BEPS and Developing Countries

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BEPS – Technical Issues

- Technical Issues
  - Taxation of digital transactions (Action 1) - income tax and VAT
  - Cross-border tax arbitrage (Action 2) – hybrid entities and instruments
  - Controlled foreign companies (Action 3)
  - Financing transactions (Action 4) – mainly thin capitalisation
  - Harmful tax competition (Action 5)
  - Treaty shopping (Action 6)
  - Avoiding PE status (Action 7)
  - Transfer pricing locating value added with intangibles (Actions 8-10)
- Note: none of these issues are new
- Tax treaty implementation through a multilateral treaty (Action 15)

BEPS – Administration Issues

- Access to information (Actions 5, 12 & 13)
  - Unilateral
    - Mandatory disclosure of aggressive tax positions
    - Country by country (CbC) reporting
  - Bilateral/multilateral exchange of information
  - Automatic exchange of rulings
- Dispute resolution (Action 14)

BEPS Mantra

- MNEs should pay tax where they earn their profits
- International norm – source country has right to tax business profits provided there is a sufficient economic presence in the country to support the taxing right
  - Concept of "permanent establishment" (PE) defines a sufficient economic presence
  - PE taxing rule developed in 1920s and 1930s through the work of the League of Nations
    - "Bricks and mortar" world
- BEPS concern = there has developed a disconnect between the location of economic activity and the location where profits are earned
  - Substantial profits can be earned without a PE
  - Most evident with digital transactions and services

Expectations with BEPS

- 2013 Report gave the impression that BEPS would result in a complete rethink of the international tax rules
  - "The OECD is committed to delivering a global and comprehensive action plan based on in-depth analysis of the identified pressure areas with a view to provide concrete solutions to realign international standards with the current global business environment. This will require some "out of the box" thinking as well as ambition and pragmatism to overcome implementation difficulties, such as the existence of current tax treaties."
  - "a holistic approach is necessary to properly address the issue of BEPS"

Admissions

- Important admissions in 2013 Report
  - Tax treaties “may” facilitate tax profit shifting
    - Undeniably tax treaties have contributed to base erosion in developing countries
    - Absence of a anti-treaty shopping rule has facilitated this
  - OECD’s earlier position on PEs and electronic commerce (outlined at paras 42.1 – 42.10 of Commentary to OECD Model DTA) may not have been the right solution to the problem of source taxation of profits from electronic commerce

Did BEPS Deliver?

- On technical issues – not really
- No fundamental rethink of international tax rules
- Some measures to address aspects of base erosion
  - Action 2 – priority to source taxation in the case of tax arbitrage involving hybrid financial instruments/hybrid entities
  - Action 4 – use of EBITDA as the basis for limiting interest deductibility
- But no comprehensive plan to deal with base erosion
  - Is this why the UK and Australia have gone it alone on base erosion?
    - UK's diverted profits tax and Australia's multinational anti-avoidance law are a more direct attack on base erosion

Did BEPS Deliver?

- Nothing more than a “tinkering around the edges” of the international tax rules
  - Action 1 came up with no new solutions to income taxation of digital transactions just raised matters for further consideration
  - Action 6 has finally seen the OECD agree to an anti-treaty shopping Article in tax treaties – why has this taken so long?
  - Action 7 addressed some long-standing weaknesses with the definition of PE
    - But no fundamental rethink of the PE concept in the context of digital transactions and services
- Is the OECD the right organisation to be in control of the BEPS project?
  - Not a genuinely international organisation
  - Member countries are essentially the world’s developed economies
    - Does it have any mandate to act for developing countries?

Did BEPS Deliver?

- On the information side, Country by Country reporting ("CbC") is a significant development
  - CbC report sets out the global allocation of MNE group's income and taxes, and the indicators of location of economic activity within the group
  - Will CbC reporting facilitate a move to global formulary apportionment and thereby result in the end to the arm's length principle?

Action 2 – Cross-border Tax Arbitrage

- Cross-border tax arbitrage - planning to benefit from differences in income tax laws between two countries
- Final Report focuses primarily on hybrid financial instruments and hybrid entities
  - Comprehensive and highly technical
  - Other forms of arbitrage, such as cross-border leasing
- Rise of exemption systems in OECD countries has increased the opportunities for tax arbitrage involving hybrid instruments and entities

Options for Countering Tax Arbitrage

- First best solution is for the two states to agree a common characterisation
  - Harmonised tax laws
  - DTA
- Domestic law response - Action 2 recommends
  - (1) Taxation in the source state should depend on the tax treatment in the residence state (preferred)
    - Priority to source taxation
  - (2) Taxation in the residence state follows the source characterisation (UK approach)

Action 4 – Financing Transactions

- Traditional approach in countering thin capitalisation
  - Legislated acceptable debt-to-equity ratio
    - 3:1 has been the norm
    - Trend to lower ratio – 2:1 or 1.5:1
  - Now rely on IFRS for debt and equity classifications (limits planning)
  - Arm's length debt exception to avoid breach of Article 24 of DTAs
- Generally, thin capitalisation rules have been confined to foreign-controlled resident companies as interest is usually deducted and taxed at the same rate in a purely domestic setting

Action 4 - EBITDA

- Action 4 proposes a new approach to countering thin capitalisation practices
- Targeted generally at debt financing and not focused specifically on non-resident investment
- Interest deductions are limited to a specified ratio of the EBITDA of the company
  - EBITDA is the net income (earnings) of the company before tax with interest, deprecation and amortisation deductions added back
  - Intended that EBIDA is based on tax concepts not accounting concepts
- Each country to determine the acceptable ratio, but Action 4 suggests that it will be in the 10 – 30 per cent range

Developing Countries and EBITDA

- Advantage of EBITDA
  - Both excessive interest rates and excessive debt capitalisation dealt with in a single measure
  - Currently, transfer pricing deals with interest rates and thin capitalisation rules deal with debt capitalisation
  - Sometimes the rules can conflict particularly in relation to interest-free loans
    - TP rules may be used to impute a market interest rate
    - Thin capitalisation rules may treat interest-free loans as equity

Developing Countries and EBITDA

- Disadvantages
  - Inflexible ratio approach
    - Both transfer pricing and thin capitalisation rules have flexibility to deal with taxpayer's particular circumstances
    - Inflexibility will inevitably lead to adoption of a high ratio
  - Concern that inflexibility will distort economic activity as industries have different risk profiles
  - Finance experts are divided on the value of EBITDA analysis
- Not yet agreement in the OECD on the use of EBITDA
  - Germany – the Fiscal Court recently referred EBITDA to Constitutional Court for opinion as to whether a general limitation on interest deductibility (i.e. not limited to avoidance cases) is constitutional
  - Developing countries should await a consensus in the OECD on EBITDA

Action 5 - Harmful Tax Competition

- Tax competition vs harmful tax competition
- The work of BEPS Action 5 is described as follows (page 11 of Final Report)
  - "…the work is about reducing the distortionary influence of taxation on the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place"
- Makes "tax" sound like a commodity that countries trade in a market place to attract MNEs!

Action 5 and Corporate Tax Rates

- Is a low rate of corporate tax harmful tax competition?
- Action 5 – provided a low corporate tax rate (say 10%) is applicable to all corporate taxpayers (resident and non-resident) it is not harmful even if it is lower than rate applicable in other countries
  - Action 5 makes clear that it is the sovereign right of each country to set its income tax base and rates as it decides based on its economic circumstances
  - Concern is preferential regimes aimed at attracting economic activity from other countries rather than generating significant new economic activity
    - Harmful preferential regimes
    - Focus is on geographically <u>mobile</u> activities - finance and other service activities, particularly intangibles

Budgetary Implication for Developing Countries of Tax Competition

- Stated in Action 5 Report that free and fair tax competition is essential in moving towards a “level playing field and continued expansion of global economic growth”
- OECD seems to assume that a “race to the bottom” arises only from harmful tax competition
- Tax competition *per se* has the potential to cause a race to the bottom
  - Impacts on a country’s ability to make ethical decisions concerning the level of public services provided
    - Particular issue for developing countries as they aim to achieve the UN’s sustainable development goals (SDGs)
    - UN has said that developing countries will need to increase their tax revenue as % of GDP if they are to achieve the SDGs
  - Change in revenue mix
    - Increased reliance on consumption taxes, property and other specific taxes, and user charges

Example - Singapore

- Low corporate tax rate (17%) and a number of (non-harmful) preferential regimes
- Tax base shifted to non-mobile factors
- Diversified revenue sources
  - Government's sources of operating revenue for FY 2015
    - Income tax (CIT, PIT, withholding tax) 37.8%
    - GST 16.1%
    - Motor vehicle taxes and vehicle quota premiums 11.2%
    - Asset and property taxes 6.8%
    - Stamp duty 4.3%
    - Customs and excise 4.0%
    - Fees and charges 5.1%
    - Other taxes 9.2%
      - Mainly foreign worker levy, water conservation tax, development charge, and annual tonnage tax

Action 6 – Treaty Shopping

- Recommended a three pronged approach –
  - (1) Include a statement in the preamble that the treaty partners do not intend for the treaty to create opportunities for tax avoidance, including treaty shopping
    - Legal status?
      - Is it just a "motherhood" statement or will it influence interpretation of tax treaties?
  - (2) Inclusion of a Limitation of Benefits (LOB) article in OECD Model
    - Objective based rule
  - (3) Inclusion of a general anti-abuse rule based on the principal purposes of a transaction ("principal purposes test" or "PPT"))
    - Case-by-case analysis

LOB Article

- LOB Article
  - Benefits limited to “qualified persons”
    - Genuine residents of the other CS
  - Active conduct of business exception
    - Holding financial assets not an active business
  - Derivative benefits exception
  - Discretionary relief
- Why has it taken the OECD so long to include a LOB Article in the Model DTA?
- Design of the LOB article to be based on LOB Article in the new US Model Treaty (2016)

Principal Purposes Test

- Treaty benefit denied if reasonable to conclude having regard to all facts and circumstances that obtaining the treaty benefit was one of the principal purposes of the arrangement or transaction that resulted in the benefit
- Applies even to qualified persons
- One of the principal purposes
  - Can there be more than one principal purpose?

Domestic Law Treaty Override

- Action 6 makes recommendations for future treaties or the entering into of protocols in existing treaties (including through the multilateral treaty)
- What about existing tax treaties if multilateral treaty does not apply?
  - Can a state apply a treaty override rule to counter abuse of treaty?
  - May depend on the constitutional status of tax treaties

Action 7 – PE Concerns

- Avoiding an agency PE (Article 5(5))
  - Commissionaire arrangements
  - Substantial negotiation but contracts concluded outside the Contracting State
  - Independent agent exception
- Article 5(4)
  - Overall character of specific activities exemptions
  - Fragmentation of activities into several fixed places of business
- Article 5(3) - splitting up contracts
  - Relevant also for agency PE under Article 5(3)(b) of the UN Model
    - Connected projects
- Amendments proposed to Article 5(4), (5), and (6)
- Proposed that PPT will apply to fragmentation arrangements to avoid a construction PE (Article 5(3)) – why not anti-fragmentation rule?

BEPS Action 15 - Multilateral Tax Treaty

- Implement BEPS reforms through a multilateral protocol to existing tax treaties
  - Open to all countries
- Is a multilateral instrument feasible?
  - While most tax treaties are based on the OECD Model (or UN Model), each tax treaty is a result of a negotiation
    - How can a multilateral treaty capture variations in individual treaties?
    - Will it just lead to increased uncertainty?
  - Rule of thumb with treaties generally is that the more countries involved the less detailed the treaty
    - Dealing with double non-taxation needs more not less detail in coordinating tax laws
- Does a country have to sign up to the whole of the multilateral treaty or can it agree to some amendments only?

Developing Countries and Base Erosion

- BEPS practices - the interests of developed and developing countries do not necessarily coincide
- Base erosion is a major issue for developing countries
  - Unlike for developed countries – what a developing country loses on source taxation is not made up by greater residence taxation
  - Taxation of of cross border services is a significant base erosion problem for developing countries
    - Loss of taxing rights under tax treaties because no PE
    - Major issue for extractive industries where there is a high use of subcontractors

Developing Countries and Base Erosion

- The 2013 BEPS Report created an expectation that base erosion involving services would be addressed, but this has not happened
- Developing countries need to be able to protect their taxing rights over income from cross border services under tax treaties
- As BEPS has not delivered on this issue, what do developing countries do now?
  - If a tax treaty excludes taxation of the services income paid to a non-resident because of the absence of a PE, then can/should the tax base be protected through a deduction denial rule?
    - Loss of double tax relief
    - Breach of treaty??
      - See paragraph 35 to the OECD Commentary to Article 11(6)
  - Is the UK diverted profits tax a model for the way forward for developing countries?

Developing Countries and CbC Reporting

- Action 13 – CbC reporting required only of globally significant MNEs based on an annual group turnover of 750 million euros
- To be filed only in the jurisdiction where the global parent company is resident and then automatically exchanged with the competent authorities of other jurisdictions where the MNE operates
  - Why? Given that the CbC Report is prepared, it should be lodged in all countries where MNC operates
  - Requires information exchange agreements
  - Developing countries?
    - Is this intended to force developing countries in information exchange arrangements with OECD countries?
    - No reason why TP reporting rules in developing countries cannot require CbC report to be filed