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# Getting to grips with the BEPS Action Plan

*What the OECD's planned overhaul of the international tax system means for your business and how you can get ready for the shake-up ahead.*

# Foreword

**Tax management within multinational enterprises (MNEs) has never been more challenging.**

The rapid growth in the volume of transactions subject to transfer pricing and the countries across which supply chains stretch are creating an increasingly tangled web of intra-group and inter-government arrangements. The importance of being able to demonstrate defensible tax policies is heightened by the intensifying spotlight on how transfer pricing is undertaken. Cash-strapped governments are desperately seeking ways to increase revenues. The taxes paid by MNEs are also coming under intense public scrutiny. This has already resulted in a flurry of new national legislation and disclosure requirements in countries around the world.

The Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) Action Plan is set to add yet more complexity to this already fast changing and politically fraught tax landscape. Some of the objectives may be valid. They include the elimination of loopholes that allow profits to 'disappear' for tax purposes and ensuring the tax system keeps pace with the shift towards an increasingly borderless digital economy. The problem is that the scope has broadened to such an extent that the Action Plan will touch almost every area of international taxation.

*It's as if in an attempt to get rid of some traffic black spots, the authorities have decided to overhaul the entire road network and require every driver to modify their car.*

The timeline is equally ambitious. The OECD intends to have all the Action Plan's 15 points agreed and ready to implement by September 2015. It is telling that only 19% of those surveyed in Grant Thornton's International Business Report (IBR) think that the Action Plan is likely to be successful and only 4% very likely.[1]

The larger MNEs we work with are already engaging and gearing up for the changes ahead. Our concerns centre on the disproportionate impact on mid-size MNEs. Few have the resources or capabilities to adapt in the envisaged timelines. We at Grant Thornton are determined to ensure that the legitimate interests and concerns of mid-sized MNEs are not drowned out by the political clamour over tax.

This paper aims to help clients of all sizes to understand the impact of the Action Plan and begin to prepare their businesses. It is not too late to engage in shaping the final form of many of the proposals, which will evolve and be refined over the coming months and into next year. We would very much welcome your feedback and queries as this will help us to present a strong case to policymakers.

**Francesca Lagerberg**
Global leader – tax services

[1] *The Grant Thornton International Business Report (IBR) provides insight into the views and expectations of more than 12,500 businesses per year across 44 economies*



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## Section 1

# Looking out for the pitfalls

The G20[2] and OECD's ambitions go much further than closing tax loopholes. What are the key proposed changes and what risks could they present for your business?

Corporations have urged bilateral and multilateral co-operation among countries to address the anomalies in tax rules that can result in double taxation. But inconsistencies in the rules can also allow income to go untaxed.

BEPS is the term used by the OECD to describe tax planning strategies that take advantage of gaps and mismatches in tax rules. These approaches make profits 'disappear' for tax purposes or divert income to locations where the prevailing rate of corporate tax is low, but where the company carries out little or no real activity.

The 15-point Action Plan presented by the OECD calls for the development of tools that countries can use to shape 'fair, effective and efficient tax systems', based around three core principles – coherence, substance and transparency (see Figure 1). Its proposals have been given additional weight by the strong backing from the G20.

**Figure 1: The BEPS Project**

1. Digital economy

| Coherence | Substance | Transparency |
|---|---|---|
| 2. Hybrid mismatch arrangement | 6. Preventing tax treaty abuse | 11. Methodologies and data analysis |
| 3. Controlled Foreign Company rules (CFC) | 7. Avoidance of permanent establishment status | 12. Disclosure rules |
| 4. Interest deductions | 8. Transfer pricing aspects of intangibles | 13. Transfer pricing documentation |
| 5. Harmful tax practises | 9. Transfer pricing/risk and capital | 14. Dispute resolution |
| | 10. Transfer pricing/high risk transactions | |

15. Multilateral instrument

Source: www.oecd.org

[2] *The Group of Twenty (G20) is the premier forum for its members' international economic cooperation and decision-making. Its membership comprises a mix of the world's largest advanced and emerging economies, representing about two-thirds of the world's population, 85% of global gross domestic product and over 75% cent of global trade.*

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## Need to demonstrate substance

At present, the tax system is still largely geared to a 'traditional' manufacturing economy. The Action Plan seeks to address the move towards an increasingly digital economy. This includes a potential shift in the tax focus from where intellectual property is provided (source-based) to where it is consumed (destination-based).

This approach makes some sense from an economic perspective as much of the value generation from the digital economy now comes from the interaction with digital channels rather than the system or software. For example, an internet retailer can use both direct sales data and social media monitoring to learn about customers' buying habits and hence supply them with targeted offers.

However, a shift from taxing at source to taxing more at the destination is likely to raise prices in countries where there are already consumption taxes (eg VAT) and add to tax disputes between countries.

The Action Plan will fundamentally change the international tax landscape. Channelling revenues through low tax jurisdictions will be much harder.

Michiel van den Berg,
Grant Thornton Netherlands

## From source to destination

The focus will also move away from legal structures to ensuring that the tax is paid where value is being created. There would need to be sufficient people, intellectual property and risk bearing capacity in the tax location to justify this. The taxing of intangibles will be geared more to the economic substance rather than legal structures.

Related developments include curbs on hybrid mismatches such as the use of intra-company financing arrangements designed to take advantage of different treatments of debt and equity in various jurisdictions. The concern is that legitimate capital management strategies may be caught up in the new rules, including in regulated entities such as banks.

## Open to scrutiny

The OECD sees enhanced transparency and information sharing as crucial bulwarks in its drive to eliminate the gaps and mismatches in tax rules. Disclosure would be built around a group-wide transfer pricing master file and country-by-country reports for different locations.

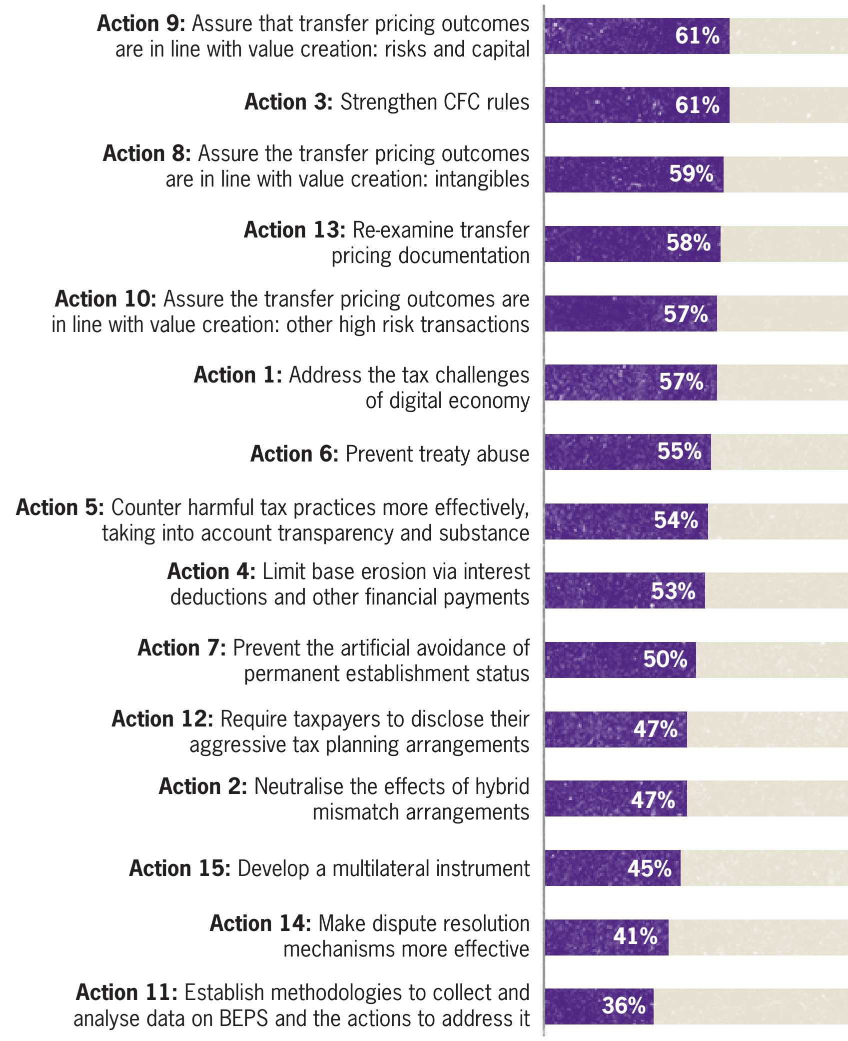
Standardised country-by-country reporting is intended as a 'risk assessment' tool for tax authorities. On the plus side, it could make it easier for a company to demonstrate that it is paying its share. A more documented approach could also provide a spur for groups to adopt more robust policies and risk evaluation ('mindful compliance').

However, there will be a huge amount of extra work needed to comply. This includes more contemporaneous information and an update of comparable financials annually. There is also likely to be a lot more focus on the 'significant people functions' (ie the people carrying out and overseeing key activities). Further concerns centre on how this information will be treated and shared, especially if confidentiality is not respected or if tax authorities use it as part of aggressive 'fishing expeditions'.

## Weighing up the impact

So what's going to have the biggest impact? A poll of Grant Thornton tax professionals around the world indicates that all 15 proposed actions would have a significant impact on businesses, but 'assuring transfer pricing outcomes are in line with value creation' and strengthening the Controlled Foreign Company (CFC) rules came out on top. However, as Figure 2 highlights, there are several aspects that are not far behind.

**Figure 2: Our tax experts' views on what aspects of the Action Plan will have the biggest impact**




**Normalised score where 0 = low importance for all; 100 = high importance for all**

The BEPS agenda is far-reaching and ambitious. Mid-size companies are going to be swept up in the tide of the changes and face extra work in complying, even though they're often not the ones using the avoidance schemes the Action Plan is seeking to eliminate. Larger MNEs will also have much to do, but should have better access to the necessary data and resources.

Wendy Nicholls,
Grant Thornton UK

## Cost, uncertainty and complexity

All corporations face considerable extra cost, uncertainty and complexity, which could be damaging to the growth of their businesses internationally. Companies relying on the development of ideas, innovations and creative content (including media and technology) are likely to be particularly affected. The Action Plan may hold up investment and development within businesses by making it harder to expand operations overseas, for example. This is a counter to the stated mission of the OECD to 'promote policies that will improve the economic and social well-being of people around the world'.[3]

Many traditional 'bricks and mortar' companies may see little change in their actual tax arrangements. Yet they will still have to comply with more complex and onerous transfer pricing, risk assessment and disclosure requirements.

[3] *http://www.oecd.org/about/*



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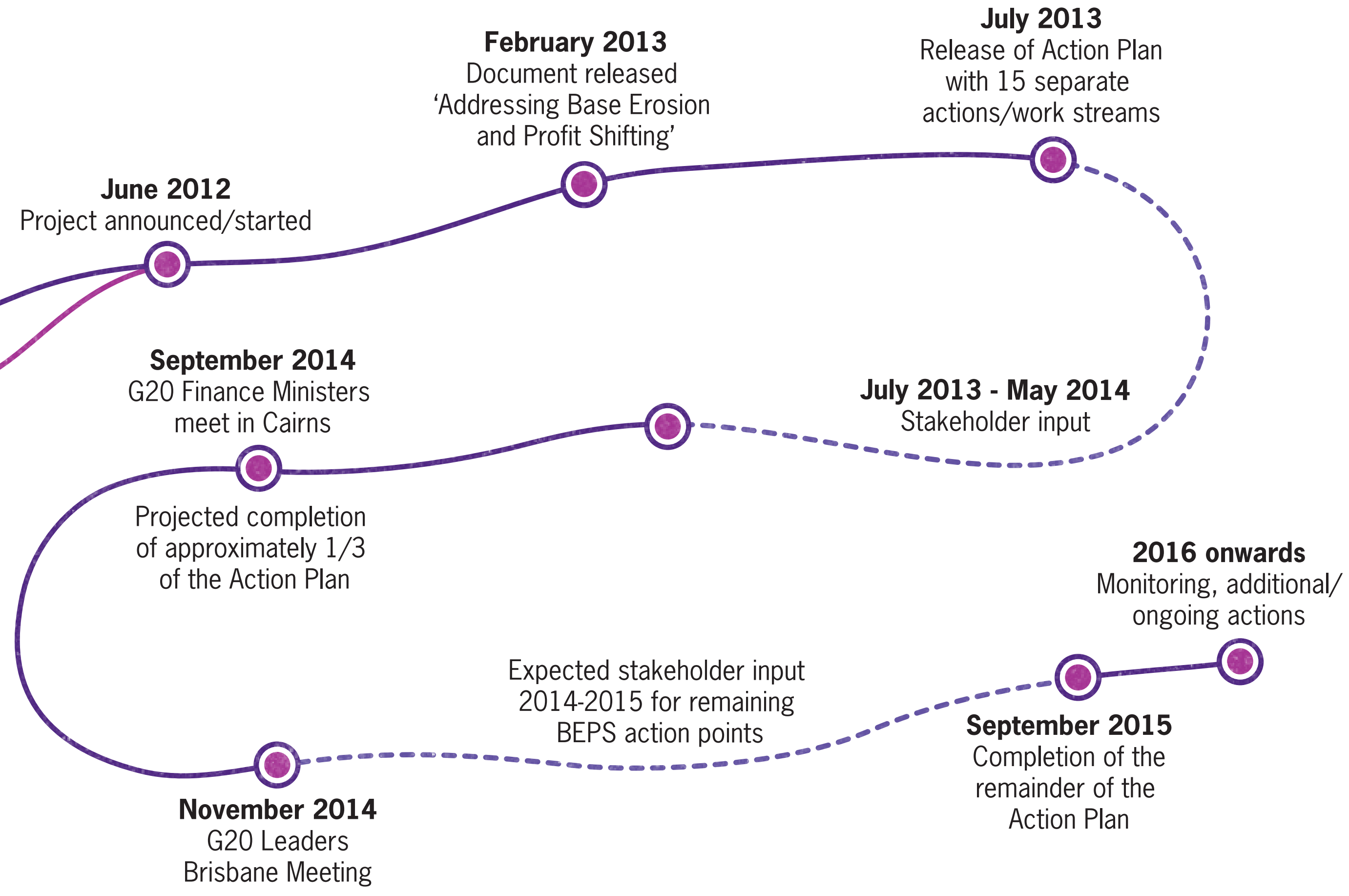
Section 2

# Are the scope and timing realistic?

The G20 has set the OECD a tight timeline to finalise the Action Plan. Is the timing realistic and how long could it be before changes are enacted on the ground?

With pressure for a swift resolution coming from the G20, the OECD is determined to complete drafting, consultation and finalisation of all 15 points in the Action Plan by September 2015 (see Figure 3).

### Figure 3: BEPS Action Plan timeline




However, the areas of initial focus such as of the format of transfer pricing documentation are a lot more straightforward than some of the points still to be addressed. Working out the details for transfer pricing for high value transactions and risk and capital could be especially challenging within the timeline. Rushed drafting heightens the risk of unintended consequences. Moreover, businesses can't change their systems in six months. It may therefore be more sensible to fast track some of the measures to tackle specific loopholes. The more complex reforms can then be given more time.

## Patchy implementation

Further questions centre on where and how the Action Plan will be implemented. For example, the US is unlikely to apply the Action Plan in full. MNE taxation is a hugely controversial and divisive issue in the US. Policymakers may eventually follow some aspects of the Action Plan. But greater consensus on tax reform will be needed before major changes are enacted and this is unlikely at the present time. And even if the US takes up some elements of the Action Plan, some lowering of the country's relatively high federal corporate tax rate of 35% would be needed to encourage major corporations to bring more of their global income into the country. Indeed, one of the main spurs for introducing BEPS-type changes may be using them as means to offset any lowering of corporate tax.

The US might eventually adopt aspects of the Action Plan. But there is insufficient political will and consensus to adopt the Action Plan in full. That means that a critical proportion of the global economy will be outside the net.

Mel Schwarz,
Grant Thornton US

Moreover, while the G20 has mandated the OECD to develop the new rules, the OECD is only 34 countries. What about the others, including India and China? Shifting the focus of taxation from where a product is made to where it's sold could provide a powerful export incentive. But many would argue that a destination tax is only viable if it's universally applied – it's unlikely to be. The situation is complicated by the fact that China and India are looking for a bigger share of any 'location savings' from moving production and support services to their countries.

Although China is not an OECD member, public pronouncements by high ranking officials from the State Administration of Taxation suggest that the country will still adopt the BEPS rules as part of an active but cautious approach. This flexibility (of being a non-member) may translate to even more stringent local legislation that stems from the BEPS Action Plan.

Rose Zhou,
Grant Thornton China

In India, the result is likely to be a selective approach to adoption. The country is a member of the G20 and has therefore endorsed the Action Plan. It's likely to welcome aspects of the proposals that are in sync with its current position in areas such as prevention of treaty abuse and artificial avoidance of permanent establishment status. Yet while India has observer status within the OECD, it's not a member and therefore not bound to accept what the OECD finally decides. It may be especially reluctant to cede ground on previously taken positions in areas such as location savings or local reporting requirements.

Giving effect to the Action Plan may not only require the rewriting of the model commentary but also renegotiation of treaties between countries. For instance, changing rules governing permanent establishments would require change in the commentary as well as the model treaty. Furthermore, this change has to find its way into the bilateral tax treaties. It is a complex and time consuming process and therefore full implementation of the BEPS Action Plan may take much longer than anticipated.

Arun Chhabra,
Grant Thornton India

The complexity and uncertainty are further heightened by the fact that many countries are already pre-empting BEPS by introducing tough new rules on transfer pricing and disclosure, often with little guidance on what is expected and how they interact with other countries' legislation.

What this means in practice is that while some countries will adopt the Action Plan relatively soon after it's finalised, or even before, it may be years before a real idea of the wider impact on today's diffuse international tax system emerges. It could be at least another five years before we have anything approaching a settled framework. What we can conclude now is that real convergence and consistency are virtually inconceivable. Without this convergence, the burden on business will only increase.

Section 3

# Implications for organisational structures and tax planning

While the impact of the Action Plan is likely to be uneven, it will affect tax management and wider organisational structures within all MNEs. What are the key considerations that will have to be addressed?

At present, income can be channelled through low tax jurisdictions even if there is little economic substance behind this. At the other end of the spectrum, some countries are claiming a bigger share of the cake based on 'emotion' rather than real analysis of ownership of assets, functions and risks.

The Action Plan aims to address some of these anomalies by bringing tax closer to where real value is created. It will be much harder to demonstrate that value is being created within a country that has little human capital and infrastructure to support intellectual property generation, even if this is where the rights reside or from where investment has been financed.

To meet tougher permanent establishment stipulations, companies will need to demonstrate that people and structures are there to support the bearing of risk. Transfer pricing is going to be more complex and more important as a result. It will no longer be possible to look at value creation, transfer pricing and tax planning strategies in isolation – all should work in harmony.

Early adopters (the UK and Australia look likely to be among them) may put their home companies at a disadvantage if other key markets delay implementation or are selective in what they adopt. However, there may be some benefits for countries with relatively low corporate tax rates and the ability to back this up with value creating capabilities (eg skilled people, R&D etc). There may be a case to create something likened to the UK's 'patent box', which it is hoped will provide an incentive for companies looking to locate high-value creating jobs within the country.

> By bringing tax closer to where value is created, the Action Plan will encourage investment in R&D and jobs in countries like Ireland.
>
> Frank Walsh,
> Grant Thornton Ireland

Yet any benefits need to be weighed up against uncertainty over what will eventually be agreed within the finalised Action Plan and how consistently this will be implemented. For example, over many years we have seen widespread moves among MNEs to offshore production and centralise back office functions such as IT. However, the treatment of such manufacturing hubs or offshore service centres for tax purposes is now less clear, which may raise questions over where and how groups should organise their operations in future.

> Companies face considerable uncertainty over how to structure business going forward, which could hold up investment and stifle creativity.
>
> Jason Casas,
> Grant Thornton Australia





Section 4

# What to do next

Many aspects of the BEPS Action Plan could have disproportionate or unintended consequences for your business. It's therefore vital that your business moves quickly against unfair and unintended consequences and takes strong steps to prepare for what eventually lies ahead.

Many MNEs, especially fast-growing ones, have yet to evaluate the potential impact of the Action Plan proposals on their business. But they are the ones with the most to lose. So it's vital to understand the implications and seek to avert any proposals that could have a damaging impact. Business representations appear to have reduced the likely burden of country-by-country reporting, which shows it is worthwhile having your say.

> The Action Plan is going to be difficult enough to apply. Engagement in the process can help to ensure that you're not landed with measures that are impossible to apply.
>
> Martin Lambert,
> Grant Thornton UK

## Step one

A good starting point for gauging the implications is to filter out what doesn't apply to your particular business so you can focus attention on the significant impacts. Key considerations include:

1. The nature of your business (eg balance of value from tangible and intangible assets)
2. Where patents/intellectual property rights are located
3. The relative complexity of your supply and value chains
4. Use of hybrid structures
5. How much international transfer pricing is involved in the business.

## Step two

Based on this evaluation, you can prepare the case you want to put to policymakers. As tax has become such a sensitive reputational issue, there may be some reluctance to engage directly. But you can speak through your trade association. You can also speak to us at Grant Thornton in confidence. We can then relay your ideas and concerns as part of our regular dialogue with the OECD.

## Step three

Preparation for all eventualities is vital. It's important to base your contingency and implementation plans on a full evaluation of all potential outcomes including the worst case scenarios. The assessments shouldn't just look at the direct tax implications, but also any reputational risks that could arise from particular tax strategies. Other key considerations include the impact on pricing and decisions over where operations are located.

## Step four

Ultimately, it is up to the board to weigh up the options and determine the right way forward. The fundamental questions that need to be addressed are: "What reputational risks are we willing to absorb to limit tax payments?" and "What can be done to minimise these risks including unwinding any overly aggressive tax arrangements?" With tax in the headlines, the key decisions should be made at the top. The longer term priorities include a review and possible rethink of tax structures, along with the organisational collaboration, risk evaluation and reporting lines to support this.

## The time for action is now

The Action Plan will fundamentally change the international tax landscape. Few think it's going to be successful. Many think it could have a significant impact on their businesses. Everyone agrees it's going to be difficult to implement. Therefore it's vital that your business makes its voice count as quickly and as forcefully as possible and is fully geared up for the more onerous demands ahead.

Appendix

# Summary of 15-point Action Plan

## Action 1

**Address the tax challenges of the digital economy**

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.

## Action 2

**Neutralise the effects of hybrid mismatch arrangements**

Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (eg double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities.

## Action 3

**Strengthen CFC rules**

Develop recommendations regarding the design of controlled foreign company (CFC) rules.

## Action 4

**Limit base erosion via interest deductions and other financial payments**

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.

## Action 5

**Counter harmful tax practices more effectively, taking into account transparency and substance**

Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime.

## Action 6

**Prevent treaty abuse**

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

## Action 7

**Prevent the artificial avoidance of PE status**

Develop changes to the definition of permanent establishment (PE) to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.





## Action 8, 9 and 10

**Assure that transfer pricing outcomes are in line with value creation**

**Intangibles (Action 8)**

Develop rules to prevent BEPS resulting from the movement of intangibles among group members.

**Risks and capital (Action 9)**

Develop rules to prevent BEPS resulting from the transfer of risks among, or allocation of excessive capital to, group members.

**Other high-risk transactions (Action 10)**

Develop rules to prevent BEPS resulting from transactions which would not, or would only very rarely, occur between third parties.

## Action 11

**Establish methodologies to collect and analyse data on BEPS and the actions to address it**

Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis.

## Action 12

**Require taxpayers to disclose their aggressive tax planning arrangements**

Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules.

## Action 13

**Re-examine transfer pricing documentation**

Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.

## Action 14

**Make dispute resolution mechanisms more effective**

Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP (Mutual Agreement Procedures), including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.

## Action 15

**Develop a multilateral instrument**

Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.

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# Contacts

If you would like further advice or information in relation to the issues outlined, please speak to your usual Grant Thornton contact or any of the individuals listed below:

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