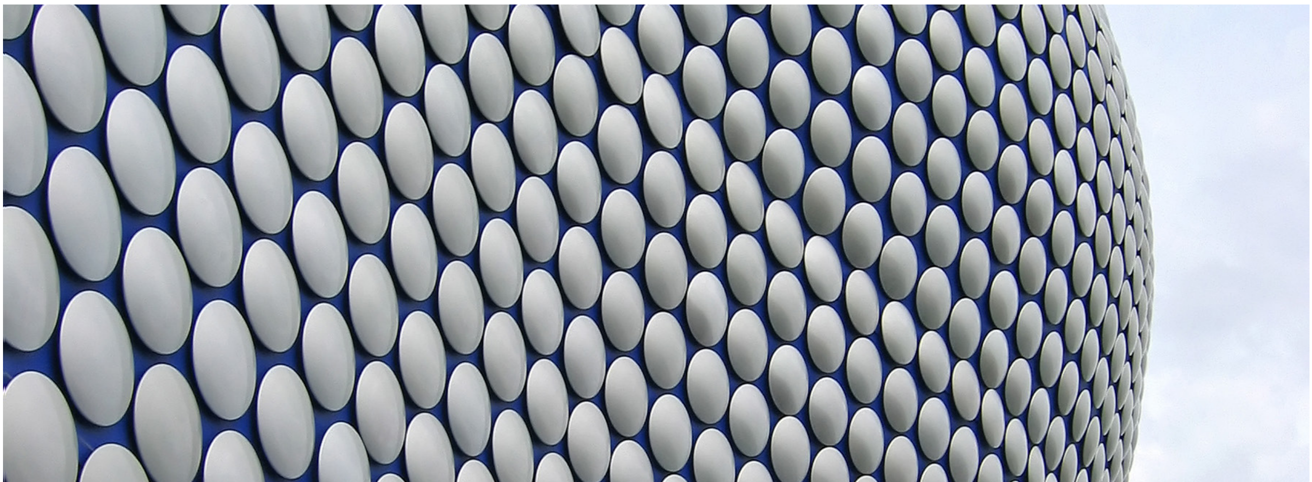
OECD TACKLES BASE EROSION AND PROFIT SHIFTING

Mazars tax newsletter - September 2013



ABOUT MAZARS

Mazars is an international, integrated and independent organisation, specialising in audit, accounting, tax and advisory services. We rely on the skills of more than 13,500 professionals in the 71 countries which make up our integrated partnership.

In China, Mazars has 600 highly-qualified professionals based in Beijing, Guangzhou, Hong Kong and Shanghai. They are fully committed to serving the growing and diversified needs of both Chinese companies and international firms.

OECD ACTION PLAN WILL CHANGE THE LANDSCAPE OF INTERNATIONAL TAX PLANNING

The OECD 'Action plan on Base Erosion and Profit Shifting' ('BEPS') was issued on 19 July 2013. This identifies 15 key actions along with timelines, with most actions being addressed within two years. The scale of the plan is ambitious, and will result in a dramatic change in the landscape of tax planning in the international arena. An underlying theme is tackling the artificial separation of taxable income from the activities that generate it. Going forwards, the focus will be much more on the underlying substance and where value is really created within an international business.

The action plan highlights the huge changes in the way multinational enterprises (MNEs) operate in the 21st century – particularly the impact of the digital economy, and the impact this can play in tax avoidance. Other changes over the years which have also had an impact include the removal of trade barriers, the free movement of capital, exploitation of intellectual property and the way risk is managed. As international standards and bilateral tax treaties have not kept pace with these changing business models, they have been unable to tackle aggressive tax planning.

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Sweeping changes are proposed in many areas, and these will require cooperation at international level. The current mood in the G20 suggests that the political will to see this through will be forthcoming.

WHAT ACTIONS HAVE BEEN PROPOSED?

As noted above, there are 15 actions identified altogether, and these have been split into the timeframe set out below. The action plan anticipates that some of the actions could take faster, and there is a real sense of urgency that rapid action must be taken.

ACTIONS IN THE NEXT 12 – 18 MONTHS

The first tranche of actions will focus on the following areas:

1. Report on the implications of the digital economy and possible actions – this will cover both direct and indirect taxes. A key issue identified is the ability of a company to have a significant digital presence in another country but without being liable to tax on the resulting profits;
2. Putting a stop to hybrid mismatch arrangements and arbitrage opportunities – these are structures that exploit the different tax regimes of countries. Whilst the OECD action plan acknowledges it is hard to see which country is actually losing tax, it is clear this practice will no longer be tolerated. For example, this includes 'double dip' arrangements where the same interest expense is relieved in two different countries, or where an asymmetry of treatment between countries is exploited, so that one county grants a tax deduction for a payment which is not then taxed in the hands of the recipient;
3. Prevention of treaty abuse - by developing model treaty provisions and the provision of guidance on domestic provisions to deny treaty benefits in inappropriate circumstances (such as the double non-taxation of profits);
4. Updating transfer pricing on intangibles - to prevent the siphoning off of profits by moving IP in such a way that the profits are divorced from where the real value has been created. There will be a greater emphasis on underlying substance;
5. Re-examining transfer pricing documentation requirements with a common template to allow Governments to see the big picture regarding the global allocation of profits, economic activity and taxes paid;
6. Starting work looking at harmful tax practices i.e. preferential tax regimes. This is particularly an issue for income such as profits from financial activities and IP, as the underlying assets can easily be moved anywhere. More account is to be taken of the underlying substance. The OECD will also engage with non-OECD members – it remains to be seen whether they will cooperate or if the 'problem' of base erosion will simply shift to new territories.

ACTIONS IN THE NEXT TWO YEARS

The next tranche of actions identified are:

1. Strengthening controlled foreign companies ('CFC') rules. The OECD wishes to remove or reduce the incentives for multinational enterprises to shift profits into low taxed jurisdictions;
2. Limit base erosion by using related party and third party debt to achieve excessive interest deductions, or to finance the production of income which is either tax exempt or deferred;
3. Change the trigger for creating a taxable presence in another country, known as a permanent establishment ('PE') – at present, companies can avoid tax in another country by ensuing their business there is limited to preparatory or auxiliary activities, such as marketing activity and the storage of goods, and by making sure that sales are actually concluded in a different (low tax) territory. Another arrangement under attack is the use of commissionaire arrangements. These are sales agency arrangements which allow a third party agent in a country to make sales by acting as an undisclosed agent for the principal, and where the bulk of profits remain with the principal (which can therefore be located in a low tax territory). The only profits the 'host' country (i.e. where the sales agent is based) can tax are the commissions received by the sales agent, which are relatively low. Commissionaire arrangements are only possible in civil law jurisdictions, such as those in continental Europe;
4. Transfer pricing work on the allocation of risks and capital within a multinational enterprise. There will be a greater focus on where value is actually created and underlying substance;
5. Further work will continue reading transfer pricing of intangibles and harmful tax practices;
6. The development of a mandatory requirement for the disclosure of aggressive or abusive transactions. This will draw on the rules some countries already have in place in a domestic context.

7. On the positive side, there will also be work done to improve dispute resolution between countries as regards taxing rights.

ACTIONS BEYOND 2 YEARS

Work will continue on tackling BEPS beyond the first two waves of action. Longer term work will focus on:

1. Transfer pricing aspects of financial transactions;
2. Further work on harmful tax practices; and
3. Development of a multilateral instrument to change bilateral tax treaties.

IMPLICATIONS FOR CHINA AND HONG KONG

As a G20 state, China has interest in adopting the BEPS initiatives as well as taking part in the discussion on the details of the action plan in order to protect its tax base. Over the past few years, China led tax developments in relation to indirect equity transfer, beneficial ownership, and transfer pricing practices towards these goals.

In the area of transfer pricing, China has been advocating both its position on intangibles and its response to challenges to comparability analysis in developing countries (e.g. location savings and market premium concepts).

While the OECD action plan has ruled out formulary apportionment, i.e. apportionment of global profits based on the assets or turnover etc., there is still much room for the application of special measures beyond the arm's length principle. It is very probable that China sees the BEPS as an encouragement to experiment more non-traditional methods such as profits split methods. Therefore, we expect more controversies and uncertainties and we recommend multi-national corporations with operations in China to take a closer look at their transfer pricing policies.

China's determination and efforts to strengthen its cooperation with the international tax community has been reinforced with the signature of the Convention on Mutual Administrative Assistance in Tax Matters (the "Convention") on 27 August 2013. In a nutshell, this Convention means that China will be joining a network of 56 countries, including the G20 countries, in the cooperation of tax administration in the world.

The Convention would focus and allow:

1. Exchange of Information
2. Assistance in recovery
3. Service of documents

Although the implementation details need to be ironed out, where China may use its rights as allowed by the reservation clauses, we expect further discussions on:

1. **Automatic exchange of information**, as it goes beyond the Exchange of Information Clauses in Tax Agreements and Tax Information Exchange Agreement;
2. **Convention allowing tax inspection** and possibility to lead a **tax examination abroad**.

China has not yet clearly expressed its position to these extended measures but the signature of the Convention would provide China an additional channel to combat tax evasion on the profits shifted outside China.

Hong Kong will not be in a position to exert the same level of direct influence in shaping responses to BEPS as China. One of the important points in the action plan is a call for more tax transparency. Hong Kong has just passed the bill allowing Hong Kong tax authority to enter into standalone Tax Information Exchange Agreements (TIEAS) and to have a broader and more effective information exchange with its Comprehensive Double Tax Agreements (CDTAs). There is undoubtedly pressure for Hong Kong to increase cooperation with other tax authorities in the Exchange of Information area.

The focus on treaty shopping in the action plan will also have an implication for multi-national or Chinese enterprises using Hong Kong as a holding company to take advantage of its expanding CDTAs. To benefit the tax treaty, economic and physical substance needs to be maintained in Hong Kong.

Hong Kong and Chinese investors with overseas investments and/or operations will need to be aware of the more challenging tax environment overseas resulting from the BEPS.

The content of this newsletter is only for general guidance on matters of interest and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Readers are advised to consult their tax advisors before making any business decisions.

Mazars is present on 5 continents.

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