# International tax trends: BEPS, OECD Convention on MAA and CRS

ICPAK Transfer Pricing Workshop : 5th July, 2016

Presenter: Jemimah Mugo

Building a better working world

# Agenda

- Global trends
- What is BEPS?
- The status and the impact on your business?
- OECD Convention on Mutual Administrative Assistance
- Common Reporting Standards

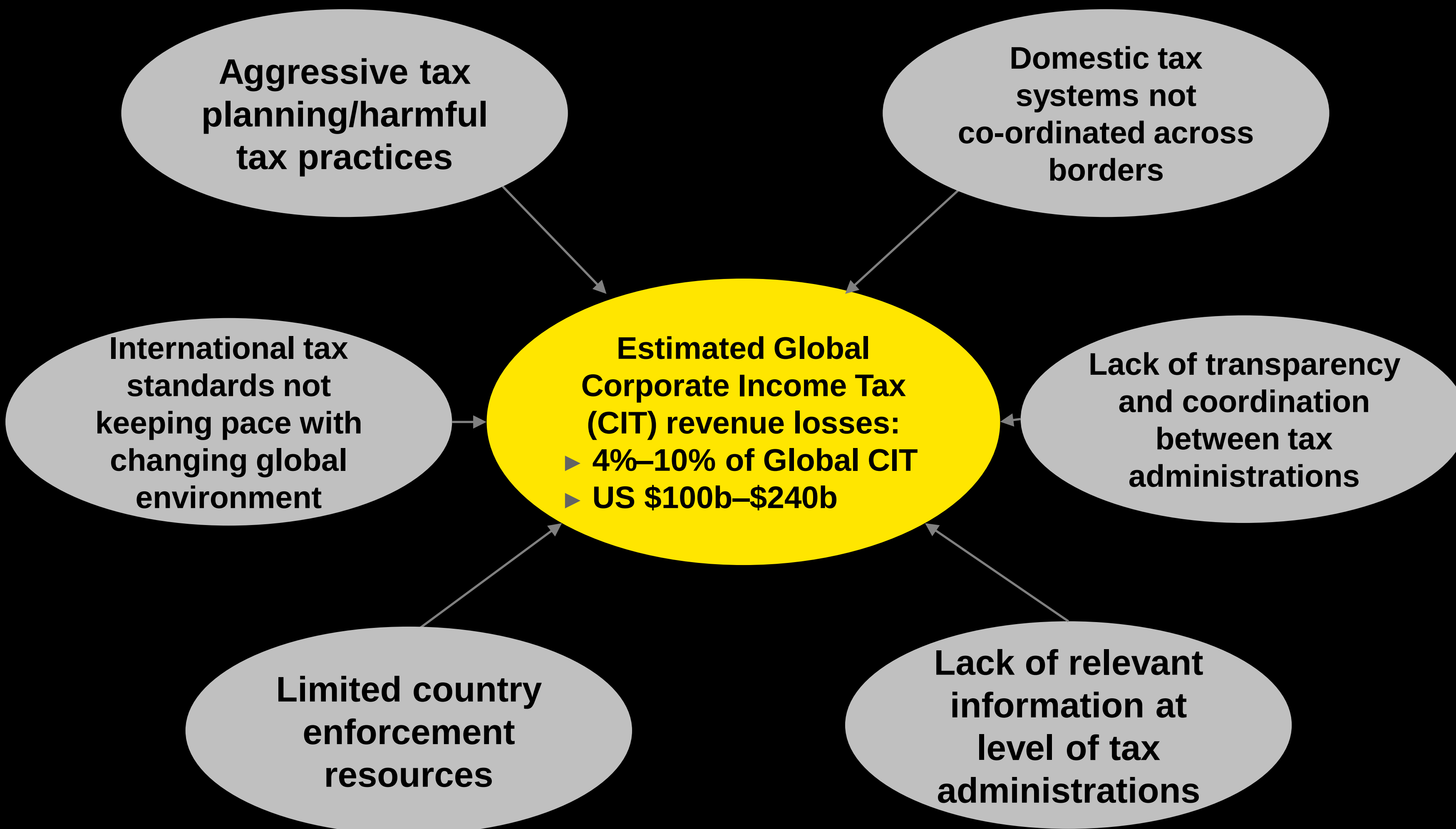
# The new global tax environment

- Government deficits and debt are now driving a far greater focus on raising tax revenue
- In many countries, tax activism and media coverage is sparking broad public discussion and political focus on business taxation
- High rate of tax policy legislative and regulatory change continues, as do changes in tax administration, to improve tax enforcement – both at country and global level - which affect operation of taxpayers.
  - Behavior and attitude towards tax risk has changed
  - Tax authorities have access to more information:
  - Aggressive tax assessments and tax fraud allegations
  - Generalized increase in source taxation
  - Unilateral domestic law changes aimed at curbing tax avoidance: e.g. GAARs, restrictions on Interest and royalty deductibility and Anti-treaty abuse rules

# The OECD BEPS project

- BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid
- The G20 member countries requested the OECD to come up with  an Action plan to deal with BEPS

# Why BEPS?


Aggressive tax planning/harmful tax practices
Domestic tax systems not co-ordinated across borders
International tax standards not keeping pace with changing global environment
Estimated Global Corporate Income Tax (CIT) revenue losses:
▶ 4%–10% of Global CIT
▶ US $100b–$240b
Lack of transparency and coordination between tax administrations
Limited country enforcement resources
Lack of relevant information at level of tax administrations

# The OECD BEPS project

- The OECD developed an Action plan, consisting of 15 specific actions, which were adopted by the G20 and OECD in September 2013 .
- The final outputs for the actions were released in October 2015

# Overview of the Specific Actions

1. Address the tax challenges of the digital economy
2. Neutralize the effects of hybrid mismatch arrangements
3. Strengthen CFC rules
4. Limit base erosion via interest deductions and other financial payments
5. Counter harmful tax practices taking into account transparency and substance
6. Prevent treaty abuse
7. Prevent the artificial avoidance of PE status
8. Consider transfer pricing for intangibles
9. Consider transfer pricing for risks and capital
10. Consider transfer pricing for other high-risk transactions
11. Establish methods to collect and analyze data on BEPS and actions to address it
12. Requires taxpayers to disclose their aggressive tax planning arrangements
13. Re-examine transfer pricing documentation
14. Make dispute resolution mechanisms more effective
15. Develop a multilateral instrument

# Overview of the Specific Actions...

## Coherence

*Harmful or inappropriate use of international tax legislation to obtain unintended tax benefits*

**Action 2**
**Hybrid mismatch arrangements**

**Action 3**
**Controlled foreign corporation (CFC) rules**

**Action 4**
**Interest deductions and other financial payments**

**Action 5**
**Harmful tax practices**

## Substance

*Mismatches where profits are being taxed vs. where people responsible for generating these profits are located*

**Action 6**
**Preventing tax treaty abuse**

**Action 7**
**Artificial avoidance of permanent establishment (PE) status**

**Action 8**
**Transfer pricing (TP) aspects of intangibles**

**Action 9**
**TP aspects of risk and capital**

**Action 10**
**TP aspects of high-risk transactions**

## Transparency

*Provide tax authorities information to carry out audits better and determine if "fair share" of taxes are being paid*

**Action 11**
**Methodologies and data analysis**

**Action 12**
**Disclosure rules**

**Action 13**
**TP documentation and country-by-country (CbC) reporting**

**Action 14**
**Dispute resolution**

**Action 15 Multilateral instrument**

**Action 1**
**Digital economy**

# Action 1: Addressing the tax challenges of the digital economy

- Main area of concern was the tax evasion loopholes challenges brought about by the Digital Economy
  - Development of new business models that were not previously in existence when the current domestic and international tax laws were developed, hence income from such business often goes untaxed
    - Examples: several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services
  - The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations

# Action 1: Addressing the tax challenges of the digital economy

- The proposed measures for dealing with the tax challenges brought about by the digital economy include
  - Permanent Establishment related changes
    - Modification of the list of exceptions to the definition of PE to restrict each of the exempted activities to a “preparatory or auxiliary” character, the introduction of new anti-fragmentation and modifications to the PE definition to counter commissionaire and similar arrangements
  - Revision of transfer pricing guidelines making it clear that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible
  - Recommendations on the design of effective CFC include definitions of CFC income that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent company

# Action 2 : Neutralising the Effects of Hybrid Mismatch Arrangements

- These arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral.
  - An example of such an arrangement would be a syndicated that are may be treated as a debt instruments in one country and as an equity instruments in another country .
- Effects of hybrid mismatch arrangements usually result in multiple deductions for a single expense, deductions without corresponding taxation or the generation of multiple foreign tax credits for one amount of foreign tax paid

# Action 2 : Neutralising the Effects of Hybrid Mismatch Arrangements

- Recommendations - the design of domestic rules and the development of model treaty provisions that would neutralise the tax effects of hybrid mismatch arrangements.
  - **Part I** deals with changes in the domestic laws
    - Main proposal - the introduction of a primary linking rule that that align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction but otherwise does not disturb the commercial outcomes.
    - For instance such a rule would deny a taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction.
  - Part II - aimed at ensuring that hybrid instruments and entities, as well as dual resident entities, are not used to obtain unduly the benefits of tax treaties and that tax treaties do not prevent the application of the changes to domestic law recommended in Part I

# Action 3: Designing Effective Controlled Foreign Company Rules.

- Concern: MNC often create non-resident affiliates to which they shift income and that these affiliates may be established wholly or partly for tax reasons rather than for non-tax business reasons
  - Controlled foreign company (CFC) and other anti-deferral rules combat this by enabling jurisdictions to tax income earned by foreign subsidiaries where certain conditions are met.
- The recommendations:
  - CFC exemptions and threshold requirements
  - Definition of CFC income
  - Rules for computing income
  - Rules for attributing income
  - Rules to prevent or eliminate double taxation

# Action 4: Limiting base erosion involving interest deductions and other financial payments

- BEPS risks that may arise with respect to interest expense could be grouped into in three basic scenarios
  - MNCs placing higher levels of third party debt in high tax countries.
  - MNCs using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense.
  - MNCs using third party or intragroup financing to fund the generation of tax exempt income
- Proposed recommendations to tackle the concerns related to interest expense deductibility include
  - Introduction of a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA). Range of 10% to 30% has been proposed .
  - Further, to supplement the fixed ratio rule with other provisions that reduce the impact of the rules on entities or situations which pose less BEPS risk

# Action 5 : Countering harmful tax practices more effectively, taking into account transparency & substance

- Concerns: preferential regimes that risk being used for artificial profit shifting and lack of transparency in connection with certain rulings
- The priority
  - improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and
  - on requiring substantial activity for any preferential regime (for both intellectual property (IP) regimes and other preferential regimes.)
- Consensus was reached that  substantial activity requirement used to assess preferential regimes should be strengthened in order to realign taxation of profits with the substantial activities that generate them.
- The nexus approach has been agreed on to in the context of IP regimes, and it allows a taxpayer to benefit from an IP regime only to the extent that the  taxpayer itself incurred qualifying research and development (R&D) expenditures that gave rise to the IP income

# Action 6: Preventing the granting of treaty benefits in inappropriate circumstances

- Concern is in the form of treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues.
- Recommendations include the introduction of new treaty anti-abuse rules through the following approaches
  - Inclusion of a clear statement in tax treaties that the States that enter into the tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance
  - Introduction of a specific anti-abuse rule, the limitation-on-benefits (LOB) rule, that limits the availability of treaty benefits to entities that meet certain conditions in the OECD Model Tax Convention
  - Introduction of a more general general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or “PPT” rule) in the OECD Model Tax Convention to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule described above

# Action 7: Preventing the artificial avoidance of PE status

- Concerns: circumvention of the existing definition of the term PE to artificially shift profits to low or no tax jurisdictions
- Avenues used to avoid creating PE status include:
  - Commissionaire and Similar arrangements \
  - Abuse of the exemptions to the definition of PE including the fragmentation of cohesive business functions to smaller preparatory or auxiliary functions.
- Proposals: changes to be made to the definition of PE in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties.
- Further to the changes recommended, there will be restored taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates as result of the provisions of tax treaties

# Action 8 -10: Aligning transfer pricing (TP) outcomes with value creation

- Concern: the misapplication of the existing international standards for TP rules resulting in outcomes in which the allocation of profits is not aligned with the economic activity that produced the profits
  - Action 8 looked at TP issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has contributed to BEPS
  - Action 9 addressed the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. Further, Action 9 addressed the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company

# Action 8 -10: Aligning transfer pricing (TP) outcomes with value creation

- Action 10 focused on other high-risk areas, including:
  - the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation),
  - the scope for targeting the use of TP methods in a way which results in diverting profits from the most economically important activities of the MNE group, and
  - neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation
- Recommendation: revised guidance to the existing TP rules that requires careful delineation of the actual transaction between the associated enterprises by analysing the contractual relations between the parties in combination with the conduct of the parties

# Action 8 -10: Aligning transfer pricing (TP) outcomes with value creation – cont'd

- The revised guidance includes two important clarifications relating to risks and intangibles:
  - Risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks.
  - For intangibles, the guidance clarifies that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions.
- The proposals under Action 8-10 will ensure that transfer pricing outcomes better align with value creation of the MNE group.

# Action 11: Collecting and analysing data on BEPS

- Concerned with measuring BEPS activity rather than addressing it
  - It is intended to estimate the size of BEPS, identify indicators of BEPS, and provide recommendations for improving the measurement of BEPS.
- The final report notes estimates that global CIT revenue is reduced by 4% to 10% (i.e., US$100B to US$240B annually) as a result of BEPS.
- The six indicators of BEPS identified in the Final report include
  - the concentration of foreign direct investment in low tax countries;
  - the profit rates of MNE affiliates in low tax countries compared to those in high tax countries;
  - the profit rates of MNE affiliates in low tax countries compared with the profit rate of their own global groups;
  - the effective tax rates of MNEs compared to those of domestic-only enterprises;
  - the separation of intangible assets from the location of their production;
  - the concentration of debt in MNE affiliates located in higher-tax rate countries.
- Recommendation: greater cooperation between the OECD and taxing authorities in the collection and sharing of data

# Action 12: Mandatory Disclosure Rules

- Focus - the lack of timely, comprehensive and relevant information on aggressive tax planning strategies - main challenges faced by tax authorities worldwide.
- 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.
- The report provides a modular framework that enables countries without mandatory disclosure rules to design a regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes and their users.
- The Report also sets out specific recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations.

# Action 13: TP documentation and country-by-country (CbCR) reporting

- Aim: development  of rules regarding TP documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business.
- In response to this requirement, a three-tiered standardised approach to TP documentation was developed.
  - First, the guidance on TP documentation requires MNEs to provide tax administrations with high-level information regarding their global business operations and TP policies in a “master file” that is to be available to all relevant tax administrations.
  - Second, it requires that detailed transactional TP documentation be provided in a “local file” specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company’s analysis of the TP determinations they have made with regard to those transactions.
  - Third, large MNEs are required to file a CbC Report that will provide annually and for each tax jurisdiction in which they do business: the amount of revenue, profit before income tax and income tax paid and accrued.

# Action 13: Transfer pricing documentation and country-by-country reporting

## Master file

High-level information about MNC's business, transfer pricing policies and agreements with tax authorities in single document available to all tax authorities where MNC has operations.

## Local file

Detailed information about MNC's local business, including related party payments and receipts for products, services, royalties, interest, etc.

## Country-by-country report (CbCR)

High-level information about jurisdictional allocation of profits, revenues, employees and assets.



EY

# Master file – information required

| Organizational Structure | Business description | Intangibles | Intercompany financial activities | Financial and tax positions |
|---|---|---|---|---|
| Structure chart:<br>▸ Legal ownership<br>▸ Geographic location | Important drivers of business profit | Overall strategy description | Financing arrangements for the group (related and unrelated lenders) | Annual consolidated financial statements |
| | Supply chain of:<br>▸ Five largest products/services by turnover<br>▸ Products/services generating more than 5% of turnover | List of important intangibles and legal owners | Identification of financing entities | List and description of existing unilateral advance pricing agreements (APAs) and other tax rulings |
| | Main geographic markets of above products | List of important intangible agreements | Details of financial transfer pricing policies | |
| | List and brief description of important service arrangements | R&D and intangible transfer pricing policies | | |
| | Functional analysis of principal contributions to value creation by individual entities | Details of important transfers | | |
| | Business restructuring/acquisitions/divestitures during fiscal year | | | |

# Local file – information required

| Local entity | Controlled transactions | Financial information |
|---|---|---|
| ▸ Management structure<br>▸ Local organization chart<br>▸ Details on individuals to whom local management reports | ▸ Description of material controlled transactions and context in which they take place.<br>▸ Identification of associated enterprises party to controlled transactions and relationship<br>▸ Functional analysis<br>▸ Transfer pricing methods used<br>▸ Comparables and details of methodology | Local entity financial statements |
| Description of business and business strategy pursued | Amounts of intragroup payments and receipts for controlled transactions (products, services, royalties, interest etc.) | Reconciliation to show how financial data used in applying the transfer pricing method ties to the financial statements |
| Details of business restructurings and/or intangible transfers | Unilateral and bilateral/multilateral APAs and other tax rulings related to the controlled transactions | Summary of relevant financial data for comparables and sources from which data was obtained |
| Key competitors | | R&D and intangible transfer pricing policies |
| | | Details of important transfers |

# Action 14: Making dispute resolution mechanisms more effective

- Action 14 is contains measures aimed at strengthening the effectiveness and efficiency of the mutual agreement procedure (MAP) mechanism.
- The main objectives of the measures are to
  - allow taxpayers access to the MAP process when the requirements for taxpayers to access the MAP process are met;
  - ensure that domestic administrative procedures don’t block access to the MAP process; and
  - ensure that countries implement Article 25 of the OECD Model Tax Convention in good faith.
- The measure aims to minimise the risks of uncertainty and unintended double taxation by ensuring the consistent and proper implementation of tax treaties, including the effective and timely resolution of disputes regarding their interpretation or application through the MAP mechanism

# Action 15: developing a multilateral instrument to modify bilateral tax treaties

- Action 15 explored the technical feasibility of a multilateral instrument to implement the treaty-related measures developed during  the course of the BEPS project and to amend bilateral tax treaties.
- The main objective of a multilateral instrument would be to modify existing bilateral tax treaties in a synchronised and efficient manner to implement the tax treaty measures developed during the BEPS Project, without the need to expend resources individually renegotiating each treaty bilaterally.
- The multilateral instrument should be ready for signing by the end of the 2016.

# Recent Developments

- On 23 February 2016 , the OECD agreed to a new all inclusive framework that would broaden country participation in the BEPS project .
  - The framework allowed non OECD and non-G20 member countries to participate in the BEPS Project on an equal footing as BEPS Associates.
  - In joining the inclusive framework, the BEPS Associates commit to the implementation of the four minimum standards, i.e.,
    - the work on harmful tax practices (Action 5),
    - tax treaty abuse (Action 6),
    - Country by Country reporting (Action 13) and
    - dispute resolution mechanisms (Action 14).

# Recent Developments

- The inclusive framework also supports the development of toolkits for developing countries.
- The toolkits are being prepared as  a joint effort between the OECD, IMF , UN and the World Bank to help developing countries implementing measures to tackle BEPS as well as other issues that developing countries have identified as priorities during the regional consultations
- On 30 June 2016, when the OECD held its first of the framework 36 countries  including Kenya joined  the framework as BEPS associates

# OECD Convention on Mutual Administrative Assistance

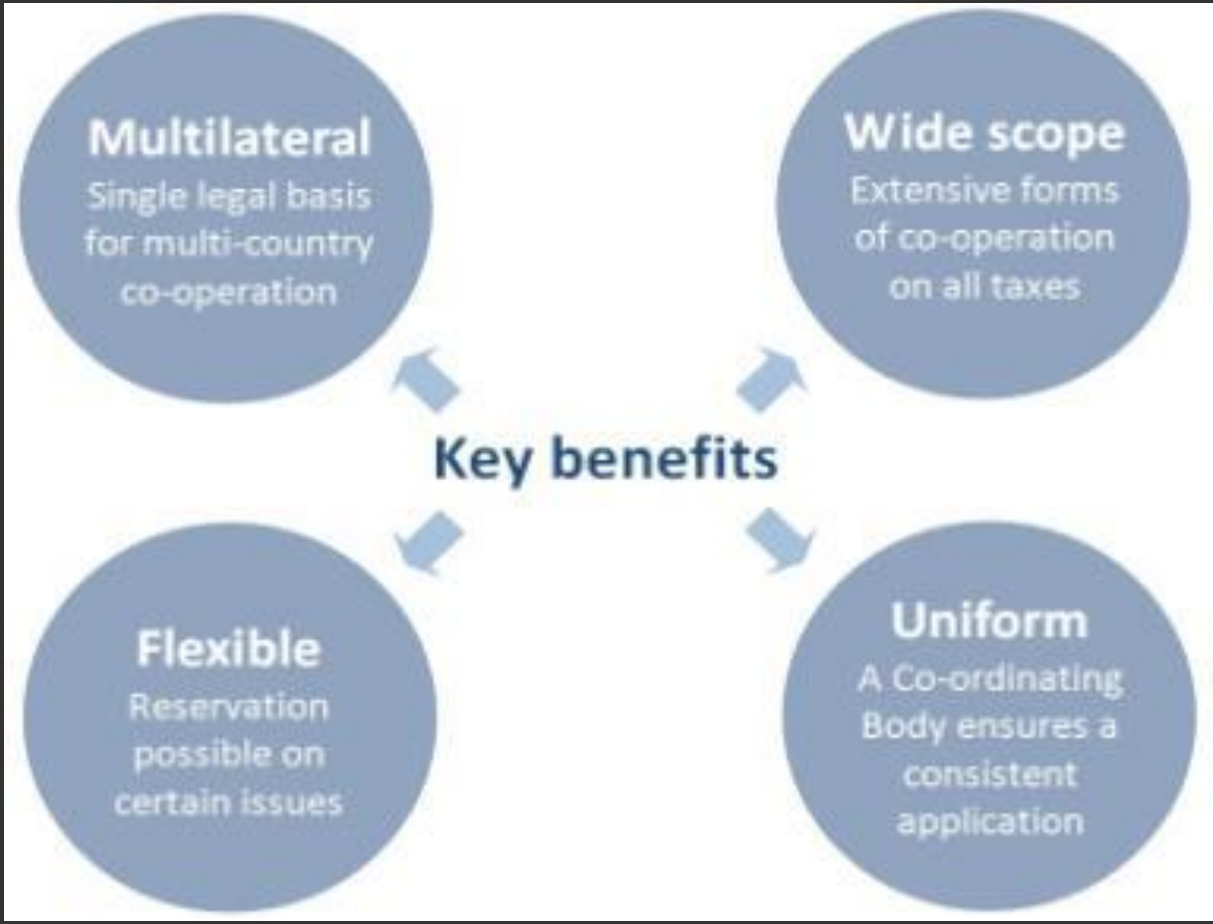
# The Multilateral Convention on mutual administrative assistance in tax matters: amended by the 2010 Protocol

- Developed jointly by the OECD and the Council of Europe in 1988 and amended by Protocol in 2010.
- The Convention is the most comprehensive multilateral instrument available for all forms of tax co-operation to tackle tax evasion and avoidance.
- The Convention was amended to respond to the call of the G20 at its 2009 London Summit to align it to the international standard on exchange of information on request and to open it to all countries, in particular to ensure that developing countries could benefit from the new more transparent environment.
- The amended Convention was opened for signature 1 June 2011

# The Multilateral Convention on mutual administrative assistance in tax matters: amended by the 2010 Protocol

- The amended Convention provides for all possible forms of administrative co-operation between states in the assessment and collection of taxes, in particular with a view to combating tax avoidance and evasion.
- The co-operation ranges from exchange of information, including automatic exchanges, to the recovery of foreign tax claims..
- Kenya became the 12th African country and the 94th Country to sign  the amended Convention in February 2016 .

# The Multilateral Convention on mutual administrative assistance in tax matters: amended by the 2010 Protocol



# Common Reporting Standards

# CRS

- The global standard for automatic exchange of financial account information.
- It has been developed by the OECD, working with G20 countries, and in close co-operation with the EU
- Under the standard, jurisdictions obtain financial information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis.
- The standard consists of two components:
  - The CRS, which contains the reporting & due diligence rules; and
  - The Model Competent Authority Agreement (CAA), which contains the detailed rules on the exchange of information.

# CRS

- To prevent circumventing the CRS it is designed with a broad scope across three dimensions:
  - The financial information to be reported with respect to reportable accounts includes all types of **investment income** (including interest, dividends, income from certain insurance contracts and other similar types of income) but also **account balances** and **sales proceeds** from financial assets.
  - The financial institutions that are required to report under the CRS do not only include **banks** and **custodians** but also other financial institutions such as **brokers, certain collective investment vehicles and certain insurance companies**.
  - Reportable accounts include accounts held by **individuals** and **entities (which includes trusts and foundations),** and the standard includes a requirement to look through passive entities to report on the individuals that ultimately control these entities.

# Key features

- To be effective it must be specifically designed with residence jurisdictions' tax compliance in mind rather than be a by-product of domestic reporting
- Be standardized to benefit the maximum number of residence jurisdictions, but also allow flexible for local implementation
- The model needs to have a global reach, because tax evasion is a global issue, so that it addresses the issue of offshore tax evasion and does not merely relocate the problem rather than solving it.

# Questions