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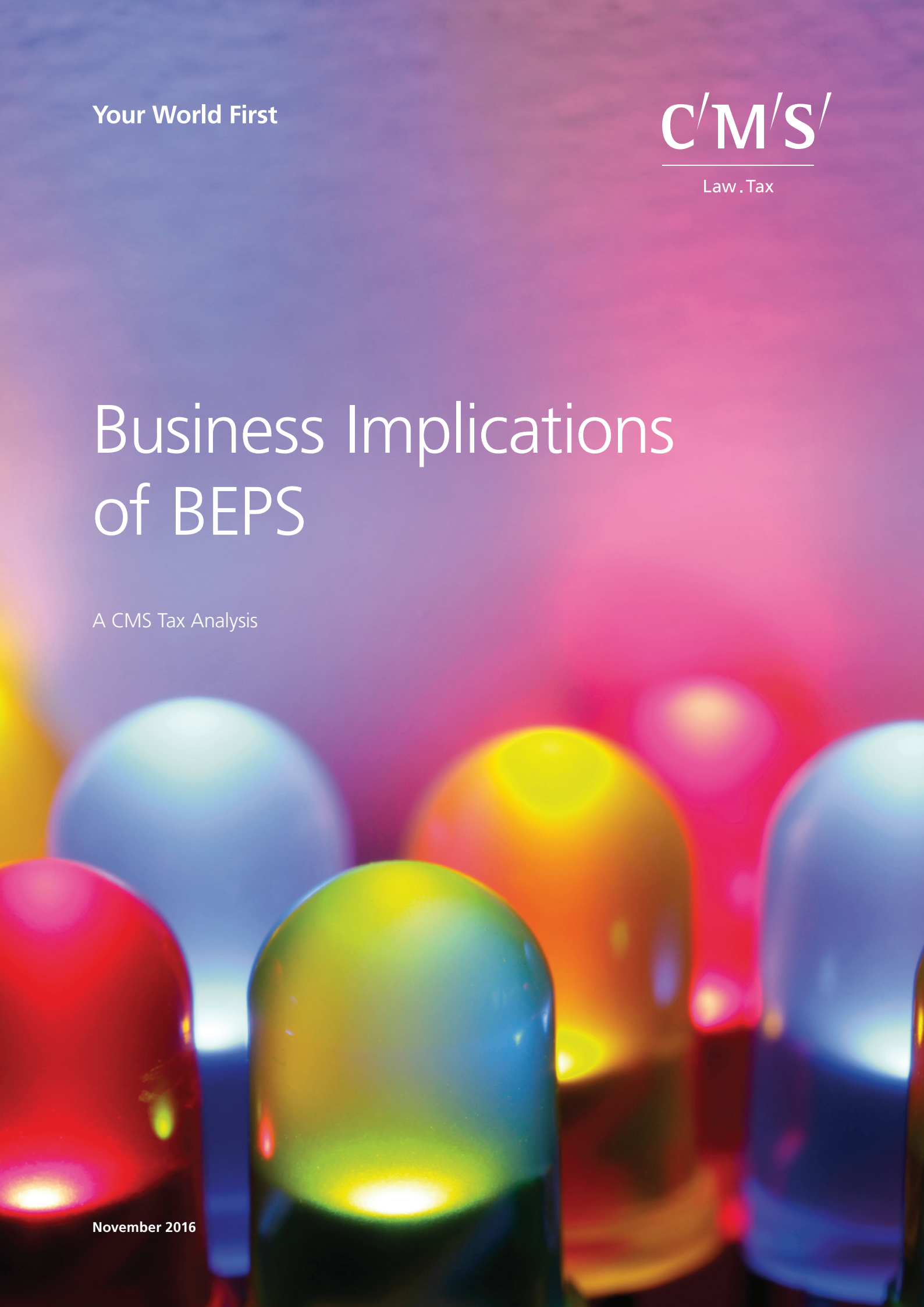
Business Implications of BEPS

A CMS Tax Analysis



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Foreword

Three years ago, following the 2013 Saint-Petersburg summit, the G20 leaders made the following statement: *"In a context of severe fiscal consolidation and social hardship, in many countries ensuring that all taxpayers pay their fair share of taxes is more than ever a priority. (…) We fully endorse the ambitious and comprehensive Action Plan – originated in the OECD – aimed at addressing base erosion and profit shifting with mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. Profits should be taxed where economic activities deriving the profits are performed and where value is created"*.

Three years later, the BEPS project has made considerable progress. Among its notable achievements, on 5 October 2015, the 13 reports for the 15-point Action plan were released in their final form. Based on three core principles – coherence, substance and transparency – these Actions address a wide array of international taxation matters, but also raise numerous questions in terms of practical application.

It is important to note that the BEPS project remains an ongoing work (a work in progress) by the OECD. While the reports on the 15 Actions are final, the OECD continues to publish Discussion Drafts with requests for commentaries by tax experts (for example: Discussion Draft on the Revised Guidance on Profit Splits, Discussion Draft on the Attribution of Profits to Permanent Establishments).

The following articles, written by CMS tax experts, offer in-depth analyses of some of the major BEPS Actions, giving their insight on the applicability of these Actions, their impact on domestic tax laws (and vice-versa), and both immediate and expected consequences on the taxpayer's day-to-day operations.

— In *"BEPS Action 1 and the Digital Economy: an Unsolvable Issue?"*, Raquel Fernandes (CMS Portugal), Elisabeth Ashworth (CMS France) and Stéphane Bouvier (CMS France) explain the elaborate ties between BEPS and the Digital economy, the difficulties encountered by BEPS Action 1 in addressing them, as well as various VAT issues such as the notion of Fixed Establishments when dealing with digital businesses.

— In *"Hybrid Mismatch Arrangements – Interest Deductions and Other Financial Payments"*, Heino Buesching (CMS Germany) presents the two BEPS Actions which most impact financing: Action 2 and Action 4, with a detailed analysis of the new rules aimed at hybrid financing instruments and hybrid legal forms as well as of the new rules proposed by Action 4 to limit the use of interest expense.

— In *"Taxation of Controlled Foreign Companies: Controversies and Challenges"*, Andrzej Pośniak (CMS Poland) and Arkadiusz Michaliszyn (CMS Poland) review Action 3, commenting on the general difficulties encountered when applying CFC rules, and on how the report for Action 3 proposes to deal with such issues as hybrid tax planning, defining levels of control, and use of exemptions and thresholds.

— In *"BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances"*, Fabrizio Alimandi (CMS Italy) studies the framework of Action 6, with an in-depth presentation of the Limitation of Benefits rule and Principal Purpose Test it introduces, as well as a review of specific bilateral tax treaties which have already incorporated comparable measures.

— In *"BEPS and Transfer Pricing: What Do We Do Now?"*, Xavier Daluzeau (CMS France) covers Actions 8, 9, and 10 and the new guidance on the delineation of actual transactions, the renovated framework on intangibles in transfer pricing, the definition and remuneration of low value-adding services and the revisions to Transfer Pricing Documentation – including the new measures from Action 13 – before explaining which steps multinational companies should take in light of these new rules.

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BEPS Action 1 and the Digital Economy: an Unsolvable Issue?

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According to the OECD and G-20 countries, the significant profits generated by the digital economy are being subject to minimum taxation through tax optimization schemes. For this reason, the OECD Final Report on BEPS Action 1 recommends taxing these profits where they are generated.

In February 2016, the French tax administration announced it would expect 1.6 billion euros from the tax reassessment of Google and would not negotiate the amount of applicable penalties. In other countries, e-commerce companies have negotiated their penalties with the competent tax authorities: Google for 172 million euros in the U.K. and Apple for 318 million euros in Italy. These amounts illustrate the importance of the tax challenges raised in the scope of the digital economy.

In just a few years, the digitization of the economy has changed the way companies do business, thus changing the economy itself. As pointed out by the OECD in its Final Report released in October 2015 on Action 1 ("Addressing the tax challenges of the digital economy") of its BEPS Action Plan, the digital economy "is increasingly becoming the economy itself."

However, according to the OECD and G-20 countries, the significant profits generated by the digital economy are subject to a minimum taxation through tax optimization schemes. For this reason, the Final Report on Action 1 mainly recommends to tax these profits where generated.

I. The Digital Economy Emphasizes BEPS Issues

In September 2013, the OECD and G-20 countries adopted a 15-point Action Plan to address tax challenges identified in a preliminary BEPS Report. The BEPS Action Plan raises the issue that, based on the use of intangible assets, the digital economy is a challenge to current tax regulations, which require a certain degree of economic presence to consider a company sufficiently integrated into the economy of a jurisdiction and to justify taxation in that country. In fact, the development of the digital economy challenges the traditional concept of "taxable presence", which remains the taxable event in most tax systems.

Studies show that more than two-thirds of the e-commerce companies' value arises from intangibles (patents, trademarks, goodwill, etc.). Nevertheless, these companies are often said to tend to disconnect legal and economic ownership of their assets, to locate their intangible assets in intermediary structures set up in low-tax countries and to repatriate their income without being subject to any withholding tax, or at a low level, especially in the case of royalties which create an important added value.

Furthermore, they are said to minimize profits in the market country and in the country of residence of the ultimate parent company which are traditionally high-tax jurisdictions, by avoiding a taxable presence. In case of taxable presence in these countries, e-commerce companies can reduce their taxable base by maximizing the deduction of payments made to other group companies in the form of interests, royalties, service fees, etc.

The BEPS Action Plan also raises awareness of the fact that the abuse of international tax treaties and domestic tax regimes leads almost to the tax exemption of profits achieved by these companies in high-tax jurisdictions. E-commerce companies are typically exploring significant existing tax loopholes between states, especially hybrid instruments and structures which can be used to achieve unintended double non-taxation or long-term tax deferral. Some companies are also being accused of abusing the tax competition engaged in between states and combining preferential regimes or intra-group mechanisms, misusing foreign tax credit or participation exemption regimes, resulting in tax exemption.

II. Action 1 of BEPS Action Plan does not Provide any Specific Answer to the Digital Economy Issues

Throughout its 285 pages, the Final Report on Action 1 regarding the digital economy tries to answer these various issues. However, the picture is mixed: while OECD and G-20 countries have made the digital economy the number one action of the BEPS Action Plan, two years later companies are still waiting for unambiguous answers.
Confirming the interdisciplinary character of the digital economy, the Final Report corroborates that the answers may not be specific to the digital economy itself but should concern the economy as a whole. As a consequence, it refers directly to the recommendations provided by the other taskforces of the BEPS Action Plan.
Regarding the issue of the transfer and use of intangible assets, Action 1 provides no practical answers and merely refers to Actions 8 to 10 relating to transfer prices. The taskforce concludes that a reform of transfer pricing is necessary in order to tax business profits in line with

economic value and to avoid the transfer of assets in low-tax countries. Indeed, the BEPS measures encourage the taxation of intangible assets based on their economic ownership, not only on their legal ownership.

Regarding the issues related to tax optimization and base erosion, Action 1 refers to Actions 2 to 6, regarding treaty shopping and abuses, hybrid mismatch arrangements, Controlled Foreign Company rules and interest deductions, but it does not directly answer the questions raised by the BEPS Action Plan concerning the digital economy. Furthermore, Action 1 entrusts domestic laws with the implementation of the solutions the states might identify themselves. For illustrative purposes, the taskforce on the digital economy ("TFDE") released previous reports which developed three options to address the digital economy challenges: the implementation of a new nexus in the form of a significant economic presence; a withholding tax on certain types of digital transactions; or an equalization levy. Finally, while these options conveyed a major ambition from the TFDE, none of them are recommended by the Final Report. However, the jurisdictions may nevertheless introduce them in their domestic laws.

Thus, on April 1, 2015, the U.K. Government introduced a "diverted profits tax," applying a punitive rate of 25% to profits diverted by companies avoiding a taxable presence in the U.K. The Italian Government also promises the implementation of a "digital tax": a withholding tax of 25% would apply on payments to nonresident companies for goods and services purchased online, requesting Italian financial intermediaries to act as withholding agents. In case no practical answer is implemented on a worldwide basis, this measure would be effective on January 1, 2017.

Regarding the taxable presence, the Final Report requires a new definition of the concept of "permanent establishment" ("PE") and concludes with the need to deal with this issue as per Action 7, dedicated to the definition of PE. Action 7, preventing the artificial avoidance of PE status, recommends the introduction of a new anti-fragmentation rule and the restriction of the "preparatory and auxiliary" exception of PE status. In addition, Action 7 encourages a new definition of the PE concept, modifying Article 5 of the OECD model tax convention. The result of this work should be implemented upon conclusion of a multilateral treaty modifying bilateral tax treaties (Action 15).

The aim is the effective taxation (both corporate income tax and value added tax ("VAT")) in the country of consumption of the goods or where the value is generated. This requires a change of the traditional concept of PE regarding corporate tax purposes.

Concerning VAT, the OECD mainly recommends that the place of consumption should become the general principle of taxation for the business-to-consumer ("B2C") services provided through electronic means, backed by a mechanism of distance VAT return filling and payment system such as the Mini One Stop Shop available, on a voluntary basis, within the EU VAT system since 2003 for non-EU companies and since January 1, 2015 for all EU traders when not established in the country of consumption.

As for goods consumption, the Action 1 Report also notes that the massive increase of B2C cross-border (EU and non-EU) trading has made some of the current system rules (such as the small business arrangement for distance sales within the EU or exemption of low value goods importation) conducive to fraud and unfair competition.

Under BEPS the OECD is also pushing for a harmonization (or even a merging?) of the concepts of "fixed" and "permanent" establishments; however, such an approach is not expected to be easily accepted by the EU institutions, since fixed establishment is an autonomous VAT concept not related to the equivalent concept for direct tax.

III. What is a Fixed Establishment for VAT, Exactly?

One should first notice that as far as the principle of taxation at the place of consumption applies, the stake for VAT purposes is to determine where the purchaser is established, and also, for business-to-business ("B2B") transactions, who is liable for the payment of VAT (provider if established and participates in the transaction, vs purchaser if the provider is not established or such establishment does not participate in the provided service). The aim is thus quite different from that for direct tax.

In the absence of a legal definition in the VAT Directive,[1] the concept of fixed establishment was gradually fine-tuned by the Court of Justice of the European Union ("CJEU") in a number of cases—notably *Berkholz*,[2] *Aro Lease BV*,[3] *DFDS*[4] and *Planzer Luxembourg*.[5]

In 2011, taking into account the CJEU case law, the EU legislator finally approved a definition (in fact, two definitions) of fixed establishment; Article 11 of the VAT Implementing Regulation[6] thus states the following:

1. With regard to Article 44 of the VAT Directive (B2B operations), a "fixed establishment" shall be any establishment of the recipient of the services, other than its seat of business, characterized by a sufficient degree of permanence and a suitable structure in terms of human and technical *resources to enable it to receive and use the services supplied to it for its own needs*;
2. With regard to B2C transactions, notably Article 45 of the VAT Directive, a "fixed establishment" shall be any establishment of the supplier of the services, other than the seat of business, characterized by a sufficient degree of permanence and a suitable structure in terms of human and technical resources *to enable it to provide the services which it supplies (the same rule also applies for the designation of the person liable for the payment in B2B transactions under Article 192a of the VAT Directive).*

In 2014, the CJEU ruled its first (and so far only) case law on e-commerce—*Welmory*.[7] It was also the first time the

question referred to the CJEU concerned a scenario in which services are supplied to (rather than from) a business's fixed establishment, applying the new place of supply rules.

The dispute concerned the power to tax services provided by a Polish company to a Cypriot business under a rather complicated cooperation agreement of e-commerce services. The question arose whether the Cypriot company maintained a fixed establishment in Poland within the meaning of Article 44 of the VAT Directive when receiving services supplied by the Polish company.

It is clear from the case that the Cypriot business did not own any resources in Poland. However, it had used resources mainly (or totally) belonging to the Polish company (which is simultaneously the supplier of the services), resources allegedly located outside Poland.
The CJEU considered that the concept of fixed establishment must be determined in relation to the taxable person receiving the services—the Cypriot business. Nonetheless, the Court reaffirms the seat of business as the primary point of reference to establish the place of supply of services.

The CJEU has also ruled that despite the nature of the services (e-commerce), the concept of fixed establishment requires at least a structure that is appropriate in terms of human and technical resources, such as computer equipment, servers and software; it is to the national court to ascertain the location of such elements in the present case. Nevertheless, the Court points in the direction of a fixed establishment should such resources be located in Poland.

The Court also considered it important to differentiate the services supplied by the Polish business to the Cypriot company (which VAT treatment is under dispute) from the onwards supplies from the latter to consumers in Poland, hinting that for the purposes of Article 44 such output transactions should be disregarded, in line with the definition of Article 11(1) of the VAT Implementing Regulation (though the dispute was previous to its entry into force).

The CJEU still follows the definition of fixed establishment laid down in previous case law[8] which was based on scenarios where the provision of services required a certain type of structure and, in particular, a combination of both human and technical resources on a permanent basis. Yet this may not always be fitting in a digital global world, e.g. scenarios in which no (or minimal) human intervention is needed or where human and technical resources can easily be located in different jurisdictions will, in our opinion, require the CJEU to revise the elements of the fixed establishment concept in the near future, in particular to consider dropping the human resources element from this concept.

Concerns have also been raised by businesses and tax advisors in relation to potential fixed establishments triggered by the use of human and technical resources not employed by them; can the Cypriot company maintain a fixed establishment in Poland by using (only) its supplier's infrastructure?

Although the Court does not specifically raise this question, the advocate general clarifies that the concept of fixed establishment does not require its own human and technical resources provided the third-party resources at the establishment are available to it in a way that is comparable to having its own resources (otherwise the neutrality principle would be compromised).

In conclusion, the concept of a fixed establishment for VAT purposes entails specific elements and references consolidated by the CJEU case law over the years; which scope is not easily compatible[9] with the concept of permanent establishment for direct tax.

IV. Final Remarks

While OECD and G-20 countries consider the taxation of the digital economy as one of the economic challenges of the 21st century, the Final Report provides no satisfactory answer for companies and Action 1 has been stripped of its substance. It is even the only Action of the BEPS issues for which no practical solution has been drawn up: the TFDE entrusts the other taskforces to deal with the challenges raised, without providing suggestions.

This is evidence of the inability of states to develop an internationally harmonized solution when faced with the complexity of the tax challenges raised by the digital economy. Nevertheless, these challenges exceed domestic considerations, and it is crucial that OECD and G-20 countries continue their efforts to address them in a unique and coherent way. While awaiting developments, e-commerce businesses are expected to continue doing business in this uncertainty.

1 Council Directive 2006/112/EC of November 28, 2006 on the common system of VAT.
2 Case C-168/84.
3 Case C-190/95.
4 Case C-260/95.
5 Case C-73/06.
6 Council Implementing Regulation (EU) n. 282/2011 of March 15, 2011.
7 Case C-605/12.
8 Although such case law of the Court regarded the interpretation of fixed establishment under Article 9 (1) of the Sixth Council Directive (77/388/EEC) of May 17, 1977, which only concerned the determination of a fixed establishment of the provider of services.
9 Notably the assumption that fixed establishments which are not legal entities distinct from the companies of which they form part cannot be treated as (separate) taxable persons, thus services between establishments should be disregarded for VAT (e.g. case C-210/04).

Hybrid Mismatch Arrangements: Interest Deductions and Other Financial Payments

Heino Buesching, Partner - CMS Germany

The OECD BEPS 15-point Action Plan contains two action points addressing aspects of financing in the broadest sense. Action 2 is intended to neutralize the effects of hybrid mismatch arrangements, and Action 4 seeks to limit base erosion involving interest deductions and other financial payments.

I. Introduction

The Organisation for Economic Cooperation and Development ("OECD") and G-20 base erosion and profit shifting ("BEPS") project was finalized in October 2015. The 15–point BEPS Action Plan is an impressive work and determines the agenda of international tax discussions. At the end of 2015, recommendations were endorsed by the representatives of the participating G-20 states. Of the 15 action points two address aspects of financing in the broadest sense:

— Action 2—neutralizing the effects of hybrid mismatch arrangements;
— Action 4—limiting base erosion involving interest deductions and other financial payments.

These action points essentially concern issues regarding the allocation of taxation associated with internal group financing arrangements. However, they also address structured financing.

Viewed from the perspective of the group as a whole, it goes without saying that this also involves tax considerations. Financing foreign subsidiaries through borrowing makes sense where the level of tax in the parent company's domicile is lower than in that of the subsidiary. It is standard international practice for expenses incurred by companies for borrowing to be tax-deductible. By contrast, in most countries this generally does not apply to interest on equity (there are exceptions, such as Belgium and Brazil). The BEPS Action 4 addresses this point.

The criteria for equity and borrowed capital are not clear; at any rate there are no agreed international standards. Essentially, each state decides autonomously on what constitutes equity and borrowed capital and hence—indirectly—on whether the costs of providing borrowed capital are deductible and how the financing entity's earnings are treated—as a tax-exempt dividend or as income from interest in the context of regular taxation. The differences in how financing instruments are characterized from one country to another thus make it possible to create tax-deductible expenses in one country which do not have an equivalent in the other country or which generate double tax deduction in two countries.

The BEPS Action 2 addresses this point.

II. Key Aspects of BEPS Final Package Relating to Hybrid Mismatch Arrangements—OECD Action 2

The OECD Action 2—Hybrid arrangements concerns two types of scenarios:

— hybrid financing; and
— hybrid legal forms.

Both of these can be used to achieve:

— non-taxation (deduction/no inclusion);
— double business expense deduction (double deduction); or long-term deferral outcomes.

Ultimately, the hybrid mismatch stems from the difference in how hybrid financing is treated in different countries. Hence, it arises not because existing rules are transposed in a manner which is inconsistent with the law but because corporate organizations take advantage of the differing tax rules in at least two countries.

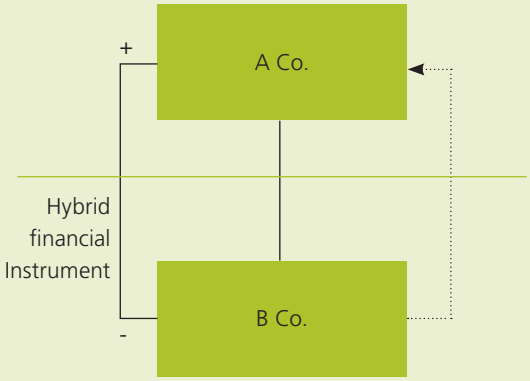
OECD Action 2 sets out recommendations for changes to domestic rules (Part 1 of the OECD Report) and proposed changes to the Model Convention (Part 2 of the OECD Report) to counter the effects of such hybrid mismatches.

The Report proposes primary response rules for initial action. These take the form of "linking" rules which make tax treatment in one country dependent on treatment in another. Essentially the Report proposes that business expenses should not be deductible in the payer's country if the corresponding earnings cannot be taxed as ordinary income in the country of the payee. Beyond that, the Report proposes a secondary "defensive" rule which will apply if the primary rule is not applicable. Quite apart from the fact that the Report recommends all countries to introduce the recommended rules in full, this therefore mitigates the effect of a hybrid structure even if the other country concerned does not have effective hybrid mismatch rules.

As a rule, hybrid financing is very complex. In order to create greater clarity and transparency the OECD has subdivided the principal scenarios into a number of different illustrative

categories, some of which are illustrated below in a simplified manner (for detailed examples see BEPS Final Report Action 2 (page 171 onwards) and for an overview of the recommendations, page 20).

Example (1): Hybrid financial instruments



— Company B (B Co.) issues a hybrid financial instrument to Company A (A Co.).
— The hybrid financial instrument is characterised as debt in Country B but characterised as equity in Country A
— Consequence:
  • Interest deduction in Country B
  • Tax exemption in Country A

→ **Deduction/No Inclusion (D/NI)**

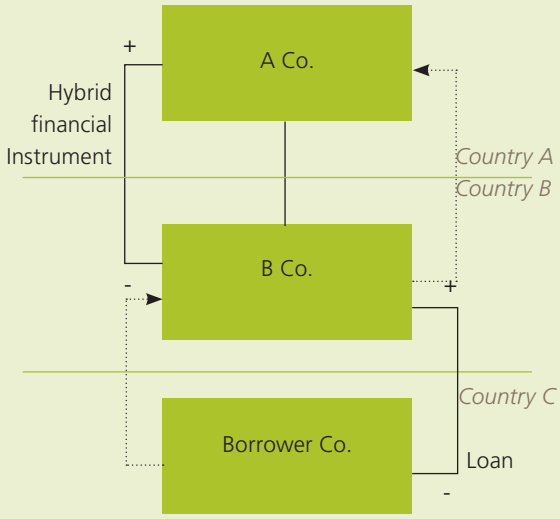
The basic scenario is that the subsidiary issues a hybrid financing instrument to the parent company. Country A treats the financing instrument as equity, whereas Country B treats it as borrowed capital. Hence, financing expenditure in Country B can be treated as an interest expense, whereas in Country A the earnings are classified as tax-exempt dividend earnings. This gives rise to no inclusion at Level A and a deduction at Level B. Where Countries A and B are both European Union ("EU") Member States they are subject to the European Parent–Subsidiary Directive 2014, which states that dividend income is tax exempt in Country A only if it is nondeductible at the level of Company B. In other words, within the EU a defensive rule already exists. Such rule has been implemented into German national law since 2014.

In Article 10 of its proposal for a "Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market" of January 28, 2016 the European Commission (Council Directive Proposal) now advocates that the legal characterization applied in the source state be followed by the receiving country.

German lawmakers tried to incorporate the limitation of such interest deduction in the source state in a bill in 2014. The bill is not yet in force and is likely to come up for discussion again shortly. The main obstacle facing the draft was that it was to apply to all capital market financing and not just financing within a corporate group, and would thus have had unforeseeable consequences for capital market financing.

By contrast, the OECD Report rule is only to apply to group financing, which is a welcome development.
However, it does not mitigate the problems associated with a linking rule, as can be seen in example 2.

Example (2): Importing mismatch from hybrid financial instrument



  • Company A grants a loan to sub Company B by using a hybrid financial instrument
  • Interest is tax-exempt in Country A but deducted in Country B
  • Company B grants a loan to Borrower Co.
  • Interest deducted in Country C and characterised as operating revenue in Country

→ **Indirect Deduction/No Inclusion (D/NI)** between country A and C

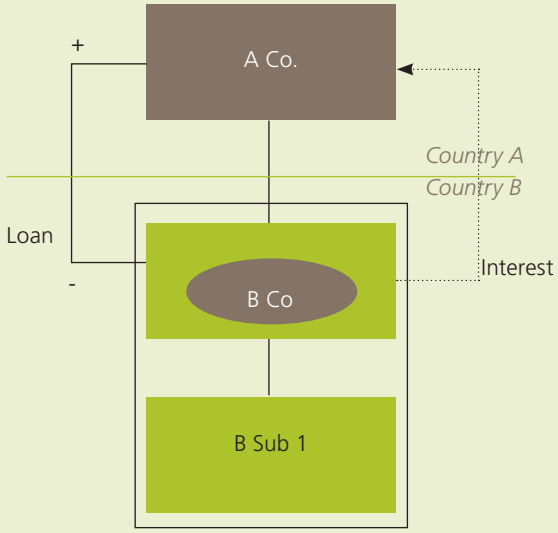
In this example the financing extends to two levels and two national borders. Company A grants a loan to its subsidiary B, using a hybrid financial instrument. Country A characterizes the hybrid financial instrument as equity, whereas Country B characterizes the financial instrument as borrowed capital. Company B grants a loan to Borrower Co, located in Country C, which is domiciled in Country C. Netting in Company B gives rise to interest income/expenses. Viewed from an economic point of view, interest deduction in Country C is balanced by tax-exempt income in Country A. The hybrid mismatch can only be neutralized in Country C if Country A does not change this characterization. Accordingly, the OECD proposes limiting interest deduction in Country C. Extending the limitation to indirect recipients is then only justifiable where such recipients are group entities. Relaxing the timing constraints which apply to expenses on the one hand and

income on the other will not eliminate the effects of hybrid mismatches.

It will be crucial that the equivalence rule does not give rise to obligations to deliver proof which are simply not practicable. It will also be essential to develop dispute resolution procedures to prevent hybrid mismatch neutralization turning into double taxation.

Other scenarios where cross-border group taxation gives rise to deduction/no inclusion are shown in examples 3 and 4.

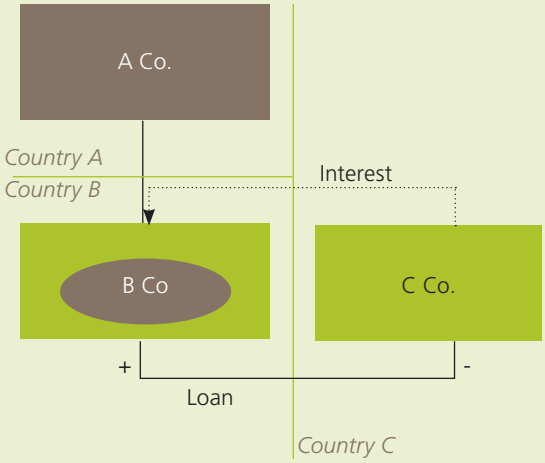
Example (3): Disregarded payment made by a Hybrid Entity



- Company A grants a loan to sub Company B, a hybrid entity characterised as fiscally transparent in Country A, but as a taxable legal entity in Country B
- Company B is consolidated with Company B Sub 1
- Consequence:
  - Interest deduction in Country B
  - Tax exemption in Country A

→ **Deduction/No Inclusion (D/NI)**

Example (4): Payment to a foreign Reverse Hybrid

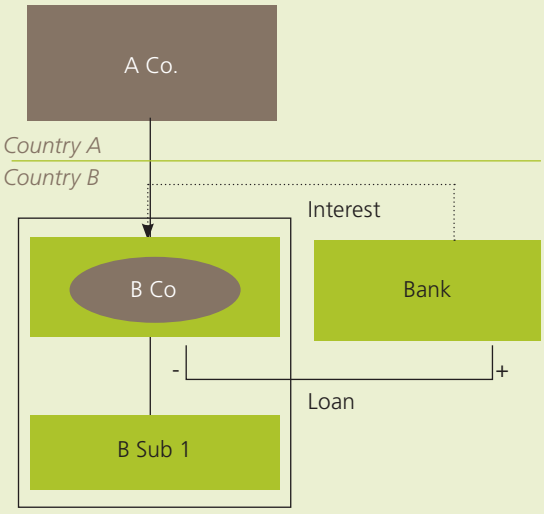


- Company B is characterised as fiscally transparent in Country B but as a taxable legal entity in Country A
- Company B grants a loan to Company C.
- Consequence:
  - Interest deduction in Country C
  - Tax exemption under the laws of Countries A and B

→ **Deduction/No Inclusion (D/NI)**

A basic scenario which leads to a double deduction is illustrated in example 5.

Example (5): Deductible payment made by a Hybrid Entity

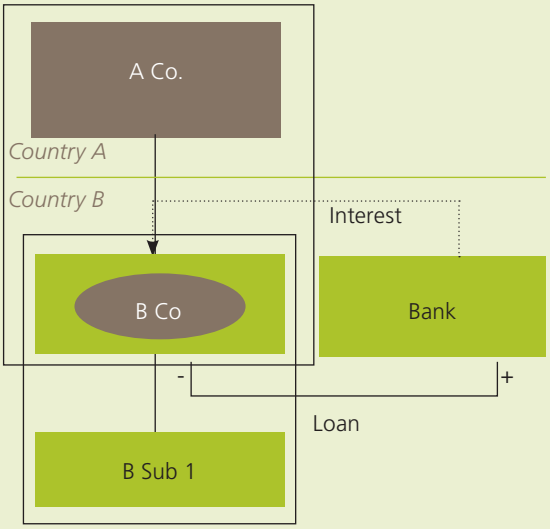


- Company B is characterised as fiscally transparent in Country A but as a taxable legal entity in Country B
- Bank grants a loan to Company B.
- Company B is consolidated with Company B Sub 1
- Consequence:
  - Interest deduction in Countries A and B

→ **Double Deduction (DD)**

The Report also addresses payments by dual residents, as shown in example 6.

Example (6): Deduction Payment made by a Dual Resident



- Company A is consolidated with its subsidiary Company B.
- Company B is consolidated with Company B Sub 1
- Bank grants a loan to Company B.
- Consequence:
  - Interest is deducted both in Countries A and B

→ **Double Deduction (DD)**

This serves to prevent scenarios which generate double business expense deduction.

The OECD Report proposes that business expense deduction should be disallowed either in Country A or in Country B and for this purpose advocates an amended tie-breaker rule (Article 4 paragraph 3 of the OECD Model Convention), referring to the Report on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances). The amendment to Article 4 paragraph 3 of the OECD Model Convention recommended in the Report on Action 6 is to apply likewise here, i.e., in an individual case the contracting states must determine the state in which the place of effective management is situated and hence the applicable set of rules. If, in an individual case, the contracting states were unable to agree, this would mean that the dual resident company would not be eligible to protection under the Model Convention.

It is important to note that these double deductions scenarios may also trigger double taxation (dual inclusion income). Where this is the case, the OECD does not want to limit the deduction of business expenses. Under the OECD recommendations it should be possible to assert claims for payments exceeding revenue which has been recognized twice (the excess deduction) in a different assessment period. Whether this rule will be practicable remains to be seen.

III. Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

Action 4 addresses aspects of corporate financing in multinational groups and frequently observed practices associated with equity and borrowed capital financing. The Report sees the following scenarios as problematic and hence as meriting sanctions:

— a tendency towards disproportionately high levels of financing through borrowed capital in high-tax countries;
— intragroup loans give rise to business expense deduction for interest payments in high-tax countries above the group equity ratio; and
— financing through borrowed capital through third parties or within the group is used to finance tax-exempt revenue.

The above issues are not new. Many states have rules which preclude or restrict recognition of interest payments—particularly interest payments to shareholders of the paying subsidiaries—as business expenses in order to safeguard national fiscal revenue. While the means of achieving this objective vary greatly, commonly adopted strategies include the following approaches:

— arm's length tests which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties;
— withholding tax on interest payments, which are used to allocate taxing rights to a source jurisdiction;
— rules which disallow the deduction of a specific percentage of the interest expense of an entity, irrespective of the nature of the payment or to whom it is made; and
— rules which limit the level of interest expense or debt in an entity with reference to a fixed ratio, such as debt/equity, interest/earnings or interest/total assets.

The implication of this for the financial decision making of corporations in an international context is that tax planning must take account of the tax rules which apply in the domiciles of both the subsidiary and the group parent.

Action 4's proposals for developing best practice rules for limiting the use of interest expense are very welcome. The policy advocated by the OECD is broadly similar to the interest deduction limit (*Zinsschranke*) in place in Germany and can be summarized as follows (to be seen as cumulative—see BEPS final Report Action 4, page 25):

- **de minimis monetary threshold to remove low-risk entities**
  - optional
  - based on net interest expense of local group
- **fixed ratio rule**
  - allows an entity to deduct net interest expense up to a benchmark net interest/EBITDA ratio
  - relevant factors help a country set its benchmark ratio within a corridor of 10%–30%
- **group ratio rule**
  - allows an entity to deduct net interest expense up to its group's net interest/EBITDA ratio, where this is higher than the benchmark fixed ratio
- **option for a country to apply an uplift to a group's net third-party interest expense of up to 10%**
  - option for a country to apply a different group ratio rule or no group ratio rule
- **carry forward of disallowed interest/unused interest capacity and/or carry back of disallowed interest**
  - optional
- **targeted rules to support general interest limitation rules and address specific risks**
- **specific rules to address issues raised by the banking and insurance sectors**

The Council Directive's Proposal of January 28, 2016 broadly reflects this proposal.

Within the system the definition of the "financial expenses" covered plays a crucial role. Under German law, for example, they are defined as remuneration for borrowed capital. This also means that certain forms of financing, such as leasing and associated expenses, are not subject to the interest deduction limit. The OECD's proposal addresses this issue and seeks to eliminate the resultant problems, suggesting that the term "financial expenses" should continue to be understood to include any expenses incurred in connection with the raising of finance, which should include: (i) interest on all forms of debt; (ii) payments economically equivalent to interest; and (iii) expenses incurred in connection with the financing.

In connection with the financing of multinational enterprises ("MNEs") it makes sense to introduce a de minimis rule. As an example, initially German lawmakers provided for a de minimis threshold of one million euros, raising this to three million euros in the aftermath of the financial crisis, and it is the three-million euro threshold which now figures in the bill. Action 4 of the BEPS Report allows the participating states to set reasonable thresholds themselves. By contrast, the European Council Proposal of January 28, 2016 anticipates a (de minimis) rule of one million euros.

In accordance with the principle that financing through borrowing should not be shifted to high-tax countries, it should still be possible for taxpayers to prove that such shifting has not taken place (*group ratio rule*). The BEPS Report proposes an escape clause according to which an entity that exceeds the benchmark fixed ratio may deduct interest expenses up to the net third party interest/EBTDA ratio of its group, where it is higher. The European Council Proposal takes a different approach and allows the escape according to the relation of the equity ratio versus the group equity ratio.

IV. Summary and Outlook

The OECD's aim of neutralizing hybrid mismatch arrangements is essentially legitimate, as is its attempt to reconcile the many rules on interest deduction and to establish a set of rules. However, it is important to acknowledge that the participating states have widely diverging interests. The interest deduction restrictions rules advocated in BEPS Action 4 are likely to have serious implications for countries—such as Luxembourg and the Netherlands—which have been selected as the domicile for subsidiaries set up for group financing purposes. For MNEs it will be extremely important that the OECD's recommendations will be implemented jointly and in a coordinated manner by the participating states. Only then will there be any chance of achieving competition neutrality. In other words: unless the OECD's recommendations are implemented in the same way in all participating states, MNEs will be at risk of double taxation. Whether the U.S. implements the BEPS program will be of particular importance, otherwise competition could be distorted further.

As far as hybrid mismatch arrangements are concerned, priority will lie in limiting financing within corporate groups if corporate financing through the capital markets is not to be greatly impaired. It will also be important to establish a procedure under which participating states will have to reach a binding agreement on whether a financing instrument is to be treated as equity or borrowed capital, thus guaranteeing consistency.

BEPS Actions 2 and 4 have presented their recommendations and proposals with admirable clarity. The real work for companies and initially for lawmakers, i.e., how to put these proposals into practice, still lies ahead. We await further developments on the international tax law front with great interest.

Taxation of Controlled Foreign Companies: Controversies and Challenges

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Action 3 of the OECD BEPS report concerns taxation of controlled foreign companies: its recommendations and potential challenges in their implementation are considered here.

I. Anti-abuse Rules

Anti-abuse rules have become an inherent part of the tax law in most jurisdictions. For some this is a natural effect of the development and improvement of tax systems, for others it shows a defeat of the existing concepts of taxation, as the position of the taxpayer is no longer based on clear and mechanical rules, but to a great extent on the subjective judgment of his behavior.

Anti-abuse instruments are usually adapted to the local laws; however, the Organisation for Economic Co-operation and Development ("OECD") saw a need to harmonize this area and published the report on base erosion and profit shifting ("BEPS report") which contains a set of recommendations on anti-abuse rules. The BEPS report is mainly addressed to lawmakers, although it could also have some practical applications for taxpayers. This is because the background behind the recommendations could sometimes be used in litigation with the tax authorities as to the meaning of local anti-abuse rules.

II. Action 3: Taxation of Controlled Foreign Companies

Action 3 of the BEPS report "Design Effective Controlled Foreign Company Rules" is devoted to taxation of controlled foreign companies ("CFC"). This instrument is becoming more and more popular against tax optimization techniques using vehicles located in low-tax countries. Under the CFC rules, a parent company is obliged to declare income earned by the CFC if certain criteria are met. CFC rules are not designed to create any new stream of income for jurisdictions, but to prevent the avoidance or long-term deferral of taxation of income, which normally would have been taxable in the country of the parent company.

The report differentiates between situations where the CFC rules apply to parent country income which is artificially shifted to a low-tax country, and foreign income which is not distributed to the parent country but to the CFC.

A. Issues around Application of CFC Rules

As mentioned above, the main problem with anti-abuse rules is that their application is based on subjective judgment, which contributes to their unpredictability. Compared to other anti-abuse rules, CFC rules are to greater extent based on a mechanical test and the element of subjective judgment is limited. However, this concept has another weakness not existing in other areas, which makes the rationale of application of the CFC rules debatable in some jurisdictions. Any tax system will be efficient only if the tax authorities have efficient instruments to verify the reporting provided by taxpayers. If the tax authorities are not able to audit the tax statements, fraudulent behavior may give an unfair advantage to some taxpayers.

Tax authorities can practically audit only the documentation available in their own jurisdiction and the facts existing in this jurisdiction. For example, if the tax returns of a German company do not truly reflect the company's income or tax deductible costs, the German tax authorities can easily audit it and identify the tax underestimation. However, if a Polish company declares income earned by its CFC located in the British Virgin Islands, in practice the Polish tax authorities will not be able to verify it or even if they could, it would be prohibitively expensive for them to do so. If a company does not declare the CFC's income (which should be declared), then the tax authorities (in any jurisdiction) in most cases will not even be aware of any tax obligation to be audited.

Disclosing the CFC's income opens another challenge for the tax authorities. According to the OECD's recommendations, the tax of the CFC should be computed according to the tax law of the jurisdiction of the parent. How can the tax authorities verify if the parent has computed the taxable income of the CFC properly? How can they check if all the income has been reported or if the tax-deductible costs are not overestimated? In theory, it is doable; in real life however, everything will depend on the goodwill of the taxpayer.

Therefore, CFC rules work properly only in jurisdictions where taxpayers have high reporting standards: otherwise, they may lead to a tax advantage for unfair taxpayers who do not report CFC income, practically without the risk of sanctions.

The BEPS report does not highlight the above issue, but focuses on the main characteristics of CFC rules and outlines possible approaches.

CFC rules may be applicable not only to the income of foreign companies, but also to foreign permanent

establishments and transparent entities owned by the parent companies. The need for a broad application of the CFC rules is obvious: otherwise, taxpayers would be able to design their tax planning structures through foreign entities which were not companies and would be able to avoid the CFC rules. The OECD recommends covering permanent establishments and transparent entities by CFC rules, unless their income is taxed in the parent country on a current basis.

However, this recommendation is debatable. On one hand, "taxation on a current basis" would be possible only if the relevant tax treaty (signed between the country of the parent company and the country of the transparent entity/permanent establishment) provides for a credit method of avoidance of double taxation. In such a case, the parent company will pay tax in its jurisdiction on the income of the transparent entity/permanent establishment and there is no need for it to be recaptured by the CFC rules. Therefore, the application of CFC rules to a transparent entity/permanent establishment would make sense only if the relevant tax treaty provides for the exemption method of taxation.

However, the exemption method of taxation provided by the tax treaty does not allow the country of the parent company to tax income of the transparent entity/permanent establishment located in the other country. The tax treaties do not allow for that even if taxation were to have its source in extraordinary measures of taxation, such as the CFC rules.

In effect, the application of CFC rules to the transparent entity/permanent establishment either will make no sense (as the parent company would pay tax any way) or will not be allowed by the tax treaties.

B. Tax Treaties

The above observation may even open a debate on whether the tax treaties may limit the application of the CFC rules in broader contexts. In theory, the CFC rules do not tax the CFC; they tax only the parent company but before they attribute to the parent the CFC's income. Therefore, at first glance, application of the CFC rules has nothing to do with the tax treaties, as the tax treaties do not limit the freedom of the parent's country to tax the parent's local income, even if this income partly consists of the CFC's income artificially attributed to the parent.

However, is that really so? Under Article 21.1 of the OECD model tax treaty, "items of income of a resident of" country A can, as a rule, be taxed only in country A, unless other provisions of the tax treaty allow to tax them in country B. Therefore, under the tax treaties, a CFC can be taxed only in its country. CFC rules in fact lead to the taxation of "items of income of" the subsidiary of the parent in the parent country, but in the hands of the parent company. From the economic point of view, there is no difference between a situation where treaty country B taxes income of a company being a resident in treaty country A (which is obviously not in line with Article 21.1 of the OECD model tax treaty) and the situation where treaty country B taxes "items of income of a resident of" treaty country A, having attributed it before to a resident of treaty country B being the parent of the country A resident. In both situations, at the end of the day, some "items of income of the resident of" country A are taxable in country B.

It seems that in some jurisdictions, the wording of the equivalent of Article 21.1 of the OECD model tax treaty may serve as an argument to treat the CFC rules as infringing the tax treaties. Convincing the courts not to apply the CFC rules based on non-compliance with the tax treaty will most likely be difficult. However, it is interesting to note that the CFC rules created to prevent anti-abuse practices on the other hand circumvent the provisions of the tax treaty not allowing the country of the parent company to tax the income earned by a subsidiary being a resident of another country. The whole idea behind the tax treaties is to draw a border between what can be taxed in a given country. CFC rules cross this line, which makes them not much different from the behaviors against which they are designed.

C. Hybrid Tax Planning

Application of the CFC rules to CFCs being companies is not free of controversy either. The report discusses the issue of hybrid tax planning, which paves the way to treat some CFCs as being outside the scope of the CFC rules. Such tax planning is available in jurisdictions where the CFC rules provide for the exception for payments made between the companies in the same country (the same country exception). "Smart" structuring of CFCs may lead to a situation where two companies from different countries are treated as residents of the same country, and as a result CFC rules will not apply to the payments made between them. Since the U.S. Inland Revenue is the main victim of such a practice, we may expect that U.S. tax law will soon adopt measures against this.

D. Type and Level of Control

Another interesting area is the type and level of control over a CFC which justifies the application of CFC rules. The report discusses four types of control: legal, economic, de facto and control based on consolidation. While legal and economic controls are mechanical tests focusing on voting rights or entitlement to the underlying assets, the de facto control test requires a subjective assessment. However, the introduction of de facto control is necessary to eliminate the simple holding structure aiming to circumvent the CFC rules.

Again, the application of this measure depends on the taxpayers' reporting standards, and identifying the underlying agreements granting actual control to a party other than the nominal shareholders may be difficult for the tax authorities. In addition, CFC rules usually require a certain minimal level of control for them to be applicable. Proving that de facto control exceeds the minimum threshold of, for example, 50%, could be another challenge for the tax authority, as there are no reliable measures to quantify the amount of the de facto control. Speaking of the minimal threshold of control, the BEPS report recommends to capture by way of the CFC rules also the group of

minority shareholders (even if none of them exceeds the minimal threshold) if they are "acting in concert". This recommendation is justified, as otherwise some taxpayers may create "joint ventures" in low tax jurisdictions, aimed at avoiding the CFC rules, but this is another example of a subjective test which is not easy to enforce in practice.

E. Exemptions and Thresholds

When issuing its recommendations, the OECD looks for optimal solutions that ensure the efficient application of the CFC rules and, on the other hand, limit the number of administrative and compliance burdens for taxpayers. Following this principle, the report postulates the introduction of certain exemptions and thresholds to exclude from CFC rules situations that do not pose a risk of base erosion or profit shifting. For example, the report discusses the de minimis threshold which exempts entities which do not achieve a certain level of income from the CFC rules. Such exemptions certainly provide an opportunity to circumvent the CFC rules through, for example, fragmentation of the CFCs. To avoid that, a special anti-avoidance rule may be required.

Another interesting observation: jurisdictions introduce some extraordinary measures into their laws which protect the laws against anti-abuse. A broad application of these rules would be unbearable, therefore there is a need to create a reasonable system of exemptions. However, taxpayers may use the exemptions to avoid anti-abuse rules, and therefore exemptions are available subject to "subordinated" anti-abuse rules. Now the question is: why are the tax laws so complicated …

CFC rules usually do not apply to entities located in countries in which the tax rate is above a certain minimal threshold (tax rate exemption). Again, such exemption is fully justified, as otherwise it would significantly complicate foreign investments that are not motivated by tax planning. If the tax rate exemption is defined as a blacklist of countries to which CFC rules apply or a whitelist of countries to which CFC rules do not apply, then determining if CFC rules apply is simple. However, if the local rules refer to tax rates, then it becomes more complicated. CFC rules may refer to the nominal rate of tax, which is the most straightforward approach.

However, low-tax jurisdictions often adopt their law to anti-abuse rules of high-tax countries. For example, they provide for a possibility of a refund of the tax upon distribution, which is a hidden reduction of the effective tax rate, where the nominal tax rate may be maintained at a satisfactory level. Therefore, a reference to the effective tax rate would be more appropriate, but this would open the door for disputes on how the effective rate of tax should be calculated. To do this, the local tax authorities would have to become experts on the tax laws of other jurisdictions.

III. Summary

Summing up, the CFC rules seem to be the most efficient instrument to prevent the use of vehicles located in low-tax countries in order to evade the parent jurisdictions' base. It seems that, so far, the OECD recommendations have not affected CFC rules in particular EU jurisdictions, but since there are still many jurisdictions offering solutions which may be used in international tax planning, more and more common application of CFC rules by high-tax countries seems inevitable.

This concept, however, is not free of weaknesses. The main one is poor auditability of CFCs. The efficiency of application of the CFC rules therefore depends on the reporting standards of taxpayers.

BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

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The OECD BEPS project Action 6 identifies tax treaty abuse and, in particular, treaty shopping, as one of the most significant sources of BEPS concerns.

I. Introduction

Corporate tax revenues have been falling across OECD countries since the global economic crisis, putting greater pressure on individual taxpayers to ensure that governments meet financing requirements, according to new data from the OECD's annual Revenue Statistics publication. "Corporate taxpayers continue finding ways to pay less, while individuals end up footing the bill," said Pascal Saint-Amans, Director of the OECD Centre for Tax Policy and Administration. "The great majority of all tax rises seen since the crisis have fallen on individuals through higher social security contributions, value added taxes and income taxes. This underlines the urgency of efforts to ensure that corporations pay their fair share."

As a response, the OECD base erosion and profit shifting ("BEPS") project is mainly addressed to corporate taxpayers. The aim is to find solutions for closing the gaps in existing international rules that allow corporate profits to disappear or to be artificially shifted to low/no tax environments, where little or no economic activity takes place.

On October 5, 2015, the OECD released its final reports, which were presented to the G-20 finance ministers on October 8, 2015. BEPS Action 6 identifies tax treaty abuse and, in particular, treaty shopping, as one of the most significant sources of BEPS concerns.

II. Generic Framework

From a first reading of Action 6 it is possible to become lost in the complex package designed to prevent treaty abuse. Whilst new rules are relatively easy to be interpreted for individuals (where entitlement to treaty is basically linked to the place of residence), they give rise to a series of practical concerns for corporations and, more generally, for persons other than individuals, e.g., collective investment vehicles ("CIVs"), non-CIVs, funds and partnerships.

The complexity is twofold: on the one hand, it derives from a large number of definitions and details, e.g., the limitation on benefits ("LOB") rule; and on the other hand, from the use of more enlarged, at least in scope, anti-abuse clauses referring to general statements such as "reasonable to conclude", "relevant facts and circumstances" and "principal purposes", e.g., the principal purpose test ("PPT"). Ultimately, however, it seems clear that the new package is really a strong and effective solution against treaty abuse, with no space left for tax savings other than those generated by genuine tax planning. In addition, the OECD promptly reacted to the complexity described above by providing (i) a simplified LOB version, (ii) some flexibility for countries in relation to the adoption of the new rules ("minimum standard"), and (iii) a number of examples that support comprehension of the statements used.

The basic framework of Action 6 is based on a three-pronged approach to be used by countries to release new treaties or to modify existing ones:

1. a clear statement that the Contracting States wish to prevent tax avoidance and creation of opportunities for treaty shopping;
2. a specific anti-abuse rule derived from the U.S. experience (LOB);
3. a general anti-abuse rule based on the principal purposes of transactions or arrangements (PPT).

In light of a certain degree of flexibility granted by the OECD model proposal, countries took the commitment to ensure a minimal level of protection (minimum standard) by inserting in their treaties the statement under (1) above, plus (i) the combined approach of an LOB clause and PPT rule; or (ii) the PPT rule alone; or (iii) the LOB rule supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties.[1]

A. The Limitation on Benefits Rule

The LOB rule comes from the U.S. experience and is also currently adopted in other countries such as India and Japan. Action 6 clarifies that, pursuant to the release from the U.S. of a new version of its LOB rule for public discussion, the OECD will revise this part once the U.S. finalizes the provision on the basis of the comments received.

As already anticipated, the LOB rule is a very detailed and specific anti-abuse provision. The rule provides for the concept of "qualified person" to whom treaty benefits apply. First of all, it is a necessary preliminary to underline that the concept of qualified person does not extend in any way the scope of the benefits granted by the OECD Model Tax Convention ("the Convention"), with the consequence that a resident of a Contracting State who constitutes a

qualified person must still meet the conditions of the other provisions of the Convention in order to obtain these benefits (e.g., that resident must be the beneficial owner of dividends in order to benefit from the provisions of paragraph 2 of Article 10) and these benefits may be denied or restricted under the applicable anti-abuse provision.

As a preliminary framework, a qualified person is:
- an individual;
- a Contracting State, or a political subdivision or local authority thereof;
- a charitable association.

For the above categories the application of the LOB rule is quite straightforward.

As explained in the Introduction, there are no special BEPS concerns around individuals that ended up footing the bill of the recent economic crisis. An individual is a qualified person to the extent he is a resident of one of the Contracting States.

As far as charitable associations are concerned, those entities are identified by each Contracting State based on certain social functions fulfilled (e.g., charitable, scientific, artistic, cultural or educational). Even in this case, the LOB provision is very basic and these subjects automatically qualify for treaty benefits without regard to the residence of their beneficiaries or members.

Things instead become more complicated when the concept of "qualified person" is applied to other entities: inter alia, publicly-traded companies and entities, other forms of legal entities and CIVs (for this latter, the special provisions should be drafted based on how CIVs are treated in the Convention and are used and treated in each Contracting State).

For those residual entities the mechanism works through the application, at different levels, of a series of tests that the person should meet in order to obtain treaty entitlement. Those tests are briefly described below.

1. Stock Exchange Test

A company/person other than a company is a qualified person if the principal class of its shares[2] is regularly traded on one or more recognized stock exchanges or if its beneficial interests are regularly traded on one or more recognized stock exchanges.

Because the shares of publicly-traded companies and of some entities are generally widely-held, these companies and entities are unlikely to be established for treaty shopping. The test provides for the additional requirement that shares should be primarily traded in stock exchanges located in the state of residence of the company or entity.

However, states may decide to apply the test disregarding the place where shares are exchanged if they believe that listing may represent by itself a sufficient safeguard for treaty shopping purposes.

2. Ownership and Base Erosion Test

This is a residual test and applies to any form of legal entity that is a resident of a Contracting State. It is a two-part test, and both parts must be satisfied for the resident to be entitled to treaty benefits.

A person other than an individual is a qualified person provided that:

4. other qualified persons that are residents of that Contracting State own, directly or indirectly, shares representing at least 50% of the aggregate voting power and value (so-called ownership test);
5. less than 50% of the person's gross income is paid or accrued, directly or indirectly, to persons that are not resident of either Contracting State entitled to the benefit of the Convention (so-called base erosion test).

The rationale of the test is to grant treaty benefits to all subjects that are owned by persons that are entitled to the benefits of the Convention, to the extent that tax base is not artificially eroded by the shifting of the income to third states.

3. Active Trade or Business Test

If a resident of a Contracting State does not pass the tests above with respect to an item of income, it shall nevertheless be entitled to the benefit of the Convention if the resident is carrying on a business in one of the Contracting States and that item of income is derived in connection with, or is incidental to, that business. Based on this alternative test, it is recognized that where an entity resident of a Contracting State actively carries on business activities in that State and derives income from the other Contracting State *in connection with*, or *incidental to*, such business, granting treaty benefits in relation to such income does not give rise to treaty-shopping concerns regardless of the nature and ownership of the entity.

Uncertainty may derive from the interpretation of the statements "in connection with", or "incidental to", the business of the resident. In general terms, the Commentary clarifies that an item of income is derived in connection with a business if the income-producing activity in the state of source is a line of business that forms a part of, or is complementary to, the business conducted in the state of residence of the income recipient.[3] Some examples included in the commentary illustrate the meaning from a practical perspective.[4]

4. Equivalent Beneficiary Test (or Derivative Benefits Test)

This test entitles certain companies that are residents of a Contracting State to treaty benefits if the owner of the company would have been entitled to at least the same benefit had the income in question flowed directly to that owner. In other words, treaty benefits are not denied where the interposition of the company is not instrumental, considering that the benefits would have been available if the owner had operated directly.

5. Discretionary Relief

This is the last available test for a resident to meet treaty entitlement. In particular, the competent authority of the Contracting State may determine, upon request of the

resident, and in accordance with its domestic law and administrative practice, that the establishment, acquisition or maintenance of the resident and the conduct of its operations, are considered as not having as one of their principal purposes the obtaining of an undue benefit.

As already anticipated, the PPT, as opposed to the LOB rule, is a general anti-abuse provision. Its scope is therefore wider. It should be aimed to catch any residual form of abuse that might not be neutralized through the application of the LOB rule. In other words, as clarified in the Commentary, it supplements and does not restrict in any way the scope of application of the LOB rule.[5]

As per the minimum standard approach, countries are free to adopt in their treaties the PPT only, combined with the general statement that Contracting States wish to prevent tax avoidance and creation of opportunities for treaty shopping.

Based on the PPT, a benefit under the treaty would be denied if "**it is reasonable to conclud**e, having regard to all **relevant facts and circumstances**, that obtaining that benefit was one of the **principal purposes** of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of" the Convention.

The said definition is connoted by a certain degree of unpredictability. It requires the interpreter not only to assess the principal purposes of a transaction but also whether, and in which circumstances, it would be reasonable to conclude that obtaining a treaty benefit is one of those purposes.

It will be interesting to see how tax administrations will actually interpret this provision. For the time being, the first impression on reading the provision is that it applies to all circumstances where a treaty benefit is granted and the structure of the transaction is not adequately supported, from a substantial perspective, by economic reasons (or at least, the tax reasons would prevail over or equal the economic ones).

While waiting for the practical implementation of the PPT, some key elements of interpretation may be derived, rather than from the definition itself, from the numerous examples illustrated in the OECD Commentary. Most of the examples provided in the Commentary refer to the interposition of third parties or the exploitation of third treaties in order to circumvent the overall tax burden the party would have suffered in the most reasonable and straightforward behavior, considering the relevant facts and circumstances.

As a general guideline, it looks like the approach must be pragmatic. Namely, where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit. Where, however, an arrangement is entered into for the purpose of obtaining similar benefits under a number of treaties, it should not be considered that obtaining benefits under other treaties will prevent obtaining one benefit under one treaty from being considered a principal purpose for that arrangement.

Action 6 also identifies specific situations where a person seeks to circumvent treaty limitations,[6] most of them already addressed in other BEPS actions (such as Action 1 and Action 7): inter alia, splitting-up of contracts, dividend transactions, tie-breaker rule for determining the treaty residence and abuse of the permanent establishment status.

C. Current Implementation of Action 6

Implementation becomes key at this stage. As far as Action 6 is concerned, the BEPS package is designed to be implemented via changes in domestic law and practices, and via treaty provisions, with negotiations for a multilateral instrument under way and expected to be finalized in 2016. The main objective of a multilateral instrument would be to modify existing bilateral tax treaties in a synchronized 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.

Notwithstanding the above, the objective fixed by the OECD is still far from being reached and, for the time being, there are few countries that have implemented the new rules in their treaties. We provide below a brief comment with regard to some of them.

1. Germany

Germany recently signed two tax treaties with Australia and Japan which comprehensively incorporate the OECD final recommendations of Action 6.

The tax treaty signed on November 12, 2015 between Germany and Australia (not yet effective) addresses treaty abuse in Article 23 ("Limitation of Benefits"). Based on the flexibility granted by the OECD (minimum standard approach), the choice made in this tax treaty was to adopt a "soft" level of protection, including the PPT only, together with (i) a general mechanism to avoid double taxation "where double taxation arises as a result of the application of any such provision, the competent authorities shall consult for the elimination of such double taxation in accordance with paragraph 3 of Article 25" and (ii) a general provision safeguarding the application of domestic anti-abuse rules designed to prevent the avoidance or evasion of taxes "as long as those provisions are in accordance with the object and purpose of the Agreement".

On the other hand, the tax treaty signed on December 17, 2015 between Germany and Japan (not yet effective) adopts a "full" protection approach. Article 21 ("Entitlement to benefits") provides for an LOB rule (with all the different tests already commented on in Section A, above) plus a PPT and a general provision safeguarding the application of domestic anti-abuse rules which do not conflict with the Agreement.

2. United Kingdom

U.K. tax rules contain various main or principal purpose tests that are similar to the PPT proposed in the BEPS report on Action 6. One example is the U.K.'s so-called General anti-avoidance Rule ("GAAR") introduced in the Finance Act 2013, the objective of which is to counter tax advantages from "abusive" "tax arrangements". Arrangements are defined as "tax arrangements" where "…having regard to all the circumstances it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements." This is an objective, and thereby broader, test, which in turn is narrowed down by the subjective test of "abusive". Tax arrangements will be "abusive" where "entering into or carrying out the arrangements cannot reasonably be regarded as a reasonable course of action." To trigger the GAAR, the U.K. tax authority will be required to prove, on the balance of probabilities, that the tax arrangements were in fact "abusive."

The structure and concepts of the GAAR appear very similar to those of the PPT. It is expected that the extensive guidance from HM Revenue & Customs published in respect of the GAAR may be of some assistance for U.K. taxpayers when interpreting and applying the PPT. It is very likely that the U.K. delegates have been heavily involved in drafting the language of the PPT test included in the BEPS report on Action 6, using their U.K. experience.

At numerous presentations, the delegates from HMT (Her Majesty's Treasury), who attended the BEPS talks on behalf of the U.K. Government, have confirmed that the U.K. clearly favors the PPT approach and expects to refrain from including, and accepting requests to include, LOB provisions in U.K. tax treaties. HMT is apparently of the view that the LOB rule is far too rigid and that the PPT will be more easy and sufficiently flexible to apply in practice. The U.K. Government has in the past few years, and even before the BEPS project commenced, followed a practice of negotiating PPT–like tests into the U.K. tax treaties. A good example of this would be the 2008 UK–Netherlands tax treaty, Articles 10, 11 and 12 of which include targeted PPT–like tests.

3. France

French recent treaty policy is strongly influenced by the OECD proposals regarding abuse of tax treaties. However, it is worth mentioning that the OECD "doctrine" has been implemented in different ways, depending on the treaty in question.

In the tax treaty signed by France and the U.K. on June 19, 2008, articles related to dividends, royalties and interests contain a mini anti-abuse provision drafted as follows:

…the provisions of this Article shall not apply if it was the main purpose or one of the main purposes of the person concerned by the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.

In Article 10.7 of the French–Chinese tax treaty signed on 26 November 2013, the wording is slightly different:

…the provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person intervening in the creation or the sale of the shares or other rights in respect of which the dividends are paid to take advantage of this Article by means of that creation or sale.

This "mini-provision" is reinforced by a general anti-abuse provision which cannot be found in the Franco-British convention. In its Article 24, entitled "Miscellaneous rule", the French-Chinese treaty states that:

…the benefits of any reduction in or exemption from tax provided for in this Agreement shall not be available where the main purpose for entering into certain transactions or arrangements was to secure a more favorable tax position and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions of this Agreement.

4. Italy

The OECD package is reflected in the tax treaty signed between Italy and Chile, whose negotiations ended on October 23, 2015 (not yet in force and not yet effective). Article 27 of the tax treaty ("Entitlement to benefits") provides for the PPT combined with (i) a specific rule applicable to permanent establishments, and (ii) a discretionary relief. An interesting point to highlight is a closing section of Article 27 which provides that:
Any other income to which the provisions of this paragraph apply shall be taxed in accordance with the domestic law of the other Contracting State, notwithstanding any other provision of this Convention.

A particular attention in this closing section may come from an historical (and aggressive) approach taken by the Italian tax administration towards any form of abuse of law; this may justify a particular caution for Italy to keep safe its right to tax based on its domestic tax legislation. Italy has included in the domestic law, since 1997, a very generic and, at the same time, comprehensive anti-abuse rule (recently revised), which was indiscriminately used over the years to contrast any form of abuse (at any time there is an interest of one of the parties to obtain undue tax savings, disregarding formal arrangements). It is felt that Italy will interpret the PPT in a very restrictive manner, so that the term "reasonable to conclude" may be somehow interpreted as "reasonable to tax". Italian tax culture was always oriented to BEPS, many years before the OECD started to work on this project, and one of the most recurring jokes by the tax heads of multinational companies doing business in Italy is that the Italians invented BEPS.

III. Conclusions

Whilst, as explained, the new set of rules provided by Action 6 may apparently create some uncertainty among OECD Member States (especially those based in the European Union that are not historically confident with the LOB clause), it appears that the level of flexibility granted in relation to the implementation process (minimum protection) will facilitate countries in amending their treaties accordingly. It is likely that most of the European Union Member States will adopt a PPT–based approach, which is easier and sufficiently flexible to apply in practice, in contrast with an LOB approach, which is considered by many as too rigid and unfamiliar with European culture. Time is now crucial, as OECD expectations are rather ambitious (implementation to be concluded by the end of 2016). It goes without saying that the main role will be played by the mandate for the development of the multilateral instrument to streamline the implementation of tax treaty-related BEPS measures (including Action 6 measures) without need for treaty negotiations on an individual basis. Much of the substantive work is still ongoing. However, on 31 May 2016, the OECD released a discussion draft requesting input on the multilateral instrument to be developed under the OECD BEPS Action 15. it is still premature to talk of potential development of the instrument; however, considering the strong commitment made by each country and its delegates, work is proceeding quickly and tax operators are not expected to stay on the sidelines for much longer.

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1 See para. 22, p. 19 of Action 6.

2 The term "principal class of shares" means the class or classes of shares of a company which represents in the aggregate a majority of the voting power of the company (see definition given in para. 71, p. 47 of Action 6).

3 See para. 49, p. 38 of Action 6.

4 See para. 50, p. 38 of Action 6:
Example 1: ACO is a company resident of State A and is engaged in an active manufacturing business in that State. ACO owns 100% of the shares of BCO, a company resident of State B. BCO distributes ACO's products in State B. Since the business activities conducted by the two companies involve the same products, BCO's distribution business is considered to form a part of ACO's manufacturing business.
Example 2: The facts are the same as in Example 1, except that ACO does not manufacture products. Rather, ACO operates a large research and development facility in State A that licenses intellectual property to affiliates worldwide, including BCO. BCO and other affiliates then manufacture and market the ACO-designed products in their respective markets. Since the activities conducted by ACO and BCO involve the same product lines, these activities are considered to form a part of the same business.

5 See para. 3, p. 55 of Action 6.

6 See pp. 69 onwards of Action 6.

BEPS and Transfer Pricing: What Do We Do Now?

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After more than two years of work, the final recommendations of the Base Erosion and Profit Shifting ("BEPS") project led by the Organization for Economic Cooperation and Development ("OECD") were approved by representatives of the G-20 countries at the end of 2015. Among the 15 actions that had initially been identified to tackle BEPS, four were related to transfer pricing:

— three actions (actions 8, 9 and 10) aimed at aligning transfer pricing outcomes with value creation by reviewing the principles applicable to specific items/transactions: intangibles (rules to prevent BEPS by moving intangibles among group members), risks and capital (rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members) and other high-risk transactions (rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties). Indeed, though the arm's length principle is viewed as an appropriate tool to allocate the income of multinational enterprises ("MNEs") among jurisdictions, MNEs—according to the OECD[1]—"have been able to use and/or misapply those rules to separate income from the economic activities that produce that income and to shift it into low-tax environments."
— the fourth action (action 13) aimed at increasing the transparency of taxpayers' organizations vis-à-vis tax authorities by reexamining the transfer pricing documentation to be prepared by MNEs.

This article will describe certain key aspects of the BEPS final package relating to transfer pricing and will try to anticipate some of its impacts over the coming months, both from the perspective of the countries/tax authorities and that of MNEs.

I. Key Aspects of the BEPS Final Package Relating to Transfer Pricing

From a practical standpoint, the BEPS final package relating to actions 8, 9, 10 and 13 is composed of two reports (totaling around 250 pages). As regards action 13, the appendices to the report include an implementation package to assist countries in implementing the country-by-country reporting: this package includes (i) a model legislation; and (ii) model competent authority agreements that could be used to facilitate implementation of the exchange of country-by-country reports.

The BEPS final package will lead to a substantial modification of the OECD transfer pricing guidelines (on 23 May 2016, the OECD Council approved the amendments to the transfer pricing guidelines as set out in the reports relating to actions 8, 9, 10 and 13):[2]

— out of the nine chapters of the current OECD transfer pricing guidelines, six will be modified;
— out of the six chapters that will be modified, four chapters will be deleted in their entirety and replaced by new provisions.

Given these changes, in July 2016, the OECD also proposed draft conforming changes to Chapter IX of the transfer pricing guidelines entitled "Transfer Pricing Aspects of Business Restructurings".

A. Arm's Length Principle

As regards the substance of the BEPS final package, it can first be underlined that the arm's length principle remains the international cornerstone of transfer pricing rules. Though the temptation to define "special measures, either within or beyond the arm's length principle (…)"[3] had existed at the outset of this project, the final reports do not include such special measures. Alternative income allocation systems, including formula based systems, are also not envisaged in the final reports.

B. Delineation of Actual Transactions

Another key aspect of the BEPS final package is that it emphasizes the need to delineate the actual transaction between the parties for which the transfer prices need to be established (as opposed to contractual arrangements that do not reflect the actual conduct of the parties). This aspect appears particularly in the revisions to chapter I (guidance for applying the arm's length principle) and to chapter VI (intangibles) of the OECD transfer pricing guidelines.

In the revisions to chapter I, and as was the case so far, it is recommended to identify the following five economically relevant characteristics or comparability factors in the commercial or financial relations between the associated enterprises:

1. the contractual terms of the transaction;
2. the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices;
3. the characteristics of property transferred or services provided;
4. the economic circumstances of the parties and of the market in which the parties operate;
5. the business strategies pursued by the parties.

As regards the second comparability factor (functional analysis), the revisions provide a more detailed framework to analyze risks borne in a transaction between associated enterprises. This framework can be summarized as follows:

1	Identify economically significant risks with specificity.
2	Determine how these risks are contractually assumed by the associated enterprises under the terms of the transaction.
3	Determine through a functional analysis how the associated enterprises that are parties to the transaction operate in relation to assumption and management of these risks, and in particular which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk.
4	Determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by analyzing (i) whether the associated enterprises follow the contractual terms; and (ii) whether the party assuming risk, as analyzed under (i), exercises control over the risk and has the financial capacity to assume the risk.
5	Where the party assuming risk under steps 1–4(i) does not control the risk or does not have the financial capacity to assume the risk, allocate the risk in accordance with control and financial capacity.
6	The actual transaction as accurately delineated by considering the evidence of all the economically relevant characteristics of the transaction, should then be priced taking into account the financial and other consequences of risk assumption, as appropriately allocated, and appropriately compensating risk management functions.

Though not modifying the principles, the revisions try to provide supplemental guidance on the transaction to retain for the purposes of a transfer pricing analysis:

— If the characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associated enterprises, the actual transaction should generally be delineated for purposes of the transfer pricing analysis in accordance with the characteristics of the transaction reflected in the conduct of the parties.

— In exceptional cases, a transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances. On this point, the revisions clarify that the question is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties (the revisions continue to admit that associated enterprises may enter into a much greater variety of arrangements than can independent enterprises, and may do so for sound business reasons).

C. Intangibles

Concerning the revisions to chapter VI (intangibles) of the OECD transfer pricing guidelines, this "quest" for the actual transaction can be seen in the new framework proposed to analyze transactions involving intangibles between associated enterprises. This framework includes the following steps:

1	Identify the intangibles used or transferred in the transaction with specificity and the specific, economically significant risks associated with the development, enhancement, maintenance, protection, and exploitation of the intangibles.
2	Identify the full contractual arrangements, with special emphasis on determining legal ownership of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, license agreements, other relevant contracts, and other indicia of legal ownership, and the contractual rights and obligations, including contractual assumption of risks in the relations between the associated enterprises.
3	Identify the parties performing functions, using assets, and managing risks related to developing, enhancing, maintaining, protecting, and exploiting the intangibles by means of the functional analysis, and in particular which parties control any outsourced functions, and control specific, economically significant risks.
4	Confirm the consistency between the terms of the relevant contractual arrangements and the conduct of the parties, and determine whether the party assuming economically significant risks, controls the risks and has the financial capacity to assume the risks relating to the development, enhancement, maintenance, protection, and exploitation of the intangibles.

5	Delineate the actual controlled transactions related to the development, enhancement, maintenance, protection, and exploitation of intangibles in light of the legal ownership of the intangibles, the other relevant contractual relations under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets and risks, taking into account the framework for analyzing and allocating risk.
6	Where possible, determine arm's length prices for these transactions consistent with each party's contributions of functions performed, assets used, and risks assumed.

As can be seen from the list above, this framework will lead MNE groups to analyze their intragroup transactions involving intangibles in light of the concepts of development, enhancement, maintenance, protection, and exploitation of intangibles; these concepts were not that clearly expressed in the current OECD transfer pricing guidelines. This type of analysis based on the contributions of the entities (and other development in the revisions) could "encourage" tax authorities to implement more frequently the transactional profit split method to transactions involving intangibles. It can also be noted that the revisions seem to cautiously admit the use of valuation techniques, whereas they are very frequently used by practitioners. This will raise practical difficulties for taxpayers and probably trigger more debates during tax audits.

The revisions to chapter VI (intangibles) also propose a definition of the term "intangible" that is specific to transfer pricing matters. For transfer pricing purposes, an "intangible" would therefore address "something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances." The revisions confirm that this definition includes "standard" intangibles such as patents, know-how and trade secrets or trademarks, trade names and brands. However, this definition—which is not necessarily consistent with legal and accounting rules—is likely to trigger debates with tax authorities on the existence or otherwise of an intangible and hence, on the existence and pricing of transactions.

D. Low Value-Adding Intragroup Services

Among the "other high-risk transactions," the revisions to chapter VII (special considerations for intragroup services) include new provisions relating to "low value-adding intragroup services."[4] Low value-adding intragroup services are services performed by one member or more than one member of an MNE group on behalf of one or more other group members which:

— are of a supportive nature;
— are not part of the core business of the MNE group (i.e. not creating the profit-earning activities or contributing to economically significant activities of the MNE group);
— do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
— do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

Under the revisions, MNEs could elect for a simplified approach to determine arm's length charges for such low value-adding intragroup services (including a simplified benefits test) and to document such services and charges. In practice, the main benefit from qualifying services as "low value-adding intragroup services" seems to be that such services can be charged according to a cost plus methodology and that a markup of 5% of the relevant costs would be applicable (this 5% rate would not need to be justified by a benchmark study). Though the proposed 5% markup is a simplification, it can unfortunately raise practical issues for MNEs which apply a different markup: for example, in Europe, further to the guidelines drawn up by the European Union Joint Transfer Pricing Forum, a 3% to 10% markup can be viewed as acceptable for low value-adding services.

It can be noted that services of corporate senior management (other than management supervision of services that qualify as low value-adding intragroup services) are excluded from the scope of low value-adding services. This raises another important practical issue: assuming such services would be invoiced according to a cost plus method, taxpayers would need to perform a benchmarking analysis to determine the markup applicable. It is at this stage unclear which comparable service providers could be found by taxpayers. Such exclusion therefore raises a difficulty and an additional burden for taxpayers; for many years taxpayers have invoiced such services within their management fees by using a cost plus (generally) 5% methodology and this approach has been in the main accepted by tax authorities.

E. Revisions to Transfer Pricing Documentation

The revisions to chapter V (documentation) also constitute a key aspect of the BEPS final package. These revisions propose a profound change in the OECD's approach to transfer pricing documentation: the current transfer pricing guidelines include an indicative list of information that could be relevant to define/examine a transfer pricing policy, whereas the revisions propose a standardized list of information that should be included in a transfer pricing documentation. The revisions to chapter V (documentation) also propose that countries implement a three-tier documentation[5] consisting of: (i) a master file containing standardized information relevant for all MNE group members; (ii) a local file referring specifically to material transactions of the local taxpayer; and (iii) a country-by-country report ("CbCR") containing certain information relating to the global allocation of the MNE's income and

taxes paid together with certain indicators of the location of economic activity within the MNE group.

The information required in the master file can be grouped into five categories: (i) the MNE group's organizational structure; (ii) a description of the MNE's business or businesses; (iii) the MNE's intangibles; (iv) the MNE's intercompany financial activities; and (v) the MNE's financial and tax positions.

In contrast to the master file, the local file should be specific to each entity of the MNE group. The local file should focus on material transactions with associated enterprises. It should in particular include relevant financial information regarding those material transactions, a comparability analysis, and the selection and application of the most appropriate transfer pricing method.

The third tier of this standardized approach is also a new development: in the CbCR, MNEs should indicate, for each tax jurisdiction where they operate, the turnover realized, their income before tax, the income taxes paid and income taxes accrued. They should also report, for each tax jurisdiction, the number of employees, the stated capital, the accumulated earnings and the tangible assets. They should also identify each group entity operating in a given tax jurisdiction and, for each entity, the type of activity performed. According to the revisions to chapter V (documentation), the CbCR "*will be helpful for high-level transfer pricing risk assessment purposes. (…) However, the information in the Country-by-Country Report should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and a full comparability analysis. (…) It should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income.*"

This three-tier documentation should be prepared on a yearly basis. As regards the CbCR, it is recommended that the first CbCRs be required to be filed for MNE fiscal years beginning on or after January 1, 2016. Given the recommendation that MNEs be allowed one year from the close of the fiscal year to which the CbCR relates to prepare and file the CbCR, the first CbCR should be filed by December 31, 2017. The revisions recommend that MNE groups with annual consolidated group revenue of less than 750 million euros be exempted from the obligation to file a CbCR.

In principle, the CbCR should be filed by the ultimate parent company of the MNE group with the tax authorities of the state in which it is resident and the CbCR should be automatically exchanged with the other jurisdictions where the MNE group operates. In case a jurisdiction fails to provide information to another jurisdiction, because (i) it has not required the CbCR from the ultimate parent entity of such MNE group, (ii) no competent authority agreement has been agreed in a timely manner under the current international agreements of the jurisdiction for the exchange of the CbCR, or (iii) it has been established that there is a failure to exchange the information in practice, a secondary mechanism would be accepted as appropriate, through local filing or through filing of the CbCR by a designated member of the MNE group acting in place of the ultimate parent entity and automatic exchange of these reports by its country of tax residence.

II. Potential Impact for Countries/Tax Authorities and MNEs

First of all, the work in relation to the BEPS project is not finished. In particular:

— draft guidance in relation to the transactional profit split method was issued by the OECD in July 2016 and is expected to be finalized in the first half of 2017;
— the implementation of the CbCR by the countries participating in the BEPS project should be monitored and the outcome should be reviewed in 2020 (in addition, in June 2016, the OECD released guidance on the implementation of the CbCR).

As mentioned above, the implementation of the CbCR (and, where applicable, of the new documentation requirement) will require laws in the countries willing to implement it and, where applicable, the conclusion of (or amendment to existing) tax treaties to allow the automatic exchange of CbCR among those countries. Taxpayers should therefore monitor the enforcement of these provisions/tax treaties in the various countries in order to be able to determine their obligations in this respect: in particular, which entity (and, as the case may be, entities if for example the exchange of information is not fully implemented) of the MNE group will be required to prepare and file the CbCR. To date, the United States, China ,France, Spain, the U.K., Ireland, Italy, Poland, the Netherlands and Australia (among others) have introduced or envisage introducing in their legislation provisions in relation to the CbCR. Taxpayers should also start preparing this CbCR to determine (i) the entities to disclose, (ii) the financial data to use and (iii) the process to collect the necessary data/information. MNE groups should also try to anticipate how tax authorities will "react" at the review of their CbCR: the CbCR should indeed be used by tax authorities to plan and organize tax audits.

According to the OECD,[6] the revisions to the OECD transfer pricing guidelines resulting from actions 8, 9 and 10 are immediately applicable.[7] Though this issue may not be that clear-cut in all countries (it is for example not certain that France would share the position of the OECD), the revisions are obviously likely to have a rapid impact on the practices of tax authorities. Taxpayers should therefore review—and, where necessary, amend—their transfer pricing policies and documentation in light of the revised guidelines. Needless to say, for new transactions or structures, the revised guidelines should be taken into account by MNE groups.

Further to the development above, the following points should, among others, be reviewed by groups for their existing intragroup transactions:

- Assess whether they accurately delineated their intragroup transactions, in particular in view of the new framework to analyze risks (and assess the risk of non-recognition by tax authorities).
- Review whether certain of their assets or rights could be viewed as "intangibles" in the meaning of the revisions to chapter VI (intangibles) of the OECD transfer pricing guidelines (whereas they have not been viewed as such so far).
- Review their intragroup transactions in relation to intangibles in light of the new framework proposed by the revisions and, among others:
  - determine legal ownership of intangibles and identify the full contractual arrangements;
  - identify the parties performing functions, using assets, and managing risks related to developing, enhancing, maintaining, protecting, and exploiting the intangibles (and, in particular, which parties control any outsourced functions, and control specific, economically significant risks).
- Review their intragroup transactions in relation to services (and, in particular, management fees agreements) to see in particular whether certain services can qualify as "low value-adding intragroup services."
- Based on these analyses:
  - review whether the transfer pricing policies implemented can still be seen as complying with the arm's length principle and, as the case may be, envisage an evolution of such transfer pricing policies;
  - review—and, where applicable, amend—their contractual documentation to make sure that it appropriately reflects the actual characteristics of the intragroup transactions and actual conduct of the parties;
  - review—and, where applicable, amend/supplement—their transfer pricing documentation to make sure that it is in line with the revised guidelines and appropriately justifies the arm's length character of their intragroup transactions.

The revisions to the OECD transfer pricing guidelines do not materially modify the principles contained in such guidelines. However, as shown above, they provide supplementary guidance on many aspects that will trigger an additional burden for taxpayers and, at least initially, additional uncertainty for taxpayers as regards the appropriateness of their transfer pricing policy and documentation. It required more than two years to prepare the final BEPS package and, undoubtedly, more than two years will be needed to fully appreciate its impact on taxpayers and tax administrations.

1 OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, p. 19.
2 OECD (2010), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing.
3 OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, p. 20.
4 Note that, further to the works of the European Union Joint Transfer Pricing Forum, guidelines on low value-adding intragroup services already existed at European level.
5 Note that, further to the works of the European Union Joint Transfer Pricing Forum, a two-tier structure (master file and local file) was already recommended/ applicable at European level.
6 BEPS—Frequently asked questions, answers to questions 57 and 58 (http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm).
7 According to the OECD, a consolidated version of the new transfer pricing guidelines in book form should be available in 2017.

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EPS and Transfer Pricing: What Do We Do Now?

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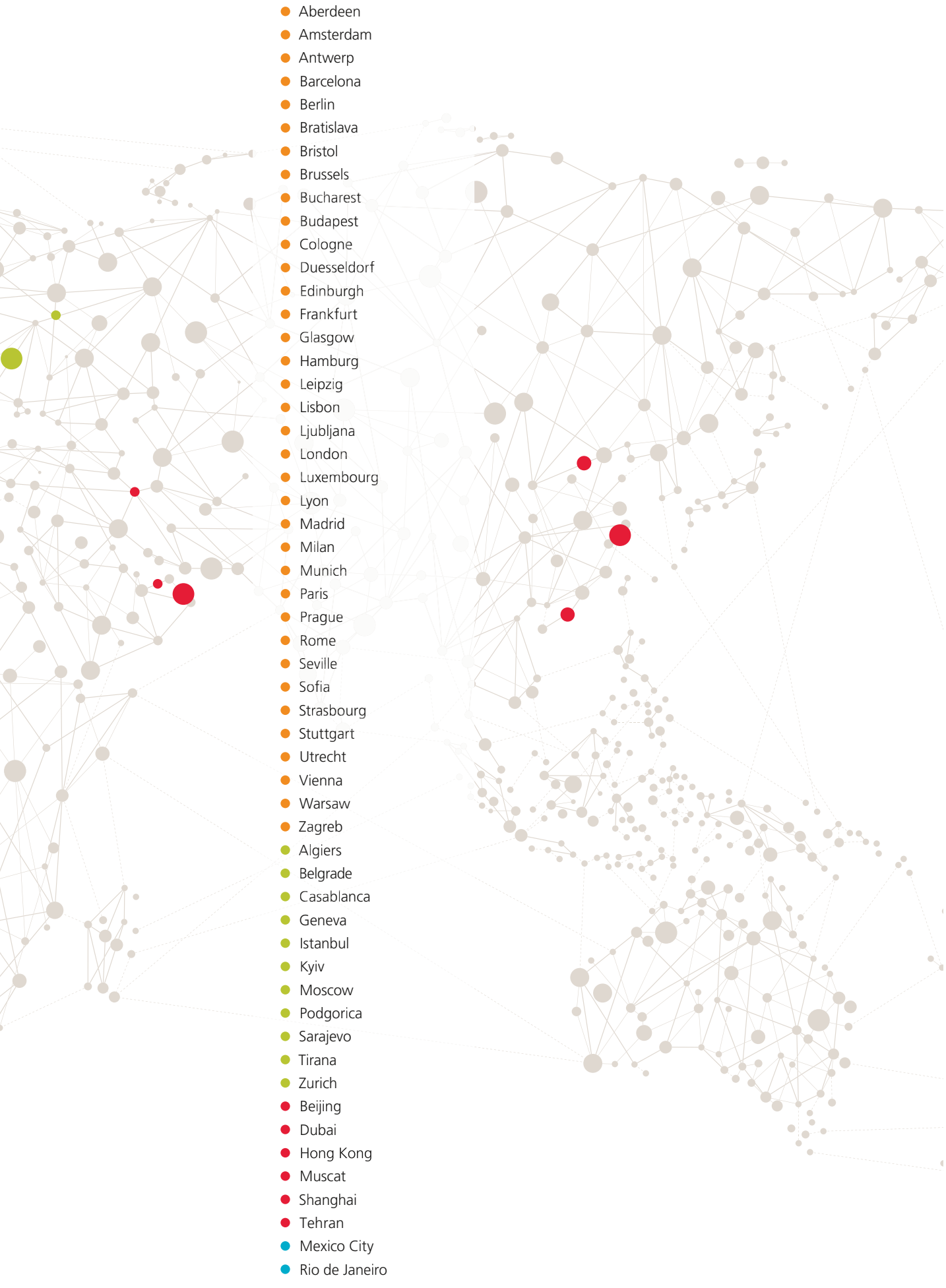

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- Lisbon
- Ljubljana
- London
- Luxembourg
- Lyon
- Madrid
- Milan
- Munich
- Paris
- Prague
- Rome
- Seville
- Sofia
- Strasbourg
- Stuttgart
- Utrecht
- Vienna
- Warsaw
- Zagreb
- Algiers
- Belgrade
- Casablanca
- Geneva
- Istanbul
- Kyiv
- Moscow
- Podgorica
- Sarajevo
- Tirana
- Zurich
- Beijing
- Dubai
- Hong Kong
- Muscat
- Shanghai
- Tehran
- Mexico City
- Rio de Janeiro