Analysis

Implementation of BEPS around the world

Speed read

The OECD's publication in October 2015 of the 'final' recommendations of the base erosion and profit shifting (BEPS) project was a milestone in the history of the international tax system. However, it quickly became clear that this was only the end of Act 1 in what was to be a long drawn-out production. The two and a half years that had been spent on it would be dwarfed by Act 2 comprising implementation, clarification and iteration (the latter referring to some additional standard setting). During this period, we have seen: 102 countries joining the BEPS 'inclusive framework', making a commitment to implementing the BEPS minimum standards; 70 territories signing the multilateral instrument (MLI), which potentially modifies the terms of a large number of double tax treaties to give effect to BEPS measures; the OECD's Forum on Harmful Tax Practices continue its work examining compliance with the recommendations on minimum standards in Action 5, and a number of countries making changes to their IP/ patent box rules to align them with nexus requirements or set up new compliant regimes; countries generally endeavouring to put in place the framework requiring CBC reporting of various tax information. Nonetheless, there is still plenty of work to be done.

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Minimum standards, best practices and common approaches

Consensus amongst the OECD members, other G20 members and a handful of other representative countries, together forming the BEPS project participants, was fully reached on only a few minimum standards. It always seemed likely that these would be among the first measures to be implemented. Some countries had even started the process ahead of the October 2015 report.

Other recommendations, which seek to reinforce existing standards, establish best practices or follow common approaches, represented only a partial consensus. To the extent that there wasn't total agreement on these matters, it was to be expected that implementation would be more limited and potentially slower. That has generally been borne out in practice so far.

There are minimum standards in four of the BEPS Action areas, but those areas also include recommendations which are not minimum standards. The four areas are: Action 5 (harmful tax practices), Action 6 (treaty abuse), Action 13 (country by country reporting, as part of transfer pricing documentation) and Action 14 (dispute resolution).

OECD and inclusive framework developments

Countries which were not original BEPS project participants were invited to join Act 2 and take part in the remaining BEPS standard setting and related activities on an equal footing with the OECD members and other participants. In order to become part of this 'inclusive framework', countries had to make a commitment to implementing the BEPS minimum standards (though without any agreed time frame) and to pay an annual membership fee. Therefore, this was one way in which the breadth of implementation could be extended. At the time of writing there are 102 members of the inclusive framework.

The inclusive framework countries all play an equal part not only in reaching consensus on further standards or commentary but in reviewing and monitoring the consistent implementation of all the BEPS measures. The monitoring exercises are generally referred to as 'peer reviews' and the processes for these have been published in relation to the minimum standards. These exercises have already begun and are quite well advanced in some areas, which encourages countries to implement for fear of being 'named and shamed'.

Treaty-related changes and the MLI

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI) under BEPS Action 15 was published in November 2016 and 68 territories signed up to it on 7 June 2017. Two more have signed since while additional countries have committed to signing shortly and many more are expected to do so.

The MLI is a way of potentially modifying the provisions of a large number of existing double tax treaties in order to give effect to BEPS project measures. It is not the only way of implementing BEPS treaty-related recommendations, and countries like the United States which do not intend to sign the MLI largely do so on the premise that they already meet the standards (at least the minimum standards) or will implement them, primarily by bilateral negotiation through new treaties or protocols to existing treaties. In this regard, draft updates to the OECD's Model Tax Convention – published for partial consultation – include the BEPS treaty-related recommendations as well as other proposed changes.

Most territories that have signed up to the MLI have listed as 'covered tax agreements' nearly all their existing double tax treaties and protocols. That means those agreements will potentially be modified should the counterparty territories have signed the MLI or sign it in future. Agreements which have been left out of a territory's list are typically those where a new agreement that incorporates the BEPS measures has recently been signed or is in the process of finalisation, rather than any 'cherry-picking' exercise.

The majority of the choices available to signatories under the MLI require that both parties choose the same option before the effect of an existing treaty between them would be modified. There are a limited number of provisions where asymmetry involving different choices is permitted.

The MLI addresses BEPS recommendations in relation to Action 2 (hybrids), Action 6 (treaty abuse), Action 7 (permanent establishments) and Action 14 (dispute resolution, including a new Arbitration standard). Some of the provisions in these areas work hand-in-hand with domestic law changes and, for convenience, they will all be considered in this section.

Hybrids

The hybrid changes recommended for tax treaties, dealt with in the MLI, cover transparent entities, dual resident entities and the application of a tax credit rather than exemption in various circumstances. While only about one third of the MLI signatories opted-in to each of these, their reasons for not doing so will need detailed consideration.

The UK's legislative changes over the last two years have led the way in dealing with the practical issues in implementing the other, domestic BEPS project recommendations on hybrids under BEPS Action 2. The EU's anti-tax avoidance directives, generally known as ATAD I and ATAD II, have applied many of those same principles in establishing a minimum level of protection for all member states to transpose. Outside the EU, Australia was one of the quickest to announce an intention to legislate with effect from 1 January 2018, but nothing was in this year's Federal Budget other than specific provisions on cross-border transactions relating to regulatory capital. This kind of commitment to consider the proposals in the light of specific issues faced locally seems to have been reflected by other countries, like South Africa, New Zealand, India and Hong Kong.

Treaty abuse

BEPS project participants agreed minimum standards under BEPS Action 6 on a preamble dealing with the purposes of a treaty and on a principal purpose test (PPT), limitation on benefits (LOB) and anti-conduit rule, or PPT and simplified LOB (SLOB).

At the time of signing, all 70 MLI signatories chose to apply the PPT, although eight indicated that, where possible, they intend to adopt a detailed LOB provision, in addition to the PPT or in replacement of, through bilateral negotiation (Canada, Chile, Colombia, Kuwait, Mauritius, Poland, Senegal, Seychelles). In all, 12 territories indicated a choice to include an SLOB although the majority of territories opted not to allow this asymmetrically nor to agree to apply it where only the other party specifically chose it. We've also seen a mixture of PPT and PPT plus SLOB in new treaties signed over the last year or two.

The United States will be at the forefront of negotiations on establishing an LOB agreeable to other territories, and has already published proposals on the necessary updates to the LOB in various existing treaties to meet the BEPS project standard.

The PPT and, later, LOB are likely to have a significant impact on access to beneficial rates of withholding taxes on dividends, interest and royalties as well as other treaty benefits.

Territories have been able to be more selective in their take-up of other BEPS project recommendations in the MLI which are not minimum standards. Only about 20–25% have generally chosen to amend existing rules on the minimum holding period to test the level of shareholding enabling a reduced withholding on dividends, the testing period for whether capital gains on entities are derived from land and other real property, the denial of benefits where income is paid to a non-business PE which is exempt in the home state and taxed in the PE state at a low rate (<60% of home state rate) and the 'saving clause' confirming that a treaty does not generally restrict a country's right to tax its own residents.

Permanent establishments

There is a significant proportion of the list of 70 signatories that have not opted to apply the MLI changes extending the meaning of a permanent establishment (PE) to include more situations in which an 'agent' broadly plays a key role in contract negotiations. Australia originally published draft choices for consultation that included these modifications, but its current position is that it will not adopt them: this is apparently on the basis that it has safeguards in the multinational anti-avoidance law (MAAL) and any other changes will be negotiated bilaterally. The UK's reasons for not applying them similarly include the perception of the level of abuse and the protection afforded by the diverted profits tax (DPT). Other territories no doubt have similar lines of thinking and we're probably unlikely to see very wide changes in their domestic definitions of a PE either.

Almost two-thirds of MLI signatories have opted to clarify existing wording on whether specific activity exemptions for warehousing, purchasing goods, collecting information, etc. need to be of a preparatory or auxiliary character – generally choosing the overarching requirement that they do need to satisfy that criteria. The UK has chosen only to apply the anti-fragmentation rule, which essentially combines 'closely related' entities' activities for this test where they are part of a cohesive business operation; Portugal has a similar approach. A slight majority overall have chosen the anti-fragmentation rule.

A discussion draft on the attribution of profits to PEs was published on 22 June 2017. This looks in particular at the situations where PEs are identified as a result of the above recommendations where they would not have been previously. A consultation process will be undertaken before this guidance is finalised and the lack of numbers in the examples in the draft will be one area of focus.

Whatever positions territories take under the MLI, on attribution of profits and any other specific domestic anti-avoidance legislation introduced under BEPS Action 7, the behaviour of many tax administrations on the PE threshold has changed since the start of the BEPS project. More questions are being asked, particularly in relation to the activities of employees and their mobility between different countries. Tax administrations are using 'big data' solutions to combine knowledge of key individuals and establishments while many organisations are starting to use technology applications to track the travel arrangements of their people. Some tax administrations have been seeking much more aggressive profit attributions.

Dispute resolution

The mutual agreement procedure (MAP) recommendations of the BEPS project Action 14 are a minimum standard but there are a number of choices available to signatories, partly because some measures rely on domestic provisions rather than the bilateral treaty which provides the main agreement between the territories.

The mandatory binding arbitration process was not set out in the October 2015 BEPS report but was worked on by an Ad Hoc Group, which still has some ongoing work and currently includes 104 countries. The standard on this is set out in the MLI and 26 of the 70 signatories have currently opted-in. About half of these propose to limit in some way the kinds of cases to which arbitration can be applied, although the UK does not. The default baseball arbitration seems acceptable in most cases but others, like Greece, may prefer reasoned opinion arbitration. There are other options, for example, about timing, imposing confidentiality obligations on taxpayers and preserving provisions that already provide for mandatory binding arbitration of unresolved issues arising from a MAP case (of which the UK has quite a few).

Harmful tax practices, preferential regimes and exchanges of rulings

The OECD's Forum on Harmful Tax Practices (FHTP) has largely dictated the speed and extent of compliance with the recommendations on minimum standards set out in Action 5 of the BEPS project. This has focused on setting up and initiating the compulsory spontaneous exchange of certain advance tax rulings and then, on a more ongoing basis, on the substantial activity test for preferential regimes, looking first at intellectual property (IP) and then on a broader basis. The former is primarily targeted at improved transparency around country practices while the latter is to encourage countries to remove or amend existing regimes, and to establish improved criteria for future guidance and assessments.

The OECD suggested in a recent webinar that FHTP had reviewed more than 90 regimes from 46 jurisdictions at that point, but that the work was ongoing. There had been 43 regimes reviewed and identified at the time of the October 2015 BEPS report. We have seen a number of countries making IP/ patent box changes to align these with nexus requirements or set up new compliant regimes (including Belgium, China, Cyprus, Germany, Ireland, Israel, Italy, Liechtenstein, Luxembourg, Netherlands, Portugal, Singapore, Spain, Switzerland and the United Kingdom). A number of tax regimes over and above IP specific ones have been identified as being potentially harmful within the criteria tested (including sector specific regimes and holding company/ headquarter regimes). We expect more remedial action in these areas and further guidance on the updated criteria.

Original BEPS participant countries should have exchanged information on various rulings made prior to 1 April 2016 by 31 December 2016 and for subsequent rulings as soon as possible after the ruling was granted, but at the latest three months from when the competent authority received it. These dates roll forward by one or possibly two years for other inclusive framework countries that joined in 2016, except that by EU Directive, where earlier member states have to share amongst themselves rulings from 1 January 2017 on a six-monthly basis and within three months of that period's end (the definition of 'past rulings' also varies slightly). It should not be forgotten that one of the categories of rulings to be exchanged relates to preferential regimes.

The FHTP is responsible for the peer review on Action 5, involving the inclusive framework countries. On preferential tax regimes, it largely follows the way the FHTP works while specific procedures apply for the transparency framework, involving the information-gathering process, the exchange of information, confidentiality of information received, and statistics. The review for the period from 1 January to 31 December 2016 has largely taken place and a summary report may be made public towards the end of 2017.

Country by country reporting

Country by country (CBC) reporting was established as a minimum standard as part of BEPS project Action 13 recommendations on transfer pricing documentation (discussed further below).

Countries have generally endeavoured to have in place the framework requiring CBC reporting of various tax information so that MNE groups can file the first CBC reports for periods beginning from 1 January 2016 within 12 months thereof (e.g. by 31 December 2017 for the 2016 calendar fiscal year). However, some will not and have to rely on filing elsewhere under 'surrogate filing' arrangements: recent guidance from the OECD states that the following jurisdictions have confirmed they will have processes in place to allow this: Hong Kong, China, Japan, Liechtenstein, Nigeria, Russian Federation, Switzerland, United States.

The exchange will require Qualifying Competent Authority Agreements (QCAA) to be in place with jurisdictions of the inclusive framework that have the exchange capability (via treaty or tax information exchange agreement) for that year and meet the confidentiality, consistency and appropriate use prerequisites. Exchanges will be expected to have started by within 18 months of the end of an MNE group's fiscal year (or 15 months for subsequent reporting periods).

There has been domestic legislation introduced in a wide range of countries to establish the criteria for reporting other than the timing as noted above. These include local filing requirements if the parent jurisdiction of the foreign MNE has the necessary agreement in place but has not entered into a QCAA to actually exchange the CBC report. It also includes notification requirements for identifying which entity in the MNE group will file the report and where (for the UK, the first notification will have to be made by the later of the end of the reporting period or 1 September 2017). The deadlines for these notifications have in many cases been delayed as it has become clear that processes will not be ready in time.

On the corporate side, many have been gearing up and testing their capabilities for producing the necessary information as well as considering whether the raw figures represent what they thought was happening in the business. As a result, we have found some incorrect mapping of information which needs to be corrected. Our experience also suggests that a number have not fully got to grips with some of the definitional issues, such as the difference between cash tax and accrued tax, and what constitutes 'stateless' income.

The annual review for the period 1 January to 31 December 2016 of CBC reporting implementation is well underway and this apparently contributed to the urgency with which tax administrations tackled their obligations. The framework and confidentiality (referring to the Global Forum on Tax Transparency and Exchange of Information) have been the focus for this review. The second review, for 1 January to 31 December 2017, will look at the reports being received. The third review, for 1 January to 31 December 2018, will be able to focus on the exchange.

Transfer pricing otherwise

The BEPS project provided recommendations on transfer pricing (TP) documentation in the form of a master file and local file under Action 13 alongside CBC reporting (above). Other TP recommendations under Actions 8–10 (now included in the 2017 edition of the OECD's Transfer Pricing Guidelines) dealt with a range of other issues that might give rise to base erosion or profits shifting concerns, such as intangibles, risk allocation, capital adequacy, etc.

The take-up by countries of domestic requirements to produce a master file and local file has depended to a large extent on the apparent success of existing documentation arrangements. The UK and US are among the countries that have not sought to amend their existing laws; others like Australia have partially implemented the master file concept while its local file is largely different to the BEPS project version, in order to supplement but not replace existing more strict documentation requirements. Some countries have been prompted to adopt a more formalised approach where there had previously been only informal practices. Size criteria for businesses brought into these requirements have varied considerably. Although not part of the peer review on CBC reporting, the reviewers have been seeking information for purposes of monitoring the implementation of the master file and local file recommendations.

The transfer pricing recommendations included in the October 2015 BEPS report set out a number of revised guidelines around taxing profits where economic activities are performed and value is created, including robust functional analysis and risk recognition. A few countries set about updating their existing domestic arrangements: see for example the fourth edition of Singapore's TP guidelines (generally) and China's 2017 *Public Notice 6* (dealing with transfer pricing methods, intangibles, equity transfers and service transactions). However, before deciding whether there is a need to adjust their own domestic arrangements, many countries have been waiting for further guidance on matters left to be completed; a discussion draft is expected on financial transactions shortly, while discussion drafts were recently published on profit splits and hard-to-value intangibles. Some tax administrations have for some time been working on the basis of the direction of travel of a number of these issues.

Interest deductibility

The OECD released in December 2016 an updated version of the BEPS Action 4 report (limiting base erosion involving interest deductions and other financial payments). This is not a minimum standard but a recommended approach. It includes further guidance on the design and operation of the group ratio rule, and approaches to deal with risks posed by the banking and insurance sectors.

A number of countries have for some time had rules limiting the deductibility of interest to a specified proportion of EBITDA with some also having an alternative group ratio or 'equity escape' rule. An indication of the different approaches to adopting the rules is given by comparing the de minimis thresholds for India and the UK, both adopting an EBITDA limit for the first time. India proposes that its 30% cap be applied once net interest expense exceeds 10m rupee (£120,000) while the UK proposes its 30% cap kicks in for net interest expense above £2m.

While few countries have yet implemented these recommendations, it seems to be the case that groups will have to compute a separate group ratio test using different rules for the different territories which implement Action 4. This is a result of the tension between getting the group interest number calculated in a way which will be recognised by all territories (and therefore standardising and simplifying compliance) and allowing territories to make adjustments to suit their own domestic tax rules and policies. Inconsistency can also be expected in the banking and insurance sectors since territories are given a great deal of flexibility in applying a special regime, including exemption and identifying particular risks.

Digital

The Task Force on the Digital Economy (BEPS Action 1) was not due to reform until nearer the 2020 deadline to review what effective unilateral actions countries have adopted, how digital business have evolved and how BEPS measures have impacted the digital space. However, the G20 Presidency (Germany) has been keen to progress digital transformation generally and, as a result, the tax element needs to be accelerated. A 'Whole of OECD' project looking at digital is aimed at making that something positive for all society. Tax is just 'one small component' of this exercise.

In particular, apart from matters highlighted previously in Action 1, the task force will be asked to look at the sharing economy and how tax administrations are dealing with the additional challenges posed. It may also address the topical questions of whether and how to tax robots. Specifics of this project are apparently not yet fully defined. An interim report is to be presented to the G20 ahead of the Spring 2018 WBG and IMF meetings tentatively scheduled for 12–14 October. This will not affect the timing of the final Action 1 review report being expected in 2020.

Other: CFC, MDR, data analytics

The controlled foreign company (CFC) best practices (BEPS Action 3) perhaps represented one of the weaker sets of BEPS recommendations. They virtually allowed countries with existing CFC regimes to 'stick' leaving only those without any CFC rules to consider whether to 'twist' and take on additional measures. Chile was one of the first players to introduce a CFC regime in light of the BEPS discussions, with the likes of Taiwan and Colombia following. Others, such as China, Japan and Norway, have been making changes to provide a more closely aligned regime.

There has been very little solid movement on disclosure of aggressive tax planning schemes (BEPS Action 12). Israel announced expansion of its reportable transaction regime and Colombia introduced a new mandatory disclosure regime (MDR). In addition, China announced its intent in October 2015 to consider introducing an MDR but was cautious of the additional compliance burden. Australia did include an MDR in consultations which closed in July 2016 and Sweden opened an investigation into the possibility on 7 April 2017. The European Commission also consulted on intermediaries and disincentives for aggressive tax planning with an MDR now put forward in a draft Directive.

Data analytic work (BEPS Action 11) is focusing on trying to measure the impact of the changes adopted under the project and the remaining revenues lost by countries to base erosion or profit shifting. It needs to take into account that there will be continued competition between states for foreign direct investment and tax revenues. Overall, this is part of a bigger picture in looking at the efficiency of different taxes, expanding on previous studies and including, for example, combinations of taxes, hypothecation and the wider interaction with government spending and the benefit system. There is a growing emphasis on tax certainty for both tax administrations and taxpayers.

What's next?

There will be a number of critical points towards the end of 2017 and into early 2018.

The ratification by territories of the MLI will signal when modifications to bilateral double tax treaties start to take effect. Many territories thought these ratifications would be achieved before the end of the year and the UK's experience in dealing with bilateral treaties has been that it often takes six to ten months from signing. Once five territories have ratified the MLI, it takes a further three clear months from ratification by both parties to a bilateral treaty for their mutual choices to take effect on that treaty. It generally then applies to withholding tax events from the next 1 January, so if the later ratification is not before 1 October 2017, the earlier impact on those will be from 1 January 2019. For other taxes the periods affected commence after a six clear month 'lag' period, subject to the territories agreeing differently. For MAP and arbitration, it can apply to cases in some instances almost immediately following ratification, including open cases.

There will then be a review of the BEPS project as a whole in 2020 (including a review of the interim report on digital produced in Autumn 2018). This will include an assessment of whether further measures are needed or whether those recommended and adopted have achieved their aims. There is still plenty of work to be done. ■

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- 30 questions on BEPS (Jill Gatehouse & Susie Brain, 29.10.15)
- The multilateral convention to implement tax treaty related measures to prevent BEPS (Sandy Bhogal & Kitty Swanson, 19.1.17)