound investment scenarios. It examines existing approaches to tackling these issues and sets out different options for approaches that may be included in a best practice recommendation. The identified options do not represent the consensus view of the Committee on Fiscal Affairs, but are intended to provide stakeholders with substantive options for analysis and comment. This article discusses the Discussion Draft for Action 4 of the B.E.P.S. Action Plan.

INTRODUCTION

Most countries tax debt and equity differently for the purposes of their domestic law. Interest on debt is generally a deductible expense of the payer and taxed at ordinary rates in the hands of the payee.

Dividends, or other equity returns, on the other hand, are generally not deductible and are typically subject to some form of tax relief (an exemption, exclusion, credit, etc.) in the hands of the payee. While, in a purely domestic context, these differences in treatment may result in debt and equity being subject to a similar overall tax

1 O.E.C.D. (2014) "BEPS Action 4: Interest Deductions and Other Financial Payments."

burden, the difference in the treatment of the payer creates a tax-induced bias, in the cross-border context, towards debt financing. The distortion is compounded by tax planning techniques that may be employed to reduce or eliminate tax on interest income in the jurisdiction of the payee.

The policy concerns surrounding interest expense deductions relate to debt funding of outbound and inbound investment by groups. Parent companies are typically able to claim relief for their interest expense while the return on equity holdings is taxed on a preferential basis. The result is a net reduction of tax revenue. At the same time, subsidiary entities may be heavily debt financed, bearing a disproportionate share of the group's total third party interest cost and incurring interest deductions used to shelter local profits from tax. Taken together, these opportunities surrounding inbound and outbound investment potentially create competitive distortions between groups operating internationally and those operating in the domestic market. According to the Discussion Draft, this has a negative impact on capital ownership neutrality, creating a tax preference for assets to be held by overseas groups rather than domestic groups.

Base erosion and profit shifting techniques include the use of intragroup loans to generate deductible interest expense in high tax jurisdictions and taxable interest income in low tax jurisdictions; the development of hybrid instruments which give rise to deductible interest expense but no corresponding taxable income; the use of hybrid entities or dual resident entities to claim more than one tax deduction for the same interest expense; and the use of loans to invest in structured assets which give rise to a return that is not taxed as ordinary income.

To illustrate the planning opportunity in an outbound context, a multinational group consists of two companies, A Co (the parent) and B Co (the subsidiary). A Co is resident in a country with a 35% rate of corporate income tax. It relieves double taxation through a territorial system under which foreign source dividends are exempt from tax. B Co is resident in a country with a 15% corporate tax rate. B Co borrows €100 from a third party bank at an interest rate of 10%. B Co uses these funds in its business and generates additional operating profit of €15. After deducting the €10 interest cost, B Co has a pre-tax profit of €5 and an after-tax profit of €4.25.

Alternatively, A Co could borrow the €100 from the bank and contribute the same amount to B Co as equity. In this case, B Co has no interest expense and its full operating profit of €15 is subject to tax. B Co now has a pre-tax profit of €15 and an after tax profit of €12.75. Assuming A Co can set its interest expense against other income, A Co has a pre-tax cost of €10 and an after tax cost of €6.50. Taken together, A Co and B Co have a total pre-tax profit from the transaction of €5 and a total after-tax profit of €6.25 reflecting a rational group treasury decision. The Discussion Draft describes this as a negative effective rate of taxation (*i.e.*, the group's after tax profit exceeds its pre-tax profit). Management would, however, describe this as an effective tax rate reduction.

A similar result can also be achieved in an inbound investment context. In this case, A Co (the parent) is resident in a country with a 15% rate of corporate income tax and B Co (the subsidiary) is resident in a country with a 35% corporate tax rate. B Co borrows €100 from a third party bank at an interest rate of 10%. B Co uses these funds in its business and generates additional operating profit of €15. After deducting the €10 interest cost, B Co has a pre-tax profit of €5 and an after tax profit of €3.25.

Alternatively, A Co could replace €50 of existing equity in B Co with a loan of the same amount. In this case, B Co has a pre-tax and after-tax profit of nil. A Co has interest income on its loan to B Co, and has a pre-tax profit of €5 and after-tax profit of €4.25. The group has reduced its effective tax rate from 35% to 15% by shifting interest costs from B Co to A Co. Again, this is a rational business decision, but is viewed by the Discussion Draft as profit shifting. This can be taken one additional step by having A Co replace €100 of existing equity in B Co with a loan of the same amount. Assuming B Co can set its interest expense against other income, from this transaction B Co now has a pre-tax cost of €5 and an after tax cost of €3.25. A Co receives interest income from B Co, and has a pre-tax profit of €10 and after-tax profit of €8.50. Taken together, A Co and B Co have a pre-tax profit of €5 and after-tax profit of €5.25. As a result of thinly capitalizing B Co and shifting profit to A Co, the group is now subject to a negative effective rate of taxation. Again, the group treasury function has made a rational decision and reached a rational result.

"Action 14 is intended to encourage multinational groups to adopt funding structures that more closely align the interest expense of individual entities with that of the overall group."

In all examples, B is resident in a country that has chosen to impose high rates of tax in relation to the country where A is resident and operates. One rational result of this tax policy choice by that country is the encouragement of corporations to remove high profit items from companies subject to tax in that country and to increase discretionary expenses to that country. A second rational decision is to disinvest in that country, removing jobs and all related income from that country's tax base.

The Discussion Draft maintains a different view regarding these potential reactions. According to the Discussion Draft, a consistent approach utilizing international best practices is essential to address base erosion and profit shifting arising from intercompany loans. This will promote group-wide systems that produce required information and remove opportunities for base erosion and profit shifting.

POLICY CONSIDERATIONS

Action 4 is intended to encourage multinational groups to adopt funding structures that more closely align the interest expense of individual entities with that of the overall group. Overall, groups should still be able to obtain tax relief for an amount equivalent to their actual third party interest cost. However, the opportunity of stuffing interest expense into countries based in in high-tax jurisdictions will be removed. This result reflects various government concerns including (i) addressing base erosion and profit shifting, (ii) minimizing distortions to competition and investment when comparing tax outcomes of groups operating in a solely domestic environment with other groups operating globally, (iii) avoiding double taxation that might arise from unilateral action of one or more countries, (iv) reducing administrative and compliance costs, (v) promoting economic stability by de-emphasizing tax benefits from over-leveraged structures, and (vi) providing certainty of outcome.

Certain arrangements are targeted to prevent circumvention of Action 4. These include (i) the use of orphan entities or special shares to disguise control of an entity or break a group relationship, (ii) arrangements to disguise payments through back-to-back loans, (iii) structures to convert other forms of taxable income into an interest-like return in order to reduce an entity's net interest expense below the level of a limit or cap, and (iv) the use of foreign exchange instruments to manipulate the outcome of rules. Action 4 is intended to adopt rules that are consistent with E.U. rules in order to be fully implemented on a global basis.

EXISTING APPROACHES

Rules currently applied by countries fall into six broad groups, with some countries currently applying combined approaches. These are:

- Rules that limit the level of interest expense or debt in an entity with reference to a fixed ratio. Examples of these rules include debt to equity ratios, interest to E.B.I.T.D.A. ratios and interest to assets ratios. This approach is relatively easy to apply and links the level of interest expense to a measure of an entity's economic activity. However, the same ratio is applied to entities in all sectors and as a tool, these rules are relatively inflexible. Finally, the Discussion Draft comments that the ratios may be set too high to be an effective tool in addressing base erosion and profit shifting.

- Rules that compare the level of debt in an entity by reference to the group's overall position. Existing rules that compare the level of debt in an entity to that in its group often operate by reference to debt to equity ratios. Again, these are reasonably easy to apply, but the Discussion Draft expresses the view that the amount of equity in an entity is not a good measure of its level of activity and equity levels can be easily subject to manipulation.

- Targeted anti-avoidance rules that disallow interest expense on specific transactions. These can be an effective response to specific base erosion and profit shifting risks. However, as new tax planning opportunities are exploited, new targeted rules may be required. Ultimately, this may result in a more complex system that is costly to administer.

"Rules currently applied by countries fall into six broad groups."

- Arm's length tests that compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties. This approach is not considered in the Discussion Draft. An arm's length test requires consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third party lenders and the terms under which that debt could be borrowed. It allows a tax administration to focus on the particular commercial circumstances of an entity or a group but it can be resource intensive and time consuming for both taxpayers and tax administrations to apply. Also, because each entity is considered separately, the outcomes of applying a rule can be uncertain, although this may be reduced through advance agreements with the tax administration. An advantage of an arm's length test is that it recognizes that entities may have different levels of interest expense depending on their circumstances, and should not disturb genuine commercial behavior. However, some countries with experience of applying such an approach in practice expressed concerns over how effective it is in preventing base erosion and profit shifting, although it could be a useful complement to other rules.

- Withholding tax on interest payments that are used to allocate taxing rights to a source jurisdiction. This approach is not considered in the Discussion Draft. Withholding taxes are primarily used to allocate taxing rights to a source country, but by imposing tax on cross-border payments they may also reduce the benefit to groups from base erosion and profit shifting transactions. Withholding tax has the advantage of being a relatively mechanical tool which is easy to apply and administer. However, unless withholding tax is applied at the same rate as corporate tax, opportunities for base erosion and profit shifting would remain. Where withholding tax is applied, double taxation can be addressed by giving credit in the country where payment is received, although the effectiveness of this is reduced if credit is only given up to the amount of tax on net income. In practice, where withholding tax is applied the rate is often reduced (sometimes to zero) under bilateral tax treaties. It would also be extremely difficult for E.U. member states to apply withholding taxes on interest payments made within the E.U. due to the Interest and Royalty Directive.

- Rules that disallow a percentage of the interest expense of an entity, irrespective of the nature of the payment or the identity of the lender. This approach is not considered in the Discussion Draft. While this approach reduces the general tax bias in favor of debt financing over equity, it does not address base erosion and profit shifting issues.

"There is a general view that in many cases international groups are still able to claim total interest deductions significantly in excess of the group's actual third party interest expense."

In recent years many countries have made significant changes to their approaches to combating base erosion and profit shifting through interest deductions, either through the introduction of new rules or through amendments to their existing rules. This suggests that countries have struggled to fully address the issues that they are actually seeing. There is a general view that in many cases international groups are still able to claim total interest deductions significantly in excess of the group's actual third party interest expense. A limited survey based on published data indicates that for the largest non-financial sector groups, the vast majority has a net interest to E.B.I.T.D.A. ratio of below 10% and many do not have any net interest expense. However, the majority of countries which currently seek to address base erosion and profit shifting using earnings-based ratios allow entities to gear up to the point where net interest to E.B.I.T.D.A. reaches 30%.

International debt shifting has been established in a number of academic studies[2] which show that groups leverage more debt in subsidiaries located in high tax countries. Academics have shown that thin capitalization is strongly associated with multinational groups[3] and that multinational groups use more debt than comparable widely held or domestically owned businesses.[4] Additional debt is provided through both related party and third party debt, with intragroup loans typically used in cases where the borrowing costs on third party debt are high.[5]

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2 Møen *et al.*, 'International Debt Shifting: Do Multinationals Shift Internal or External Debt?' (2011) University of Konstanz Department of Economics Working Paper Series 2011-40, 42; Huizinga et al., 'Capital structure and international debt shifting' (2008) 88 Journal of Financial Economics 80, 114; Mintz and Weichenrieder, Taxation and the Financial Structure or German Outbound FDI' (2005) CESifo Working Paper No. 1612, 17; Desai et al., 'A Multinational Perspective on Capital Structure Choice and Internal Capital Markets' (2004) 59 The Journal of Finance 2451, 2484.

3 Taylor and Richardson, 'The determinants of thinly capitalized tax avoidance structures: Evidence from Australian firms' (2013) 22 Journal of International Accounting, Auditing and Taxation 12, 23.

4 Egger *et al.*, 'Corporate taxation, debt financing and foreign-plant ownership' (2010) 54 European Economic Review 96, 106; Mintz and Weichenrieder (n 4) 17.

5 Buettner *et al.*, 'The impact of thin-capitalization rules on the capital structure of multinational firms' (2012) 96 Journal of Public Economics 930, 937.

Academics have also looked at the effectiveness of thin capitalization rules and illustrated that such rules have the effect of reducing the total debt of subsidiaries.[6] Where thin capitalization rules relate solely to interest deductions on related party debt, such rules are effective in reducing intragroup debt but lead to an increase in third party debt, although not to the same extent. Theoretical studies on the impact of interest limitation rules on investment reach similar conclusions.[7] However, the empirical analysis that has been done does not support this theory. Two studies, both analyzing the effect of German interest limitation rules on investment, find no significant evidence of a reduction of investment either in relation to thin capitalization rules[8] or interest barrier rules based on a ratio of interest expense to income.[9]

WHAT ARE INTEREST AND INTEREST EQUIVALENTS?

At its simplest, interest is the cost of borrowing money. However, if a rule restricted its focus to such a narrow band of payments, it would raise three broad issues:

- It would fail to address the range of base erosion and profit shifting that countries face in relation to interest deductions and similar payments;
- It would reduce fairness by applying a different treatment to groups that are in the same economic position but use different forms of financing arrangements; and
- Its effect could be easily avoided by groups re-structuring loans into other forms of financing.

"Academics have also looked at the effectiveness of thin capitalization rules and illustrated that such rules have the effect of reducing the total debt of subsidiaries."

To address these issues, rules to tackle base erosion and profit shifting using interest should apply to interest on all forms of debt as well as to other financial payments that are economically equivalent to interest. Payments that are economically equivalent to interest include those which are linked to the financing of an entity and are determined by applying a fixed or variable percentage to an actual or notional principal over time. A rule should also apply to other expenses incurred in connection with the raising of finance, including arrangement fees and guarantee fees.

- Interest equivalent payments include:
- Payments under profit participating loans;
- Imputed interest on instruments, such as convertible bonds and zero coupon bonds;

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6 Blouin *et al.*, 'Thin Capitalization Rules and Multinational Firm Capital Structure' (2013) 26-27; Buettner *et al.*, *Id.*, 937.

7 Ruf and Schindler, 'Debt Shifting and Thin Capitalization Rules - German Experience and Alternative Approaches' (2012) 21.

8 Weichenrieder and Windischbauer, 'Thin-capitalization rules and company responses - Experience from German legislation' (2008) CESifo Working Paper No. 2456, 29.

9 Buslei and Simmler, 'The impact of introducing an interest barrier Evidence from the German corporation tax reform 2008' (2012) DIW Discussion Papers 1215, 29.

- Amounts under alternative financing arrangements, such as Islamic finance;
- The finance cost element of finance lease payments;
- Amounts recharacterized as interest under transfer pricing rules, where applicable;
- Amounts equivalent to interest paid under derivative instruments or hedging arrangements related to an entity's borrowings;
- Foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- Guarantee fees with respect to financing arrangements; and
- Arrangement fees and similar costs related to the borrowing of funds.

TARGETS OF THE RULE

A robust rule addressing base erosion and profit shifting should apply to all incorporated and unincorporated entities and arrangements, including permanent establishments, which may be used to increase the level of interest deductions claimed in a country. Four scenarios are identified:

- Companies and other entities in a group, including permanent establishments. Entities are in a group where one entity has direct or indirect ownership or control over another entity or both entities are under the direct or indirect ownership or control of a third entity.
- Connected parties. For these purposes entities are connected parties where they are under common ownership or control but are not part of a group. This may arise where (i) an individual, fund, or trust exercises control over the entities or (ii) a shareholder agreement exists which has the effect of bringing the entities under common control. The proposition is that collective investment vehicles under the control of the same investment manager should not be treated as connected parties if there is no other connection between them.
- Payments made to related parties. Related parties include (i) significant shareholders and investors (and members of their family), (ii) entities where there is a significant relationship but which is not sufficient to establish control, and (iii) third parties where the payment is made under a structured arrangement. A significant shareholding or a significant relationship is a 25% or greater holding.
- Standalone entities. Entities not otherwise described above.

Companies and entities in each of the foregoing fact patterns pose different risks. Consequently, the Discussion Draft proposes that different interest limitation rules may be applied. For example, risks posed by international groups may be addressed through rules which link interest expense deductions in each group entity to the position of the worldwide group, while risks posed by connected and related parties may be addressed through targeted rules which apply to specific arrangements. Whichever rule is applied it is the intent of the Discussion Draft to avoid rules that provide a competitive tax advantage regarding interest expense deductions to certain entities and the way they are held.

WILL THE TARGET BE EXCESSIVE INTEREST OR EXCESSIVE DEBT? WILL EXCESSIVE RELATE TO GROSS OR NET POSITIONS?

As a preliminary matter, two key questions exist in formulating a rule to combat base erosion and profit shifting arising from excessive interest expense.

- Should the target be excessive levels of interest expense in relation to income or excessive amounts of debt in relation to assets?
- Whichever target is used, should the rule apply to an entity's gross position with regard to interest or debt, by looking only at the liability or expense item, or should the rule apply to an entity's net position, by offsetting interest expense with interest income and offsetting the debt obligations it issued with debt securities it holds?

As to the first question, the Discussion Draft concludes that rules to tackle base erosion and profit shifting should operate directly by reference to the level of interest expense in an entity and not the level of debt. Factors that support that approach include:

- Financial liabilities may be difficult to identify and value.
- The level of debt in an entity may fluctuate throughout a period, which means that the amount of debt on a particular date, or an average for the period, may not be representative of an entity's true position. On the other hand, the level of interest expense in an entity will reflect all changes in borrowings throughout the period.
- Because the target of the provision is excessive interest, a rule that refers to the level of deductible interest will directly address the key risk factor.
- A rule to limit interest expense deductions by reference to the value of the debt would still require a determination of the level of interest expense that is to be disallowed if a limit is exceeded. Also, cases of excessive interest on acceptable debt levels will be problematic.

"Should the target be excessive levels of interest expense in relation to income or excessive amounts of debt in relation to assets?"

Factors that favor the testing of debt levels, which were not persuasive, include:

- A rule based on the level of debt may provide leeway to allow an entity subject to high interest rates on its borrowings to deduct more interest expense than an entity with the same level of debt but subject to a lower interest rate.
- The level of debt in an entity is under the control of the entity's management and may be stable and easier to predict. The amount of interest expense, however, may vary reflecting market interest rate fluctuations.

Regarding the second question – net or gross valuations of interest expense – the Discussion Draft concludes that a general interest limitation rule should apply to the entity's net interest expense after offsetting interest income. The rule could be supplemented by targeted interest limitation rules to prevent groups avoiding the effect of a rule or which disallow gross interest expense on specific transactions identified as posing base erosion and profit shifting risks.

A gross interest rule may have the benefit of simplicity and is also likely to be more difficult for groups to avoid through planning. However, a gross interest rule could lead to double taxation where interest is paid on intragroup loans, and each entity is subject to tax on its full gross interest income, but part of its gross interest expense is disallowed. In comparison, a net interest rule will reduce the risk of double taxation, as interest income will already be taken into account before the interest limitation is applied.

SMALL ENTITY EXCEPTION

The Discussion Draft suggests that smaller entities may pose a lower risk to base erosion and profit shifting using interest and it has been suggested that these low risk entities be excluded from the interest expense limitation rules. Action Plan 4 suggests two thresholds for exclusion:

- Size Threshold. Using a combination of indicators such as number of employees and turnover, the size threshold assumes that a "smaller" entity poses less risk. However, it ignores the fact that a highly leveraged small entity may have a high level of interest expense.

- Monetary Threshold. The monetary threshold looks at the level of net interest expense in an entity and would be simple to apply. The level of interest expense is at the heart of the issue. The threshold amount will be set based on the economic situation and interest rate in a country because it will consider the effect profit shifting using interest will have on its environment. It will consider entities of the same group as a single unit to prevent companies from forming smaller entities to escape the threshold. Current thresholds range from €0.5million to €3 million.

Introducing thresholds could make them a consideration in reducing interest expenses or raising them to reach a limitation. The Discussion Draft comments that thresholds are not part of the best practice recommendation. Where adopted, they should be designed to exclude low risk entities based on their net interest expense computed on a local country group basis in order to avoid fragmenting.

LIMITING BASED ON GROUP POSITION

Group-wide Tests

Group-wide rules limit an entity's deductible interest expense based on factors applied on a worldwide basis. This approach is based on several premises. First, the best measure for total net interest deductions for a group is the difference between the interest expense paid to unrelated parties and interest income received from unrelated parties. Second, within a group, interest expense should be matched with economic activity. Groups will receive tax relief equivalent to their third party interest cost where the two premises match up.

Group-wide tests are viewed to be advantageous because they allow the centralization of third party borrowings and may be the most effective in tackling base erosion and profit shifting using interest. Consistently applied among countries, this approach avoids problems arising from contradictory application of rules by two or more countries. Nonetheless, the Discussion Draft suggests that they may need to be supplemented by more targeted limits based on specific factors within a group. For example, specific rules could prevent base erosion and profit shifting interest expense on debt held by unrelated parties is excessive. Or they might be necessary to deal with groups in which members are engaged in different business lines having different leverage rules that tilt the computation.

The cost of compliance and administration is something that must be considered under the groupwide rule.

Different Rule Options

Two variations of groupwide tests may be considered:

1. Groupwide Interest Allocation Rule. This variation allocates a worldwide group's net third party interest expense between entities of that group in proportion to economic activity in one of two ways. The first is a deemed interest rule in which allocation would be made according to earnings or asset values and this deemed interest expense would be tax deductible. The interest actually paid or received by the group as a whole would be disregarded. This rule is easy to apply. However, some countries have expressed concerns about introducing rules that allow deductions for amounts not paid or accrued by an entity.

   The second variation is an interest cap rule. Here, each entity would be provided an interest cap based on the allocation made according to earnings or asset values. Interest expense on intragroup and third party debt up to the cap would be tax deductible and any interest income received by the group would be taxed.

2. Group Ratio Rule. This rule compares a relevant financial ratio of an entity with the equivalent financial ration of the entire group. Third party and intragroup interest expense is deductible where the ratio is equal to or less than the ratio of the group. To stay with or under the ratio, groups may reorganize their intragroup financing.

Although similar, consistency is the key distinguishing factor between both approaches. While the interest allocation is more consistent, the group ratio would be more flexible for different countries that continue to apply existing laws. Furthermore, group ratios would work well for countries with volatile currencies as group ratios can also be applied directly to the earnings or asset value in its functional currency and an interest cap is more likely to be calculated in the reporting currency. Though the flexibility is a benefit for different economies, this would give a rise to a spectrum of rules. Therefore, it can be expected to increase compliance costs.

Entities to be Included

It is important to define the group when designing a group-wide rule as this will identify the companies that are considered in computing the ratio or cap and the companies affected by the ratio or cap. It is important for the group to be easily verifiable by entities and tax authorities in order to facilitate the collection of financial information. The Discussion Draft cautions that control and composition of the group may change based on differing accounting standards among several affected countries.

Membership should be based on one of two methods. The first is to apply the highest and most inclusive level of consolidated financial statements prepared by the parent of the group so as not to have contradictory statements and to ensure that all of the entities have been accounted for. If an entity isn't part of a group that prefers consolidate financial statements, the entity would need to obtain financial information on the group in order for the rule to be applied. Alternatively, a single standard definition of an interest limitation group could be applied for all entities, disregarding the actual composition. This would ensure that the same definition would be used by all entities but may require accounting if the interest limitation group differs from the financial reporting group.

Determining Net Third-party Interest Expense

Financial statements are a good starting point for information on the group's net interest position. These statements should be adjusted to include any income or expenses economically equivalent to interest not included in these financial reporting figures and exclude any income to expense treated as interest that wouldn't be taken into account for tax purposes.

"Under the group wide rule, the net interest expense of an entity is linked to net third party interest expense based on earnings and assets values that are used as a measure of economic activity."

An interest allocation rule would require agreement on the items that should be excluded. A group ratio rule would allow each country to decide based on its own tax law.

Measuring Income Activity

Under the group-wide rule, the net interest expense of an entity is linked to net third party interest expense based on earnings and assets values that are used as a measure of economic activity.

Economic activity can be measured using accounting or tax figures which would reduce compliance costs. Earnings or asset values can also be determined using tax principles by basing the economic activity on taxable profits or the tax value of an entity's assets. But using tax figures poses an administrative burden on tax authorities of the different countries.

The most obvious measure of economic activity is earnings and asset values. This indicator yields a fairer result for mixed groups that include entities engaged in activities requiring different levels of investment in assets. The levels of earnings are direct measures of an entity's obligation to pay interest and determining the amount of debt that can be borrowed.

Earnings as a Measure

The Discussion Draft states that a direct correlation exists between earnings and profit shifting. Entities that shift profits out of a country will reduce available net interest deductions. The measure of earnings used is most commonly known as "earnings before interest, taxes, depreciation and amortization" ("E.B.I.T.D.A."). It measures the cash flow of an entity that can be used to meet its interest expense obligations.

Gross profit is another measure of earnings that has the advantage of being calculated on a broadly comparable basis across most accounting standards, with greater differences introduced as an entity works down its income statement. However, the use of gross profit could lead to problems where one entity in a group provides, for example, marketing or distribution services to other group entities. This is because the entity providing the service will include its income within its own gross profit whereas the entity paying for services will deduct the corresponding expense further down its income statement, making the comparison of entities difficult.

Intercompany transactions within a group may mean that there are fact patterns where an individual entity recognizes earnings that are not included in the consolidated earnings of the overall group. For example, this may arise where an entity sells components to another entity in its group. The purchaser uses the components to manufacture products for sale to customers. At an entity level, the seller will recognize revenue from these intragroup sales, but on a consolidated level, this should not be recognized until a sale takes place outside the group. Other consolidation adjustments may be required to strip out payments between entities for intragroup services.

Entity earnings may be relatively volatile compared with asset values and there is a limit to the extent this can be controlled by a group. This means that under an earnings-based rule it may be difficult for a group to anticipate the level of net interest expense that will be permitted in a particular entity from year to year. A rule could be designed to include features to reduce the impact of this volatility. One such feature would entail averaging of income over a designated period. Another possible feature would entail carryforwards of disallowed interest expense or unused capacity in order to deduct interest expense in future periods.

A particular aspect of earnings volatility is the possibility that individual entities or an entire group may be in a negative earnings position. Three issues arise as a result. First, under an earnings-based approach, loss-making entities will not be able to deduct any net interest expense, though a rule may allow disallowed interest to be carried into future periods. Second, the aggregated earnings of profitable entities in the group will exceed the group's actual total earnings. Therefore a group-wide rule could allow these entities to deduct an amount of net interest expense that exceeds the group's total net third party interest expense. Third, unless a rule takes account of the impact of losses, a group-wide rule based on earnings would become impossible to apply where a group is in a loss-making position overall.

"Under an earnings-based rule it may be difficult for a group to anticipate the level of net interest expense that will be permitted in a particular entity from year to year."

Alternative potential solutions are provided to address this issue. One is that a group's total earnings could be determined using only the results from entities that have positive earnings. This would remove the risk that entities would be able to deduct an amount of interest expense in excess of the group's actual net third party interest expense. Alternatively, a rule could provide that, to the extent an interest limitation group includes loss-making entities, the protection offered by a group-wide rule is reduced or eliminated.

Earnings should be calculated applying the same standards that are used in preparing the group's consolidated financial statements. Where local G.A.A.P. is substantially similar to the accounting standards used in preparing the group's consolidated financial statements, a rule could provide for an entity's earnings to be calculated under local G.A.A.P. as a cost saving measure.

Asset-based Approaches

Third-party debt is often raised to fund the group's revenue generating assets. Valuing these assets determines the amount of debt they can garner. However, the link between asset valuation and taxable income is not as strong as that of earnings and therefore an asset based approach is the less preferred method of measure under the Discussion Draft.

A wide range of assets should be taken into account to reflect a group's activities. These include land and buildings, plant and equipment, goodwill and other intangible assets, inventory or stock, trade receivables, and financial assets which do not give rise to amounts treated as interest. However, financial assets that give rise to interest income and equity instruments yielding dividend income should not be considered. The ability to deduct interest expense should be allocated to entities with economic activity and not by reference to the location of debt instruments.

The advantages of asset values are that they are more stable than earnings and reduce compliance costs. Furthermore, an asset value approach means that entities with losses would still be able to deduct an amount of net interest expense.

Intangible assets, including trademarks, patents and trade secrets, can be among a group's most valuable assets. This is particularly the case for major brands and for hi-tech groups. However, accounting standards typically impose stringent requirements on groups before they are able to recognize an intangible asset on their balance sheet, particularly where the asset has been internally created. Even where an intangible asset can be recognized, its carrying value is usually at historic cost, which may be only a fraction of its actual fair market value. Revaluations of intangible assets are generally only possible by reference to a fair value on an active market, and as such will rarely be permitted for most types of intangibles.

The impact is that for a number of large groups, an approach to limiting interest deductions based on asset values for accounting purposes will ignore the group's most valuable assets.

Groups are allowed to offset derivative assets and liabilities carried at fair value if two parties owe each other a determinable amount and there is a right to offset.

Accounting and Tax Mismatches

In most cases an entity's interest cap under an interest allocation rule will have been calculated in the currency of the group's consolidated financial statements. However, an entity's taxable income will generally be calculated in its functional currency. Therefore, under an interest allocation rule, the interest cap will need to be translated into the entity's functional currency before it can be applied. This translation may be performed at the average exchange rate for the period, although a rule could allow a different exchange rate to be used if this would give a more reasonable result.

Some differences between the amount of net interest expense allowable under a group-wide rule and an entity's taxable net interest expense will be the result of mismatches in how interest is recognized for accounting and tax purposes. These will include timing mismatches and permanent mismatches. Timing mismatches arise because the interest expense is recognized in different periods for accounting and tax purposes, and in most cases these should correct over the life of a debt.

“Related parties ... are, however, in a relationship that means they may enter into transactions to generate a tax benefit, which is typically shared between the parties.”

Permanent mismatches arise where the payments treated as interest or economically equivalent to interest in the group consolidated financial statements are different to those treated as such for tax purposes. For example, where an instrument is treated as debt for accounting purposes but equity for tax purposes, payments on that instrument are likely to give rise to permanent mismatches. Permanent mismatches could be taken into account by allowing a small uplift in the amount of net interest expense that would be deductible under a group-wide rule.

The Discussion Draft acknowledges that the time for filling entity and group financial statements will be determined under local law applicable to the entities. As a result, an entity may be required to file its tax return and pay tax before the group financial statements are audited and published.

Cash Pooling

Cash pooling arrangements are a common part of treasury management in an international group. They allow a group to reduce its net third party interest expense by setting surplus cash balances in certain entities against borrowing needs in other entities so the group only pays interest on the net position. The interest expense is then allocated based on transfer pricing mechanisms. A group-wide rule will take into account the benefits obtained from the cash pool and the interest paid and received.

Connected and Related Parties

The Discussion Draft cautions that net third party interest expense can be artificially increased through transactions with connected and related parties. Connected parties include entities under a common control but not part of the group. Related parties include entities where there is a relationship below that required to establish control, and third parties which are party to structured arrangements. Related parties are not in the same economic position as members of a group. They are, however, in a relationship that means they may enter into transactions to generate a tax benefit, which is typically shared between the parties.

Targeted provisions are required to deal with risks posed by all connected and related parties. One option could be for interest payments to connected and related parties to be excluded from net third party interest expense in applying a group-wide rule. This could apply to all interest paid to connected and related parties, or to payments which meet certain conditions. The Discussion Draft views this approach as administratively cumbersome within a group and for tax authorities. An alternative approach would entail removing these payments from a group-wide rule. The entity making a payment to a connected or related party would reduce its interest cap or the amount of interest deductible under a group ratio rule by the value of the payment. At that point, a separate targeted rule would apply. It could disallow all interest payments to connected or related parties or allow payments subject to a limit based on a fixed ratio or a requirement that the recipient must be subject to a minimum level of taxation on the corresponding income. It is likely that this approach would be simpler to apply, as only the entity making a payment to a connected or related party would be required to make an adjustment. However, this approach also has disadvantages.

LIMITING INTEREST DEDUCTIONS WITH REFERENCE TO A FIXED RATIO

Fixed Ratio Approach

Fixed ratio rules are premised on the assumption that an entity should be able to deduct interest expense up to a specified proportion of its earnings, assets, or equity. This ensures that a portion of an entity's profit remains subject to tax in a country. The government determines the ratio that is applied irrespective of the actual leverage of an entity or its group.

Fixed ratio rules are relatively simple to apply because they do not require the financial information on the whole group; the tests are based entirely on the entity's own financial position. In addition, the test may use tax figures or any other figures that makes compliance easier.

The approach doesn't take into account the fact that groups operating in different sectors may require different amounts of leverage, which makes determining the correct level difficult. There is a risk that the ratio may be set too high for some entities and too low for others.

Interest Deductions and Level of Assets of Earnings

Borrowing funds and paying interest enables funding a group's assets and activities. Therefore, the Discussion Draft comments that there is a natural link between the value of assets held and the interest expense of the entity.

Because the Discussion Draft acknowledges that asset values are more stable than earnings, using asset values as a basis to determine deductible interest expense would increase certainty and reduce compliance costs. Additionally, asset tests may also be suitable for tackling base erosion and profit shifting involving the use of debt to fund tax exempt or deferred income, which would stop entities from claiming a higher level of deductible interest expense. The disadvantage with using asset values is the valuation. Using asset values as a base leaves a possibility of cash manipulations and artificial inflation.

"Fixed ratio rules are relatively simple to apply because they do not require the financial information on the whole group."

Linking fixed ratios to a measure of earnings means that a group will only be able to increase their level of net interest deductions by increasing taxable profits in that country. Excluding dividend income will help address base erosion and profit shifting using interest to fund tax exempt or deferred income. Nonetheless, as discussed before, an earnings based rule would be volatile and influenced by outside market factors. In addition, there are different types of earnings that include or don't include certain deductions.

Existing Fixed Ratio Levels

The next questions is whether the group ratio rules and fixed ratio rules described above could be combined in a way that reduces administrative and compliance costs by applying simpler rules to entities that pose less risk.

Two possible options for a combined approach are presented.

- Under the first option, a country could provide for a monetary threshold that establishes a *de minimis* level of net interest expense below which an entity will not be required to apply a general interest limitation rule. This threshold should apply to the aggregate net interest deductions in all group entities in a country. As a result, an entity with deductible net interest expense (above the monetary threshold) would come within the group-wide interest allocation rule. The entity could deduct interest expense up to an interest cap that is equal to an allocated portion of the group's net third party interest expense, based on a measure of earnings or assets. A country may allow disallowed interest expense to be carried forward and set against unused interest cap in a future period.

- Under the second option, entities with levels of deductible interest expense above any monetary threshold would come within a fixed ratio test, whereby an entity would be able to claim relief for deductible net interest expense up to a fixed percentage of its earnings or assets. To be effective in addressing base erosion and profit shifting and to remove the risk of entities gearing up and claiming further interest deductions to the point where the fixed ratio is reached, this ratio should still be at a level that is lower than that which is currently applied in many countries. The rule would be subject to an exception under which entities in more highly leveraged groups may apply a carve-out so that where an entity's ratio is (i) higher than the fixed ratio, but (ii) does not exceed the ratio of its group, the entity does not need to apply the fixed ratio rule. Again, disallowed interest expense may be carried forward and set off against unused interest cap in a future period.

SUPPLEMENTAL RULES FOR TARGETED TRANSACTIONS

Some countries do not currently apply a general interest limitation rule to address base erosion and profit shifting risks, but rely solely on targeted rules. One benefit of such an approach is that it reduces the risk that a rule negatively impacts on entities which are already appropriately capitalized. However, this approach has some drawbacks. Targeted rules will always be a reactive response, requiring countries to be aware of specific base erosion and profit shifting risks as they emerge. There is a risk that some groups may consider all arrangements not covered by targeted rules to be acceptable, meaning that over time new targeted rules may be required. Targeted rules also require active application, meaning the tax administration must be able to recognize situations where a rule could apply, often as part of a complex transaction, and then engage with a group to determine the correct result. In contrast, a general rule could provide an effective response to a broad range of base erosion and profit shifting issues.

Nonetheless, the Discussion Draft suggests that there could be a role for some targeted provisions to prevent entities from avoiding the effect of the general rule or to address specific risks not covered by the general rule, for example, if the general rule only applies to groups. Overall, targeted rules hold the potential to address specific base erosion and profit shifting risks. However, an approach based entirely on targeted rules may result in a large number of rules that will increase complexity and compliance and administrative costs. If the rules are not comprehensive then they are unlikely to deal with all base erosion and profit shifting risks.

NON-DEDUCTIBLE INTEREST EXPENSE AND DOUBLE TAXATION

As discussed above, deductions interest above any limit or cap will be denied if an interest limitation rule is applied. The Discussion Draft presumes that entities will comply with the limitation rules and will attempt to rearrange financing terms to avoid problems. Nonetheless, situations will exist where interest expense deductions are disallowed and double taxation will exist within a group. To rectify the problem, certain provisions may be included to reclassify nondeductible interest or to allow it to be used in other periods.

"Situations will exist where interest expense deductions are disallowed and double taxation will exist within a group."

Permanent disallowance may work for certain transactions but not all. Under targeted rules, items of interest expense that give rise to permanent base erosion or profit shifting should be disallowed. Where nondeductible interest expense is a result of a timing mismatch due to fluctuating levels of earnings, a permanent disallowance may introduce an undesirable uncertainty.

Recharacterization of Disallowed Interest as a Dividend

If recharacterizing a disallowed interest expense as a dividend is accepted by the country of the recipient, the risk of double taxation can be reduced. However, several problems could arise:

- Under a general interest limitation rule, the disallowance of interest expense will not be allocated to specific payments. If the recharacterization is applied on a *pro-rata* basis to all interest payments made by an entity, a large number of very small deemed dividends would be created.
- Disallowed expenses may be financial payments that are not interest in legal form and the reclassification of which may pose issues in the countries of the payer and recipient.
- Dividend withholding rates may be different from interest withholding rates and reclassification could reduce the impact of a disallowance.

While reclassification as a dividend may not be the best approach, reclassification under a specific targeted role may still be advisable.

Carryforward of Disallowed Interest or Unused Capacity

Some countries already allow disallowed interest expense to be carried forward for relief. However, an indefinite carryforward could reduce the overall impact of an interest limitation rule and introduce planning opportunities that would negate the effect of the interest limitation rule that was implemented in the first place.

One way to tackle this problem would be to restrict the number of years the carry forward could apply. It has also been suggested that a disallowed interest expense shouldn't be deductible at any point.

GROUPS IN SPECIFIC SECTORS

- Banks and Insurance Companies. Banks and insurance companies present unique issues that do not arise in other sectors. Interest expense is the largest cost on a bank's income statement, but this is less so for insurance companies. Interest expense in banking and insurance groups is closely tied to their ability to generate income, more so than for groups operating in other sectors. Therefore, any rule that restricts deductions for general gross interest expense will have a significant impact on a bank's business model. Moreover, financial sector businesses typically are subject to strict regulations on their capital structure. The 2011 Basel III agreement is an example for banks, and the Solvency II Directive in the E.U. is an example for insurers in the E.U. Specific rules will be required for the banking and insurance sectors that may differ in the treatment of regulatory capital and other borrowing. Limits could be placed on net deductions regarding regulatory capital (ignoring the interest income generated from using the capital to write business), so that only amounts of interest paid to third parties would be deductible. Alternatively, a best practice approach could focus on a group's interest expense other than the expense related to regulatory capital.

- Oil and Gas; Real Estate. Companies operating in these sectors may be subject to special tax regimes that are designed to ensure that a country shares in the benefits derived from the extraction of natural resources. These regimes may include specific features that limit interest expense deductions.

- Infrastructure Projects. These projects are often highly leveraged using a mixture of bond issues and bank debt. Special rules may be required in light of the impact of limitations on large public infrastructure projects.

- Other Businesses in the Financial Services Sector. Entities such as asset management, leasing, and the issuance of credit cards have their own unique issues that must be addressed to ensure an appropriate result in preventing base erosion and profits shifting.

CONCLUSION

B.E.P.S. Action 4 evidences a view that internal manipulation of capital within a group between equity and debt is an evil that must be dealt with harshly. To the drafters, all internal debt is abusive if the amount of the debt is not tied to the third party borrowing of the group. Presumably, this approach is intended to prevent internal manipulation. However, as in other anti-abuse rules designed to prevent certain action, taxpayers have found relief by adjusting business models to put actual substance in places where none previously existed. There is little doubt that the first action as contemplated in the Discussion Draft of Action 4 will beget a reaction by groups that is unexpected by the drafters.

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B.E.P.S. ACTION 5: COUNTERING HARMFUL TAX PRACTICES MORE EFFECTIVELY

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Tags
B.E.P.S.
Compulsory Spontaneous Exchange of Information
F.H.T.P.
Harmful Tax Competition
Harmful Tax Practices
Nexus Test
Qualified Expenditures
Transparency and Substance

The Organization for Economic Co-operation and Development ("O.E.C.D.") worked together with G20 countries[1] to develop a 15-point action plan to deal with Base Erosion and Profit Shifting ("B.E.P.S."). The goal of the B.E.P.S. Action Plan is to develop a single global standard for automatic exchange of information and stop corporations from shifting profits to jurisdictions with little or no tax in order to ensure taxation in the jurisdiction where profit-generating economic activities are performed and where value is created.

B.E.P.S. occurs in situations where different tax laws interact in a way that creates extremely low global tax rates or results in double non-taxation. This kind of planning gives a competitive advantage to multinational entities that have substantial budgets to engage high-powered tax advisers and to implement their plans.

The O.E.C.D. published deliverables that intend to eliminate double non-taxation resulting from B.E.P.S. The final measures will be completed in 2015 and will be implemented either through domestic law or the existing network of bilateral tax treaties.[2]

ACTION ITEM 5: HARMFUL TAX PRACTICE

Harmful Tax Competition: An Emerging Global Issue

In 1998, the O.E.C.D. published the report *Harmful Tax Competition: An Emerging Global Issue*[3] ("the 1998 Report") with the intention of developing methods to prevent harmful tax practices with respect to geographically mobile activities. These methods have been adopted in the Forum on Harmful Tax Practice ("F.H.T.P.") with some modifications. Significant attention is given to:

- Elaborating on a methodology to define a substantial activity requirement in the context of intangible regimes; and
- Improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes.

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1 The G20 countries are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.

2 O.E.C.D. Action 5: 2014 Deliverable.

3 O.E.C.D. (1998), Harmful Tax Competition: An Emerging Global Issue, O.E.C.D. Publishing.

“In order for a regime to be considered preferential it must offer some form of tax reference in comparison with the general principles of taxation in the relevant country.”

Forum on Harmful Tax Practice

The 1998 Report describes three stages to determining whether a regime is harmful or provides preferential treatment:

- Consideration of whether a regime is within the scope of work of the F.H.T.P. and, if so, whether it is preferential;
- Consideration of the four “Key Factors” and eight “Other Factors” set out in the 1998 Report to determine whether a preferential regime is potentially harmful; and
- Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful in practice.

In order for a regime to be considered preferential it must offer some form of tax preference in comparison with the general principles of taxation in the relevant country. The preferential regime may take a wide variety of forms, and even a small amount of preference is sufficient for the regime to be considered preferential.

To determine whether a preferential regime is potentially harmful, the F.H.T.P. uses four Key Factors and eight Other Factors set out by the 1998 Report.

Key Factors:

1. The regime imposes no or low effective tax rates on income from geographically mobile financial and service activities.
2. The regime is ring-fenced from the domestic economy.
3. The regime lacks transparency (*e.g.*, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).
4. There is no effective exchange of information with respect to the regime.[4]

Other Factors:

1. An artificial definition of the tax base;
2. Failure to adhere to international transfer pricing principles;
3. Foreign source income exempt from taxation in the country of residence;
4. A negotiable tax rate or tax base;
5. The existence of secrecy provisions;
6. Access to a wide network of tax treaties;
7. The promotion of the regime as a tax minimization vehicle; and
8. The regime encourages operations or arrangements that are purely tax-driven and involve no substantial business activities.[5]

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[4] O.E.C.D. Action 5: 2014 Deliverable.

[5] O.E.C.D. Action 5: 2014 Deliverable.

The presence of first factor is established once it is determined that the regime has a "no or low effective tax rate." This is a gateway criterion. It is evaluated based on the combined effective tax rate for both national and subnational taxes. Once this first criterion is met the regime will be considered *potentially harmful* based on an overall assessment of the other three Key Factors and, where relevant, the eight Other Factors. As the presence or absence of any one factor is not controlling, a tax regime may be characterized as potentially harmful if at least one of the Key Factors or Other Factors is met. By its nature, if a tax regime provides a preferential rate and is an attractive *entrepôt* in the context of a cross border transaction, it almost certainly will be viewed as potentially harmful.

Once the regime is considered *potentially harmful* it may still not be viewed as *actually harmful*. The following three questions are identified as helpful in assessing whether or not the regime is actually harmful:

- Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?
- Is the presence and level of activities in the host country commensurate with the amount of investment or income?
- Is the preferential regime the primary motivation for the location of an activity?

Once the preferential regime is found to be actually harmful, the relevant country is given an opportunity to abolish the regime or remove the features that create the harmful effect.

Action Item 5: Substantial Activity

Action Item 5 requires the F.H.T.P. to revamp the existing standard to concentrate on the existence or absence of substantial activity and improve transparency through mechanisms such as compulsory spontaneous exchanges on rulings related to preferential tax regimes. The framework for the substantial activity test was established by the 12 factors outlined in the 1998 Report. Its importance is now elevated.

The substantial activity test looks at whether a regime encourages purely tax-driven operations or arrangements. Action Item 5 observes that many harmful preferential tax regimes are designed to allow the taxpayers to derive benefits from those regimes while engaging in operations which are purely tax-driven and involve no substantial activities. The 1998 Report contains limited guidance on how to apply this factor.[6]

Substantial Activity Requirement

There is no clear definition of a "substantial activity requirement," but there is general agreement among the O.E.C.D. countries that it is an important factor in determining if a regime is potentially harmful. The substantial activity factor from the 1998 Report has been elevated under the Action Item 5 and is now considered with the four Key Factors in determining if a regime is potentially harmful.

The F.H.T.P., for the first time, focuses on regimes which provide preferential treatment for income arising from intellectual property ("I.P."). It is understood that

[6] O.E.C.D. (1998), Harmful Tax Competition: An Emerging Global Issue, O.E.C.D. Publishing.

I.P.-intensive industries are beneficial to a country, and therefore governments are free to grant incentives for research and development ("R&D") activities, but such incentives should be created within the scope of the principles agreed upon under the F.H.T.P. All intangible regimes in member countries are being reviewed simultaneously.

Application of Substantial Activity in the Context of Intangibles

> ***"The nexus approach focuses on the relationship between R&D activities actually carried out in a jurisdiction and preferential tax treatment … If the nexus test is met, both front-end and back-end tax regimes that incentivize innovative activities will not be categorized as actually harmful."***

Three different approaches were considered to define substantial activity in an I.P. regime. These approaches address value creation, transfer pricing, and nexus. Action Item 5 eliminates the first two approaches and concentrates solely on nexus. The nexus approach focuses on the relationship between R&D activities actually carried out in a jurisdiction and preferential tax treatment. This approach is designed to encourage R&D by only allowing tax benefit for taxpayers who are actually engaged in R&D activity. If a taxpayer outsources its R&D to an unrelated party, the taxpayer will continue to be entitled to the benefit of an I.P. regime. However, if R&D activity is assigned to a related party, the taxpayer will not be entitled to the benefit from an I.P. regime even if it funds the entire activity with its own capital.

If the nexus test is met, both front-end and back-end tax regimes that incentivize innovative activities will not be categorized as actually harmful. A front-end regime provides benefits when and as I.P. is created or developed. An example would be an allowance of more than 100% of development costs as funds are expended. A back-end regime would provide a preferential tax rate when and as developed I.P. is exploited. An example would be a preferential rate on royalty income.

Under the approach approved in Action Item 5, the portion of I.P. income that may benefit from an I.P. regime is based on the portion that qualified expenditures by the taxpayer bear to the overall expenditure for R&D activity. As a result, capital contributions or expenditures for substantial R&D activity by parties other than the taxpayer will disallow subsequent income from the benefits of an I.P. regime.

This approach becomes complex when several entities bear a share of substantial R&D. Where that occurs, the ratio of qualifying expenditures of each entity to the total amount of expenditures is applied to the qualifying I.P. income generated from the R&D at the level of each entity. The formula is as follows:

$$\frac{\textbf{Qualifying expenditures incurred to develop I.P. asset}}{\textbf{Overall expenditures incurred to develop I.P. asset}} \times \textbf{Overall income from I.P. asset} = \textbf{Income receiving tax benefits}$$

Action Item 5 suggests that this calculation should be treated as a rebuttable presumption. The taxpayer can demonstrate that more income should receive a benefit than in the presumed calculation by showing a direct link between income that would benefit from the I.P. regime and qualifying expenditures. This may require a greater degree of recordkeeping on the part of the taxpayer. The circumstances under which the taxpayer can rebut the presumption are not yet defined, but further guidance is being developed.

Where the amount of income receiving benefits under an I.P. regime does not exceed the amount determined by the nexus approach, the regime has met the substantial activities requirement. Note that this analysis is conducted on a country-by-country basis and is applied to entities that are taxpayers in the jurisdiction providing the benefits. Consequently, a permanent establishment ("P.E.") maintained in a foreign jurisdiction cannot be taken into account by the head office of an entity unless the I.P. income of the P.E. is subject to tax in the jurisdiction of the head office. Also, expenditures of a P.E. that ceases to exist cannot be taken into account at the time I.P. revenue is generated.

"Action Item 5 presumes that outsourcing to unrelated parties is not a significant problem. Thus, the nexus approach allows all qualifying expenditures for activities undertaken by unrelated parties."

Definitions

An exact definition of the term "qualified expenditures" is not provided under Action Item 5. Instead, each jurisdiction will provide its own definition, which must meet certain requirements to be deemed acceptable. The definition must be limited to actual R&D activity and would exclude interest payments, building costs, acquisition costs, and other assets that do not have a direct connection to the I.P. assets. Suggested qualified expenditures include salary and wages, direct costs, overhead costs, cost of supplies, and, in some circumstances, depreciation.[7]

The term "overall expenditures" will be defined in such a way that if the qualifying taxpayer incurs all relevant expenditures itself, the ratio will allow 100% of the income from the I.P. asset to benefit from the preferential regime. This means that the taxpayer's overall expenditures must equal the sum of all qualifying expenditures. Any expenditure that would not be included as a qualifying expenditure, if incurred by the taxpayer, cannot be included in overall expenditures. This general rule is subject to several exceptions. I.P. acquisition costs, for example, are included in the overall expenditures, even though they are not considered qualifying expenditures at the level of the entity. Additionally, comparable treatment is given to acquisition costs and outsourcing costs. In each of these cases, the rationale is that benefits under an I.P. regime should relate to all of the taxpayer's qualifying expenditures.

The term "overall income" will be defined by each jurisdiction according to its domestic laws. However, the definition must meet a standard under which income benefitting from a preferential regime is not disproportionately high in relation to the percentage of qualifying expenditures claimed by qualifying taxpayers. Under this standard, overall income means overall net income.

The goal is to exclude capital contributions or expenditures for substantial R&D activity by parties other than the taxpayer from the definition of a "qualified expenditure."

Outsourcing

Action Item 5 presumes that outsourcing to unrelated parties is not a significant problem. Thus, the nexus approach allows all qualifying expenditures for activities undertaken by unrelated parties to qualify even if the activities of the unrelated party were not carried out within the jurisdiction. Individual countries may further limit the definition of an unrelated party to universities, hospitals, R&D centers, and nonprofit entities.

Tracking Income and Expenditures

The nexus approach mandates that an I.P. regime must require taxpayers to track expenditures, I.P. assets, and income to ensure that only income related to R&D

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7 O.E.C.D. Action 5: 2004 Deliverable.

expenditures benefit from the preferential regime. While tracking may be relatively simple for a taxpayer that has only one I.P. asset, the task becomes more complex when more than one I.P. asset is owned. Action Item 5 cautions against manipulation of revenue streams to artificially provide benefits to income that is not overall income, in substance.

Grandfathering

Grandfathering of a harmful preferential regime will be permitted so long as the regime in question meets the following conditions:

- No new entrants are permitted;
- A definite date for complete abolition of the regime has been announced; and
- The regime is transparent and has effective procedures for exchange of information.

Presumably, the grandfathering provision found in Action Item 5 will apply to the winding down of so-called "double Irish" arrangements. Residency rules terminating these arrangements will take effect on January 1, 2015 with regard to new Irish companies. Existing companies will enjoy a grandfathering period until the end of 2020.

Transparency through Compulsory Spontaneous Exchange

Lack of transparency is one of the key issues addressed under Action Item 5. Lack of transparency may arise as a consequence of the way in which a regime is deigned and administered. It may also arise from the existence of secrecy laws or other impediments regarding the effective exchange of information. To combat the lack of transparency, the F.H.T.P. is authorized to focus on developing a framework for the compulsory spontaneous exchange of information regarding rulings related to preferential regimes. This will introduce an obligation for an individual country to spontaneously exchange information that could be relevant to another country, even when the information has not been requested by the second country. In addition, the F.H.T.P. is authorized to prepare a report on preferential regimes for public dissemination – *viz.*, name and shame.

Application of Filters

The framework developed for compulsory spontaneous exchanges addresses four key design questions:

1. When does the obligation to spontaneously exchange information arise?
2. With whom must information be exchanged?
3. What information must be exchanged?
4. What is the legal basis for the spontaneous information exchange?

Other issues involve time limits, relevance of reciprocity, confidentiality, and feedback from the receiving country.

The framework for the compulsory spontaneous exchange of information contemplates the use of a mechanical filter methodology to reduce the level of discretion for spontaneous exchange. This means that a ruling would apply certain tests in which the answer is either yes or no. Only rulings that pass though the filter with all "yes" answers will be subject to compulsory spontaneous information exchange. Please see the annexed flow chart provided at the end of the article for spontaneous information exchange on rulings related to preferential regimes.

The tests in the mechanical filter ask the following questions:

1. Is the regime within the scope of the F.H.T.P.'s work?

2. Is the regime a preferential regime?

3. Does the regime meet the "no and low effective tax rate" factor?

If the answer to all three questions is "yes," and the ruling is specific to a taxpayer or group of taxpayers, a spontaneous exchange of information is required if a taxpayer is entitled to rely on the ruling. Examples include an Advance Tax Ruling ("A.T.R.") and an Advance Pricing Agreement ("A.P.A.").

Procedures for the Exchange of Information

A two-step procedure is contemplated in Action Item 5. The first step involves a disclosure generated by the country granting the preferential tax ruling. The second step is a follow-up by the country receiving the information.

The automatic exchange in the first step will contain the following information:

- Identification of the taxpayers and the entities involved in the cross-border transaction;
- Details of the transaction and the period covered by the transaction; and
- If the ruling is in the form of an A.P.A., the transfer pricing methodology that was applied and the price that was agreed upon.

For rulings other than an A.P.A., an additional filter is created so as not to overly burden either country taking part. Non-A.P.A. rulings are divided into three categories:

- Inbound investment into the county in which the taxpayer has obtained the ruling;
- Outbound investment from that country; or
- Transactions or situations involving other countries.

The sending country will have discretion regarding how much information to share with the receiving country. The minimum that the sending country should provide is:

- The identity of the taxpayers and the accounting period covered by the ruling;
- A summary of the issues and income covered, preferably in English or any other language bilaterally agreed; and
- The tax administration's response and reasoning.[8]

[8] Action 5.

Once the ruling is granted, it should be exchanged with all affected countries as soon as possible and not later than three months from the date the ruling became available. An appropriate system must be in place to provide the ruling to the appropriate authorities. Presumably, the taxpayer requesting the ruling will identify the affected countries.

Under the second step for compulsory spontaneous exchanges, the receiving country may request additional information related to the transaction. It is expected that feedback will improve spontaneous exchange of information procedures and may facilitate the identification of potential tax adjustments in the sending country. Whether the country initiating the exchange will make the adjustment is an open question. Presumably, an adjustment will be made only if the facts provided by the taxpayer are not accurate and complete.

Confidentiality of the Information

Action Item 5 contemplates the necessity of legal protections for the information being exchanged. Countries that do not have appropriate domestic laws in place to protect the confidential tax information received will be expected to develop a legal framework for the protection of such information. All treaties and exchange of information instruments contain provisions for confidentiality and address the obligation to protect that information. International exchange of information instruments will prevail when the domestic law provides for a broader use of the exchanged information. It is contemplated that through continuous monitoring of exchanged information transparency procedures will continue to develop and improve.

In 2010, each member country of the F.H.T.P. was asked to respond to a survey of its preferential regimes. The self-evaluation was followed by extensive analysis and peer review. The F.H.T.P.'s work on preferential regimes in member and associate countries is an ongoing process that will continue beyond September 2014.

"The results the authors of Action Item 5 hope for are self-evident. However, as with many of the B.E.P.S. Action Items, questions remain regarding actual implementation and timing for compulsory spontaneous exchanges of information."

CONCLUSION

At this point, Action Item 5 is a work in progress – one clearly directed toward countries currently in the news, such as Luxembourg and Ireland. Eventually, countries that utilize double structures and substance officers will discover acceptable ways to comply with the O.E.C.D. system while only providing limited information in spontaneous exchanges. Alternatively, published guidance accompanied by proper caveats may also be considered, as well as a unification of tax rates and the elimination of withholding taxes in specified circumstances. At the same time, the F.H.T.P. will continue evaluating tax systems.

The results the authors of Action Item 5 hope for are self-evident. However, as with many of the B.E.P.S. Action Items, questions remain regarding actual implementation and timing for compulsory spontaneous exchanges of information.

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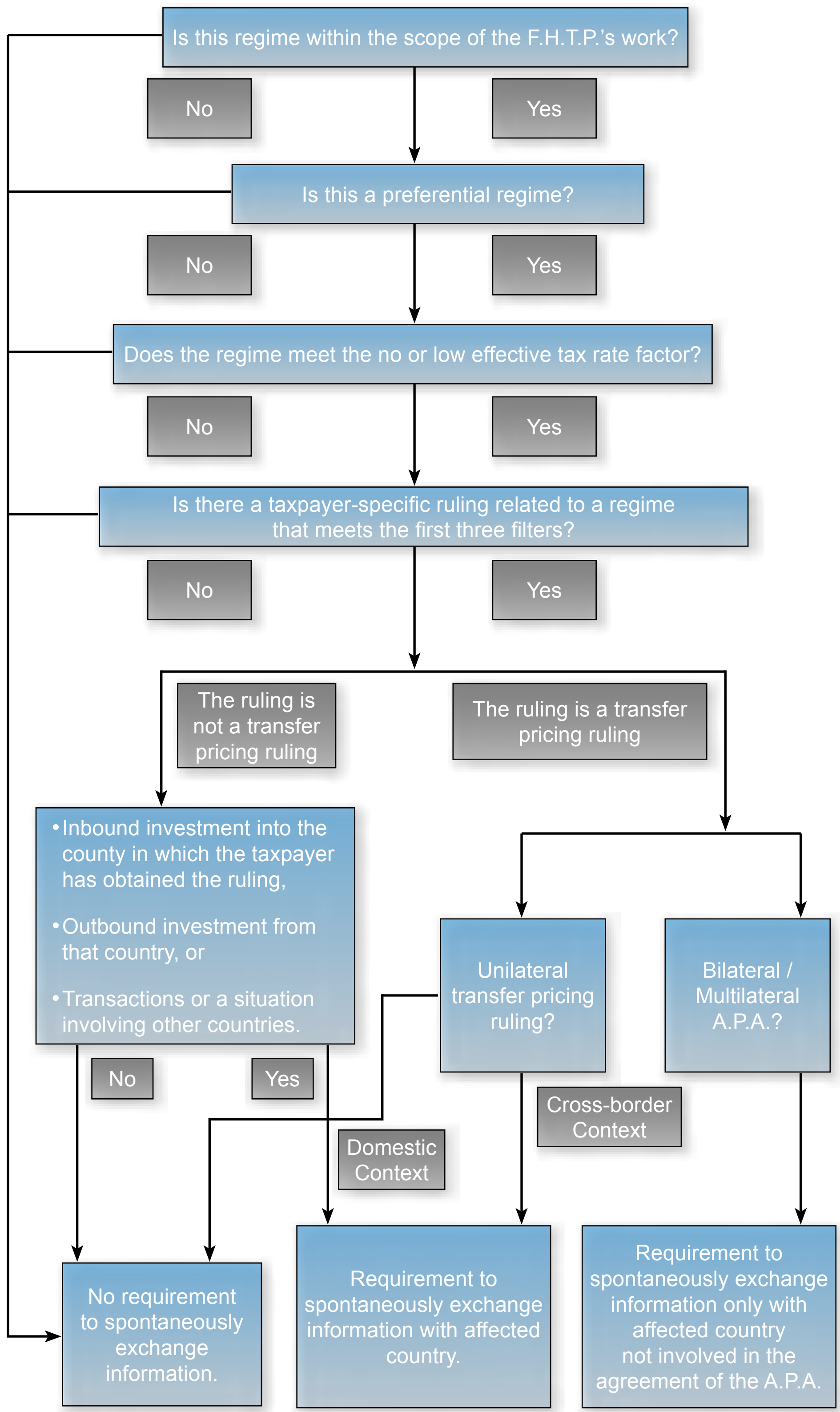
Flow Chart: Spontaneous Information Exchange on Rulings Related to Preferential Treatments



B.E.P.S. ACTION 6: ATTACKING TREATY SHOPPING

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Tags
B.E.P.S.
Double Non-taxation
GAAR
General Anti-Avoidance Rule
Limitation on Benefits
L.O.B.
P.P.T.
Principal Purpose Test
Treaty Abuse
Treaty Shopping

BACKGROUND

Action Item 6 addresses abuse of treaties, particularly focusing on treaty shopping as one of the most important sources of B.E.P.S. The approach adopted amends the O.E.C.D. Model Convention that borrows from the U.S.'s approach to treaties but expands upon it in a way that can be very helpful to the U.S. and other developed countries if adopted by the C.F.E. next year in their final report. Among other measures, the report recommends inclusion of a Limitation on Benefits ("L.O.B.") provision and a general anti-avoidance rule called the Principal Purpose Test ("P.P.T.") to be included in the O.E.C.D. Model Convention. While it is expected the report will be finalized next year, whether countries will adopt the recommendations is the crucial factor that is still unclear.

RECOMMENDATIONS

The key recommendations can be found in Paragraph 14. It contains two basic recommendations:

- Countries should agree to include in the tax treaties an express statement of the common intention to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance through use of treaties.
- Countries should demonstrate their commitment to this goal by adopting an L.O.B. provision and a P.P.T. provision in income tax treaties.

The report also notes that special rules may be needed to address application of these rules to collective investment funds ("C.I.F.'s"). The provision should be supplemented by a mechanism that would deal with conduit arrangements not currently dealt with in tax treaties.

Having established a goal, Paragraph 6 of Action Item 6 recognizes four constraints that may prevent full adoption of the recommendations in certain circumstances. This caveat will be helpful for a specific country that cannot fully adopt these measures. However, any exception that prevents wide acceptance of a recommendation may prevent the consistent approach needed to insure the success of the recommendations.

These four situations that may call for an exception are the following:

- Some countries have constitutional or E.U. law restrictions that prevent them from adopting the exact recommended wording.

- Some countries may have domestic anti-abuse rules that effectively prevent some of the treaty abuses described in the report. If those rules already address some of the issues in the report then treaty modification may not be needed. Nonetheless, a clear rule in an easily accessible treaty would be more helpful than having to explore the complexities of local law for guidance.
- The courts of some countries have developed judicial tools to combat these issues, such as an economic substance requirement and a substance over form doctrine, that effectively address these concerns. However, dealing with the local courts for relief is a major burden imposed on administrators.
- Limited administrative capacity of some countries might prevent implementation of a program involving detailed treaty rules. Instead, these countries might opt for more general anti-abuse provisions.

"The report recommends inclusion of a Limitation on Benefits ('L.O.B.') provision and a general anti-avoidance rule called the Principal Purpose Test ('P.P.T.')."

LIMITATION ON BENEFITS

The L.O.B. proposal recommends the adoption of a new Article X (Entitlement to Benefits) of the O.E.C.D. Model Convention. Paragraphs 1 through 6 of Article X address treaty shopping through a series of objective rules.

Paragraph 1 provides the general rule:

> Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25), unless such resident is a "qualified person", as defined in paragraph 2, at the time that the benefit would be accorded.

Paragraphs 2 through 5 address when a resident is a "qualified person" and, alternatively, when a resident is entitled to benefits even though it is not a qualified person. The standard used is comparable to that which is applied in an L.O.B. provision of a typical U.S. income tax treaty. Thus, the following are considered to be qualified residents or to be entitled to certain treaty benefits even if not qualified:

- An individual who is a tax resident of a treaty country;
- The Contracting States that are parties to the convention and sub-national governments;
- A corporation having shares that are regularly traded on a recognized exchange (a "Publicly Traded Corporation") for the entire tax period in which a benefit is claimed, provided either that the exchange is in the treaty country in which the corporation is tax resident or the primary place of management and control is in that country;
- A corporation in which shares representing at least 50% of the voting power and value are owned, directly or indirectly, by five or fewer Publicly Traded Corporations;
- Certain not-for-profit entities and pension arrangements;

- An entity meeting the following tests: (i) shares in the entity representing at least 50% of the voting power and value are owned, directly or indirectly, on at least half the days of the taxable year by any of the above qualified residents other than a Publicly Traded Corporation or an entity it owns, and (ii) it is not a conduit of income through deductible payments to a related party resident in a third country;
    - A conduit relationship exists if at least 50% of the entity's gross income is paid or accrued directly or indirectly to residents in third countries. Relationships are identified at the time of payment. Arm's length payments, made in the ordinary course of business for services or tangible property, are not considered to be part of a conduit arrangement.
    - Regrettably, neither the recommendation nor the commentary defines arm's length for this purpose. This may lead to a dichotomy of treatment if arm's length is defined in one country by reference to ownership – viz, a sister corporation can never be at arm's length from a payor – or by the terms of the transaction – *viz.*, a payment of interest to a sister corporation under a loan agreement that sets interest at LIBOR plus an appropriate mark-up based on the credit rating of the borrower is *prima facie* made at arm's length terms and conditions. Payments to a local permanent establishment of a related person are not base eroding when the permanent establishment is a full taxpayer in the jurisdiction where it operates.
- A resident of Contracting State that is engaged in the active conduct of a trade or business, but only to the extent that the income is derived in connection with that business or is incidental to that business;
    - An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting, such as officers or employees of a company conduct substantial managerial and operational activities.
    - There is no recognition given for the attribution to a holding company of active operations from an operating company.
    - The business of the person claiming the benefit must be substantial in relation to the business in the payor's state of residence, which is to be determined on a facts and circumstances basis. Where this provision applies, the resident is entitled to the benefit even if not a qualified person.
- A company that is at least 95% owned by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary. The company must not be a conduit as previously defined. Where this provision applies, the resident is entitled to the benefit even if not a qualified person;
- A resident benefitting from discretionary relief afforded by the relevant tax authority as to its qualification as a treaty resident. Where this provision applies, the resident is entitled to the benefit even if not a qualified person.

“For a U.S. tax adviser, the scope of the P.P.T. may be problematic because intent to obtain a treaty benefit is typically not enough to deny the benefit if it is accompanied by economic substance.”

PRINCIPAL PURPOSE TEST

While the L.O.B. proposal borrows heavily from the U.S. treaties, the P.P.T. general anti-avoidance rule adopts principles already recognized in the O.E.C.D.’s Commentary on Article 1 of the O.E.C.D. Model Convention. In contrast to the detailed and objective L.O.B. rules, the P.P.T. rule is a more general and subjective way to address treaty abuse cases. The P.P.T. provision appears in paragraph 7 of proposed Article X.

> Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

The P.P.T. is a rule that will deny tax treaty benefits if “one of the principal purposes of an arrangement or transaction” is to obtain tax treaty benefits “unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant” treaty provision. Where this is the case, however, the last part of the provision allows the person to whom the benefit would otherwise be denied the possibility of establishing that obtaining the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

The P.P.T. supplements, and does not restrict in any way, the scope and application of the limitation-on-benefits rule. Consequently, a benefit that is denied in accordance with the L.O.B. provision is not a benefit that the P.P.T. would also deny. In comparison, the fact that a person is entitled to benefits under the L.O.B. provision does not prevent benefits from being denied under the P.P.T. Thus, for planning purposes, the L.O.B. and the P.P.T. provisions must be met.

CONCLUSION

Action Item 6 is a productive step forward in dealing with treaty shopping. From the viewpoint of the U.S. and any country that has an income tax treaty in effect with the U.S., the L.O.B. provisions are “old hat.” However, for a U.S. tax adviser, the scope of the P.P.T. may be problematic because intent to obtain a treaty benefit is typically not enough to deny the benefit if it is accompanied by economic substance.

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B.E.P.S. ACTION 8:
CHANGES TO THE TRANSFER PRICING RULES IN RELATION TO INTANGIBLES – PHASE I

Authors
Robert Rinninsland

Tags
B.E.P.S.
Comparable Market Method
Cost Method
Excess Profits Method
Intangible Property
I.P. Valuation
Net Present Cash Flow
Relief of Royalty Method
Transfer Pricing

INTRODUCTION

Unlike some of the other B.E.P.S Action Items, Action Item 8 has a basis in existing O.E.C.D. rules. In this regard, the O.E.C.D. Transfer Pricing Guidelines[1] have established the operating rules for transfer pricing. It is understandable that Action Item 8 merely presents a series of amendments to Chapters I, II, and VI of the *O.E.C.D. Guidelines*.

Action Item 8 states that it seeks to:

- Clarify the definition of I.P.,
- Provide guidance on identifying transactions involving I.P., and
- Provide supplemental guidance for determining arm's length conditions for transactions involving I.P.

Action Item 8 also considers the treatment of local market features and corporate synergies.

Action Item 8's recommendations intend to accomplish these three goals by:

- Adopting a broad and clearly delineated definition of I.P.,
- Ensuring that profits associated with the transfer and use of I.P. are appropriately allocated in accordance with (rather than divorced from) value creation,
- Developing transfer pricing rules or special measures for transfers of hard-to-value I.P.,
- Updating the guidance on cost contribution arrangements, and
- Adopting transfer pricing rules or special measures to ensure inappropriate returns will not accrue to an entity solely because it contractually assumed risks or provided capital.

THRESHOLD ISSUES

Definition of Intangible Property

Intangible property ("I.P.") for both O.E.C.D. and U.S. tax purposes is broadly defined. It includes

[1] O.E.C.D Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the O.E.C.D. Guidelines").

- Patents, inventions, formulae, designs, patterns, or know-how;
- Copyrights, such as for literary, musical, or artistic compositions;
- Trademarks, trade names, or brand names;
- Franchises, licenses, or contracts;
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- Items similar to these listed.[2]

"The purpose of the valuation controls the choice of method used to value I.P."

Further guidance regarding the definition of I.P. is found in the U.S. tax law provisions regarding the amortization of I.P. acquired as part of a trade or business.[3] Intangible assets include:

- Workforce in place;
- Business books and records;
- Patents, copyrights, formulae, etc.;
- Customer-based I.P.;
- Supplier-based I.P.; and
- Any similar items.

Goodwill is recognized under these U.S. tax law principles as an item of I.P. and is defined as the value of a business attributable to the continued expectancy of customer patronage, due to name reputation or any other factor.[4] Note that goodwill for this purpose is not accounting goodwill or the goodwill embedded in another item of I.P. such as trademarks. Rather, it must be a standalone item of property.[5]

Valuation of I.P.

The purpose of the valuation controls the choice of method used to value I.P. These purposes include:

- Transaction Strategy: Consideration of buying, selling, or transferring the I.P. in a licensing arrangement or acquisition;
- Financial Reporting: Valuing prescribed intangible assets for reporting on public financial statements;
- Litigation Strategy: Computation of damage awards in infringement suits; and

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2 Code §936(h)(3)(B). These items are considered separately identifiable intangible property where they have substantial value independent of the services of any individual.

3 Code §197(d)(1)(C); Treas. Reg. §1.197-2(b) provides detailed descriptions of the Section 197 intangible property.

4 Treas. Reg. §1.197-2(b)(1).

5 *International Multifoods Corp. v. Commr.*, 108 TC 25, supplemental op., 108 TC 579 (1997).

- Bankruptcy: Valuing assets to properly repay creditors or to reorganize the company.

Various methods may be used to value I.P. From a transfer pricing perspective, the most important methods are:

- Relief of royalty,
- Excess profits,
- Net present cash flow,
- Comparable market, and
- Cost.

The relief from royalty method assumes that if a business loses ownership of a particular I.P., it would be forced to pay a royalty to the owners of the I.P. for the right to use the property. This royalty rate can be based on a number of variables, but is most often based on revenues. The percentage rate for the royalty will differ depending on the characteristics of the asset considered and the industry in which that asset is deployed. The value of the I.P. under this method is the capitalized value of the after-tax royalties that the company is relieved from paying because it is the owner of the asset. Determining the appropriate royalty rate is the key consideration. Ideally it is calculated by reference to standard industry values and practices or comparable transactions.

The excess profits method is used primarily to determine the value of a brand to a business and involves determining a fair market value of the net tangible assets used in producing the branded product. A rate of return is then used to estimate the profits required to promote investment in those assets. Any return in excess of this amount represents the maximum royalty payable. That amount is capitalized to compute the value of total intangible assets. This approach is a variation of the method in which the business is valued as a whole. The current market value of the business's net tangible assets is subtracted from that overall value. It assumes that the entire excess return can be attributed to the presence of the brand name alone. It ignores the possibility that other intangible factors, such as an established distribution network or statutory protection from competition, may influence the return.

Under the net present cash flow value method, the value of the I.P. comprises the present value of cash flows generated by the asset over its useful life. The useful life of an asset depends on its economic life. Critical factors include life cycle, rate of technological change, and barriers to entry. This method has been considered to have the strongest theoretical foundation because it is based on the economic measure of cash flow, including a focus on the future risks associated with the assets, and the duration of the economic life of the assets. The key is to readily identify the net cash flows that are directly associated with the I.P. These include cash flows attributable to a library of film, music, or program copyrights or royalty income from licensing a brand name.

The comparable market methodology values the I.P. by referring to prices obtained for comparable assets in recent similar transactions and licensing arrangements.[6]

[6] The residential real estate market is a market where these conditions are usually present, albeit for real property.

The method is credible, objective, and relevant in the context of market-based valuation exercises. Major requirements are:

- An active market,
- An exchange of comparable assets,
- Access to price information at which assets are exchanged, and
- Transactions that reflect market values.

There may be difficulties in valuing I.P. using this methodology even when information is available because particular transactions may be affected by non-value related factors. These factors include:

- Different levels of relevant knowledge,
- Different negotiating skills between the parties, and
- Fundamental differences between the assets used in the comparable analysis and the asset that is valued in the subject transaction, which may have the effect of over-pricing or underpricing the value of the I.P.

The cost-based approach seeks to measure future benefits of owning I.P. by quantifying the amount spent on developing an I.P. asset to its present form or the amount required to replace the future service capability of that asset. The issue here is whether or not it is correct to assume that the value of the I.P.'s development costs, usually incurred over a lengthy period of time, reflects its ability to derive future economic benefit.

HISTORICAL PERSPECTIVE

The O.E.C.D. has had a long-standing project to revise Chapter VI of the 2010 O.E.C.D. Guidelines relating to I.P. Discussion drafts were released in June and September 2012. Almost simultaneous with the release of the B.E.P.S. Action Plans in 2013, the O.E.C.D. issued the "Revised Discussion Draft" on Transfer Pricing Aspects of Intangibles. The revised draft was consistent with the 2012 discussion drafts. The groundwork provided by the discussion drafts has enabled Action Item 8 to move at an accelerated pace, focusing the deliverable on the revision of Chapter VI of the O.E.C.D. Guidelines.

The 2013 Revised Discussion Draft discussed the definition of I.P., location savings, synergies, and pricing methods. The public debate focused on the allocation of income from the exploitation of I.P. among the members of a related party group. This contrasted with the prior discussion drafts, which placed more emphasis on functions performed and control over risk and less emphasis on I.P. ownership, funding, and contractual terms. For example, in the 2013 Revised Discussion Draft, emphasis was placed on certain important functions such as control over research and marketing programs, budgets, or strategic decision-making. These were key factors in valuation and were given special significance.

The 2013 Revised Discussion Draft diminished the role of capital by proposing to restrict the return that a related party should expect from bearing a funding risk. These risks typically appear in calculations supporting a cost sharing or contract

R&D arrangement. In that regard, it provided,

> Bearing a funding risk, without the assumption of any further risk, and without any control over the use of the contributed funds or the conduct of the funded activity, generally would entitle the funder to a risk-adjusted rate of anticipated return on its capital invested but not more.

What this return should be is left open, but the implication is that it should be modest.

By the end of May, it was reported that Working Party 6 completed a revised text for Chapters I, II and VI to the Transfer Pricing Guidelines.

ACTION ITEM 8 AND THE THRESHOLD ISSUES

"Both positive and negative effects of organizational synergies should be considered, a point often overlooked by taxation authorities when dealing with multinational corporations."

Action Item 8 addresses these threshold issues in its amendments to the O.E.C.D. Guidelines, Chapters I and II and VI, and is supplemented by a number of examples.

Chapters I and II Key Points

- Location savings, assembled workforce, and group synergies are to be taken into account to determine comparability of functions and risks in benchmarking the controlled transaction at issue to the appropriate set of comparables. The existence and relevance of each of these factors to transfer pricing is to be determined by a robust functional and comparative analysis.
- Location savings (*i.e.*, cost reductions from operating in a given market having comparatively cheap labor) may or may not be passed on to the customer. If not passed on to the customer, it is assumed that the members of the multinational group will share in the location savings based on their relative contributions to the benefits derived from the location savings.
- Assembled workforces with unique skills may differentiate the multinational group's controlled transaction from potential comparables. Where these workforces can be transferred from one entity/location to another, the associated cost savings to the recipient entity (time and expense of recruiting) would most likely represent an adjustment that would need to be made in determining the group's transfer pricing for purposes of the comparables' benchmarking.
- Both positive and negative effects of organizational synergies should be considered, a point often overlooked by taxation authorities when dealing with multinational corporations. Positive synergies might include the ability to purchase raw materials at a bulk discount or other indicia of economies of scale. Negative synergies might include bureaucratic hurdles to necessary business decisions or outdated company standards in comparison to the competition.
- The functional and comparable analysis to identify the existence and relevance of location savings, assembled workforce, and organizational synergies should identify any I.P. developed or used by the multinational group in the transaction. For example, location savings may be attributable to a license to conduct business within a given jurisdiction or market, which would be in and of itself I.P., depending on whether that license represents a barrier

to entry of the market for other competitors. Transfer of an assembled workforce might include transfer of I.P. in the form of the business know-how resident in the workforce. Group synergies may result from concerted efforts by the multinational organization to achieve structural advantages over the competition. These efforts will necessitate a determination of, (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the group. Thus, the implication is that I.P. can be developed as a result of internal corporate organizational initiatives.

Chapter VI

Action Item 8 has amended Chapter VI in its entirety, replacing the old with the new. The new Chapter VI focuses on special situations in transfer pricing due to the nature of I.P. and emphasizes that the procedures set forth in the earlier chapters regarding robust functional analyses and determination of comparable transactions especially applies to I.P. The functional and comparability analyses must consider:

- The identification of specific I.P.;
- The legal ownership of I.P.;
- The contributions of multinational group members to their development, enhancement, maintenance, protection and exploitation; and
- The nature of the controlled transactions involving I.P., including the manner in which such transactions contribute to the creation of value.

"Action Item 8's Working Group 6 was concerned with the issue of whether legal ownership of an intangible determined share of anticipated income from the intangible."

On these four threshold points, Chapter VI provides the following guidance:

- Chapter VI identifies I.P. as including anything that can be owned or controlled by parties in a commercial setting and whose use or transfer would be compensated for by independent parties in comparable circumstances. That certainly includes the items noted above and most likely others, as Chapter VI points out that the definition of I.P. for transfer pricing purposes should not be limited to accounting definitions or to items for which R&D expenses have been incurred and expensed rather than booked to a balance sheet account. Note that separate transferability is not necessary for something to be considered an intangible item. Chapter VI notes that I.P. can be transferred along with non-I.P. and that they are not tied to contractual rights but can exist separately.
- Action Item 8's Working Group 6 was concerned with the issue of whether legal ownership of an intangible determined share of anticipated income from the intangible. In sum, Chapter VI provides that legal ownership will entitle the owner to such income if the legal owner of an intangible, in substance:
  - Performs and controls all of the functions (including the important functions described in paragraph 6.56) related to the development, enhancement, maintenance, protection and exploitation of the intangible;
  - Provides all assets, including funding, necessary to the development, enhancement, maintenance, protection, and exploitation of the I.P.; and

- Bears and controls all of the risks related to the development, enhancement, maintenance, protection, and exploitation of the intangible.

- Determination of group members' assumption of functions and risks related to the development and exploitation of an intangible will be based on a function and risk analysis performed pursuant to the principles laid out in the earlier chapters. To the extent use of the I.P. or performance of these activities are carried out by other members of the multinational group, those members would be entitled to share in the anticipated returns from the I.P. in the form of arm's length consideration for their efforts. Chapter VI notes that this compensation may constitute all or a substantial part of the anticipated return from the I.P., depending on the facts and circumstances. Chapter VI notes that entitlement to profit or loss relating to unanticipated events will depend on the terms and conditions of relevant contracts and on the functions performed, assets used and risks assumed by each member.

- Chapter VI sets out the basis for identifying and analyzing the transactions involving I.P. The required steps are:

  - o Identifying the legal owner of I.P. based on the terms and conditions of legal arrangements, including relevant registrations, license agreements, other relevant contracts, and other indicia of legal ownership;

  - o Identifying the parties performing functions using assets, and assuming risks related to developing, enhancing, maintaining, protecting, and exploiting the I.P. by means of the functional analysis;

  - o Confirming the consistency between the conduct of the parties and the terms of the relevant legal arrangements regarding intangible ownership through a detailed functional analysis; and

  - o Identifying the controlled transactions related to the development, enhancement, maintenance, protection, and exploitation of I.P. in light of the legal ownership of the I.P. under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets, risks and other factors contributing to the creation of value.

  In principle, an accurate determination of an arm's length price reflecting each party's contribution will result when the foregoing steps are followed.

Chapter VI has certain transactions in mind that require this type of analysis, including:

- Development and enhancement of marketing I.P.;

- Research, development, and process improvement;

- Use of the company name;

- Transfers of I.P. or rights to I.P.;

- Transfers of combinations of I.P.;

- Transfers of I.P. or rights to I.P. in combination with other transactions, such as services or tangible property.

Chapter VI provides supplemental guidance for transactions most likely to reflect incorrect application of the transfer pricing guidelines. Points to be checked include:

- The quality of the intangible transfer – such as the exclusivity, geographic scope, useful life, and stage of development – for purposes of checking comparability of I.P. transactions;
- Inherent risks regarding the likelihood of future benefits from the exploitation of the I.P.; and
- Obsolescence of the intangible or infringement.

I.P. Valuation

Valuation of I.P. is integral to the determination of income attributable to the intangible, particularly where no third party comparable transactions can be identified. In this regard, Chapter VI reflects the general O.E.C.D. direction of recommending close scrutiny of the value of the intangible transferred out of a highly taxed jurisdiction to a low tax jurisdiction. Here again, Chapter VI gravitates away from reliance on accounting concepts, noting that accounting assumptions may be too conservative in order to avoid overstating the balance sheet. Chapter VI instead relies on realistic alternatives that take into account the perspective of the parties and attribution of risk. Income valuation methods such as discounted cash flow are considered particularly useful when properly applied. Chapter VI anticipates that valuation methods will also be used within the context of proper application of the approved O.E.C.D. transfer pricing methods related to I.P. as those methods have been outlined in Chapter II.

NEXT STEPS & OPEN ISSUES

Work remains on related Action Items, such as Action Item 9 on Risks and Capital, and Action Item 10 on Other High Risk Transactions. Work on these two Action Items anticipates a December 2014 discussion draft. Developments on Action Items dealing with permanent establishments, deductibility of interest, the C.F.C rules, and the digital economy are also anticipated to have an effect on I.P. In 2015, work is anticipated on special measures related to:

- Providing tax administrations with authority in appropriate instances to apply rules based on actual results to price transfers of hard-to-value I.P. and potentially other assets;
- Limiting the return to entities whose activities are limited to providing funding for the development of I.P., and potentially other activities, for example, by treating such entities as lenders rather than equity investors under some circumstances;
- Requiring contingent payment terms or the application of profit split methods for certain transfers of hard-to-value I.P.; and
- Requiring application of rules analogous to those applied under Article 7 of the O.E.C.D. Model Tax Convention and the Authorized O.E.C.D. Approach to certain situations involving excessive capitalization of low function entities.

As far as open issues are concerned, one query is whether further work needs to be done on the definition of I.P. Chapter VI seemed to conclude that I.P. should be limited to assets that are proprietary in nature, meaning that rights related to the I.P. are protected by law or contract. Chapter VI defined goodwill as I.P. for most I.P. transactions. An over-emphasis on the discounted cash flow valuation method could be detrimental in situations where other valuation methods are more appropriate.

From the U.S. perspective, it seems that the core U.S.-centric concern remains in issue. That concern is whether the favored methodologies in Chapter VI yield the most accurate arm's length result. If Action Item 8 is nothing more than an emphasis on functions and risks and a de-emphasis on capital investment, then the U.S. concern has not been addressed. Chapter VI's approach to I.P. transfer pricing may become overly political as each jurisdiction applies different methodologies based on factors that favor its position.

From the multinational group perspective, the author's advice has consistently reflected the following approach:

- Align transfer pricing strategy for tax purposes with the enterprise's business model. Do this in the context of a function and risk analysis.
- Monitor written intercompany agreements and procedures and amend them if necessary to reflect changes in the business. Do this in the context of affirmatively identifying the intangible and the intangible transaction.
- The quality of a transfer pricing analysis depends on the quality of the comparables. Note the increased focus on identifying proper comparables for use in benchmarking the I.P. transaction being valued.
- Know the comparables. Identify why a given comparable company has been selected and how that company's functions and risk allocations relate to the tested party's functions and risks. The I.R.S. analysis of comparables is often based on brief excerpts of 10-K reports that do not shed light on the ways in which the comparable companies conducted business.
- When push comes to shove, substance trumps writing. In this regard, stay faithful to your agreements as noted above.

"From the U.S. perspective, it seems that the core U.S.-centric concern remains in issue. That concern is whether the favored methodologies in Chapter VI yield the most accurate arm's length result."

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B.E.P.S. ACTIONS 8, 9 & 10: ASSURING THAT TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION

Authors
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Tags
Action 8
Action 9
Action 10
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B.E.P.S.
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Hard-to-value Intangibles
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Over-capitalization
Recharacterization
Risk
Transfer Pricing

On December 19, 2014, the Organisation of Economic Co-operation and Development ("O.E.C.D.") released a discussion draft on Actions 8, 9, and 10 of the Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan ("Discussion Draft" or "Draft")[1]. Actions 8, 9, and 10 reinforce the goal of assuring that transfer pricing outcomes are in line with value creation.

In July 2013, the O.E.C.D. published the B.E.P.S. Action Plan for the purpose of establishing a comprehensive agenda to resolve B.E.P.S. issues. The B.E.P.S. Action Plan identifies 15 actions to combat B.E.P.S. and establishes deadlines for application of each action.

The Discussion Draft introduces revisions to Chapter I of the Transfer Pricing Guidelines and addresses the related topics in Actions 8, 9, and 10. Specifically, the Discussion Draft focuses on the development of the following:

> (i) rules to prevent B.E.P.S. 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.
>
> (ii) rules to prevent B.E.P.S. 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 recharacterized.
>
> (iii) transfer pricing rules or special measures for transfers of hard-to-value intangibles.

The Discussion Draft establishes guidance on these risk and recharacterization issues in two parts. Part I consists of proposed revisions to Section D of the Chapter I Transfer Pricing Guidelines and focuses on accurately defining the actual transactions and allocating of risk. Part II introduces a framework of questions along with five potential options for special measures relevant to intangible assets, risk, and over-capitalization.

The revisions to Section D, discussed in Part I of the draft, focus on the application of the arm's length principle and provide detailed guidance on determining the economically relevant characteristics or comparability factors of the controlled transaction. The revisions also establish criteria on when an actual transaction should not

1 O.E.C.D. (2014) "BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)"

be recognized or be recharacterized. Part I stresses the importance of:

> (i) the accurate delineation of the actual transaction based on both the contractual arrangements and the conduct of the parties, (ii) the specification of associated risks and allocation of risk to risk management, and (iii) the non-recognition of transactions which lack the fundamental attributes of arrangements between unrelated parties, for purposes of matching where profits are reported and where value is created.

These issues are identified by the Discussion Draft as "giving rise to several issues at the heart of the arm's length principle." In this context, additional points are raised by the Discussion Draft to be taken into consideration for comments, these include "moral hazard" (*i.e.*, the lack of incentive to guard against risk where one is protected from its consequences), "risk-return trade-off" (*i.e.*, the inclination to take on or lay off risk in return for higher or lower anticipated nominal income), and whether or not distinctions should to be made in applying the guidance to the financial sector.

Part II outlines potential special measures pertaining to intangible assets, risk, and over-capitalization. These special measures are either within or beyond the scope of the arm's length principle. The primary aims of these special measures are to ensure that transfer pricing outcomes are in line with value creation and to limit the risk of B.E.P.S. for governments.

The special measures are introduced through the following five options:

- Option 1 addresses hard-to-value intangibles;
- Option 2 addresses issues with regard to an independent investor;
- Option 3 addresses thick capitalization;
- Option 4 addresses determination of a minimal functional entity;
- Option 5 addresses appropriate taxation of excess returns.

The situations proposed in these options closely relate to Action 3 (on strengthening the controlled foreign corporation ["C.F.C."] rules) and Action 4 (on interest deductions). According to the Draft, some of the measures are closely related to C.F.C. rules or "can be seen as [C.F.C.] rules." The Discussion Draft explains that such measures were included in order to obtain public comments in this respect prior to the public consultation on C.F.C. rules, which is planned for April 2015. The Draft also contains a series of ten questions that serves as a framework for determining whether and how each option should be implemented in order to achieve the transfer pricing goals of the B.E.P.S. Action Plan.

The views and proposals included in the Discussion Draft do not represent consensus views of the Committee on Fiscal Affairs or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comments. Accordingly, the O.E.C.D. invites the public to submit written comments on the Discussion Draft by February 6, 2015. There will also be a public consultation on the Discussion Draft and other topics on March 19 and 20 at the O.E.C.D. Conference Centre in Paris.

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B.E.P.S. ACTION 10 – PART I: PROFIT SPLIT METHOD IN THE CONTEXT OF GLOBAL VALUE CHAINS

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Tags
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One-sided Method
Profit Split Method
Unanticipated Events
Unique and Valuable Contributions

INTRODUCTION

There has been another release on Base Erosion and Profit Shifting ("B.E.P.S.") deliverables. B.E.P.S. refers to the tax planning that moves profits to a low-tax jurisdiction or a jurisdiction that allows a taxpayer to exploit gaps in tax rules. These deliverables have been developed to ensure the coherence of taxation at the international level. The aim of these deliverables is to eliminate double non-taxation. The measures have been developed throughout 2014, and they will be combined with the work that will be released in 2015.

In the December 16th release on Action 10 (the "Discussion Draft" or "Draft"),[1] Working Party No. 6 on the Taxation of Multinational Enterprises ("M.N.E.'s.") released various factual scenarios, posed questions and invited affected persons to suggest answers. The goals of the Draft are to assure that transfer pricing outcomes are in line with value creation and to determine whether it is more appropriate to apply the profit split method in some circumstances instead of a one-sided transfer pricing method.

RELEVANT ISSUES

The Draft identifies relevant issues in the posed scenarios, asks questions, and invites commentary as follows.

Value Chains

The term "global value chain" describes a wide range of activity, from the consumption of the product to the end use and beyond. Therefore, one particular method of transfer pricing may not be appropriate.

Scenario 1:

Three associated Original Equipment Manufacturing ("O.E.M.") enterprises in the durable goods industry are located in different territories in Europe. Each of the O.E.M.'s manufactures finished goods and components for its local market and the European market. They license in technology I.P. from their non-E.U. parent, for which they pay a royalty, but otherwise the European operation of the group is largely independent of the parent. The O.E.M.'s have a number of subsidiaries in Europe providing contract manufacturing services in relation to certain components. Sales and distribution takes place

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[1] O.E.C.D. (2014), "BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains."

through other group subsidiaries, and, in the O.E.M.'s own state, through a division of the O.E.M. itself.

The Draft identifies that a one-sided method can be appropriate and reliable to determine arm's length pricing for the royalty and for the contract manufacturing and distribution services.

However, a one-sided method may not be reliable and the profit split method may be preferable under the following conditions:

- Highly integrated transactions involving O.E.M.'s.;
- An over-arching Leadership Board on which all three O.E.M.'s are represented;
- The Leadership Board that makes decision for the business as a whole (*e.g.*, the board identifies the new products to be developed, the location within Europe where the products will be developed, the location where the products will be built, the scope of plant investment is to be made, and strategic marketing);
- The O.E.M.'s trade with each other, buying and selling components and finished goods; and
- The success of the business depends on having a wide portfolio of products to sell across the European market.

Questions:

1. *Can transactional profit split methods be used to provide a transfer pricing solution to this Scenario? If so, how?*
2. *What aspects of Scenario 1 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?*
3. *Is the application of a transactional profit split method more useful than other methods for dealing with particular aspects of value chains, such as highly integrated functions and the sharing of risks?*
4. *What guidance should be provided to address the appropriate application of transactional profit split methods to deal with these aspects of value chains?*

Multisided Business Models

This following scenario highlights a multisided and integrated digital economy business model. The diverse functions are carried out by various entities of the M.N.E. group which closely relate to the group's core business model.

Scenario 2:

The RCo Group provides a number of internet services such as search engines, e-mail services, and advertising to customers worldwide. On one side of the business model, the group provides advertising services through an online platform and charges clients a fee

“The Draft points out that when there are unique and valuable contributions from two parties, the transactional profit spit method is the most appropriate method.”

based on the number of users who click on each advertisement. On the other side, the RCo Group provides free online service to users that provide the RCo Group with substantial data information such as location-based data, data on online behavior, and users’ personal information. Over the years, the RCo Group refines its methodology for data collection, processing, and analysis. As a result, it provides clients with a sophisticated technology that allows them to target specific advertisements to certain users.

The technology and algorithms used in providing the internet advertising services were originally developed and funded by Company R, the parent company of the RCo Group.

In order to interface with key clients, the group formed local subsidiaries to perform various functions:

- Promote the free use of online services by users, translate advertising into local languages, tailor advertising to the local market and culture, ensure that the services provided respect local regulatory requirements, and provide technical consulting to users.
- Generate demand for and adapt advertising services.
- Regularly interact with Company R staff responsible for developing technology to provide feedback on the algorithms and technologies to enhance business in various markets.

Questions:

1. *Can transactional profit split methods be used to provide an appropriate transfer pricing solution in the case of Scenario 2? If so, how?*
2. *What aspects of Scenario 2 would need to be elaborated to determine whether a transactional profit split method or another method would be appropriate in this case?*

Unique and Valuable Contributions

The Draft points out that when there are unique and valuable contributions from two parties, the transactional profit spit method is the most appropriate method. The term “unique and valuable contributions” is not defined, but it is used in the amendments to Chapter VI, contained in the 2014 report *Guidance on the Transfer Pricing Aspect of Intangibles*. The term connotes a key source of competitive advantage for the business.

Scenario 3:

Company P, located in country P, is a manufacturer of high technology industrial equipment. Company S, a subsidiary of Company P, markets and distributes the equipment to unrelated customers in country S. Both companies are members of Group X.

Company P conducts extensive R&D activities to develop and improve the technological features of its equipment; it also funds and has legal ownership of all the technology intangibles it develops. In addition, Company P owns the global trademark, and provides broad guidance to its subsidiaries around the world on its overall marketing strategy. There are several global competitors making similar equipment that operate in Country S, which is a large market for such equipment.

Company S is responsible for sales of the equipment and undertakes marketing activities. Due to the nature of its business, Company S develops close relationships with customers. It provides on-site services, carries an extensive stock of spare parts, and is highly proactive in detecting potential problems. Company S advises customers on equipment choices and suggests modifications for particular local conditions, or to maximize performance efficiency, or to enhance effectiveness. These activities provide a significant competitive advantage as customers place high value on the reliability and performance of the equipment. In this case, Company S is recognized as not merely a "routine" distributor, but its activities constitute a key source of competitive advantage for the Group.

Questions:

1. *Does the way in which the term "unique and valuable" is defined for intangibles assist in defining the term "unique and valuable contributions" in relation to the transactional profit split method?*

2. *What aspects of Scenario 3 need to be further elaborated in order to determine whether a transactional profit split or another method might be the most appropriate method?*

3. *Based on the abbreviated fact-pattern set out in Scenario 3, what method could be used to provide reliable arm's length results to determine the remuneration for Company S? If a transactional profit split method is used, how should it be applied?*

4. *What are the advantages and disadvantages of considering the application of a transactional profit split in Scenario 3?*

Integration and Sharing of Risks

The Draft points out that one-sided methods may not be reliable to account for the synergies and benefits created by integration. Moreover, where an M.N.E.'s business operations are highly integrated, strategic risks may be jointly managed and controlled by more than one enterprise in the group, creating a strong interdependence of key functions and risks between the parties.

Scenario 4:

Company A, in country A, manufactures and sells sophisticated medical equipment to unrelated customers. In developing a new generation of equipment, it outsources the development and production of certain key equipment components to its associate enterprises, Companies B and C. The development of the components is a lengthy and complex process. The components are highly specific and unlikely to be useful in other types of products. Companies A, B, and C each control and perform their own research, development, and production processes.

All third-party sales revenue from the equipment will initially accrue to A. The rewards to companies A, B, and C are contractually determined by the M.N.E. group on a profit-sharing basis.

Questions:

1. *In what circumstances might the application of a transactional profit split method be an appropriate approach for dealing with sharing of risks?*
2. *Would a one-sided method produce more reliable results?*
3. *What aspects of Scenario 4 need to be further elaborated in order to determine whether a transactional profit split method or another method might be the most appropriate method?*

"The M.N.E.'s divide various functions within a value chain. This is sometimes referred to as fragmentation of functions."

Fragmentation

The M.N.E.'s divide various functions within a value chain. This is sometimes referred to as fragmentation of functions. It is difficult to find comparable uncontrolled enterprises with similar specialized activities. In addition, it may be hard to account for the high level of interdependence between the functions performed by the associated enterprises that may be absent in independent enterprises. For this reason, the Draft suggest that it may be feasible to undertake a transactional profit split method approach to identify comparables for some or all the fragmented activities on a combined basis, and to apply the principles of a contribution analysis to divide benchmark profit.

Questions:

1. *Should the guidance on the scope of transactional profit split methods be amended to accommodate profit split solutions to situations such as those referred to in the interim guidance on intangibles? If so, how?*
2. *Can transactional profit split methods be used to provide reliable arm's length transfer pricing solutions for fragmented functions? If so how? Can other methods address the issue of fragmentation, and, if so, how?*
3. *What aspects of fragmentation need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?*

Lack of Comparables

The Draft points out that one-sided methods can be reliable even when there is a lack of comparables, by broadening the scope of the search to other jurisdictions with similar economic conditions and by making accurate comparability adjustments. However, when limitations to the accuracy of a one-sided method exist, the Draft considers using the transactional profit split method.

Scenario 5:

An M.N.E. group operates as a supplier of office stationery in a region. The group has operations in several countries, and each operating company supplies stationery products to its local customers. Some larger customers also operate across the region and primarily want to deal with suppliers who can operate regionally. As a result, the activities of each operating company of the M.N.E. involve:

- Selling to local customers,
- Agreeing to terms and taking orders from local customers buying on behalf of their regional organizations, and
- Fulfilling orders placed with other group companies.

All orders are invoiced and fulfilled locally in accordance with the terms agreed. The mix of local and regional business varies from year to year and from operating company to operating company.

“In cases where available comparables for the application of a one-sided method may not be reliable, a transactional profit split approach may offer a better means to measure results.”

Questions:

1. *How can comparables be found and applied in Scenario 5? What method is likely to be appropriate for determining an arm’s length remuneration for the activities of the group companies?*
2. *How can comparables be found and applied in Scenario 3 (or to any other relevant Scenario in this discussion Draft)?*
3. *What aspects of Scenario 5 need to be further elaborated in order to determine whether a transactional profit split or another method might be more appropriate?*

In cases where available comparables for the application of a one-sided method may not be reliable, a transactional profit split approach may offer a better means to measure results. For example, application of a one-sided method may result in establishing a range of operating margins of 4-10% for one of the parties to the transaction: a baseline return of 7% is adopted which would vary in accordance with a predetermined computation upwards to 10% and downwards to 4% depending on the levels of consolidated profits or sales achieved by the parties to the transaction.

Questions:

1. *In what circumstances, if any, might an approach described in the last sentence above be appropriate?*
2. *More generally, in what circumstances would a transactional profit split approach be useful in supporting the application of other transfer pricing methods, and what guidance would be useful to develop for the supporting use of such approaches?*

Aligning Taxation with Value Creation

The Draft views the profit split method as a means of achieving an alignment between profits and value creation. But at the same time, the Draft identifies the weakness of the transactional profit split method: because it is subjective, allocation keys can be difficult to verify from objective evidence.

In Scenario 8, the Draft focuses on ways to develop objective profit split factors and asks if there are other factors that are likely to reflect value creation in particular industry sectors. Scenario 1, discussed above, involves a set of integrated activities of three manufacturing O.E.M.'s. In Scenario 8, the Draft looks at the same fact pattern adjusted to account for post-royalty residual profits or losses. These items are split between the O.E.M.'s on the basis of three factors:

- Production capacity – This recognizes capital investment;
- Headcount – This recognizes the key input of labor; and
- Value of production – This recognizes the contribution to actual output.

Each factor is intended to reflect key value drivers in the business, as identified from a detailed functional analysis. These factors may require adjustments to take into account special circumstances.

Questions:

1. *In what ways should the guidance be modified to help identify factors which reflect value creation in the context of a particular transaction? Are there particular factors which are likely to reflect value creation in the context of a particular industry or sector?*

2. *What guidance is needed on weighting of factors?*

In addition, Scenario 6 considers using a matrix that evaluates the relative importance of the parties' various contributions to value creation.

> **Scenario 6:**
>
> Company A, located in country A, purchases technological goods from its associated manufacturer (Company B) located in country B. Company A determines and controls the business development strategy of the group. It decides the markets in which the group will operate and the product range and pricing within each market. Company B obtains the use of relevant I.P. under a license from another group entity (Company C) which developed the I.P. The license fee payable to Company C is subject to a separate transfer pricing analysis based on comparable, independent transactions. Company A sells the products to local distribution entities.
>
> Company B determines and controls the global group manufacturing strategy including the procurement process and the structure of the supply chain. It develops and owns I.P. related to the manufacturing processes for the group's products. The actual manufacturing is carried out on a contract basis by another group entity (Company D) also located in country B.
>
> After undertaking a detailed analysis of the commercial and financial relations between the enterprises in the group, including the functions, assets, and risks of the parties, and considering the availability of potential comparables, the M.N.E. group adopts a transfer pricing methodology based on a split of the total system profit from transactions between Company A and Company B. From their profit shares,

Company A and Company B provide arm's length remuneration to Company C, the local distributors, and the manufacturing entity in country B using one-sided methods.

The allocation of the system profit between Company A and Company B was determined by an analysis of their respective contributions to each of the group's key value drivers. Each of the personnel (i) responsible for, or (ii) accountable for, or (iii) consulted in making, or (iv) merely informed of relevant decisions was taken into account for each process contributing to a particular value driver. The analysis was reviewed and updated annually. Risks and assets were not considered separately as they were considered by the M.N.E. group to be embedded in the processes that managed them.

Questions:

1. *How can other approaches be used to supplement or refine the results of a detailed functional analysis in order to improve the reliability of profit splitting factors (e.g., approaches based on concepts of bargaining power, options realistically available, or a R.A.C.I.-type analysis of responsibilities and decision making)?*

2. *Given the heterogeneous nature of global value chains, is it possible to develop a framework for reliably conducting a multifactor profit split analysis applicable to situations where an M.N.E. operates an integrated global value chain? What are the factors that might be considered, how should they be weighted, and when might such an analysis be appropriate?*

"There are some weaknesses in the methodology when the cost of the contribution made by the parties may be unreliable."

There are some weaknesses in the methodology when the cost of the contribution made by the parties may be unreliable. The cost contribution may not reflect correct value of the contribution.

Question:

1. *What specific aspects of transactional profit split approaches may be particularly relevant in determining arm's length outcomes for transactions involving hard-to-value intangibles?*

Dealing with *Ex Ante/Ex Post* Results

The Draft suggests that the appropriate approach may be to use a transactional profit split method when dealing with unanticipated events. Scenario 7 shows how a transactional profit split method can be used to determine from the beginning how to share profits when the outcome is uncertain.

Scenario 7:

Two associated enterprises jointly agree to share the development of a new product, and each associated enterprise will be responsible for developing and manufacturing one of the two key components. At the outset it is estimated by the enterprises that the development costs will be 100 in total, with 30 estimated to be incurred by one of the parties and 70 estimated to be incurred by the other. Several risks exist. First, there is risk that the project will not produce the

"In Scenario 9, the Draft questions whether losses should be split differently from profits."

> expected returns. Second, there is a significant risk of cost overruns. Each party manages its own cost overrun risk. The parties agree that expected profits from the sale of the new product will first be allocated to provide each party with a routine return on its manufacturing functions; with the residual profit and loss split 30/70 notwithstanding that the actual development costs may vary from what was projected.

Question:

1. *How can transactional profit split methods be applied to deal with unanticipated results? What further guidance is advisable?*

In Scenario 8, we see how transactional profit split methods do not always results in spilt of actual profits, *e.g.*, conversion of the profit split into a fixed royalty.

> **Scenario 8:**
>
> Parent Company P licenses patent rights relating to a potential pharmaceutical product to subsidiary Company S. Company S is responsible for marketing the product. P performs all of the basic research and most of the development functions, with S contributing to late stage development and marketing. For the purposes of this scenario, both companies are understood to contribute to the development of the intangible. It is possible to weigh the risk of the expenditure based on reported industry data about success rates at each development stage for products in the same therapeutic category. The current and anticipated costs, determined on a net value basis, are contributed by P and S in the ratio 80:20. At the time of the license, projections are prepared on a net present value basis of the expected sales, production and sales costs (including a benchmarked return on those costs), and resulting profits. The respective contributions to product development are then used to split the anticipated profits in the ratio 80:20. At this point, however, P's expected profit from the expected sales is converted to a royalty rate on those sales. In this Scenario, the transactional profit split method is used to calculate a royalty.

Question:

1. *Is the application of a transactional profit split method to calculate the royalty in Scenario 8, or in other circumstances to set a price, helpful? What are the advantages and disadvantages?*

Dealing with Losses

The Draft points out that under the O.E.C.D. Guidelines (paragraph 1.108), the profits and losses are split in the same manner. In Scenario 9, the Draft questions whether losses should be split differently from profits.

Scenario 9:

Three companies in a banking group carry on trading in a type of structured financial product through an integrated model. Each operates in one of the main time zones. Profits from this business are allocated between the three companies using a multi-factor profit split methodology that gives different weight to each factor. The greatest weighting is given to the factor based on remuneration paid to the traders in each location, including bonuses based on performance.

However, significant losses may be generated in this line of business and the correlation between bonus compensation and such losses will not be the same as that between bonuses and profits. To ensure the allocation of losses would be in line with what would have been made up-front by independent enterprises, the methodology incorporates principles for the adjustment of the remuneration-based factor where losses are incurred. This is based on an analysis of the group's compensation policy in such circumstances as well as a careful consideration of the types of circumstance in which losses may be incurred in the particular business.

Questions:

1. *In what circumstances might it be appropriate under the arm's length principle to vary the application of splitting factors depending on whether there is a combined profit or a combined loss?*

2. *Are there circumstances under the arm's length principle where parties which would share combined profits, would not be expected to take any share of combined losses?*

The Draft poses additional questions which illustrates the difficulty of the issue:

1. *Paragraph 2.114 of the Guidelines points to some practical difficulties in applying the transactional profit split method. Do those pointers remain relevant, and what other practical difficulties are encountered? How are such difficulties managed?*

2. *Finally, what further points would respondents wish to make about the application of transactional profit split methods not covered by previous questions?*

These questions and factual scenarios illustrate the hard work ahead in finalizing the Chapter II of the O.E.C.D.'s Transfer Pricing Guidelines. All comments received in response to the questions provided in the Draft will be made public.

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B.E.P.S. ACTION 10 – PART II: THE TRANSFER PRICING ASPECTS OF CROSS-BORDER COMMODITY TRANSACTIONS

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Tags
Action 10
B.E.P.S.
Commodity Transactions
C.U.P. Method
Deemed Pricing Date
Transfer Pricing
Global Value Chains

The discussion draft on Action 10 (the "Discussion Draft")[1] deals with transfer pricing issues in relation to commodities transactions and the potential for Base Erosion and Profit Shifting ("B.E.P.S."). The commodity sector constitutes major economic activity for developing countries and provides both employment and government revenue.

In seeking to create clear guidance on the application of transfer pricing rules to commodity transactions, the Discussion Draft identifies several problems and policy challenges and seeks to establish a transfer pricing outcome that is in line with value creation.

PROPOSALS TO CHAPTER II OF THE TRANSFER PRICING GUIDELINES

The Discussion Draft identifies issues and invites commentary on the *O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "Transfer Pricing Guidelines")[2] as follows:

- *Use of the C.U.P. Method* – the Discussion Draft identifies the Comparable Uncontrolled Price ("C.U.P.") method as the appropriate transfer pricing method for establishing an arm's length price. Some adjustments will be required when the "quoted price" relates to a commodity that is not similar in terms of physical features and quality. The application of the C.U.P. method should be documented in writing to assist tax authorities in carrying out an informed examination. The documentation should provide the price-setting policy and other relevant information related to the pricing of the commodity.
- *Deemed Pricing Date for Commodity Transactions* – Sometimes there is a significant delay between the date of entering into a contract and the date of delivery. During this time, the price of the commodity fluctuates, and it is often difficult for the tax administration to verify the pricing date. The Discussion Draft proposes the use of a "Deemed Pricing Date" for commodity transactions. The related parties may select the Deemed Pricing Date for the commodity, but if the evidence pertaining to this date contradicts the facts of the case, the tax authorities may impute the price date based on the evidence provided by the related parties. If reliable evidence does not exist, the date of

1. O.E.C.D. (2014), "BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions."
2. O.E.C.D. (2010), "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations."

shipment will be treated as the pricing date. This provision has the potential to wreak havoc on a business model that uses a forward price on an earlier date when parties enter into a commodity transaction.

- *Potential Additional Guidance* – When dealing with the transfer pricing of commodities among related parties, adjustments should be made based on physical deferences, processing costs, and other features of the transaction. The Discussion Draft invites responses to clarify the common adjustments or differentials on the quoted price and the sources of information used to conduct these adjustments or differentials. In addition, it specifies that the commodity transactions should be read with B.E.P.S. Actions 9, 10, and 13 to ensure that transfer pricing outcomes in commodity transactions are in line with value creation.

The complexity of commodity pricing has created the need for consistency within and outside the O.E.C.D. member countries. In particular, countries in the Latin American region have developed methods that create inconsistency. The potential for B.E.P.S. stemming from this inconsistency explains the O.E.C.D.'s motivation for proposing clear guidance on the application of transfer pricing rules to commodity transactions.

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B.E.P.S. ACTION 13: GUIDANCE ON TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING

Authors
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Tags
B.E.P.S. Documentation
CbC Reporting
Transfer Pricing

INTRODUCTION

On July 19, 2013, the Organization for Economic Cooperation and Development ("O.E.C.D.") released its full *Action Plan on Base Erosion and Profit Shifting* (the "B.E.P.S. Action Plan"), with expectations to roll out specific items over the subsequent two years. According to the O.E.C.D., the B.E.P.S. Action Plan will allow countries to draft coordinated, comprehensive, and transparent standards that governments need to prevent B.E.P.S., while at the same time updating the current rules to reflect modern business practices. Of the 15 action items listed in the B.E.P.S. Action Plan, four relate specifically to transfer pricing and several others indirectly address this area, as well. The four with direct impact on transfer pricing are Action Items 8, 9, 10, and 13:

- **Action Items 8, 9, and 10 (Assure that Transfer Pricing Outcomes are in Line with Value Creation)** develop rules to prevent B.E.P.S. by (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles, capital, or other high-risk transactions are appropriately allocated in accordance with value creation; (iii) developing transfer pricing rules for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.
- **Action Item 13 (Re-examine Transfer Pricing Documentation)** develops rules regarding transfer pricing documentation to enhance transparency for tax administrations, taking into consideration the compliance costs for multinationals.

With these and the 11 other Action Items, the O.E.C.D. aims to foster (i) coherence of corporate income taxation at the national level; (ii) enhanced substance, through bilateral tax treaties an in transfer pricing; and (iii) transparency and consistency of requirements.

Further guidance on the transfer pricing Action Items 8-10 is not expected until September of 2015. On September 16, 2014, however, the Centre for Tax Policy and Administration, part of the O.E.C.D., released its first round of recommendations under the B.E.P.S. project (the "B.E.P.S. recommendations"), including for Action Item 13 (as well as 6 other Action Items discussed in this issue). Though these deliverables are not finalized, the recommendations are perceived to represent the consensus of 44 countries (O.E.C.D., G20, plus Columbia and Latvia).[1]

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[1] There is overlap between O.E.C.D. and G20 member countries.

TRANSFER PRICING DOCUMENTATION & COUNTRY-BY-COUNTRY REPORTING

In keeping with the third pillar of the B.E.P.S. initiative listed above – transparency and consistency – Action Item 13 calls for a revamp of transfer pricing documentation. The new guidance calls for a three-tiered approach to global transfer pricing documentation, including:

1. A Master File – a high-level overview of the multinational group business;
2. A Local File – detailed information on specific group transactions for a given country; and
3. A Country-by-Country ("CbC") report – a matrix of specific data for each jurisdiction, ostensibly to be used as a risk assessment tool by tax authorities (as well as, potentially, taxpayers).

Each of these proposed documentation elements is described below.

Master File

The Master File is meant to provide tax authorities with high-level information about a multinational's global business and transfer pricing policies. The latter can include entity characterizations (*e.g.*, distributors, manufacturers, service companies), nature of intercompany transactions, and data used to benchmark remuneration.

This recommendation endorses a practice already being followed by many multinationals concerned with efficiently presenting a consistent "story" to any tax authority that may institute a tax audit or otherwise challenge transfer pricing arrangements.

- In general, the Master File should include:
- An organization chart;
- A description of the multinational's business operations;
- A description of primary intangible assets;
- A description of intercompany financial activities (*e.g.*, loans, guarantees, cash pools); and
- Relevant financial and tax information.

The B.E.P.S. recommendation includes specific requirements for each of these items.

Local File

In addition to the Master File, multinationals would be required to prepare local-country transfer pricing reports that would describe business operations and intercompany transactions relevant to entities operating in that country. These reports would describe the transfer pricing method(s) applied to evaluate each transaction, the benchmarks used (comparable companies or transactions), and the conclusions reached as to the arm's length nature of the related-party dealings. (Depending on the country, the Local File may need to be prepared in the local language.)

The Local File should include:

An organization chart for the local entity(ies), along with a description of the management structure;

- A description of the local business(es) and key competitors;
- A description of material intercompany transactions, including corresponding intra-group payments;
- Identification of affiliates involved;
- Copies of all relevant intercompany agreements;
- Detailed functional analysis of the local multinational(s) and relevant affiliates;
- A description of the transfer pricing methods applied for each transaction and the financial information utilized;
- A description of the economic/benchmarking analysis, including key assumptions and adjustments made to market benchmarks;
- Conclusions as to the arm's length nature of the intercompany transactions;
- Local entity audited or unaudited financial accounts and their links to the financial information used in the transfer pricing analysis; and
- Information on any existing Advance Pricing Agreements or other tax rulings not involving the local entities that may impact the pricing of the controlled transactions under review.

In practice, the detailed information provided in the Local Files should be entirely consistent with the more general information provided in the Master File.

CbC Report

Among the three recommended documentation elements, the CbC report has garnered the most attention. It would include the following items to be listed by jurisdiction:

- Revenues;
- Profit/loss before tax;
- Income tax (paid & accrued);
- Capital and accumulated earnings;
- Number of employees;
- Tangible assets;
- Main business by activity; and
- Country of organization/incorporation.

The information can come from any source (statutory accounts not a priority), as long as it is consistent across the relevant jurisdictions.

CHALLENGES & STRATEGIES

Master & Local Files

The Master File and Local File concepts are familiar to many multinationals that have been following a similar strategy. In many cases, a Master File is prepared at the end of a transfer pricing planning analysis[2] to memorialize the relevant business information and the corresponding transfer pricing policies being implemented. That planning report can then be updated on an annual basis (reflecting any changes in business operations and incorporating new financial information) and serve as the basis for any Local Files needed. This "wheel and spokes" approach ensures consistency and maximizes efficiency in the preparation of needed documentation.

"Filling out the template now, at least for major jurisdictions in which a multinational does business, will help ascertain the ease with which the needed data can be collected. It also can be used to expose potential audit risks."

As a practical matter, a multinational will not prepare a Local File annually for each country in which it operates. Rather, potential exposure (based on audit risk, volume of intercompany flows, complexity of transactions, types of transactions) should be evaluated on a regular basis in order to decide how resources should be deployed in preparing local documentation, especially for companies that do not have relatively large tax departments containing tax lawyers, accountants, and economists. Consideration should also be given to specific country practices regarding time limits imposed by the tax authority once documentation is requested and possible requirements to translate documentation into the local language.

CbC Reporting

The new documentation standards, particularly the CbC reporting template, have the stated purpose of providing enough information for tax authorities to determine "whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments."[3] As such, it is intended to be used as a "risk assessment" tool by tax administrations, perhaps helping to focus attention and resources on particular transactions and jurisdictions.

Given that CbC reporting standards have not been finalized or formally adopted by individual countries, it may be prudent for multinationals to adopt a wait-and-see approach before adjusting transfer pricing documentation strategies. On the other hand, since it is likely that something comparable to the proposed template will be put into use in a significant number of jurisdictions, internal CbC reporting may be a viable part of the risk assessment process for multinational tax departments wishing to plan ahead. Filling out the template now, at least for major jurisdictions in which a multinational does business, will help ascertain the ease with which the needed data can be collected. It also can be used to expose potential audit risks or, at a minimum, the business and geographic areas that are likely to invite detailed inquiries from tax authorities. Further, since broad measures in the CbC reporting template

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2 That is, an exercise aimed at determining the proper transfer pricing structure, as opposed to justifying one already in place.

3 OECD/G20 Base Erosion and Profit Shifting Project, Guidance on Transfer Pricing Documentation and Country-by-Country Reporting, Action Item 13: 2014 Deliverable, pages 9-10.

– such as total number of employees and profits broken down on a country-by-country or entity-by-entity basis – do not shed light on whether transfer pricing policies are supportable, a global group might consider augmenting the CbC template with additional information that clarifies and is consistent with its transfer pricing. Any such additional information, as with the basic CbC data provided, should be fully consistent with contents of the Master File and Local Files.

The B.E.P.S. recommendations expressly discourage tax administrations from using the CbC information "to propose transfer pricing adjustments based on a global formulary apportionment of income."[4] However, there is considerable, and perhaps reasonable, trepidation among the multinational community that use of the CbC template will move past general assessment into some sort of apportionment argument, at least in some jurisdictions. For example, some less developed countries might take the position that local taxable income should be in direct proportion to the total share of employees.[5] This or a similar approach would bypass any insights gained through a comprehensive functional analysis of the multinational enterprise, which would go beyond superficial numbers to identify the true profit-generating activities and assets of the global business.[6] Global groups will likely benefit by proactively conducting an adjusted analysis that identifies value drivers and meticulously documenting the facts and resulting transfer pricing policies under the three-tiered structure described in the B.E.P.S. recommendations.

NEXT STEP – IMPLEMENTATION

Though there is consensus on the content, there remains substantial uncertainty as to how the B.E.P.S. recommendations on Action Item 13, particularly CbC reporting, will be implemented by individual countries. For example, let us take a selective survey as follows:

- United States officials, while stepping up transfer pricing enforcement efforts in recent years (particularly with respect to intangibles and services), have adopted a wait-and-see attitude regarding the Action Item 13 proposed documentation standards.[7]
- France has been requesting consolidated accounts and management reports during audits and is widely expected to introduce CbC reporting in some form.
- Germany has already implemented some B.E.P.S. measures and is in favor of consistent adoption by all countries.
- The United Kingdom views its current transfer pricing audit practices as consistent with the B.E.P.S. initiative and is likely to adopt the Action Item 13 recommendations as part of a coordinated international effort.

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4 *Ibid.*, page 20.

5 This could be an indirect way for countries where routine functions are centralized, such as India or China, to capture a share of the "location savings."

6 Multinationals that have centralized ownership of valuable intellectual property might be particularly vulnerable to a simplified apportionment argument.

7 Many U.S. multinationals and transfer pricing practitioners have voiced reservations.

- The “B.R.I.C.” countries (Brazil, Russia, India, China) have identified incomplete information disclosure as a primary reason for tax-base erosion and are, therefore, proponents of the CbC report.

“Adoption of the Action Item 13 recommendations will require consideration of such issues as confidentiality, timeliness, and usefulness of the information collected.”

In each country, adoption of the Action Item 13 recommendations will require consideration of such issues as confidentiality, timeliness, and usefulness of the information collected (particularly through the CbC template). Taxpayers also have concerns with respect to how the information would be disseminated. At this point, it is unclear whether there will be any thresholds (size/type) with respect to affiliates and countries that should be covered in the Master File, Local File, or CbC documentation.

Finalization of all B.E.P.S. Action Plans will focus on these implementation and coordination challenges; unilateral action by countries would be counterproductive. The O.E.C.D. has made it clear that the recently-released B.E.P.S. recommendations, including those on Action Item 13, may be impacted by decisions made with regard to the remaining eight elements of the B.E.P.S. Action Plan, which are scheduled to be presented to the G20 for final approval in 2015.

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B.E.P.S. ACTION 14: MAKE DISPUTE RESOLUTION MECHANISMS MORE EFFECTIVE

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Tags
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M.A.P.
Mutual Agreement Procedures
O.E.C.D.
Transparency

INTRODUCTION

The O.E.C.D. has continued to publish discussion drafts under its 15-part action plan (the "B.E.P.S. Action Plan") for combatting base erosion and profit shifting ("B.E.P.S."), with Action 14 being the most unique.

Action 14, entitled "*Make Dispute Resolution Mechanisms More Effective,*" provides as follows:

> 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.

While most components of the B.E.P.S. Action Plan address the problems caused by base erosion and profit shifting, the recently proposed discussion draft for Action 14 ("Discussion Draft" or "Draft")[1] addresses the mutual agreement procedures ("M.A.P.") used to resolve treaty-related disputes. Action 14 addresses the current obstacles faced by taxpayers seeking M.A.P. relief to avoid economic double taxation and provides suggestions as to how to revise provisions in order to improve the integration of M.A.P. dispute resolution mechanisms. The O.E.C.D. describes it as a unique opportunity to overcome traditional obstacles and to provide effective relief through M.A.P. The Discussion Draft proposes complementary solutions that are intended to have a practical and measurable impact, rather than merely providing additional guidance which may not be followed.

The Discussion Draft introduces a three-pronged approach to enhance the M.A.P. program as a means of resolving disputes. The three-pronged approach consists of (i) political commitments to effectively eliminate taxation not in accordance with the Convention, (ii) new measures to improve access to the M.A.P. and procedures for conducting a M.A.P. resolution, and (iii) a monitoring mechanism to check the proper implementation of the political commitment.

This article will look at the obstacles and options suggested to improve implementation of the M.A.P. In particular, it will discuss mandatory binding M.A.P. arbitration as a means of dispute resolution.

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1 O.E.C.D. (2014) "BEPS Action 14: Make Dispute Resolution Mechanisms More Effective."

BACKGROUND

Any plan to counter B.E.P.S. must be complemented with actions that ensure certainty and predictability for business. The interpretation and application of novel rules resulting from the B.E.P.S. Action Plans could introduce elements of uncertainty which should be minimized as much as possible. As a result, efforts to improve the effectiveness of the M.A.P. are an important complement to the work on B.E.P.S. Specific measures that will result from the work on Action 14 will constitute a minimum standard to which participating countries will commit. Notwithstanding this minimum standard, it is expected that the final results of the work on Action 14 will also include additional measures (such as, for example, M.A.P. arbitration) that some countries may also wish to commit to adopt in order to address obstacles to an effective M.A.P. in a more comprehensive way.

"Without assured good faith, member states will become wary and profit shifting will continue in some form or the other."

APPLICABLE PRINCIPLES

The Discussion Draft is guided by four main principles that together ensure the success of the M.A.P.

- Ensuring that treaty obligations related to the M.A.P. are fully implemented in good faith,
- Ensuring that administrative processes promote the prevention and resolution of treaty-related disputes,
- Ensuring that taxpayers can access the M.A.P. when eligible, and
- Ensuring that cases are resolved once they are within the M.A.P.

With these principles stated, the discussion draft identifies obstacles and suggests solutions. Most importantly, it seeks input from the private sector regarding specific solutions.

OBSTACLES TO M.A.P.

Good-Faith Commitment to M.A.P.

Mutual commitment is a cornerstone of a successful M.A.P. process and good faith is key to making sure that the M.A.P. is fully implemented by all member states. Without assured good faith, member states will become wary and profit shifting will continue in some form or the other. Only through good faith implementation can the M.A.P. truly prove to be effective.

Most countries consider economic double taxation resulting from the inclusion of profits of associated enterprises under paragraph 1 of Article 9 of the O.E.C.D. O.E.C.D. Model Tax Convention on Income and Capital (the "Model Treaty") is not in accordance with the object and purpose of an income tax treaty. However, there are some countries that take the position that they are not obliged to make offsetting adjustments or to grant access to the M.A.P. in the absence of a specific obligation in the relevant treaty. This position frustrates a primary objective of tax treaties – the elimination of double taxation – and prevents bilateral consultation to determine appropriate transfer pricing adjustments.

Adoption of Effective Administrative Processes

Appropriate tax administration practices are important to ensure an environment in which competent authorities are able to fully and effectively carry out their mandate (*i.e.*, to take an objective view of the provisions of the applicable treaty and apply it to the facts of the taxpayer's case for the purpose of eliminating taxation not in accordance with the terms of the treaty). The effectiveness of the M.A.P. may be undermined where a competent authority is not sufficiently independent, where a competent authority is not provided with adequate resources, or where the competent authority function is evaluated based on inappropriate performance indicators.

Objectivity may be compromised where the competent authority function is not sufficiently independent from a tax administration's audit or examination function. Similarly, issues may arise where the competent authority performs a policy-making function (*e.g.*, tax treaty negotiation) and does not adequately distinguish between the role of administering treaties that have entered into force and that of negotiating changes to these treaties. Challenges to the objective application of existing treaty provisions may also be presented where a competent authority's approach to a M.A.P. case is influenced by the changes it seeks to make regarding its country's treaties.

Problems will likely arise as a result of a lack of sufficient resources (personnel, funding, training, etc.) allocated to a competent authority. Lack of adequate resources is likely to result in an increase in the inventory of M.A.P. cases and increased delays in processing cases.

"Objectivity may be compromised where the competent authority function is not sufficiently independent from a tax administration's audit or examination function."

Administrative processes that promote the prevention of treaty-related disputes and the resolution of disputes that arise are also being examined in work of the Forum on Tax Administration's M.A.P. Forum (the "F.T.A. M.A.P. Forum"). The F.T.A. M.A.P. Forum has recognized that audit programs that are not aligned with international norms significantly hinder the functioning of the M.A.P. process. The evaluation of the competent authority function based on criteria such as sustained audit adjustments or the generation of tax revenue may be expected to create disincentives to the competent authority's objective consideration of M.A.P. cases and to present obstacles to good faith bilateral M.A.P. negotiations.

Effective Access to M.A.P.

On occasion, field auditors in some countries may seek to encourage taxpayers not to utilize their right to initiate a M.A.P. in relation to audit adjustments that result in taxation not in accordance with an applicable tax treaty. Taxpayers may feel pressured into giving up access to the M.A.P. process if they are given the choice between a high assessment with access to M.A.P. but no suspension of collection, or a relatively moderate assessment without access to M.A.P. Alternately, taxpayers may accept such settlements based on broader concerns for their future relationship with the tax administration involved. Such audit settlements may be a significant obstacle to the proper application of the tax treaty as well as to the functioning of the M.A.P. They lead to situations in which taxation not in accordance with the Convention remains in one country while the tax administration in the treaty partner country is not aware of the situation and may be vulnerable to self-help measures taken by the taxpayer.

Advance pricing agreements ("A.P.A.'s") concluded bilaterally between treaty partner competent authorities provide an increased level of tax certainty in both jurisdictions, lessen the likelihood of double taxation and may proactively prevent transfer pricing disputes. However, not all countries have implemented bilateral pricing agreement programs, allow a rollback of the agreement to all open years, or have administrative processes in place to allow the programs. Even where A.P.A.'s are reached by a particular country, issues resolved through an advance pricing arrangement may be relevant to earlier years, but those years are not included within the scope of the A.P.A. In a similar vein, decisions reached in a M.A.P. process may affect subsequent years where facts do not change.

In certain countries, the procedures to access the M.A.P. process are not transparent or are unduly complex. This discourages taxpayers from seeking relief under the M.A.P. process, and these taxpayers face double taxation without the opportunity for relief.

"In certain countries, the procedures to access the M.A.P. process are not transparent or are unduly complex."

Questions exist regarding the ability of a taxpayer to access the M.A.P. where the tax issue results exclusively from domestic law in one country or general anti-avoidance rules ("G.A.A.R.") in that country. Under Action 6 of the B.E.P.S. Action Plan, the benefits of a tax treaty will not be available where one of the principal purposes of a transaction is to secure a benefit under a tax treaty and obtaining the benefit would be contrary to the object and purpose of the relevant provisions of the tax treaty. Action 14 states that the interpretation or application of that rule clearly falls within the scope of the M.A.P. process.

To be admissible, a case must be presented to the competent authority of the taxpayer's country of residence within three years following the first notification of an action giving rise to taxation not in accordance with the Model Treaty. A competent authority should consider whether the case is eligible for the M.A.P. This involves a determination of whether the taxpayer's objection appears to be justified and, if it is, whether the matter can be handled unilaterally. The matter moves to the bilateral stage where unilateral relief is not appropriate.

In some cases, the competent authority in one country may find that the objection presented by the taxpayer is not justified, while the competent authority in the other jurisdiction reaches the opposite conclusion. To illustrate, competent authorities may be hesitant to overturn assessments made by their own tax administrations and, for that reason, may unilaterally determine that the taxpayer's objection is not justified. This determination may result in a refusal to discuss the case with the competent authority of the other country, even where that other competent authority considers the objection to be justified. The Discussion Draft states that such results raise legitimate concerns as to the bilateral nature of treaty application and implementation.

M.A.P. relief is available irrespective of the judicial and administrative remedies provided by the domestic law of the two states that are parties to the treaty ("the Contracting States"). Generally, a taxpayer's choice of recourse is only constrained by the condition that most tax administrations will not deal with a taxpayer's case through M.A.P. while it undergoes domestic court or administrative proceedings. This suggests that it is preferable to pursue the M.A.P. process first and to suspend domestic law procedure because an agreement reached through M.A.P. will typically provide a comprehensive, bilateral resolution of the case. A domestic law recourse procedure, in contrast, will only settle the issues in one State and may consequently fail to relieve the international issue of double taxation. Of course, the competent authority may only agree to consider a case on the condition that the taxpayer will forego any subsequent appeal in domestic courts.

Where the payment of tax is a requirement to access M.A.P., the taxpayer may face significant financial difficulties: If both Contracting States collect the disputed taxes, double taxation will in fact occur, and resulting cash flow issues may have a substantial impact on a taxpayer's business, at least for the duration of the M.A.P. process. A competent authority may also find it more difficult to enter into good-faith M.A.P. discussions when it considers that it will likely have to refund taxes already collected.

"A competent authority should engage in discussions with other competent authorities in a fair and principled manner."

Time limits connected with the M.A.P. present particular obstacles to an effective M.A.P. resolution. In some cases, uncertainty regarding the "first notification of the action resulting in taxation not in accordance with the provisions of the Convention" may present interpretive difficulties. More importantly, some countries may be reluctant to accept "late" cases – *i.e.*, cases initiated by a taxpayer within the deadline but long after the taxable year at issue. Countries have adopted various mechanisms to protect their competent authorities against late objections. These include requirements to present a M.A.P. case to the other competent authority within an agreed-upon period in order for M.A.P. relief to be implemented and treaty provisions limiting the period during which transfer pricing adjustments may be made.

Under the laws of certain countries, a taxpayer may be permitted to amend a previously filed tax return to adjust the price for a controlled transaction between associated enterprises or profits attributable to a permanent establishment ("P.E.") in order to reflect a result that is in accordance with the arm's length principle, at least in the taxpayer's opinion. Any action undertaken at the initiative of the taxpayer to adjust the previously-reported results of controlled transactions in order to reflect an arm's length result is considered a "Self-Initiated Adjustment." Uncertainty exists with respect to the obligation to make a corresponding adjustment in the case of a Self-Initiated Adjustment in a foreign jurisdiction. It is by no means clear that a foreign Self-Initiated Adjustment is considered to be an action by a Contracting State that triggers taxpayer entitlement to request M.A.P. consideration. These issues have become significant as a consequence of increased pressure on transfer pricing outcomes and P.E. issues resulting from the work to combat B.E.P.S.

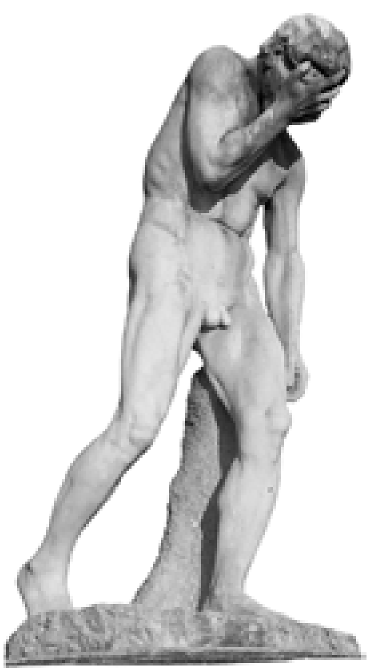
Case Resolution

As previously stated, in M.A.P. cases, the competent authority is expected to take an objective view of the provisions of the applicable treaty and apply it in good faith with a view to eliminating taxation not in accordance with the treaty. Where one or both competent authorities do not follow that approach, the resolution of M.A.P. cases becomes difficult and risks of inappropriate results exist. To avoid these problems, a competent authority should engage in discussions with other competent authorities in a fair and principled manner. As part of a principled approach, each M.A.P. case should be approached on its own merits and not by reference to any balance of results in other cases. A principled approach also requires that competent authorities take a consistent approach to the same or similar issues and not change positions from case to case based on considerations that are irrelevant to the legal or factual issues, such as the amount of the tax revenue that may be lost and a view that both Contracting States should win and lose the same percentage of cases.

A lack of cooperation, transparency or of a good working relationship between competent authorities also creates difficulties for the resolution of M.A.P. cases. A good competent authority working relationship is a fundamental part of an effective mutual agreement procedure.

Mandatory binding M.A.P. arbitration has been included in a number of bilateral treaties following its introduction in the Model Treaty in 2008. Nonetheless, the adoption of M.A.P. arbitration has not been as broad as expected and acknowledges that the absence of arbitration provisions in most treaties and the fact that access to arbitration may be denied in certain cases are obstacles that prevent countries from resolving disputes through the M.A.P.

One of the main policy concerns with mandatory binding M.A.P. arbitration relates to national sovereignty. In some States, national law, policy, or administrative considerations are considered obstacles to the adoption of mandatory binding M.A.P. arbitration. This is particularly the case where competent authorities are concerned about the risk of conflict between the decision of a court and the decision of an arbitration penalty. Some countries may restrict access to arbitration to a specific range of issues such as residence, P.E. status, business profits, arm's length transfer pricing, and royalties.



There are two principal approaches to decision-making in the arbitration process. The format most commonly used in commercial matters is the "conventional" or "independent opinion" approach, in which the arbitrators are presented with a *de novo* presentation of the facts and arguments of the parties based on applicable law and then reach an independent decision, typically in the form of a written, reasoned analysis. This approach strongly resembles a judicial proceeding and is the model for the E.U. Arbitration Convention as well as the default approach reflected in the Model Treaty. The other main format is the "last best offer" approach, often referred to as "baseball arbitration" because in a salary dispute between baseball players in the U.S. and their ball clubs, arbitration is allowed and the arbitrator must approve the position of the player or the club and cannot choose a result in between the two. This approach is reflected in a number of bilateral tax treaties signed by O.E.C.D. member countries. Under this approach, the competent authorities submit to the arbitration panel a proposed resolution together with a position paper in support of that position. The arbitration panel is required to adopt one of the proposed resolutions submitted by the competent authorities. The determination by the arbitration panel does not state a rationale and has no precedential value.

The evidence considered by the arbitration panel may largely be determined by the form of the decision-making process. The independent opinion approach ordinarily envisions a formal evidentiary process involving testimony, the *de novo* presentation of evidence to the arbitration panel and possibly taxpayer presentations. The Final Offer approach, on the other hand, generally contemplates that the arbitration panel will make a decision based on the facts and arguments as presented in the competent authorities' submissions to the arbitration panel. The most important principle relating to evidence is that there be no opportunity or incentive for the taxpayer to undermine the M.A.P. negotiation process by seeking to have the arbitration panel consider information which was previously withheld or otherwise not provided to the competent authorities. Consistent with the nature of the mutual agreement procedure as a government-to-government activity in which taxpayers play no direct role, M.A.P. arbitration processes do not require direct taxpayer input to, or appearance before, the arbitration panel, although such taxpayer participation is not precluded. While the arbitration panel might benefit from direct interaction with taxpayers, there is a concern that taxpayer involvement in the M.A.P. arbitration procedure could result in a lengthier, more expensive and more complicated process, and thus undermine the effectiveness of M.A.P. arbitration.

In light of the significant resource constraints experienced by many countries in recent years, concerns about the potential costs of M.A.P. arbitration are an important consideration in designing the format of the arbitration process. The costs associated with arbitration fall into three categories:

- Costs related to engaging the arbitration panel, consisting principally of the fees paid to the arbitrators;
- Costs related to each competent authority's participation in the arbitration procedure, which include, for example, costs related to the preparation and presentation of proposed resolutions and position papers; and
- Administrative costs, such as telecommunications and secretarial expenses, miscellaneous expenses (*e.g.*, translation or interpretation) and, possibly, travel costs (airfare, lodging, etc.).

"Participating countries could commit to making offsetting adjustments in the event of a primary transfer pricing adjustment by the competent authority of the other State."

Depending upon the evidentiary procedures established, the compensation of the arbitration panel can constitute the most significant cost of arbitration. The costs of M.A.P. arbitration, however, do not have to be significant, and various design features such as a streamlined evidentiary process or a time limit for the arbitration can significantly reduce the time and other resources necessary for the arbitration process.

M.A.P. OPTIONS

Good-Faith Commitment to M.A.P.

- Clarify in the Commentary the importance of resolving cases. The following paragraph could be added to the Commentary on Article 25 in order to emphasize that the mutual agreement procedure is an integral part of the obligations that follow from concluding a tax treaty:

> The undertaking to resolve by mutual agreement cases of taxation not in accordance with the Convention is an integral part of the obligations assumed by a Contracting State in entering into a tax treaty and must be performed in good faith. In particular, the requirement in paragraph 2 that the competent authority "shall endeavour" to resolve the case by mutual agreement with the competent authority of the other Contracting State means that the competent authorities are obliged to seek to resolve the case in a principled, fair and objective manner, on its merits, in accordance with the terms of the Convention and applicable principles of international law.

- Ensure that the obligation to make offsetting adjustments is included in tax treaties. Participating countries could commit to making offsetting adjustments in the event of a primary transfer pricing adjustment by the competent authority of the other State. This change does not create a negative inference with respect to treaties that do not currently contain the provision.

Adoption of Effective Administrative Processes

- Ensure the independence of a competent authority. Participating countries could commit to adopt the best practices currently included in the O.E.C.D. Manual on Effective Mutual Agreement Procedures ("M.E.M.A.P.") concerning the independence of a competent authority. Necessary steps should be taken to ensure the autonomy of the competent authority from the audit and examination functions, as well as to guarantee, in practice, an appropriate distinction between the objective application of existing treaties and the forward-looking determination of the policy to be adopted and reflected in future treaties.

- Provide sufficient resources to a competent authority. They could commit to provide their competent authorities with sufficient resources in terms of personnel, funding, and training to carry out their mandate to resolve cases in a timely and efficient manner.

- Use of appropriate performance indicators. Participating countries could commit to adopt the best practices currently included in the M.E.M.A.P. concerning the use of appropriate performance indicators for their competent authority functions and staffs. These would be based on factors such as consistency of position, time to resolve cases, and principled and objective M.A.P. outcomes and not on factors such as sustained audit adjustments or maintaining tax revenues already collected.

- Better use of M.A.P. process. Participating countries could commit to make more use of M.A.P. processes, and where an agreement in a M.A.P. case relates to a general matter that affects a wide group of taxpayers, to publish the agreement in order to provide guidance and prevent future disputes.

- Wider use of M.A.P. process. Participating countries could commit to adopt the best practices currently included in the M.E.M.A.P. to relieve double taxation in cases not provided for in the Convention (*e.g.*, in the case of a resident of a third country having P.E.'s in both Contracting States).

Effective Access to M.A.P.

- Ensure that audit settlements do not block access to the mutual agreement procedure. Participating countries that allow their tax administrations to conclude audit settlements with respect to treaty-related disputes which preclude a taxpayer's access to the mutual agreement procedure could commit to take appropriate steps to discontinue that practice or to implement procedures for the spontaneous notification of the competent authorities of both Contracting States of the details of such settlements.

- Implement bilateral A.P.A. programs. Participating countries could commit to implement bilateral Advance Pricing Agreements.

- Implement administrative procedures to permit taxpayer requests for M.A.P. assistance with respect to recurring or multi-year issues. Participating countries could commit after an initial tax assessment to implement appropriate procedures to permit taxpayer requests for the multi-year resolution of recurring issues with respect to filed tax years, where the relevant facts and circumstances are the same and subject to the verification of such facts and circumstances.

- Implement administrative procedures to permit taxpayer requests for M.A.P. assistance with respect to roll-back of A.P.A.'s. Participating countries that have implemented A.P.A. programs could similarly commit to provide for the roll-back of advance pricing arrangements in appropriate cases, subject to the applicable time limits provided by domestic law such as statutes of limitation for assessment where the relevant facts and circumstances in the earlier tax years are the same and subject to the verification of these facts and circumstances.

- Improve the transparency and simplicity of the procedures to access and use the M.A.P. Participating countries could commit to adopt the best practices currently included in the M.E.M.A.P. concerning the transparency and simplicity of the procedures to access and use the mutual agreement procedure, which should minimize the formalities involved in the M.A.P. process taking into account the challenges that may be faced by taxpayers. This would include a commitment to (i) develop and publicize rules, guidelines and procedures for the use of the M.A.P. and (ii) identify the office that has been delegated the responsibility to carry out the competent authority function and its contact details.

- Provide additional guidance on the minimum contents of a request for M.A.P. assistance. Participating countries could commit to adopt the best practices currently included in the M.E.M.A.P. concerning the minimum contents of a request for M.A.P. assistance. This would include a commitment to (i) identify, in public guidance, the specific information and documentation that a taxpayer is required to submit with a request for M.A.P. assistance, seeking to balance the burdens involved in supplying such information with the complexity of the issues the competent authority is called upon to resolve and (ii) avoid denying access to the M.A.P. process one the basis of insufficient information without consulting the other competent authority where a country has not yet provided any guidance.

- Clarify the availability of M.A.P. access where an anti-abuse provision is applied. Where there is a disagreement between the taxpayer and the competent authority to which its M.A.P. case is presented as to whether the conditions for the application of a treaty anti-abuse rule have been met or whether the application of a domestic anti-abuse rule conflicts with the provisions of a treaty, participating countries could commit to provide access to the mutual agreement procedure, provided the requirements of the M.A.P. article of the applicable treaty is met. In addition, (i) a participating country seeking to limit or deny M.A.P. access in all or certain of these cases could commit to agree upon such limitations with treaty partners and (ii) where a participating country would deny M.A.P. access based on the application of domestic law or treaty anti-abuse provisions, the treaty partner should be notified.

“When interpreting a tax treaty’s time limitation for requesting M.A.P. relief, requests in borderline cases should give the benefit of the doubt to taxpayers.”

- Ensure that whether the taxpayer’s objection is justified is evaluated *prima facie* by both competent authorities. Where the competent authority to which a M.A.P. case is presented does not consider the taxpayer’s objection to be justified, participating countries could commit to a bilateral notification or a consultation process.

- Clarification of the term “justification.” Participating countries could commit to clarify the Commentary on the meaning of the phrase “if the taxpayer’s objection appears to it to be justified.”

- Permit a request for M.A.P. assistance to be made to the competent authority of either Contracting State.

- Clarify the relationship between the M.A.P. and domestic law remedies. Participating countries could commit to clarify the relationship between the mutual agreement procedure and domestic law remedies to facilitate recourse to the mutual agreement procedure as a first option to resolve treaty-related disputes through appropriate adaptations to their domestic legislation and administrative procedures, which may include provision for the suspension of domestic law proceedings as long as a M.A.P. case is pending.

- Publish guidelines on the relationship between the M.A.P. and domestic law remedies. Clear guidance could be provided on the relationship between the M.A.P. and domestic law remedies, the processes involved and the conditions and rules underlying these processes. Such guidance could address whether the competent authority considers itself to be legally bound to follow a domestic court decision in the M.A.P., or whether the competent authority will not deviate from a domestic court decision as a matter of administrative policy or practice so that taxpayers may make an informed choice between the M.A.P. process and domestic law remedies.

Case Resolution

- Clarify issues connected with time limits to access the mutual agreement procedure. Participating countries could adopt the best practices currently included in the M.E.M.A.P. concerning time limits to access the mutual agreement procedure to facilitate early resolution of M.A.P. cases. When interpreting a tax treaty’s time limitation for requesting M.A.P. relief, requests in borderline cases should give the benefit of the doubt to taxpayers.

- Clarify implementation of M.A.P. relief. Participating countries could include in treaties a provision calling for the implementation of M.A.P. relief notwithstanding any time limits in domestic law. Where that provision is not included, a participating country should ensure that its audit practices do not unduly create the risk of late adjustments for which taxpayers may not be able to seek M.A.P. relief.

- Clarify issues related to self-initiated foreign adjustments and the mutual agreement procedure. Clarify the circumstances where double taxation may be resolved under the M.A.P. process in the case of self-initiated foreign adjustments. The clarification should emphasize the importance of bilateral competent authority consultation to determine appropriate corresponding adjustments and to ensure the relief of double taxation.

- Ensure a principled approach to the resolution of M.A.P. cases. Participating countries should ensure a principled approach to the resolution of M.A.P. cases. Best practices currently included in the M.E.M.A.P. should be adopted concerning fair and objective M.A.P. negotiations based on a good faith application of the treaty and the resolution of M.A.P. cases on their merits. Where the interpretation of a treaty provision is likely to be difficult or controversial, participating countries could agree on guidance in the form of a protocol or exchange of notes.

- Improve competent authority cooperation, transparency and working relationships. Participating countries could adopt the relevant best practices currently included in the M.E.M.A.P., including a cooperative and fully transparent M.A.P. process in which documentation and information are exchanged in a timely manner and regular communications, including meetings, are used to reinforce a collaborative working relationship. Competent authorities could agree to allow taxpayers to make presentations in order to facilitate a shared understanding of the relevant facts.

- Increase transparency with respect to M.A.P. arbitration and tailor the scope of M.A.P. arbitration.

- Facilitate the adoption of M.A.P. arbitration. Most favored nation provisions could be used as an elective mechanism for the quick implementation of M.A.P. arbitration between a country and its treaty partners where that country determines that M.A.P. arbitration should be included as part of its treaty policy.

- Clarify the co-ordination of M.A.P. arbitration and domestic legal remedies. Participating countries could commit to provide guidance on the interaction between the mutual agreement implementing the decision of the arbitration panel and pending litigation on the issues resolved through the mutual agreement procedure.

- Appointment of arbitrators. Participating countries could develop mutually agreed criteria for the appointment and qualifications of arbitrators. To ensure that prospective arbitrators are impartial and independent, participating countries may also wish to develop a standardized declaration attesting to fitness and to possible conflicts of interest.

- Confidentiality and communications. The disclosure of taxpayer information by a competent authority to the members of the arbitration panel would be made pursuant to the authority of the Convention and subject to confidentiality requirements that are at least as strong as those applicable to the competent authorities.

- Default form of decision-making in M.A.P. arbitration. Participating countries could develop additional guidance on the use of different decision-making mechanisms as default approaches in M.A.P. arbitration.

- Evidence in M.A.P. arbitration. Guidance could be developed to address particular evidentiary issues that may arise in connection with different forms of arbitral decision-making. Where the format is the independent opinion approach, standards should be established for allowance of taxpayer presentations.

- Multiple, contingent, and integrated issues. Participating countries could establish mutually-agreed guidance for arbitrators on how to deal with multiple, contingent and integrated issues.

- Costs and administration. Participating countries could consider ways to reduce the costs of M.A.P. arbitration procedures.

- Multilateral maps and advance pricing. The Model Treaty could be revised to address multilateral M.A.P.'s and A.P.A.'s to address the arbitration process used in a multilateral M.A.P. and to address issues connected with time limits and notification of third-State competent authorities.

- Provide guidance on consideration of interest and penalties in the mutual agreement procedure. The guidance would address the treatment of interest and penalties in the M.A.P. so that where interest and penalties are computed with reference to the amount of the underlying tax and the underlying tax is found not to have been levied in accordance with the provisions of the Convention, the penalties and interest could be addressed in the relief.

"The goal is to provide an objective M.A.P. process that addresses issues in a fair manner based on the rule of law rather than selfish interests."

CONCLUSION

In Action 14, the O.E.C.D. extends its inquiry into the behaviors of tax authorities that result in economic double taxation. The goal is to provide an objective M.A.P. process that addresses issues in a fair manner based on the rule of law rather than selfish interests. Whether Action 14 will succeed is an open question. In comparison to the other components of the B.E.P.S. Action Plan, the targets of Action 14 are the authorities that set the rules. It is not clear that these officials will have the political commitment to promote fairness over collection of tax revenue.

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B.E.P.S. ACTION 15: DEVELOPING A MULTILATERAL INSTRUMENT TO MODIFY BILATERAL TAX TREATIES

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Tags
B.E.P.S.
International Law
Multilateral Instrument
Opting in
Opting out
Tax Treaties

AN EXERCISE IN "POINT/COUNTERPOINT"

Implementation of many of the B.E.P.S. Action Items would require amending or otherwise modifying international tax treaties. According to the O.E.C.D., the sheer number of bilateral tax treaties makes updating the current treaty network highly burdensome. Therefore, B.E.P.S. Action Item 15 recommends the development of a multilateral instrument ("M.L.I.") to enable countries to easily implement measures developed through the B.E.P.S. initiative and to amend existing treaties.[1] Without a mechanism for swift implementation of the Action Items, changes to model tax conventions merely widen the gap between the content of the models and the content of actual tax treaties.

Discussion of Action Item 15 has centered on the following issues:

- Whether an M.L.I. is necessary,
- Whether an M.L.I. is feasible, and
- Whether an M.L.I. is legal.

In the spirit of these ongoing discussions concerning Action Item 15, we offer our commentary in a "point/counterpoint" format.

POINT:

Action Item 15 is Impractical on its Face

Of all the B.E.P.S. Action Items, Action Item 15 is subject to the highest degree of vagueness and ambiguity because agreement must be reached on other Action Items before drafting can begin on the M.L.I. To compensate for this ambiguity, the O.E.C.D. addresses various methods by which an M.L.I. can come into effect. But in doing so, the O.E.C.D. highlights the main dilemma that is faced. The M.L.I. must be flexible so that countries are incentivized to sign. In addition, it must supersede all existing bilateral treaties not reflecting the terms of the M.L.I. in order to enhance effectiveness. These two principles naturally come into conflict: if the M.L.I. has mandatory terms and supersedes all existing bilateral treaties, it may not be attractive.

The main weakness of Action Item 15 is that this conundrum is not addressed. Due to the uncertainty inherent in the scope of the other Action Items, the O.E.C.D. often

1 OECD (2014). *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing p. 9-10.

uses vague language to note economic principles. It is not clear that a country will wish to override all its bilateral treaties in order to achieve an uncertain result beyond the scope of its control.

The following is a list of criticisms of the various principles and ideas which the O.E.C.D. has mentioned in its recommendations:

1. **More Conferences v. Increased Efficiency**: The O.E.C.D. recommends holding a conference to negotiate the M.L.I. This conference would presumably occur after the other Action Items have been addressed. At the same time, the O.E.C.D. wishes for the M.L.I. to be implemented quickly. These two principles are somewhat in conflict. Inviting yet another negotiating conference will likely delay the implementation of B.E.P.S. measures through an M.L.I.

2. **Conflict between Efficiency and Sovereignty**: As indicated above, another conflict arises from the suggestion that a superseding clause should be placed in the M.L.I. to increase effectiveness. This proposal occurs prior to adoption of all the terms of the M.L.I. and is, in part, designed to encourage countries to assign power to override bilateral treaties in advance of the understanding what those overriding terms will look like. The O.E.C.D. suggests that the M.L.I. will be couched in so-called "soft language" to encourage cooperation. However, with the wide reach expected for B.E.P.S. legislation, countries will likely desire more clarity and less ambiguity.

3. **Problems without Solutions**: Often, the B.E.P.S. recommendations note problems but do not addressing solutions. For example, the report recommends that developing countries should be more involved in the implementation of the B.E.P.S. legislation. While a laudable point, the O.E.C.D. does not address how to involve developing countries, nor does it address whether developed countries would be encouraged to surrender economic sovereignty as a concession to developing country support. This conflict has not been resolved in other international arenas, such as climate change or the W.T.O. negotiations on agriculture. If the law of past performance holds true, loss of sovereignty may again be a stumbling block.

4. **Opt-In/Opt-Out and Competitiveness**: To calm fears that the signing of the M.L.I. will result in the breach of territorial and economic sovereignty, the O.E.C.D. recommends that the M.L.I. should be made "flexible" by including "opt-in" and "opt-out" clauses. Of course, countries will only opt in or opt out if to do so is in their best interest and will likely be wary of opting in and subjecting their economies to stringent standards, which would render them unable to compete in the global marketplace unless other major economic players, like the U.S., also opt-in. Secondly, the O.E.C.D. may be of the view that once a country signs the M.L.I., opting out will not be politically easy.

5. **Transparency**: The annex allows for public access to the M.L.I. in a bid to increase both flexibility and transparency. Increasing transparency through public record access is a commendable objective, but there are few ways to interpret "public access" beyond offering to issue a treaty online with a comparison of the M.L.I. and other bilateral agreements. Most treaties are already issued online, rendering the objective moot. Action Item 15 does not address whether the actual conversations, concessions, and negotiations

would be made available to the public at a later point in time, which may be of interest to domestic stakeholders and historians.

"The O.E.C.D. has indicated that the M.L.I. should allow for reservations only on 'non-core' items. The O.E.C.D. has not identified core issues and non-core issues."

6. **Monitoring Implementation**: To enforce the provisions of the M.L.I., the O.E.C.D. desires to monitor whether countries are properly implementing B.E.P.S. legislation through the creation of a multilateral implementation board. This raises additional questions: who would sit on such a panel, and would an economically powerful country allow other member countries to decide the fate of its tax base? While the U.S. is a party to other international treaties where monitoring groups exist, the M.L.I. monitoring with other treaties. Moreover, the U.S. tax system has more at risk than others with regard to such a board. Any multilateral implementation board that encourages smaller countries to impose more tax on foreign members of a U.S.-based multinational group would reduce the U.S. tax base. While the U.S. eliminates double taxation through a foreign tax credit mechanism, most other countries eliminate double taxation through an exemption system. For them, increased tax in a foreign trading-partner country will not reduce revenue, especially if a bilateral transfer pricing agreement is not reached with that trading partner. Finally, the negotiations to determine which countries would sit on such a board may further delay the agreement coming into effect.

7. **Reservation**: Simply put, a reservation excludes a provision of the treaty from applying. A reservation is allowed so long as it is not prohibited by the M.L.I. The O.E.C.D. has indicated that the M.L.I. should allow for reservations only on "non-core" items. The O.E.C.D. has not identified core issues and non-core issues. The likelihood is that mostly core issues will be controversial. If this proves true, the ability to reserve will be limited to the inconsequential issues. The U.S. has already hinted that there are several issues where it may declare a "reservation" if it does not agree with the O.E.C.D. Some of these issues have been mentioned in a previous article, which can be seen by clicking here. Again, where an economically powerful country like the U.S. decides to opt out of several provisions, there is a likelihood that other countries will follow – rendering the clause in question effectively null in practice.

8. **Other Multilateral Agreements are Not Relevant to the M.L.I.**: A credible case has not been made that earlier multilateral agreements facing similar issues in relation to then-existing bilateral treaties are comparable to income tax treaties and the M.L.I. An income tax treaty embodies a careful set of compromises where specific countries negotiate to allocate the right to impose tax and to endeavor to prevent double taxation. The result is that tax revenue flows into one country's treasury but not to the treasury of the other country. In this scenario, the interests of the two states are adverse with regard to most matters other than those viewed to be purely administrative. Their interests and views are adverse in the same way that the interests of a buyer and a seller of property are adverse. Absent unusual circumstances, a seller typically believes the initial offering price for the property is too low and the buyer believes the final price is almost too high. Bilateral tax treaties reflect similar interests of the signatory states: (i) is each giving up too much tax revenue; (ii) is each state a capital importer or exporter; (iii) how will the treaty affect tax residents and the local economy? In comparison, the multilateral agreements currently in existence, and discussed below, have

not been adopted in the context of adverse interests. Most countries have the same interest in extradition of purported criminals and the repatriation of minors abducted by one parent or the other. Whether the agreement is multilateral or bilateral, the issue is whether an acceptable procedure will be in existence to carry out the purpose of the treaty.

In conclusion, much of the uncertainty and vagueness of Action Item 15 results from timing. Negotiations on the other action plans have yet to begin. Once those negotiations are completed, prospects for a successful M.L.I. may be clearer. Nonetheless, the O.E.C.D. will encounter significant challenges in determining the proper balance between effectiveness and flexibility. Many commentators across the world have suggested that U.S. agreement to the M.L.I. is key to its effectiveness. Others believe that whether or not an M.L.I. is agreed upon, Action Item 15 has achieved its goal of motivating consensus to action.

COUNTERPOINT:

The M.L.I. is Both Feasible and Necessary Given the Current Geopolitical and Macroeconomic Environment & Precedent Exists Under International Law

Although objections exist to the feasibility of the M.L.I. due to its complexity and the derogation of sovereignty for the signatory nations, a multilateral approach is a practicable way to streamline implementation of the B.E.P.S. action plans. The Annex of Action Item 15 provides a toolbox of theoretical options that may be utilized to develop the M.L.I. into a vehicle for the implementation of B.E.P.S. measures. According to the Annex, these tools are based upon three principles:

- The M.L.I. can implement B.E.P.S. measures and modify the existing bilateral treaties;
- The M.L.I. can provide for flexibility in the parties' level of commitment; and
- The M.L.I. can ensure transparency and clarity for all stakeholders.

These principles derive from the success of their ongoing existence in other multilateral treaty instruments in international public law. If these same principles and tools are used in the creation of the B.E.P.S. M.L.I., it should be feasible for the O.E.C.D. to create an instrument that respects sovereignty, is created legally, and achieves its goal.

The M.L.I. would not terminate any part of the pre-existing network of bilateral treaties, but instead, would try to achieve a concurrent and cohesive application of the provisions of the instrument and the bilateral treaties as they relate to B.E.P.S. There have been several situations in which states have implemented multilateral conventions to introduce common international rules and standards, thus harmonizing the network of bilateral treaties. These conventions rely on tools of international law to achieve their goals, namely, (i) compatibility clauses, (ii) flexibility of provisions, and (iii) transparency and clarity. However, it is not clear that there are many multilateral treaties that have as their principal purpose the override of a host of bilateral treaties.

“A compatibility clause may provide for the supremacy of the multilateral agreement over existing treaties on the condition that the rights and obligations of other treaties are not affected to the extent they are compatible with the multilateral agreement.”

Compatibility Clauses

The Annex cites the use of compatibility clauses (or “conflict clauses”) to explicitly define the relationship between the multilateral instrument and the existing bilateral treaties. These have been used in several other agreements in which the provisions of a multilateral instrument have superseded the provisions of an existing network of bilateral treaties.

A multilateral agreement can supersede provisions of a bilateral treaty covering the same specific subject matter, as can be seen in the *European Convention on Extradition* (1957)[2] and the *European Convention on the Repatriation of Minors* (1970).[3]

It may also grant an exception to the general principal that the provisions of the multilateral instrument supersede those of prior agreements. Certain treaties stipulate that “more favorable” provisions of a bilateral treaty existing at the time of conclusion will not be affected.[4] Others go a step further and indicate which provisions are added to the bilateral agreements or which provisions are modified and how.[5]

A compatibility clause can also modify the provisions of a pre-existing treaty insofar as they differ from or are incompatible with the provisions of the multilateral agreement. These can be seen in treaties such as the *European Convention on the Suppression of Terrorism* (1977).[6] In some cases, any difference in the provisions can invoke this type of compatibility clause. However, in other cases, it requires inconsistency or incompatibility between the provisions.

Furthermore, a compatibility clause may provide for the supremacy of the multilateral agreement over existing treaties on the condition that the rights and obligations of other treaties are not affected to the extent they are compatible with the multilateral agreement. Such a variation can be seen in the *European Convention on Mutual Assistance in Criminal Matters* (1959).[7]

Some may argue that a single instrument would be unable to address complex situations where there are several variations of scope, wording, and paragraph numbering between bilateral treaties. However, there are precedents in which compatibility clauses address these issues and do so by identifying the provisions to be modified using a specific description, which then removes the necessity to refer to a certain provision or paragraph number in the bilateral treaties.

It is also possible for the compatibility clause to describe the exact effect of its provisions on those bilateral treaties through the inclusion of terms such as “in place of,” “in addition to,” or “in the absence of.”[8] For example, a multilateral agreement may include a clause which allows parties to take on further commitments with another

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2 *European Convention on Extradition* (1957), Article 28(1).

3 *European Convention on the Repatriation of Minors* (1970), Article 27(1).

4 See *International Convention of the Protection of the Rights of All Migrant Workers and Members of their Families* (1990), Article 81(1).

5 See *Convention for the Suppression of Unlawful Acts against the Safety of Maritime Navigation* (1988).

6 *European Convention on the Suppression of Terrorism* (1977), Article 8(3).

7 *European Convention on Mutual Assistance in Criminal Matters*, Article 26(1-2).

8 See *Agreement on Extradition between the European Union and the United States of America* (2003).

party on the condition that the subsequent agreements can only confirm, supplement, extend, or amplify the provisions of the multilateral agreement.[9] Alternatively, it may take the opposite approach and state that any subsequent agreements may not contradict the provisions or purpose of the treaty.[10] Both mechanisms are used in treaties that are currently in effect and allow for parties to prepare and commit to further objectives in their own time.

The M.L.I. could draw from other multilateral instruments and their compatibility clauses in the following ways:

1. **Negotiable Start Date**: Allowing for the participating states to negotiate the date when the M.L.I. would come into force would allow the states to maintain sovereignty. Such a provision has been implemented in the *Convention of Mutual Administrative Assistance in Tax Matters* (1988).[11] It is also possible to provide for different dates with regard to different provisions of the treaty, if necessary. Doing so can reduce complications for those parties with differing tax years.[12] It can also provide for an allowable time gap for a party joining at a later time.

2. **Accompanying Commentaries**: Also, to ensure consistency in interpretation and implementation of the multilateral agreement, many treaties are accompanied by commentaries that are agreed to by all parties and that provide background information and guidance as a supplement to the provisions. A discussion between the parties on implementation of the M.L.I. will allow for ease of monitoring with regard to practical implementation.[13] Additionally, if desired by the parties, more specific questions can be addressed by providing for mechanisms such as consultation procedures in the M.L.I. These mechanisms exist in most bilateral treaties to resolve any difficulties that may arise.[14]

3. **Use of Amendments**: Finally, to preserve the sovereignty of individual states when implementing the M.L.I., the states may agree to future amendments of the M.L.I. – but only those to which they have consented.[15]

In sum, there are many examples of compatibility clauses in existing multilateral agreements that have prevailed without challenge. The multiple variations in these clauses allow them to be flexible and invoked where and when they are necessary. Such clauses allow for the pre-existing treaties to endure while addressing only those areas that are in conflict with the new provisions of the multilateral instrument. Also, the obligations previously agreed upon by the treaty partners are not affected. This has clearly been shown to be successful when used in multilateral agreements.

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[9] See *European Convention on Extradition* (1957), Article 28(2).

[10] See *Convention on International Civil Aviation* (1944), Article 83.

[11] Article 28(2).

[12] See *Convention on Mutual Administrative Assistance in Tax Matters* (1988), Article 28(5, 6).

[13] See id., Article 24(3).

[14] See *United Nations Framework Convention on Climate Change* (1992), Article 13.

[15] See *United Nations Convention Against Transnational Organized Crime* (2000), Article 39(5).

Flexibility of Provisions

Where certain tax policies cannot be harmonized among the parties, it is possible to provide flexibility in the level of commitment the parties are prepared to undertake. Flexibility of provisions supports the idea that parties maintain their sovereignty in choosing to be part of the M.L.I.

Flexibility in the level of commitment can apply to the substance of specific provisions or it can depend on the partner jurisdiction. Also, a multilateral agreement could allow for the parties to implement a specific regime among themselves, if certain conditions are met through the use of a disconnection clause. Such clauses have been used in treaties with the European Union.

1. **Opt-out Mechanisms**: Types of flexibility mechanisms that can be implemented are opt-out mechanisms, opt-in mechanisms, or a choice between provisions. The opt-in and opt-out mechanisms are commonly used devices in treaties that allow flexibility and are standard in treaties developed within several international organizations.

   Opt-out mechanisms are frequently used and can be limited to a defined period of time.[16] The use of reservations allows for the possibility to opt out of certain provisions of a treaty and is done when a unilateral declaration is made by a state when signing, ratifying, accepting, approving, or acceding to a multilateral agreement, and it purports to exclude or to modify the legal effect of certain provisions of the agreement. To prevent parties from opting out of core provisions, the M.L.I. could allow for the formulation of reservations only on certain provisions, as was done in the *Convention on Mutual Administrative Assistance in Tax Matters* (1988).[17]

2. **Alternate Provisions**: Another mechanism to allow for flexibility that has been used in the past involves choosing between alternative provisions. Parties could be given the choice between alternative provisions or a list of provisions from which they would select a defined minimum, as in the *European Social Charter* (1961) or the *Bali Agreement on Trade Facilitation* (2013). Opt-in mechanisms allow parties that are ready to do so to commit to pursue the objectives of the treaty. This can be achieved by opting into added commitments that go beyond an outlined set of minimum commitments required by the multilateral treaty. The parties can be offered the option to accept being bound by specific provisions by making a unilateral declaration. Alternatively, the parties may add optional protocols to the instrument at the same time the main treaty is adopted or at a later date.[18]

3. **Flexible Wording**: The level of commitment can also be defined by the wording of the provisions and by the types of obligations contained in the provisions. The use of "will," "shall," and "must" can be used to achieve

[16] See *International Labour Convention No. 63, Concerning Statistics of Wages and Hours of Work* (1938), Article 2(1).

[17] See Article 30.

[18] The *European Convention for the Protection of Human Rights and Fundamental Freedoms* (1950) includes the *Second Optional Protocol to the International Covenant on Civil and Political Rights, aiming at the abolition of the death penalty* (1989), as well as the *Optional Protocol to the Convention on the Rights of the Child on the involvement of children in armed conflict* (2000).

core objectives of the treaty, and more flexible wording can be used for more desirable objectives that are not necessarily required to achieve the main objective, such as "may" or "as appropriate." These more flexible terms can be found in many treaties, such as the *Convention of Mutual Administrative Assistance in Tax Matters* (1988)[19] or in the *United Nations Convention on the Law of the Sea* (1982).[20]

"It is important that a high level of transparency and clarity exists regarding the commitments undertaken by the parties and for all those involved and affected. Mechanisms are available to ensure clear and publicly accessible information."

Transparency and Clarity

Considering the complexity of the current network of bilateral tax treaties, it is important that a high level of transparency and clarity exists regarding the commitments undertaken by the parties and for all those involved and affected. Mechanisms are available to ensure clear and publicly accessible information. The objectives of the multilateral treaty can be achieved based on the law of treaties and existing precedents in international law. Focus on the following points is necessary.

1. **Publications**: To ensure clarity and transparency, there should be a publication of consolidated versions of bilateral treaties on publicly accessible databases. Further, an M.L.I. depository is imperative for receiving and maintaining information, notifications, and communications relating to the treaties. A viable option would be to require written notifications to the depository by the parties involved, setting out the effect on the bilateral treaty, as it was done for the *Agreement on Extradition between the European Union and the United States of America* (2003).[21] As is common practice, opt-out measures are communicated to the depository, which then notifies all the parties to the treaty and can, upon request, notify other groups of all or certain communications. This same mechanism can be used for opt-in or choice-of-alternative measures.

2. **Translation**: Multilateral agreements are only negotiated and signed in a limited number of languages for practical purposes. Although it may not be possible to have official texts of the M.L.I. in all relevant languages, they may be translated at a later time. This has been done to universal human rights treaties, and the translations did not create major difficulties.

In conclusion, the many objections attacking the feasibility of the M.L.I. can be addressed by mechanisms that have been successfully used in other multilateral agreements currently in existence in public international law. Those agreements have been implemented and utilized predominantly without challenge over the many years they have been existence. Although instituting the B.E.P.S. initiative will be a complex and expansive undertaking, all concerns have already been addressed by past instruments and can be minimized by much the same mechanisms in previous cases.

POINT & COUNTERPOINT:

Treaty Provisions at Issue

The question raised by the Action Item 15's M.L.I. concept is whether or not the

[19] Article 13.

[20] Article 123.

[21] Article 3(2).

existing bilateral treaty network is equipped to deal with many different factors that may arise in today's global market. The treaty provisions at issue focus on a world where different countries have different standards, where each country is entitled to create its own standard, and where the disparity between standards can lead to the mismatching of tax results. The overriding question is whether the M.L.I. addresses real or imagined issues.

"The O.E.C.D. is concerned about the commitment of many countries to make the required changes in domestic laws to eliminate the abuse. The M.L.I. would address potential gaps in domestic legislation and existing treaty provisions."

1. **Multi-country Disputes**: The goal of an article on Mutual Agreement Procedure ("M.A.P.") in a bilateral income tax treaty is to resolve disputes between the two countries that are parties to the bilateral agreement. The M.A.P. provision in the O.E.C.D. Model Convention provides guidance for a taxpayer where taxation in accordance with the provisions of a treaty is at issue. The M.A.P. provision establishes rules for two countries to follow with the goal of resolving the dispute. Action Item 15's position is that the M.A.P. needs to be improved to address issues where more than two countries are stakeholders and where international arbitration outside the protocols of the treaty itself may be appropriate. Perhaps this reflects a view that where major economies and global financial institutions are called upon to bail out the banking systems of other countries with failing economies, the major economies and the global institutions have an interest in the collection of tax in the countries receiving support.

2. **Dual Residency**: Action Item 15 suggests that it would be more efficient for countries in a bilateral context to address these issues on a case-by-case basis that reflects an anti-abuse structure in effect across the existing bilateral tax treaty network. In the residence article of the O.E.C.D. Model Convention, the proper residence of a dual-resident corporation is the state in which the corporation's place of "effective management" is situated. An entity may have more than one place of management, but it can only have one place of effective management at any one time. Action Item 15's position is that the M.L.I. can be used to create factors that control the manner in which this issue is resolved.

3. **Linking Rules**: Hybrid mismatching has created double non-taxation or low taxation in many instances. The O.E.C.D. is concerned about the commitment of many countries to make the required changes in domestic laws to eliminate the abuse. The M.L.I. would address potential gaps in domestic legislation and existing treaty provisions – an attractive goal for the O.E.C.D.

4. **Profit Shifting**: The standard by which the existence of a permanent establishment is determined can vary in application from country to country. This disparity can result in the shifting of profits to countries that impose tax at a lower rate or that permit tax to be deferred indefinitely. These so-called "triangular situations" may be outside the scope of a bilateral treaty if taxation in a given jurisdiction is not addressed in identical fashion by treaties or domestic law in all three countries. The M.L.I. will define permanent establishment in a consistent way that can provide flexibility for countries to tailor tax policy in a way that achieves compatible domestic policies. This could be accomplished while ensuring consistency and coherency for all multinational taxpayers.

5. **Treaty Shopping**: The M.L.I. could be used to prevent treaty shopping. Bilateral treaties give specific tax benefits, which are provided on reciprocal basis to appropriate taxpayers. Treaty shoppers seek to obtain treaty benefits

by effectively using a treaty resident that channels income to a head office in a low tax jurisdiction having no comprehensive income tax treaty in effect. The M.L.I. might be appropriate as a backstop to the limitation on benefits provisions, such as those now in place in virtually all U.S. income tax treaties.

CONCLUDING POINTS

An M.L.I. could be beneficial if it quickly and efficiently address B.E.P.S. However, an M.L.I. is not possible without O.E.C.D. countries and associate countries committing to the cause, even if that means possibly giving up some sovereignty. In addition, the M.L.I. is, as of now, dependent on proposed rules that have been discussed and approved in general terms but lack the finer details which provide the proper context for the M.L.I.

The issue is one of balancing principle versus practicality. Many countries rely on multinational business structures to generate commercial activity, employment, and related tax revenues. The creation of the M.L.I. and its effect on a given multinational enterprise is yet to be demonstrated by consensus. If it is true that taxation is the core right of a given country and that a country can impose laws as its government sees fit, an M.L.I. that infringes upon this right will be resisted. This is especially true for the associate countries and other developing countries. This would not be a problem if a consensus is reached among all countries, including those with adverse interests. However, it is not clear that consensus has been reached.

On the other hand, if it is true that the provisions at issue with the bilateral treaty network cannot be amended in a timely manner and the risk of continued B.E.P.S. is too great, consideration of the M.L.I. is appropriate. The M.L.I. could address gaps that are created between bilateral agreements and domestic laws while co-existing with agreements already in place. It would be aligned with a country's given right to exercise its taxation authority. Whatever the size or shape of the M.L.I., a country's fundamental right to tax will not be changed. The right to tax includes the right to forbear from taxing.

We anticipate that a draft M.L.I. will be forthcoming in 2015. The points and counterpoints that will be addressed or deferred remain to be seen.

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