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Lessons From 2019: Impact of BEPS on Cross-Border Transactions

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In 2019, a number of common themes emerged from cross-border transactions that have continued to demonstrate the impact of the 2014 Base Erosion and Profit Shifting (BEPS) actions. These themes, which we anticipate will gain even more traction in the coming years, impact all stages of a transaction, including due diligence, structuring and valuation, integration, reporting and ongoing operation of group structures.

Shift to Substance

Increasingly, multinational groups face a marked structural shift toward aligning jurisdictions in which tax outcomes are realized and reported with the jurisdictions in which the people who contribute to those outcomes are located. This has manifested prevalently through revenue authorities feeling empowered by BEPS to deploy two-sided, function-driven transfer pricing approaches (looking at the entire value chain rather than just the tested transaction), coupled with unilateral measures such as diverted profits taxes. Advisers anticipate that the introduction of the principal purpose test in determining eligibility under tax treaties (which means taxing authorities will deny the benefit of a covered treaty if the principal purpose of the structure is to obtain treaty benefits) will require business and commercial considerations to be at the center of multinational group structuring. This shift toward substance — which oversimplified, implies real people working in a real business — may mean reduced flexibility in operating models and holding structures. Many transactions, both internal and external, already have reshaped economic flows in a way that ensures substance is more fully recognized, including by transferring intangible assets onshore.

Financing and Its Impact on Deal Costs

BEPS outcomes have perhaps been shown in their starkest light in the context of financing transactions, with changes including (i) interest restrictions based on a proportion of earnings before interest, tax, depreciation and amortization (EBITDA) or a similar metric, (ii) rules neutering advantages from hybrid structures (double deductions or deduction/no inclusion scenarios) and (iii) stricter requirements to qualify for reduced withholding rates under tax treaties. Each of these changes can be relevant in both internal and external financing transactions and potentially has a noticeable, immediate and direct effect on a group's effective tax rate.

Multinational groups will aim to maximize their use of allowable debt capacity under these new rules but will need to train themselves to reliably predict future EBITDA by jurisdiction. There also now will be an increased incentive to ensure that each jurisdiction within a group takes on a suitable share of any debt, bringing internal on-lending, "push-down" and similar structures to the fore again. However, whether utilizing debt capacity within a jurisdiction will be perceived by tax authorities as an acceptable reason to introduce debt remains to be seen.

Additional Reporting Requirements

In addition to substantive tax rules, the BEPS outcomes also introduced a new form of aggregated information sharing for large, multinational companies: country-by-country reports (CbCR). In addition to local tax returns, multinationals within the scope of CbCR must maintain and share with tax authorities on an annual basis a form identifying numerous relatively rigid data points. Because of the format, CbCR can never tell the whole story accurately and inevitably require a good deal of translation for tax authorities

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or prospective buyers who access CbCR through diligence. Currently, CbCR are confidential, but political pressure exists from some parties, especially in the European Union, to make them publicly available. Additional reporting considerations and the systems required to support and enable CbCR are already increasing compliance costs.

Coping With Uncertainty

Though many rules deriving from BEPS are in force, they remain largely untested. Scoping a diligence exercise to capture the ever-shifting global tax frameworks is becoming an art. Though some of the rules may be formulaic, it is unclear whether any group operating in a multinational environment will ever be fully "BEPS compliant."

Prudent transaction valuations may start to build in a buffer for the potential impact of some of the rules, as modelling for the future is equally critical and uncertain. More than ever, forecasting teams will require a full understanding of projected revenue streams, the jurisdiction(s) in which revenues arise, and jurisdiction-by-jurisdiction details of the implementation of and timetable for the BEPS proposals. One effect is that different market participants may have greater variance in their perceptions of deal value and synergies and, therefore, in pricing.

Each of the factors mentioned above suggests that tax will remain an area of high focus in managing cross-border transactions. The proper integration, upkeep and refreshing of structures must not be ignored, including ongoing assessments as to whether the operations follow the assumptions made in diligence or modelling. In addition to managing transactional downside risk, flexible tax and legal teams also may realize opportunities in the changing international landscape.