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OECD Publishes Final BEPS Project Reports

A focus on hybrid arrangements, interest deductions, treaty abuse and permanent establishment structures.

On 5 October 2015, the OECD published its highly anticipated final reports in relation to Base Erosion and Profit Shifting (BEPS). The reports are the culmination of a two-year project that began with the Action Plan on BEPS which G20 Leaders endorsed in July 2013. The project considers 15 action points, aimed at addressing increasing international concern at multinational enterprises avoiding taxes through BEPS and aggressive tax planning. More than 60 countries participated in the BEPS project, and participating countries have agreed a comprehensive package of measures which, together, could result in significant changes to taxation regimes internationally.

A number of the recommendations require changes to national legislation and participating countries have agreed on four “minimum standards” to prevent any adverse impact on competitiveness which might result from inaction by individual countries. Other recommendations require changes to double taxation treaties (DTTs). To speed through these changes, the OECD is co-ordinating negotiations among more than 90 countries to develop a multilateral instrument to implement changes to their DTTs.

This *Client Alert* briefly summarizes some of the important issues arising from the reports, focusing on certain key action points.

Summary of Key Recommendations

Hybrid Mismatch Arrangements (action point 2)

The OECD report on hybrid mismatch arrangements recommends changes to domestic legislation and DTTs to increase the coherence of corporate income taxation at the international level and reduce opportunities for companies to exploit differences in the tax treatment of certain instruments, transfers and entities in different countries.

The report recommends that countries implement rules to align the tax outcomes under hybrid mismatch arrangements between the relevant jurisdictions:

- ***Payments that give rise to a deduction with no inclusion outcome***: The deduction should be denied in the payer jurisdiction.

- ***Payments that give rise to a double deduction outcome***: The duplicate deduction in the parent jurisdiction should be denied.

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- ***Payments that give rise indirectly to a deduction with no inclusion outcome***: The payer jurisdiction should deny deduction for a payment if the payee sets the income from the payment off against expenditure under a separate hybrid mismatch arrangement.

If a jurisdiction does not implement its own hybrid mismatch rules, counterparties can then take steps to neutralize the effect of the arrangement by disallowing the associated deduction under their own rules.

The report also recommends that countries make legislative changes to:

- Deny dividend exemptions (or equivalent reliefs) for payments that are deductible for the issuer
- Prevent hybrid transfers being used to duplicate credits for taxes withheld at source
- Alter the effect of CFC and other offshore investment rules to bring the income of hybrid entities within the charge to taxation under the laws of the investor jurisdiction
- Adopt reporting requirements for tax transparent entities
- Restrict the tax transparency of reverse hybrids that are members of a control group

Interest Payments (action point 4)

The OECD report on BEPS action point 4 describes a "best practice approach," based around a fixed ratio rule, which limits an entity's net interest deductions to a fixed percentage of its profit, measured using earnings before interest, taxes, depreciation and amortization (EBITDA). This approach links available deductions directly to taxable income. The report recommends a fixed ratio within a corridor of 10-30% (subject to revision following review in 2020). If adopted, the changes are likely to significantly impact transactions in jurisdictions that do not currently apply an "interest barrier rule."

Countries are encouraged to combine the fixed ratio rule with a group ratio rule to allow entities to deduct additional interest expense in certain circumstances. Under the group ratio rule, an entity may deduct interest expense up to the net third-party interest/EBITDA ratio of its group, if this group ratio is higher than the fixed ratio described above. This rule is designed to reduce the impact of the fixed ratio on highly leveraged groups.

Countries may apply a de minimis threshold based upon a monetary value of net interest expense. Below this threshold, entities may deduct interest without restriction. Countries should consider including anti-fragmentation rules to prevent entities avoiding the rules by establishing a number of smaller entities.

Further work, to be completed in 2016, will consider targeted rules for the banking and insurance sectors.

Preventing Treaty Abuse (action point 6)

The OECD report on BEPS action point 6 sets out recommended changes to DTTs to prevent treaty shopping. The OECD intends that these changes will be included in the multilateral instrument currently under negotiation.

Given the risk posed by treaty shopping, countries have committed to a "minimum standard." This standard requires countries to include a clear statement in DTTs that they intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including via treaty shopping.

The minimum standard also requires DTTs to include a somewhat controversial general anti-abuse rule, referred to as the "principal purposes test." If one of the principal purposes of transactions or arrangements is to obtain treaty benefits, those benefits will be denied unless granting them is in accordance with the object and purpose of the treaty.

In addition, or as an alternative, countries shall include a specific anti-abuse "limitation on benefits rule" to limit the availability of treaty benefits to cases in which there is a sufficient link between the entity and its state of residence. If only this rule is used, countries must address conduit financing arrangements.

The report also sets out a number of targeted rules to be included in DTTs to address abuse, including:

- Dividend transfer transactions intended to lower withholding taxes payable on dividends
- Transactions that circumvent the application of the treaty rule allowing source taxation of shares of companies that derive their value primarily from immovable property
- Situations in which an entity is a resident of both of the two states party to the relevant DTT (each a Contracting State)
- Situations in which shares, debt-claims, rights or property are transferred to permanent establishments set up in countries that offer preferential treatment to such income

A further report will be published in 2016 following a review of US amendments to the US Model Income Tax Treaty which address some of these issues.

Preventing Avoidance of Permanent Establishment (PE) Status (action point 7)

The OECD report on BEPS action point 7 suggests amendments to the definition of a PE used in DTTs. These amendments are intended to address avoidance strategies used to circumvent the existing definition and artificially shift profits out of the country in which sales take place. The changes will be included in proposals for the multilateral instrument.

The key changes to the definition will mean that:

- If persons in a Contracting State habitually play a principal role leading to the conclusion of contracts without material modification by an enterprise, that enterprise will be deemed to have a PE in the Contracting State.
- The exclusions within the PE definition will be modified such that they only apply if the activity of the fixed business is of a "preparatory or auxiliary character." The accompanying commentary will specifically note that if an enterprise maintains in a Contracting State a large warehouse with a significant number of employees working for the purpose of storing and delivering goods which the enterprise owns and sells online to customers in that Contracting State, this activity will not be of a "preparatory or auxiliary character." This provision is clearly targeted at certain significant online retailers.
- As a result of new anti-fragmentation rules, entities will not be able to avoid creating a PE by splitting up a business or the obligations under a contract into its constituent parts.

The OECD will publish further guidance by the end of 2016 in relation to the attribution of profits to PEs.

Other Reports

The additional reports published on 5 October 2015 which are beyond the scope of this *Client Alert* are as follows:

1. Action 1 – Addressing the Tax Challenges of the Digital Economy
2. Action 3 – Designing Effective Controlled Foreign Company Rules
3. Action 5 – Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
4. Action 8 to 10 – Aligning Transfer Pricing Outcomes with Value Creation
5. Action 11 – Measuring and Monitoring BEPS
6. Action 12 – Mandatory Disclosure Rules
7. Action 13 – Transfer Pricing Documentation and Country-by-Country Reporting
8. Action 14 – Making Dispute Resolution Mechanisms More Effective
9. Action 15 – Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

Next Steps

The final OECD report will be presented to G20 Leaders in November 2015. The BEPS project will then move into the implementation phase which will be key to the project's overall impact in the global market. The latest reports did not contain a timescale for implementation, on which the relevant parties have yet to reach agreement. Co-ordination will be essential to ensure that the competitiveness of markets is maintained.

The OECD has stated that it expects the final multilateral instrument to be ready by the end of 2016. The OECD is in ongoing consultation with other countries and international bodies, aiming to build an inclusive framework to encourage wider participation globally. A further OECD BEPS report in relation to developing countries is due in 2016. The OECD will review the global implementation of its recommendations with an initial report expected in 2020.

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