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SOME MUSINGS ON BEPS

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The final BEPS package published earlier this month comprised over 2000 pages of reports and executive summaries, all focused on how best to tackle tax avoidance caused by base erosion and profit shifting. The EU has also taken steps to tackle tax avoidance. The Best Friends Tax Network has put together this collection of musings on the BEPS project, which we hope you will find useful in giving a flavour of the salient points at issue and highlighting their practical implications.

The Best Friends Tax Network is a group of six independent firms, consisting of more than 40 tax partners and around 100 other specialist tax lawyers, spread across seven jurisdictions. We regularly work together on an integrated basis to deliver multinational tax advice to the very high standards expected by our clients.

Please contact any of the contributors, or your usual contact in the Network, if you would like to discuss any of the issues raised.

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HYBRIDS

When Marty McFly went "Back to the Future", he came to October 2015 and purchased a Sports Almanac. The Action 2 BEPS report might have been a better choice. A bright young person, armed with the list of structures that achieve hybrid tax results could have gone far in the 1980s…

The report detailing the recommendations on hybrids now runs to over 450 pages, although the basic recommendations have not changed. They involve:

- a series of domestic law recommendations, including preventing a dividend exemption applying to receipts that were tax deductible for the payer and duplicate credits for withholding tax;
- cross border rules to deal with the three identified "outcomes"; and
- changes to the model double tax treaty as it affects dual resident and tax transparent entities.

The three outcomes are at the heart of the recommendations.

For the first outcome –the situation where a payment is deductible but the receipt is not taxable – BEPS proposes that the preferred response should be that a deduction is denied to the payer but, if that does not work, the receipt should instead become taxable.

For the second outcome, which is where there are two deductions for the same payment, BEPS specifies which deduction should be disallowed.

The third outcome arises where the first two rules have not worked (because no jurisdiction tackles the first or second outcome) and the benefit is passed to an entity in a third jurisdiction. BEPS proposes that that third jurisdiction should take steps to eradicate the hybrid benefit.

So why has it got so complicated?

The length of the report is attributable to the number of examples provided, which include just about every hybrid tax planning idea that has come out of the US in the last thirty years. This makes interesting historical reading for tax advisers, but what do jurisdictions such as Kenya and Vietnam make of it all?

The difficulty underlying the BEPS hybrid actions is the need for jurisdictions to work together to identify hybrid situations. This can require a sophisticated understanding of the other jurisdictions' tax rules and significant information gathering. This might be justifiable for transactions between the US and the UK, for example, but is it really a sensible use of resources in developing countries?

It also requires agreement on what is and is not a hybrid that should be within the scope of the rules. Should a jurisdiction be able to treat regulatory capital, or certain tax exempt entities, as outside the rules? Will the US change its "check the box" rules, which enable hybrid entities to be created by filling in a form? These are questions that go to the sovereignty of each jurisdiction.

Given that hybrid transactions are usually built around interest deductions, one wonders whether the implementation of BEPS Action 4, which looks to limit the amount of interest that may be offset against profits, will ultimately prove to be a simpler and more effective tool to eliminate hybrid planning.

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INTEREST DEDUCTIONS

Extensive debt financing has been identified as one of the key drivers of base erosion and profit shifting. The BEPS proposed action to tackle this is to provide a best practice approach for the design of domestic tax general interest limitation rules.

The proposed approach is to limit interest capacity based on a fixed EBITDA ratio of between 10% and 30%. The rationale for this is that it does not disallow interest deductions per se, but rather tackles the artificial separation of taxable income from the underlying activities that drive value creation – because the amount of deductible interest is linked to the level of the debtor's taxable economic activity (measured by the amount of taxable EBITDA).

Whilst this interest limitation rule should apply to all entities that are part of a multinational group, it can also be extended to interest paid between entities in a domestic group. For EU member states, the extension to domestic groups is in any event required under EU law.

The proposal allows states to mitigate the impact of the interest limitation rules on entities or situations which pose less BEPS risk:

- *Group safe haven*: Entities can be highly leveraged for non-tax reasons (e.g., because of the nature of their business or their overall financial situation). States can address this by applying a world-wide group test, e.g., by determining whether the entity's (stand alone) interest/EBITDA ratio is greater than the group ratio.

- *De minimis*: Entities which fall short of a certain minimum net expense threshold can be carved out. However, where a group has more than one entity in a country, the threshold should apply to the group's total net interest expenses in this country (anti-fragmentation rule).

- *Carry-forward/carry-back of disallowed interest or unused interest capacity*: In order to mitigate timing effects (e.g., volatility of earnings), the state may permit entities to carry forward disallowed interest expense or unused interest capacity for use in future periods, or carry back disallowed interest expense into earlier periods.

The above is only a minimum standard and does not prevent states imposing even stricter requirements on the deduction of interest.

Some countries, such as the US, have put forward proposals that would bring their current rules in line with the BEPS initiative, while the UK has opened a consultation to seek stakeholders' views on whether, and how, to implement best practice in the UK. The BEPS proposal essentially endorses the regimes already adopted in other countries such as Germany, Italy, Portugal and Spain. It is therefore interesting to note that the German supreme tax court has raised serious doubts as to whether the German interest stripping rules are constitutional. The court argues that the scope of the rules is too broad in that interest expenses are disallowed even in circumstances where the debt financing is clearly not aiming at the erosion of the German tax base.

It will be interesting to see if the BEPS recommended approach is a sustainable role model for other countries or just goes too far.

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THE NEW TRANSFER PRICING RULES

One of the underlying principles of the BEPS project is to ensure that multinational enterprises (MNEs) are taxed where value is created; thus transfer pricing is key. Indeed, it is the subject of Actions 8, 9 and 10, which aim at achieving one of the three pillars of BEPS: reinforcing substance requirements in the existing international standards.

The supremacy of the arm's length principle over formula-based systems was confirmed in 2013, but its application by some MNEs has also proven that the OECD transfer pricing guidelines (TPG) are vulnerable to manipulation, due in a large part to the existing emphasis on contractual allocations of activities. Substantial amendments to the TPG are therefore inevitable in order for allocation of profits to follow substance.

The BEPS proposals are primarily focused on:

- contractual allocation of risks, and the resulting allocation of profits to those risks;
- re-characterisation of transactions which are not commercially rational; and
- transactions involving intangibles.

The common thread is the further evolution of the concept of significant people functions, which was introduced in 2008 and further endorsed in the TPG in 2010 in the context of business restructuring. Actions 8, 9 and 10 take this concept further by stressing the importance of control over key activities.

Functional analysis is going to be important for determining a fair allocation of profits among associated enterprises. Indeed, MNEs performing value added functions, controlling economically significant risks and contributing non-routine assets will be entitled to the huge part of the profits generated in the MNE value chain. Contractual arrangements which are inconsistent with the real conduct of the parties will need to be reviewed.

The other side of the coin is that: (a) legally owning an intangible, in the absence of the control of key activities, might not entitle the owner to any portion of the income generated by the intangible; and (b) financing R&D without having any control over key activities is considered a financial investment that gives no right to the intangibles developed. This should mean the end of IP and cash box structures without any real substance.

The operational models of MNEs change frequently, so the outcome could differ depending upon whether, for example, the historical or current year position is analysed. The OECD has not stipulated the timeframe.

Transparency and country-by-country reporting is another main pillar of BEPS. The current template, however, excludes some key information which could be essential to understand the real risks behind the structure implemented by an MNE (such as information on business restructuring) and this could be detrimental to the taxpayer.

Finally, the OECD is still working on the application of the profit split method in the global value chain. The two-sided method – which requires an in-depth analysis of each party involved in the transaction and the identification of the portion of income attributed to them – could lead both to further alignment of the allocation of income with value creation and transparency on where MNE profits are allocated.

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IMPOSING TAX TREATY CHANGES

The Report on the feasibility of introducing changes to double tax treaties by way of a multilateral instrument is unlikely to have been the first BEPS report on most tax advisers' reading list. But the last sentence of the executive summary:

> "*Participation in the development of the multilateral instrument is voluntary and does not entail any commitments to sign such an instrument once it has been finalised.*"

may well tell us all we need to know about what might eventually be seen as an intellectual frolic by lawyers with no useful effect.

The perceived benefits of a multilateral instrument are obvious – the bilateral negotiation of treaties is time-consuming and the timetable for renegotiating all of a jurisdiction's treaties is likely to be decades rather than years. But that rather ignores the complex matrix of international relations behind a treaty network.

The BEPS recommended changes to double tax treaties are basically sensible, but forcing a jurisdiction to introduce all those changes across all of its treaties rather ignores the subtle nature of treaty negotiations. Those responsible for agreeing treaties would not want their hands tied in this way.

Indeed, this sensitivity can be seen by the way that one of the recommendations – the inclusion of an anti-abuse type provision – allows either the principal purpose test favoured by jurisdictions such as the UK or the limitation of benefits provision favoured by the US. It is difficult to see how a multilateral instrument could deal with this subtlety.

The US has already indicated what it views as the necessary treaty changes. In May 2015, long before the BEPS recommendations were finalised, the US Treasury proposed certain changes to the US model tax treaty to deal with double non-taxation and stateless income, as well as significant amendments to the model limitation of benefits article. This model will form the starting point for the US when negotiating new treaties and, given the negotiating strength of the US, is likely eventually to become the norm for treaties with the US as they are amended or renegotiated.

The Action 15 BEPS report proposes the formation of an "International Conference" to develop the multilateral instrument. It will be interesting to see which jurisdictions decide to devote resources to this. The assurance that participation in the discussions does not amount to a commitment to sign up might indicate that there is not significant demand for a place at the table.

Like many things in life, just because something is possible does not necessarily mean it is a good idea!

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"EU BEPS" – CHANGES TO THE PARENT-SUBSIDIARY DIRECTIVE

A striking example of the EU's efforts to accelerate the implementation of anti-BEPS measures is the amended Parent Subsidiary Directive (PSD). Originally designed to prevent economic double taxation of profits distributed within an EU corporate, the PSD is now also being deployed to counter undesired tax planning within the EU by requiring member states to implement in their domestic laws by 31 December 2015 both a general anti-abuse provision (AAP) and a specific anti-hybrid rule.

What does the AAP do? Under the AAP, member states shall not grant PSD benefits to arrangements that (i) are not genuine (the objective test) and (ii) have been put in place for the purpose of obtaining a tax advantage that defeats the object or purpose of the PSD (the subjective test).

The anti-hybrid rule aims to tackle deduction/non-inclusion mismatches resulting from hybrid instruments issued by an EU subsidiary to its EU parent. The rule requires the member state of the parent to tax payments received on hybrid instruments to the extent such payments are deductible by an EU subsidiary. This solution is contrary to the preferred approach proposed by the OECD in BEPS Action 2, which is that the source country should deny the deduction.

Will these changes create uniform anti-abuse legislation within the EU? The simple answer is no. First, the scope of the PSD is limited to certain payments within EU groups. There are of course plenty of situations that fall outside this scope including, at least in the view of many member states, intra-group structures using transfer pricing mismatches. Second, a quick tour through member states shows that the implementation of the amended Directive is likely to vary considerably and will require further clarification in case law. Many member states, including France, Germany and Italy, hold the view that the AAP requires no changes to their domestic laws because their existing anti-avoidance rules suffice. The scope and application of these existing domestic rules will inherently differ. These differences are expressly allowed by the Directive as long as these existing rules meet the minimum anti-abuse standard set by the AAP and otherwise comply with EU law (e.g. the fundamental EU treaty freedoms). The Dutch government's view that the amended Directive does not require them to implement an AAP is based on a rather unusual statement by the European Commission in an Annex to the amended PSD proposal.

Where the fundamental EU treaty freedoms as applied by the European Court of Justice (ECJ) have put a limit on the application of domestic anti-abuse rules to cross-border activities within the EU, the amended PSD now also sets a minimum standard. The European Commission and the European Court of Justice are likely to play a crucial role in defining the Goldilocks zone in between. On the one hand the European Commission could take enforcement action against "conduit friendly" member states on the basis that they have not properly implemented the PSD in their domestic laws or have been too lenient in enforcing these laws. On the other hand the European Court of Justice will likely be faced with questions on whether domestic anti-abuse rules that aim to implement the PSD are not overreaching in the sense that they violate fundamental EU treaty freedoms.

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THE UK'S REACTION TO THE CHANGES TO THE PARENT SUBSIDIARY DIRECTIVE

In January 2015, as part of the EU's anti-BEPS strategy, the Council of the European Union introduced an anti-abuse provision (AAP) into the Parent Subsidiary Directive (the PSD). Member States are to be prohibited from granting the benefits of the PSD to arrangements that:

- have been put into place for the purpose of obtaining a tax advantage that defeats the object or purpose of the PSD; and
- are not genuine – that is, have not been put into place for valid commercial reasons which reflect economic reality.

Member States are required to implement the AAP in their domestic law by 31 December 2015.

An initial UK government statement indicated that this change would require the UK to introduce a new anti-abuse rule into its dividend exemption legislation, but no implementing measures have been put forward. With the implementation window drawing rapidly to a close, the UK government appears to be proceeding on the basis that UK law already complies with the amended PSD. The tax profession appears broadly to share this view. But is the situation really so straightforward?

Dividends received by UK companies are chargeable to corporation tax, subject to a wide-ranging dividend exemption. The dividend exemption is subject to a series of targeted anti-abuse rules (TAARs), but there is no general anti-abuse rule specifying that a tax-avoidance purpose alone can prevent the exemption from applying.

Thus, it is possible to envisage an arrangement that satisfies the two-limb test of the AAP, but fails to fall within one of the more specific TAARs. The dividends paid under those arrangements would then remain exempt from UK tax, despite falling foul of the AAP.

Alternatively, it might be argued that the UK's general anti-avoidance rule (GAAR), introduced in 2013, prevents a dividend which falls within the scope of the AAP from qualifying for exemption. This is a more compelling argument, but the UK's GAAR, whilst wide-ranging, has certain limitations (for example, the double reasonableness test). It is not inconceivable that the ambit of the UK GAAR does not align perfectly with the scope of the AAP.

On the other hand, the amended PSD only prohibits Member States from granting the benefits of the PSD to arrangements satisfying the AAP. Is it really the case that the UK is "granting the benefits of the Directive" merely by having a general domestic dividend exemption regime which happens to include dividends paid by EU subsidiaries? The dividend exemption (which applies equally to dividends that fall outside the scope of the PSD) might instead be viewed as a stand-alone policy. If the UK is not "granting the benefits of the Directive" when exempting a dividend that falls foul of the AAP, it is arguably not in breach of its obligations.

If the UK government has concluded that no changes are required to reflect the AAP, this seems to be a bold, if not wholly unjustified, stance.

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