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The OECD Base Erosion and Profit Shifting Initiative

TEI Detroit

April 29, 2014

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Overview of Recent Developments

OECD Action Plan on Base Erosion and Profit Shifting

Action	Deadline
1. Addressing the tax challenges of the digital economy	Sept '14
2. Neutralise the effects of hybrid mismatch arrangements	Sept '14
3. Strengthen CFC rules	Sept '15
4. Limit base erosion via interest deductions/other financial payments	Sept/Dec '15
5. Counter harmful tax practices more effectively taking into account transparency and substance	Sept '14 & Sept/Dec '15
6. Prevent treaty abuse	Sept '14
7. Prevent the artificial avoidance of PE status	Sept '15
8. Assure that TP outcomes are in line with value creation: intangibles	Sept '14 & Sept '15

Action	Deadline
9. Assure that TP outcomes are in line with value creation: risks/capital	Sept '15
10. Assure that TP outcomes are in line with value creation: other high-risk transactions	Sept '15
11. Establish methodologies to collect and analyse data on BEPS/actions to address it	Sept '15
12. Require taxpayers to disclose their aggressive tax planning arrangements	Sept '15
13. Re-examine TP documentation	Sept '14
14. Make dispute resolution mechanisms more effective	Sept '15
15. Develop a multilateral instrument	Sept '14 & Dec '15

Short-Term Deliverables – September 2014

Hybrid Arrangements

Treaty Abuse

Transfer Pricing of Intangibles

Country-by-Country Reporting and Transfer Pricing Documentation

Digital Economy

Forum on Harmful Tax Practices

OECD Action Plan on Base Erosion and Profit Shifting Recent Developments

BEPS Action 1 (Address the Tax Challenges of the Digital Economy): Discussion Draft released on March 24. OECD requested comments by April 14.

- 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
- Expected output: Report identifying issues and possible actions to address the issues by September 2014

OECD Action Plan on Base Erosion and Profit Shifting Recent Developments

<u>BEPS Action 2</u> (Neutralize the Effects of Hybrid Mismatches): Two Discussion Drafts (domestic law and treaties) released on March 19. OECD requested comments by May 2

- **Domestic Law Draft**
  - Hybrid financial instruments and transfers
  - Hybrid entity payments
  - Imported mismatches and reverse hybrids
- **Treaty Draft**
  - Use of dual resident entities to obtain the benefits of treaties unduly
  - Use of transparent entities to obtain the benefits of treaties unduly
  - Interaction between the recommendations included in Domestic Law Draft and the provisions of tax treaties

OECD Action Plan on Base Erosion and Profit Shifting Recent Developments

BEPS Action 6 (Prevent Treaty Abuse): Discussion Draft released March 14. The OECD has requested comments by April 9th

- **Based on work in three areas**
  - Development of model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.
  - Clarification that tax treaties are not intended to be used to generate double non-taxation.
  - Identification of tax policy considerations that countries should consider before deciding to enter into a tax treaty with another country.
- **Key recommendations**
  - Introduction of Limitation on Benefit provision
  - Introduction of Main Purpose Test
  - Tie-Breaker rule for dual-residents
  - Triangular Provision

OECD Action Plan on Base Erosion and Profit Shifting Recent Developments

BEPS Action 13 (Re-examine Transfer Pricing Documentation) Discussion Draft released January 30, 2014. The OECD requested comments requested by February 23, 2014.

- **Objectives of Documentation**

Transfer pricing risk assessment

Ensure taxpayers give appropriate consideration
- Contemporaneous documentation
- Penalty regimes

Provide tax administrations information to audit the transfer pricing practices

- **Approach**
  - Master File
  - Local Files
  - Country by Country Report

Discussion Draft on Hybrids Overview and Key Issues

The Treaty Draft

The Treaty Draft proposes an amendment to the OECD Model Treaty to include a broader fiscal transparency provision similar to that contained in the U.S. Model Treaty:

> "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 Domestic Law Draft – Key Principles

The focus of the Domestic Law Draft is on hybrid mismatch arrangements, which are described as involving:

- A hybrid element
- A mismatch in tax outcomes
- A mismatch resulting in a reduction in the aggregate tax burden

Key mismatch arrangements targeted by the Domestic Law Draft:

- Deduction / non-inclusion (“D/NI”)
- Double deduction (“DD”)

The Domestic Law Draft also contains a proposal to prevent the “double dipping” of credits for withholding taxes imposed on hybrid transactions.

The Domestic Law Draft – Key Principles

The Domestic Law Draft makes recommendations that are proposed to be enacted into domestic law by OECD member countries.

- The approach taken in the draft is to set forth primary and secondary rules that would apply automatically to hybrid mismatches.
  - The proposals are based on objective criteria rather than, *e.g.*, determinations of tax avoidance.
- The draft makes recommendations for the coordination of hybrid mismatch rules between jurisdictions.
- Subject to one exception in the case of certain “reverse hybrid entities,” the draft’s proposals do not take into account the application of CFC rules to determine whether a hybrid mismatch exists.

The Domestic Law Draft – Targeted Arrangements

The Domestic Law Draft makes recommendations to address hybrid mismatches in three broad categories:

- **Category 1:** hybrid financial instruments and hybrid transfers (D/NI)
- **Category 2:** hybrid entity payments (D/NI and DD)
- **Category 3:** reverse hybrid entities and imported mismatches (D/NI)
  - Category 3 would include certain transactions or arrangements that do not themselves contain a hybrid element – *e.g.*, a “straight” loan or license – but that are part of an overall structure or arrangement that involves a hybrid mismatch.

Hybrid Mismatch Discussion Draft – Key Considerations

I. Scope – top down vs. bottom-up

A. Bottom-up is less disruptive commercially –defines transaction set and gives parties notice

- In fact top down would be unworkable, requiring testing for exceptions in all cases
- How define widely held, etc., needed for top down

B. Harder to coordinate changes to top, because all countries would have to agree

C. Bottom up is not inconsistent with protecting government interests – can have process to add transactions over time; could be done commonly or unilaterally

Hybrid Mismatch Discussion Draft – Key Considerations

II. Related party threshold

A. What is the rationale for an appropriate related party test?

- Is it easier to comply with/administer at say, 25% as opposed to 10%?
- Are there transactions that one would not be aware of where there is 10% rather than 25% (or 50%)

B. What practical examples of this can be provided?

Hybrid Mismatch Discussion Draft – Key Considerations

III. Structured transactions with unrelated parties

A. Rationale for applying rules to such cases

B. Indicia of structured transaction suggested in Draft

- Designed to exploit differences or marketed as a tax structured deal?
- Tax benefit priced into transaction?
- Tax benefits are significant in comparison with the non-tax consequences
- Payment adjustment/right to unwind if tax benefit not realized or terminates?
- Tax-indifferent accommodation parties or SPVs?

C. Different/other indicia?

D. Different approach?

Hybrid Mismatch Discussion Draft – Key Considerations

IV. Regulatory capital and securities lending

A. In certain counties additional Tier 1 capital is deductible

B. Is an exception appropriate and how would it be crafted? Assuming bottoms up approach, consider the following:

- Issued in structured transaction to single investor or small group
- Issued in intercompany transactions because issued to the market by the parent and mirrored through the ownership structure

C. Additional exceptions—intragroup securities lending

Hybrid Mismatch Discussion Draft – Key Considerations

V. Funds Issues

A. Collective vehicle (objective of transparency) vs. portfolio companies

B. Possible special treatment for certain regulated entities or entities recognized by statute or treaties

C. Related party threshold

D. Acting in concert standard

E. Possible standardized reporting in reverse hybrid, other issues

F. Relevance of recognized forms of entities

Hybrid Mismatch Discussion Draft – Key Considerations

VI. When is a payment not taxed and other definitional issues

A. Current CFC inclusions; proof

B. Withholding tax

Hybrid Mismatch Discussion Draft - Key Considerations

VII. Implementation by countries; coordination of regimes

A. Timing

B. Transition rules

C. Coordination rules (eg, regarding applicable regime by reference to date of issuance)

D. Changes over time - how will taxpayers and other countries be alerted to change in law?

Discussion Draft on Treaty Abuse Overview and Key Issues

Discussion Draft Background

The BEPS Action Plan identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns. Action 6 (Prevent Treaty Abuse) provides three mandates for the work on treaty abuse:

- Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances
- Clarify that tax treaties are not intended to be used to generate double non-taxation
- Identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country

Action 6 does not include the work on PE, which will be delivered in 2015.

Action 6 also provides that the work will be coordinated with the work on hybrids.

Preventing Treaty Abuse

To prevent treaty shopping, Discussion Draft recommends:

- Inclusion of a U.S. Style limitation-on-benefits provision, ***and***
- Inclusion of a general anti-abuse rule (Main Purpose Test)

Discussion Draft's Main Purpose Test

Proposes general anti-abuse rule (main purpose test)

> Notwithstanding the other provisions of this Convention, a benefit under this Convention **shall** not be granted in respect of an item of income if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was **one of** the main 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. [emphasis added]

Discussion Draft's Main Purpose Test Examples

Examples of when main purpose test may apply:

- An entity that is not entitled to the benefits of a treaty assigning the right to receive dividends to a financial institution that is treaty entitled; and
- Issuance of preferred shares to a treaty-entitled financial institution in exchange for a payment equal to the discounted present value of the dividends.

Examples of when the main purpose test may not apply:

- A company decides among three developing jurisdictions to locate a new manufacturing plant, and ultimately chooses State S, the only jurisdiction of the three with a treaty from which the company can benefit.
- A publicly traded company manages a diversified portfolio of investments, and in making its decision to invest in shares of corporations it considers the existence of treaty benefits with respect to dividends.

Concerns about a Main Purpose Test?

1) U.K. has main purpose test – what is experience in practice?

2) Will other countries implement it in the same way?

3) Does the discretionary benefits clause of the LOB import the main purpose test into the LOB and allow countries to ignore the LOB?

4) Is a main purpose test preferable to an LOB-type provision, which can be overbroad and underbroad?

Concerns About a Main purpose Test

Is a main purpose test consistent with U.S. Treaty policy?

- Excerpt from Senate Committee on Foreign Relations Report discussing a proposed U.S.-Italy Income Tax Treaty:

> “The new main purpose tests in the proposed treaty are subjective, vague and add uncertainty to the treaty. It is unclear how the provisions are to be applied. In addition, the provisions lack conformity with other U.S. tax treaties. This uncertainty could create difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty.”

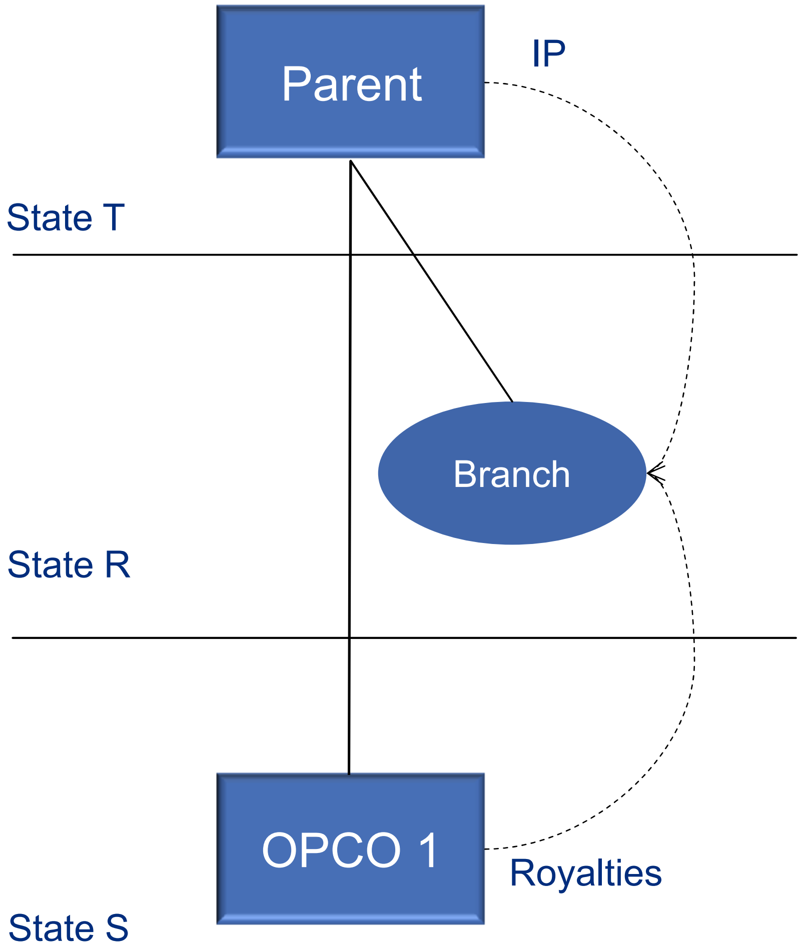
Senate Executive Report 106-8 (1999)

Discussion Draft's Other Recommended Provisions - Tie-Breaker Rule

Tie-Breaker rule for determining the treaty residence of dual-resident persons

The discussion draft recommends amending the residency article to state that the competent authorities of the Contracting States shall endeavor to determine by mutual agreement the residency of a dual-resident person, and if no agreement can be reached, no benefits are provided.

Discussion Draft's Other Recommended Provisions Triangular Provisions



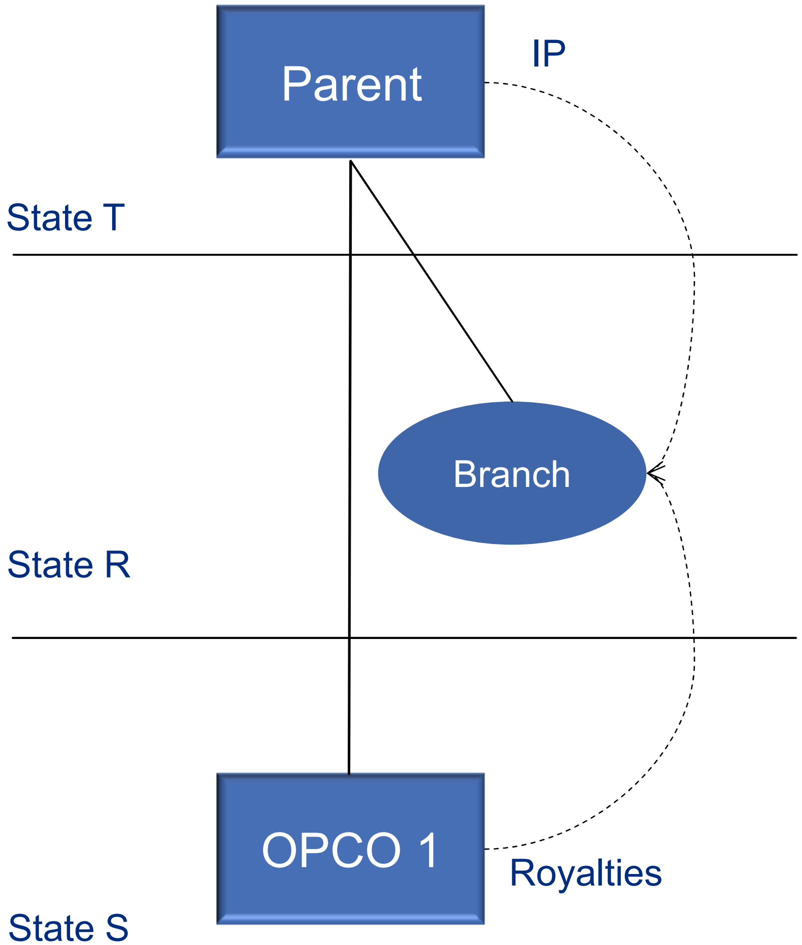
Anti-abuse rule for permanent establishments situated in third States (triangular provision)

Facts:

Parent has transferred IP to Branch, a permanent establishment located in State R because State R offers preferential treatment to royalty income earned on IP.

State T uses an exemption regime to eliminate double taxation and, thus, allows Parent to claim a participation exemption in respect to Branch's income and ultimate remittance of Branch's earnings.

Discussion Draft's Other Recommended Provisions - Triangular Provisions (cont'd)



Recommendation:

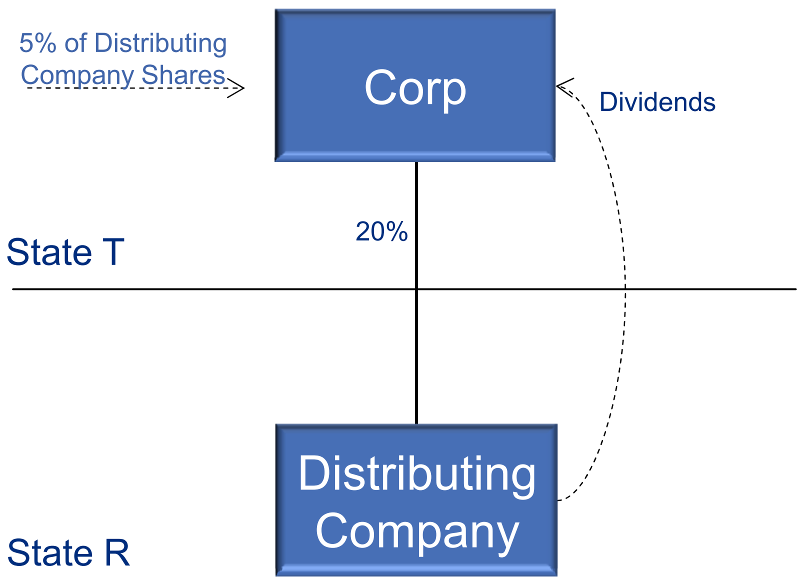
Add a paragraph to Article 1 of the Model Tax Convention allowing the source State to impose a 15% rate on royalties, dividends or interest paid to permanent establishment in a third jurisdiction if the profits of that permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State [here, State T] and third State [here, State R] that is less than 60 percent of the general rate of company tax applicable in the first-mentioned Contracting State [here, State T].

Any other income to which this paragraph applies shall remain taxable according to the laws of the source State notwithstanding any other provision of this Convention.

The provisions of this paragraph shall not apply if:

- In the case of royalties, the royalties are received as compensation for the use of, or the right to use, intangible property produced or developed by the enterprise through the permanent establishment; or
- In the case of any other income, the income derived from the source State is derived in connection with, or is incidental to, the active conduct of a trade or business carried on in the third State through the permanent establishment (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are banking or securities activities carried on by a bank or registered securities dealer).

Discussion Draft's Other Recommended Provisions Holding Period for Claiming Relief from Dividend Withholding Tax



Dividend transfer transactions

Facts:

- Corp, a resident of State T, owns 20% of the capital of Distributing Company, a resident of State R.
- Article 10(2)(a) of the State T-State R treaty reduces the State R dividend withholding tax rate to 5% if the beneficial owner of the dividend is a company which holds at least 25% of the capital of the company paying the dividends.
- Article 10(2)(b) of the State T-State R treaty provides for a 15% rate of withholding on cross-border portfolio dividends.
- Shortly before the dividend becomes payable, Corp increases its ownership in Distributing Company to 25%.
- Shortly after the dividend is received, Corp sells 5% of the capital of Distributing Company.

Recommendation:

The discussion draft recommends amending the Model Tax Convention to include a holding period requirement before a corporate shareholder may obtain the 5% dividend withholding rate under Article 10(a)(2).

Discussion Draft's Other Recommended Provisions

Transactions that circumvent the applications of Art. 13(4) (real property holding companies)

The discussion draft recommends amending Art. 13(4) to cover gains from the alienation of interests in entities holding real property and to apply the test over a look-back period to prevent avoidance of the rule.

Addition of a Savings Clause

The discussion draft recommends adding a "saving clause" similar to provision included in U.S. treaties that confirms the Contracting State's right to tax its own citizens.

Government Reactions to BEPS

Government Engagement in BEPS

OECD

- 34 members: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom, the United States
- The European Union takes part in the work of the OECD
- China, India, Brazil actively engaged

G-20

- Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, United States, European Union

Canada

- **Canada's 2014 federal budget explicitly seeks comments on which international taxation areas Canada should focus on to implement the OECD BEPS Action Plan and has set a four-month consultation period for interested parties to provide input by June 11, 2014**
- **The budget outlines a domestic treaty anti-abuse rule and invites comments.**
  - *General rule focused on avoidance transactions: adopts a "main purpose" test: no treaty benefit if it is reasonable to conclude that one of the main purposes for undertaking a transaction, or series of transactions is to obtain the benefit.*
  - *Conduit presumption: if income is primarily used to pay, distribute or otherwise transfer an amount to another person that would not have been entitled to an equivalent or more favorable benefit had the other person received the income directly.*
  - *Safe harbors: active business test/ownership test/publicly traded test*

United Kingdom

Release of paper on UK priorities for the BEPS Project

- On March 19, in conjunction with Chancellor Osborne's presentation of his budget to Parliament, HMRC released a paper describing UK priorities for the BEPS project
- The UK supports the BEPS action plan and believes in coordinated international action to prevent BEPS
- The UK does not intend to act unilaterally

Some specific positions

- Although the digital economy should not be subject to separate rules, the digital economy does highlight issues about whether the PE threshhold should be re-examined
- The UK believes that country-by-country reporting is essential to give all tax authorities the ability to detect where improper base shifting may have occurred
- The UK patent box is not a harmful tax practice; it requires an appropriate level of economic activity in the UK and applies equally to domestic and international activity
- The UK has already implemented appropriate CFC and interest stripping rules; other group members should do the same

Netherlands

- **The NL deputy Minister of Finance in charge of taxation and the Minister of Foreign Trade and Development Aid addressed a number of aspects of international tax policy in a joint memorandum to NL Parliament dated 30 August 2013:**
  - The Netherlands is an active supporter of increasing transparency e.g. through exchange of information and through enhanced corporate reporting. For the Netherlands it is important to apply a coordinated approach with the other EU and OECD Member States;
  - The OECD Action Plan and cooperation with the G-20 are a promising framework for making the rules more restrictive globally; The Netherlands has indicated to OECD that developing countries should be involved in this process;
  - The Netherlands is enthusiastic about the projects that have started on the basis of the OECD's Action Plan and especially improving transparency. The government will keep a watchful eye on making sure that such projects are in accordance with developments within OECD, that a global level playing field is secured and that no double work is done.
  - The Netherlands government has decided that it will be approaching 23 low income countries with which a tax treaty has been concluded to explore whether these jurisdictions might want to amend the existing treaties and e.g., include anti-abuse clauses. This plan was announced in an August 2013 joint letter to Parliament by the deputy Minister of Finance and the Minister of Foreign Trade and Development Aid

Germany

November 2013 Agreement of the German coalition government

- Radical tax reforms are not envisioned.
- Agreement expresses support of the OECD-BEPS initiative and contemplates National measures if applicable in anticipation of international regulations or if the objectives of the BEPS-initiative have not been reached
- Other measures contemplated by the Agreement Include
  - Limitation on the deduction of business expenses for license expenditure and for payments to “letterbox
  - Prevention of double non-taxation through relevant DTT-clauses and, where applicable, through national regulations
  - Introduction of a “country-by-country-reporting” between tax administrations
- Recent Tax Law Change on Hybrid Debt Arrangements (Germany as lender)
  - Denial of dividend exemption to the extent payments are deductible at debtor level (trade tax exemption may still be achievable)
  - New rules generally applicable as of 1 January 2014

Ireland

- **In October, 2013, Ireland's Finance Ministry Issued a Policy Statement on Ireland's "International Tax Strategy" which states that:**
  - Ireland welcomes the BEPS project, and also the coordinated effort at the OECD/G20 level to deal with the challenges BEPS poses.
  - The purpose of the project is to better align the right to tax with real economic activity. We already do this – profits charged in Ireland reflect substantive operations here – and we are fully supportive of solutions that would extend the alignment of tax and real economic activity internationally.
  - Ireland is taking an active part in the BEPS project and we are committed to working with our OECD colleagues to address aggressive international tax planning.
- **Changes to Irish Nonresident company rules: Ireland plans to enact legislation banning "stateless" companies, i.e., MNEs that are incorporated in Ireland but without tax residence anywhere**

France

- **Anti-hybrid provision (retroactive effect to FY 2013)**
  - Introduction of an additional condition on the tax deductibility of interest on loans received from related parties
  - Need to demonstrate that the lender is subject, during the same FY, to an income tax (on the interest received) of at least 25% of the standard French income tax
- **Provision on transfer of risks and functions (invalidated)**
  - Parliament passed a provision similar to German exit tax rules on the transfer of risks and functions, but the provision was invalidated by the French Constitutional Court

Australia

- **In July of 2013, the Australian Treasury published a scoping paper entitled ”Risks to the Sustainability of Australia’s Corporate Tax Base”**
  - Highlights that data limitations make it difficult to accurately assess the extent to which Australia’s corporate tax base is currently being impacted by base erosion and profit shifting
  - Makes a number of recommendations focusing on how to better identify, understand and respond to emerging risks in Australia’s corporate tax system.
  - Concludes that international tax rules have failed to keep pace with changes in the global economy and that this has led to growing global concern that this has allowed some multinationals, while acting within the law, to reduce avoid taxation in the countries in which they operate.
  - Recommends updating the rules to address the deficiencies in the tax laws requires the cooperation of the international community.
- **As G20 chair in 2014, Australia has indicated it intends to play a prominent role in determining and driving the base erosion and profit shifting reform agenda**

Mexico

Limitation on Deductions

- No deduction for interest, royalties and technical assistance payments paid to a foreign entity that controls or is controlled by the taxpayer when:
  - The entity receiving the payment is transparent (subject to exceptions)
  - The transaction is disregarded (non-existent) under the foreign entity ‘s tax regime
  - The foreign entity does not consider the payment to be taxable income (hybrid instruments)
- No deduction for payments made to a transparent entity or an entity with an income subject to preferential tax provisions unless the taxpayer proves arm’s length comparability for the transaction
- A Mexican taxpayer cannot deduct a payment that a related party (foreign or domestic) may also deduct, unless the related party is also picking up the related income (double dips)

Information Gathering

- Mexico has concluded the intergovernmental agreement on FATCA
- Mexico has been accepted in a pilot program on automatic exchange of tax information with the EU

US - Camp BEPS-Related Proposals

- **Add “Foreign Base Company Intangible Income” to Subpart F**
  - Generally, FBCII equals the excess of (1) the CFC’s adjusted gross income over (2) 10% of the CFC’s year-end tax basis in “qualified business asset investment”
- **Provide deduction for “Foreign Intangible Income”**
  - US shareholders also would receive a deduction for an “applicable percentage” of foreign intangible income
    - After 5 year phase-in, this deduction effectively taxes all foreign intangible income at 15%
- **Revise high-tax exception for Foreign Base Company Income**
  - Generally equal to maximum corporate rate, i.e., 25%
  - Special (lower) rates for FBCSI and FBCI
- **Modify Foreign Base Company Sales Income rules**
  - High tax exception (12.5%) and treaty exemption
- **Impose additional limitations on interest stripping**

US - Camp BEPS-Related Proposals (cont'd)

- **Deny deductions for reinsurance premiums related to foreign reinsurance companies**
- **Deny treaty benefits when common parent is not eligible for treaty benefits**
  - Applies where foreign reinsurance company's income is not subject to US tax

US – Baucus BEPS Related Proposals

- **Limit base shifting through intangible property transfers**
- **Deny deductions for hybrid payments and payments through conduits**
- **Repeal portfolio debt exception for debt issued by US corporations**
- **Codify look-through treatment for determining ECI when a foreign person sells an interests in partnerships engaged in a USTB**
- **Deny deductions for payments to foreign reinsurance companies**
- **Treat as a corporation any foreign affiliate wholly or partially owned by another foreign affiliate (i.e., partial repeal of CTB) Provide disfavored treatment for hybrid dividends**
  - No DRD for certain hybrid dividends paid by CFC
  - No exemption from subpart F for certain hybrid dividends between CFCs

US The Administration's FY2015 Budget – International Tax Proposals

Proposals from FY2014 budget

- Defer deduction for interest related to deferred income of foreign subsidiaries
- Determine foreign tax credit on a pooling basis
- Tax currently excess returns on intangible property transferred offshore
- Limit shifting of income through intangible property transfers
- Disallow deduction for untaxed reinsurance premiums paid to affiliates
- Modify tax rules for dual capacity taxpayers
- Tax gain from sale of partnership interests on look-through basis
- Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment
- Extend section 338(h)(16) to asset acquisitions
- Remove foreign taxes from 902 corporation's foreign tax pool when earnings are eliminated

US - The Administration’s FY 2015 Budget– International Tax Proposals (cont’d)

New proposals in FY2015 budget

- Restrict deductions for excessive interest of members of financial reporting groups
- New Subpart F category for transactions involving digital goods and services
- Prevent avoidance of foreign base company sales income through manufacturing service arrangements
- Restrict use of hybrid arrangements that create stateless income
- Limit application of Subpart F exceptions to reverse hybrid transactions that create stateless income
- Limit the ability of domestic entities to expatriate

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