OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT — FINAL REPORTS RELEASED

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Tax Alert

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On October 5, 2015, the Organisation for Economic Co-operation and Development ("**OECD**") published final reports outlining the "actions" to be undertaken by OECD members as part of the base erosion and profit shifting ("**BEPS**") project. The BEPS project has focused on renovating international tax rules that have largely not been subject to extensive review for a significant amount of time and have, as a result, failed to keep pace with the modern global economy.

The final reports contain action items requiring further development by OECD members before action items are implemented into the domestic laws of member states. According to the explanatory statement accompanying the reports, the OECD and G20 countries will extend their cooperation on BEPS until 2020 to complete pending work and ensure implementation of measures by member states is monitored. With international tax issues continuing to be high on the political agendas of most OECD countries, the closing stages of the BEPS project is likely to trigger legislative action in most member jurisdictions.

BEPS Actions

- Action 1 - Addressing the Tax Challenges of the Digital Economy
- Action 2 - Neutralising the Effects of Hybrid Mismatch Arrangements
- Action 3 - Designing Effective Controlled Foreign Company Rules
- Action 4 - Limiting Base Erosion Involving Interest Deductions and Other Financial Payments
- Action 5 - Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
- Action 6 - Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
- Action 7 - Preventing the Artificial Avoidance of Permanent Establishment Status
- Actions 8–10 - Aligning Transfer Pricing Outcomes with Value Creation
- Action 11 - Measuring and Monitoring BEPS
- Action 12 - Mandatory Disclosure Rules

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- Action 13 - Transfer Pricing Documentation and Country-by-Country Reporting
- Action 14 - Making Dispute Resolution Mechanisms More Effective
- Action 15 - Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

The Actions 8–10 reports relating to transfer pricing rules will be of particular interest to multinational enterprises given the recent focus of tax authorities on transfer pricing issues.

ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION

Transfer pricing issues generally arise where related entities — whether between related companies or between a company and its branch — trade with each other.

When independent enterprises transact with each other, the conditions of their commercial and financial relations ordinarily are determined by market forces. When associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way, although associated enterprises often seek to replicate the dynamics of market forces in their transactions with each other.

The mischief that transfer pricing rules attempt to address is where the pricing between entities, i.e. transfer pricing, does not reflect market forces and the tax liabilities of related entities are distorted causing loss of revenue in the jurisdiction of one or in some cases both jurisdictions of the related entities.

Existing OECD transfer pricing rules found in Article 9 of tax treaties are based on OECD and UN Model Tax Conventions and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. These rules apply the "arm's-length principle" to determine appropriate pricing conditions between members of multinational groups.

The BEPS actions in this area have focused on clarifying and strengthening the existing standards and OECD guidelines. This has included guidance on the arm's-length principle and an approach to ensure the appropriate pricing of hard-to-value-intangibles has been agreed upon within the arm's length principle.

The BEPS project on transfer pricing has focused on the following key areas:

- **Intellectual Property and Other Intangibles:** Action 8 considers transfer pricing issues relating to controlled transactions involving intangibles since intangibles are by definition mobile and they are often hard-to-value. Consistently with previous statements on intangibles, the report does not attempt to allocate the returns to the party in the multinational entity that merely owns the assets, but prefers to allocate these to group members that control economically the risks and returns. Misallocation of the profits generated by valuable intangibles has heavily contributed to the base erosion and profit shifting problem.
- Under Action 9, contractual allocations of risk are respected only when they are supported by actual decision-making and thus exercising control over these risks.

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- Action 10 focuses on other high-risk areas, including the scope for addressing profit allocations resulting from controlled transactions that are not commercially rational, the scope for targeting the use of transfer pricing methods in a way that results in diverting profits from the most economically important activities of the multinational enterprises ("**MNE**") group, and the use of certain type of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with the value-creation.

The final report on Actions 8–10 revises guidance that responds to these issues and aim to ensure transfer pricing rules secure outcomes that better align operational profits with the economic activities that generate them.

IMPLEMENTATION

The implementation of the BEPS project actions in a globally coordinated fashion will be a complicated task.

The K&L Gates Global Tax Team is monitoring Government responses across a range of jurisdictions to identify issues of relevance to our clients.

Australia

On October 6, 2015, the Australian Treasurer welcomed the release of the reports but highlighted the "strong measures already taken" by the Australian Government to "attack the heart of the multinational tax avoidance problem".

Draft legislation already has been released in Australia to:

- Bring offshore supplies of digital products and services within the goods and services tax (value-added tax) net;
- Extend Australia's anti-avoidance regime to multinational tax avoidance; and
- Adopt OECD standards on transfer pricing documentation and country-by-country reporting.

Relevantly, the Treasurer's media release indicated that no major issues were expected to arise from an Australian perspective for any of the BEPS actions other than in relation to Action 14 (Dispute Resolution) and 15 (Multilateral Tax Treaties). This appears to be largely due to the fact that many of the features advocated by the OECD (in relation to transfer pricing, CFC rules design and thin capitalization) are already incorporated into Australian domestic law.

In relation to Actions 8–10, the media release stated no fundamental change to Australia's transfer pricing rules would be required, but noted that "enhanced guidance" would be provided to help the Australian Taxation Office's administration of those rules.

A recent judgment of the Federal Court of Australia is Australia's most significant transfer pricing decision in recent years and will be of interest to other jurisdictions. Most OECD jurisdictions incorporate the arm's length principle in some form into their domestic legislation and bilateral treaties and also rely on the OECD transfer pricing guidelines in interpreting their domestic rules.

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The findings of the Federal Court are particularly relevant to the matters considered in Action 9 of the BEPS project, which addresses the levels of returns to funding provided by a capital rich multinational entity group members, where those returns do not correspond to the level of risk and activity undertaken by the funding company. An appeal is likely.

France

The French Finance Minister, in an October 2015 press release, said that French tax law is, in certain respects, already in line with the "highest" international standards and in particular regarding Action 4 on the limitation of base erosion involving interest deductions and other financial payments. The Minister further indicated that it plans to introduce, in the Amended Finance Bill for 2015, rules on country-by-country reporting, in accordance with Action 13.

The French government, in light of Actions 11 and 13 of the reports, already implemented in 2014 an obligation for large companies to provide full contemporaneous transfer pricing documentation as of the first day of a tax audit, as well as a simplified documentation within six months of filing the tax return for the relevant assessment year. The finance bill for 2016 proposes to expand the scope of the annual disclosure to encompass information for countries in which group companies that hold intangibles, or with which intragroup transactions are carried out, are established.

In relation to Action 2 (Hybrid Mismatch Arrangements), the 2014 finance bill introduced a rule according to which interest on related party loans is tax deductible only if the French borrower can prove that such interest is subject to an income tax in the hands of the lender at a rate equal to at least to 25 percent of the French standard corporate income tax rate.

Germany

Following the publication of the final BEPS reports by the OECD and their subsequent approval during the G20 meeting of the finance ministers and central bank presidents in Lima, the German Federal Ministry of Finance has emphasized its continuous support for the BEPS project. The Ministry again has stressed the relevance of the BEPS agreement for avoiding double taxation as well as double non-taxation, mitigating unfair international tax competition as well as improving the exchange of information, and transparency between the fiscal authorities.

The Federal Ministry of Finance further refers to its predominant goal of creating a "level playing field" meaning that mainly certain other states would have to stop unfair competition and that all states should strive to create comparable standards of taxation, closing existing tax loopholes. As far as Germany is concerned, the Federal Ministry of Finance is convinced that German tax law — by international standards — is already equipped with a robust tool kit allowing to efficiently fight abusive structures and artificial profit shifting.

Hence, the legislative measures implementing BEPS in Germany will be limited to a selected — and yet to be determined — few once taking into account that no such measures should finally prove to being overly burdensome for entrepreneurs doing business in Germany.

The German federal government will continue to expand and intensify the cooperation between the fiscal authorities around the globe

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United Kingdom

The UK government is an enthusiastic political sponsor of the OECD/G20 BEPS Project and HM Treasury has recently announced the UK government will continue to lead in international efforts to clamp down on tax avoidance and aggressive tax planning as part of its international and domestic policy agenda.
"Now that the [BEPS] process is complete, the UK government will continue to work with the G20 and other international partners to take forward the recommendations".

The UK government has anticipated some of the BEPS Actions with unilateral legislative action including Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status) with the introduction of the Diverted Profits Tax (at 25%) with effect from April 1, 2015.

The UK government is currently engaging in public consultation on:

- Action 4 (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments)
- Action 5 (Countering Harmful Tax Practices etc.) and Actions 8–10 (Aligning Transfer Pricing Outcomes with Value Creation) in the context of Intellectual Property and the reform of the UK's Patent Box Regime.

The UK government is also committed to continue to create the most competitive tax system in the G20 as part of its international and domestic policy agenda, which necessitates a relative degree of tax system stability (which may include a complex array of "grandfathering" arrangements).

Accordingly, for the foreseeable future, it will remain imperative for both existing and planned cross-border structures and arrangements within the scope of the BEPS actions including UK participants to be kept under constant review and independently of the BEPS timeframe.

United States

It is quite clear that U.S. multinationals will be greatly impacted by the BEPS project. For example, as detailed above, so called intellectual property ("**IP**") cash boxes (or returns solely based on legal ownership of IP) will generally no longer be a viable planning strategy. Further, it is believed that at least 1,600 US based multinationals will be subject to enhanced reporting under the forthcoming country-by-country reporting regime. Although debt push-down structures and the use of interest deductions are expected to remain a legitimate planning technique, some benefits are likely to be curtailed.

While almost all U.S. treaties contain a limitation on benefits clause (and the United States has signaled its intent on keeping its current more bright line limitation on benefits provisions over more nebulous principal purpose or anti-avoidance rules) the broader adoption of limitation on benefits clauses will likely make use of third country holding companies less beneficial for U.S. acquirers in the outbound acquisition context.

Finally, one of the biggest concerns moving forwarding from a U.S. perspective is the U.S. Treasury's desire to promote mandatory binding arbitration and dispute resolution provisions as part of the multilateral instrument that will be used to implement many of the BEPS provisions.

HOW THE K&L GATES GLOBAL TAX PRACTICE CAN HELP?

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Tax law and practice is becoming increasingly global in nature. The K&L Global Tax Practice provides our clients with seamless tax solutions across its multiple offices in the United States, Australia, UK, Europe and Asia.

With 70 specialists across the regions, the ability to provide comprehensive tax advice across a wide range of jurisdictions, and in collaboration with our specialists in asset and corporate finance, investment funds, international capital markets and corporate law, is an unparalleled advantage for our clients. We have experience in assisting our multinational clients negotiate the transfer pricing regimes across multiple jurisdictions and the changes to those regimes occasioned by the OECD BEPS project.

View our tax specialists at: www.klgates.com/tax-practices/#professionals

KEY CONTACTS



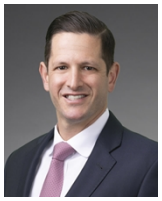
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