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International Taxation – OECD Reboot for the 21st Century

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Introduction

Following on its February 2013 report on Addressing Base Erosion and Profit Shifting (BEPS), the Organisation for Economic Co-operation and Development (OECD) has now released an ambitious action plan (Action Plan) that aims within the next 24 months to fundamentally overhaul the taxation of multinational enterprises. The Action Plan, which the OECD states has broad political support, seeks to introduce dramatically increased transparency and information sharing between multinational entities and taxing authorities. It also could ultimately affect many multinational tax and business structures, including those not viewed as involving aggressive or abusive planning.

At its heart, the Action Plan seeks to eliminate double non-taxation of corporate income and curtail tax minimization strategies that involve the segregation of taxable income from the business activities that generate that income. These issues regarding the taxation of multinational enterprises in the global economy have risen to the top of the political agenda and have become the focus of leading multilateral organizations, including the G20 and the OECD. The Action Plan claims strong political backing among OECD member countries as well as the G20 countries (including the eight G20 countries that are not OECD members), and the OECD expects public endorsement of the Action Plan from all the G20 countries, all of which have been invited to join the BEPS project on an equal footing to carry out the Action Plan.

The Action Plan is as far-reaching in its scope as it is ambitious in its timeframe. It aims to address nearly all of the issues identified in the report by either September 2014 or September 2015. Certain of the Action Plan's items are likely to be more easily implemented, in particular those focused on procedural enhancements regarding tax transparency and disclosure, as well as modifications to model treaties. Others, which implicate more complicated tax policy issues and require broader domestic law changes, are likely to require more time to achieve consensus and action.

Given the Action Plan's ambitious timeframe and its apparently strong political backing, multinational enterprises that will be affected by the BEPS project will need to engage expeditiously with policymakers to provide input regarding the business community's views on the issues addressed by the Action Plan.

The Action Plan

Broadly, the Action Plan covers three main areas:

- *Consistency* – addressing gaps and inconsistencies between countries' domestic tax laws that allow for double non-taxation;
- *Transfer pricing* – addressing the issue of tax competition that results in no or low taxation when taxable income is separated from related business activities; and
- *Transparency* – increasing transparency and tax disclosure to facilitate the monitoring of the BEPS issue.

The specific topics identified in the plan as action items, and the proposed next steps for addressing these topics, include:

- *The digital economy* – establishment of a task force to identify the main difficulties that the digital economy poses for existing international tax rules and development of detailed options to address those difficulties. Both direct and indirect tax will be covered, and the key areas to be addressed are (i) the definition of the concept of a permanent establishment (PE), which, according to the Action Plan, does not properly account for the ability of a business to have a significant digital presence, but not a taxable presence, in a jurisdiction, (ii) further consideration of the sources of value creation in the digital economy, such as value attributable to data created in a particular jurisdiction, and the proper sourcing and taxation of the income attributable to those activities, and (iii) the treatment of services provided to users where the provider's business model aims to attract users for reasons other than the collection of fee revenue.

- *Hybrid mismatches* – development of model treaty provisions and recommendations for domestic rules to neutralize the tax benefits achieved through the use of hybrid entities and hybrid financial instruments. These are expected to include provisions that prevent tax exemption for a payment that is tax deductible for the payor, and provisions that deny a tax deduction for a payment where either a tax deduction is available elsewhere or the payee is not subject to tax on the payment.

- *CFCs* – development of best practices and model legislation for CFC rules with a view to strengthening the CFC rules to blunt the incentives that multinational companies have to achieve double non-taxation of income.

- *Interest deductibility* – development of best practices and model legislation for deductibility of interest and other financial payments (such as financial and performance guarantees, derivatives, and captive and other insurance payments) with a view to preventing base erosion through the use of excessive related-party and third-party indebtedness.

- *Harmful tax practices* – strengthening existing rules to counter harmful tax practices, with a priority on enhancing transparency. Included in the review will be the treatment of tax rulings, including rules regarding compulsory exchange of tax rulings related to preferential regimes. The review will also examine certain increasingly common preferential tax regimes, such as patent box rules, and provide guidance regarding the proper scope and implementation of such regimes.

- *Treaty abuse* – development of model treaty anti-abuse rules and recommendations for model domestic rules to neutralize treaty abuse, such as use of low-taxed branches of a foreign company and conduit companies.

- *Prevent artificial avoidance of PE status* – development of a revised definition of PE to prevent businesses from organizing their affairs in a country in a manner that generates profits in that country without having a taxable PE. Commissionaire arrangements will also be reviewed.

- *Transfer pricing* – development of rules to ensure that taxable profits are allocated to the jurisdictions in which value is created, with a focus on the following three areas:

  – *Intangibles* – this will involve a number of measures, including defining the meaning of "intangibles," ensuring that profits relating to the transfer and use of intangibles are appropriately allocated in line with value creation, developing transfer pricing rules for hard-to-value intangibles, and updating guidance on cost-contribution arrangements.

  - *Risks and capital* – development of rules to align taxable profits with value creation, and to allow governments to disregard related-party contractual and risk-shifting arrangements, and instead allocate income on the basis of the location of business operations.
  - *High-risk activities* – development of rules to re-characterize transactions that would not, or would only very rarely, occur between third parties.

- *BEPS data* – establishment of methodologies to collect and analyze data on BEPS and the actions to address it.
- *Compulsory disclosure of aggressive or abusive tax planning to authorities* – development of recommendations and model legislation for the mandatory disclosure of aggressive or abusive transactions, arrangements or structures.
- *Country-by-country reporting* – development of rules mandating the disclosure of information by businesses to relevant governments, together with a template for the reporting. This is primarily focused on transfer pricing documentation to enhance transparency for tax administration. It is envisaged that multinational enterprises will have to disclose to relevant governments details of their global allocation of income, economic activity and taxes paid among different countries.
- *Mutual agreement procedures* – development of solutions to streamline mutual agreement procedures between countries, including the expanded use of compulsory arbitration where competent authorities cannot agree on an outcome.
- *Multilateral treaty* – development of a multilateral convention to address BEPS issues. This will allow interested countries to rapidly implement some of the measures developed by the BEPS project, such as the treaty anti-abuse rule, without having to renegotiate bilateral treaties. The tax and public international law issues related to the development of such a multilateral treaty will need to be analyzed.

Commentary

The BEPS Action Plan is an ambitious undertaking that would require fundamental changes to the current system of international taxation. If ultimately adopted by member countries, measures arising from the Action Plan are likely to significantly impact many, if not most, international business structures, including those that do not involve aggressive or abusive tax planning. While the OECD does not have legislative authority, there is substantial political will behind the BEPS project and wide support from the G20 countries. It is noteworthy that all of the G20 countries, including those which are not OECD members, are expected to both support and, on an equal footing, join the program set forth in the Action Plan. This indicates a unified commitment to tackle BEPS, which suggests that many of the measures developed in light of the Action Plan will be seriously considered at the national level. In particular, the concern in the U.S. is the possibility that advocates of legislation developed under the Action Plan can argue that adopting the provisions will not adversely affect the competitiveness of U.S. multinationals because if the U.S. enacts them other countries will do so as well.

Certain of the topics addressed in the Action Plan are likely to proceed on an accelerated basis. New procedural rules regarding enhanced tax transparency and disclosure may well advance rapidly. For example, the Action Plan proposes mandatory reporting by businesses of certain tax information, including the use of "aggressive tax planning strategies" and country-by-country transfer pricing data. The OECD is also proposing a framework for the automatic exchange of information between countries, such that each taxing body will be more aware of the operations of companies within its jurisdictions, together with how those companies fit into the value chain. In addition, countries that offer favorable taxing regimes, often involving the ability to obtain a tax ruling, are likely to face increasing pressure to alter their rules regarding tax rulings, including in ways that could significantly impact their tax revenues.

The enhanced transparency proposed in the Action Plan could well be implemented relatively quickly and would likely prompt increased governmental and broader public scrutiny of corporate tax practices. Indeed, the Action Plan's transparency agenda dovetails with recent announcements in both the U.S. and the U.K. In the U.S., the Obama Administration has signaled an interest in at least some kind of business tax transparency. In the U.K., the government has taken a much more detailed approach already, and has recently announced an initiative to radically expand corporate transparency and boost public trust in business. The U.K. proposals in this area include proposals for a central public registry of beneficial owners who hold more than 25 percent of the shares or voting rights in a U.K. company, abolition of bearer shares, disclosure of nominee director status and abolition of corporate directors. The U.K.'s proposals are just one example of how governments are responding to public and media demand for complete transparency and openness in the business environment. It will be critical to monitor the uptake of the broadly phrased OECD proposals in both the U.S. and the U.K.

The OECD may also be able to proceed quickly with revising model treaties to address hybrid entity and hybrid instrument mismatches, enhance MAP provisions to improve dispute resolution, and tighten treaty anti-abuse and limitation on benefits rules. And though not likely to be addressed through treaties, model legislation regarding thin capitalization rules could be released relatively quickly, with the potential for swift and broad-based implementation through domestic legislative change.

Other issues addressed in the report — those implicating more complex technical and policy issues and requiring greater domestic law changes — will likely take longer to implement. Addressing issues surrounding the taxation of the digital economy and revisions to the PE rules to address newer, technology-driven business models; developing model CFC legislation; and altering transfer pricing rules may well take a longer time both to reach international consensus and to achieve implementation.

The proposed changes to transfer pricing arrangements are particularly wide-ranging, and will likely require considerable changes to the detailed local transfer pricing rules that have been adopted to date by supporting countries. The ability to disregard related-party contractual and risk-shifting arrangements and allocate income in accordance with value creation may be a difficult concept to legislate appropriately. But perhaps even more challenging will be achieving international consensus and drafting rules to address the proper allocation of income between source or market countries on the one hand and developer countries on the other.

The Action Plan also includes a proposal for the development of a multilateral treaty that can allow signatories to swiftly adopt some of the measures outlined in the Action Plan is a novel approach to international taxation that can potentially accelerate the implementation of a number of measures. Of note, the OECD views the multilateral treaty as a platform to address other international tax issues, and not just BEPS. If the OECD is successful in tackling BEPS, the multilateral treaty platform could well be expanded to other areas of international taxation.

Given the Action Plan's broad reach and its aggressive timeframe, businesses that are likely to be affected by the Action Plan should consider engaging proactively and promptly with policymakers at the domestic and international levels to raise concerns and provide input regarding the BEPS project. Given the Action Plan's aim to address nearly all the above-described issues raised within the next 24 months, ordinary channels of engagement may not be sufficient to allow the business community to provide timely input regarding these tax issues that are of critical import to the multinational business community.

Conclusion

With the Action Plan that it has released, the OECD has set forth an ambitious agenda for tackling in a short time frame the problems of corporate tax base erosion and profit shifting. The Action Plan is comprehensive in its scope — seeking to address virtually the entire range of international tax issues facing, and opportunities available to, multinational enterprises. Multinational companies will have to carefully monitor and quickly respond to developments in the BEPS project, many of which could impose significant tax and non-tax costs on businesses and meaningfully impact the way multinational enterprises conduct their global operations.