taxsutra

BMR Advisors

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Issue - 5

SCALING BEPS

OECD BEPS G20

SCALING BEPS

CONTENTS

INTRODUCTION

Note from the Editor:

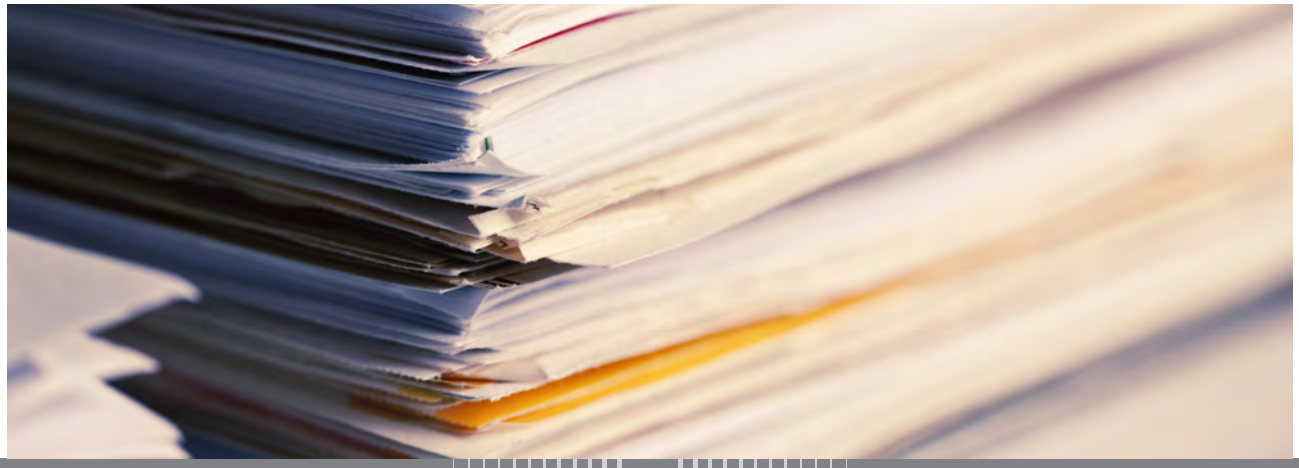
OECD's “BEPS Express", that has made impressive progress upto now, has hit its first major roadblock and it is one that 'Scaling BEPS' contributor Mr. Philip Baker had forewarned us about from the word 'go' - America's position on this entire project, that clearly has shifted from ambivalence to a hint of resistance! This extract from the letter written by senior Republican Congressional leaders - Senator Orrin Hatch & Representative Paul Ryan, to US Treasury Department, questioning its legal authority on CbC reporting and much more, should prepare us all for some tough negotiations ahead - " Regardless of what the Treasury Department agrees to as part of the BEPS project, Congress will craft the tax rules that it believes work best for U.S. companies and the U.S. economy."

In his 'Shooting Straight' piece, Mr. Baker, while laying out hope that USA will finally participate in the drafting of the Multilateral Instrument, also however enlightens the readers on the ground realities of American politics, that might not be "conducive" to a positive outcome on BEPS; he also cautions the tax world to a real problem of tax competition if the US does not implement BEPS.

In our 'Expert Gaze' section, the focus is on Action Plan 15 - Multilateral Instrument; the thorny issues that need resolution and areas that need more clarity. Mr. Garett Rose Esq. (Covington & Burling LLP), too turns his gaze to America's stand on BEPS, opining that while the refusal of the U.S. to participate seems unlikely to derail the multilateral instrument, but that refusal, coupled with the demands on mandatory arbitration that USA is making, could lead to a substantially different final product. Mr. Paul Morton (Head of Group Tax, Relx Group PLC) raises a vital question that could determine the fate of the Multilateral Instrument - “whether entering into a multilateral instrument involves a yielding of national sovereignty to others or whether it represents the collective exercise of national sovereignty for the common benefit?”

We dissect Action Plan 8 on Cost Contribution Arrangements (CCA), which emphasizes that the contribution of each participant should be determined on the basis of their ‘value’ rather than cost incurred. BMR Advisors however point out that this may lead to more disputes, as determining the ‘value’ could itself be a matter of significant debate. This edition also brings to you the 10 takeaways from the OECD's Revised Draft on Action Plan 7 dealing with Artificial Avoidance of PE.

With just over 2 months to go for the OECD to meet the deadline for most Action Plans, expect work to move ahead at a breathtaking speed... if this were a Formula One race, we are into the final laps...



1.1 ACTION PLAN 8: COST CONTRIBUTION ARRANGEMENTS

1.1.1 TAXSUTRA BRIEF ON ARTIFICIAL PE AVOIDANCE

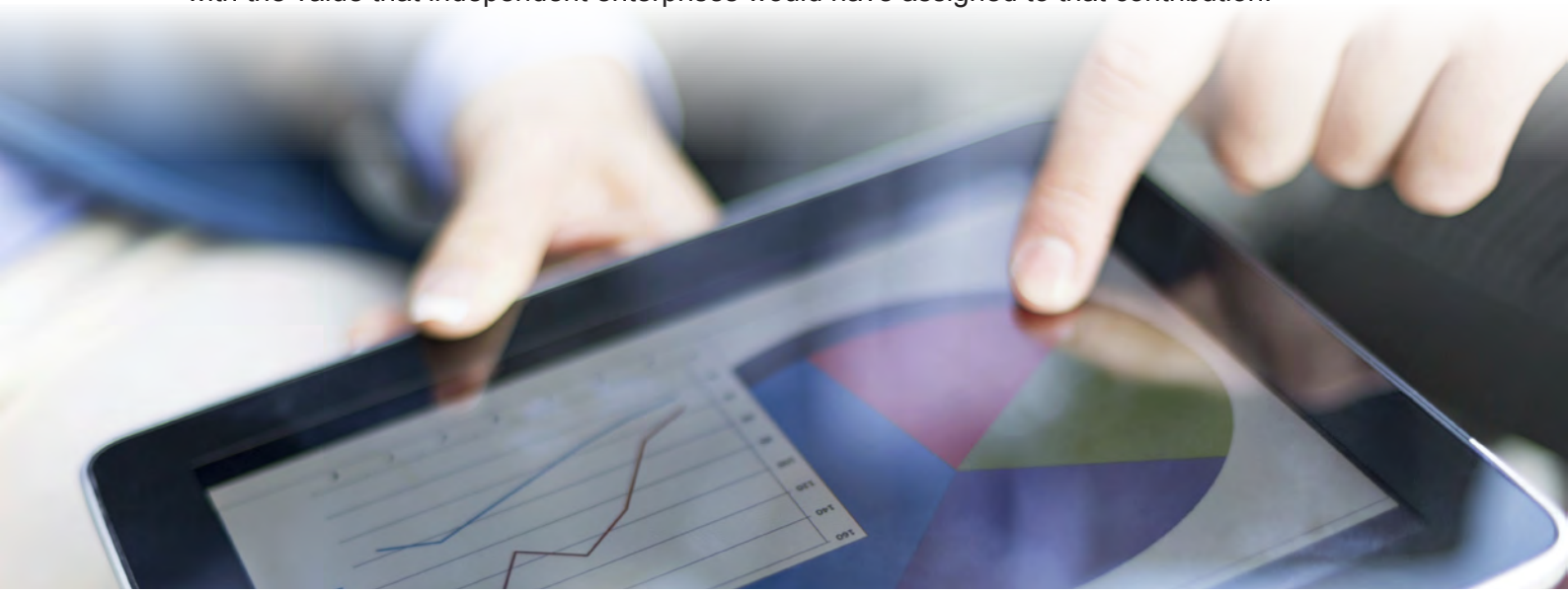
Aimed at addressing the flaws in the present transfer pricing system, the Organization for Economic Co-operation and Development (OECD) has undertaken the process of revising the various transfer pricing guidelines within the scope of the ambitious Base Erosion and Profit Shifting (BEPS) project. As a sub-sect of the "Action Plan 8: Assure that transfer pricing outcomes are in line with value creation: Intangibles", the OECD has released a discussion draft[1], "Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)" (Discussion Draft) on 29 April 2015.

As the title reads, the Discussion Draft seeks to replace the existing Chapter VIII of the Transfer Pricing Guidelines (TPG) on CCAs and provides proposed text for an updated chapter. A key objective of this revision is to align the transfer pricing of intangibles under CCAs with the general guidance on the transfer pricing of intangibles found in the revised Chapter VI of TPG.

How discussion draft deviates from current CCAs

The Discussion Draft deviates significantly from the existing guidance on CCAs in the following key areas:

- Defining a CCA as an arrangement to share contributions, which may be tangible or intangible and not merely costs
- Categorizing CCAs into two types: Development CCAs – those established for the joint development, enhancement, maintenance, protection or exploitation of intangibles or tangible assets and Service CCAs – those for obtaining services.
- Specifically requiring that to qualify as a participant to a CCA, the entity should have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA.
- Requirement that contributions to a CCA must be assessed on their value and not their cost. Under the arm's length principle, the value of each participant's contribution should be consistent with the value that independent enterprises would have assigned to that contribution.



[1]http://www.oecd.org/tax/transfer-pricing/discussion-draft-beps-action-8-cost-contribution-arrangements.pdf

Concept of CCA

A CCA is defined as "a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create direct benefits for the businesses of each of the participants."

CCA – key conditions

- The CCA participants would include only enterprises expected to derive mutual and proportionate benefits from the CCA activity itself (and not just from performing part or all of that activity).
- The arrangement would specify the nature and extent of each participant's interest in the results of the CCA activity, as well as its expected respective share of benefits.
- No payment other than the CCA contributions, appropriate balancing payments and buy-in payments would be made for the interest in intangibles, tangible assets or services obtained through the CCA.
- The value of participants' contributions would be determined in accordance with this guideline and, where necessary, balancing payments should be made to ensure the proportionate shares of contributions align with the proportionate shares of expected benefits from the arrangement.
- The arrangement would require balancing payments and / or changes in the allocation of contributions prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants.
- Adjustments would be made as necessary (including the possibility of buy-in and buy-out payments) upon the entrance or withdrawal of a participant and upon termination of the CCA.

Applying ALP principles to CCA

Determining Participants

Entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA

Expected Benefits from CCA

Estimated based on the anticipated additional income generated or costs saved or other benefits received

Applying Arm's Length Principle

Value of Contribution & Balancing Payments

Contributions to be assessed on value and not cost

Balancing payments to be imputed on mismatch between benefits and contributions

Tax Treatments

General tax principles to be followed

Tax administration shall have the power to impute balancing payments or disregard CCA when there is substantial discrepency between expected benefits and contribution

1 DISSECTING BEPS ACTION PLANS

1.1 ACTION PLAN 8: COST CONTRIBUTION ARRANGEMENTS

The Discussion Draft provides that for a CCA to satisfy the arm's length principle, the value of participants' contributions must be consistent with what independent enterprises would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits they reasonably expect to derive from the arrangement. Some of the key takeaways in this section are:

- ***Determining Participants:*** To qualify as a participant in a CCA an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA. Example 5 to the Discussion Draft portrays a similar scenario, wherein two entities A and B have decided to develop certain intangibles. Company A provides the funding and Company B will contribute its existing intangibles and perform the activities. In the example where Company A does not control the risks associated with the CCA, it is concluded that A cannot be regarded as a participant.

- ***Expected benefits from CCA:*** In estimating the expected benefits of each participant allocation keys such as sales, units used, produced or sold, number of employees etc can be used as a basis for such determination. Where the benefits are expected to arise in future, the allocation of contribution will also consider projections. Periodic assessments would also be necessary to make adjustments to contributions as may be necessary.

- ***Value of Contributions:*** As a significant change to the CCA guidelines, the Discussion Draft provides that contributions must generally be assessed based on their value (rather than their cost) in order to be consistent with the arm's length principle. However, it further provides situations for cost based valuations, where the value of services corresponds to the cost or the difference between the two is relatively modest. Strangely, unlike the existing Chapter VIII of the TPG, the Discussion Draft is now silent on treatment of subsidies and tax incentives that may be enjoyed by any participant.

- ***Balancing Payments:*** Balancing payments which increase the value of contributions of the payer and decreases that of the payee. While tax authorities are entitled to impute balancing payments, such adjustments should take into consideration the status of the arrangement over a period of years and tax administrations should generally refrain from making adjustments based on a single fiscal year.

- ***Tax Treatment:*** The general rules of the tax system will prevail in treatment of contributions and balancing payments, as would be applicable to such transactions outside the CCA. The tax administration is entitled to disregard part or all of the purported terms of a CCA where over time there has been a substantial discrepancy between a participant's proportionate share of contributions and expected benefits, and the commercial reality is that the participant bearing a disproportionately high share of the contributions should be entitled to a greater interest in the subject of the CCA.

BEPS QUOTES

We will strive to improve existing international information networks and cross-border cooperation on tax matters, including through a commitment to establish binding mandatory arbitration in order to ensure that the risk of double taxation does not act as a barrier to cross-border trade and investment.

G7 leaders' declaration

CCA ENTRY, WITHDRAWL OR TERMINATION

A New entrant to an existing CCA will generally have to make a “buy-in payment” to the existing participants based on the value of the interest in the intangibles and/or tangible assets the new entrant obtains, taking into account the new entrant’s proportionate share of the overall expected benefits to be received under the CCA. Similarly an existing participant shall receive a buy-out payment for disposing its results in favour of the remaining participants. The taxation of such payments shall be governed by the general rules of tax systems.

CCA STRUCTURE RECOMMENDATIONS

The Discussion Draft lays down certain key components of a CCA structure for reference, which is neither a minimum compliance standard nor an exhaustive list of the information that a tax administration may be entitled to ask for:

A. List of participants and other associates that will be involved in the CCA activity or is expected to exploit the results of the CCA activity

B. Scope of the CCA activity and management of the same

C. Duration of the arrangement

D. Manner of determination of participant's expected share of benefits and description of their contributions

E. Manner of exploitation of the future benefits

F. Anticipated allocation of responsibilities and tasks

G. Procedure for entering, withdrawing from and termination of the CCA

H. Provisions for adjustment of terms or balancing payments to reflect changes in economic circumstances

I. Over the term of the CCA, it is necessary to document any changes to the arrangement and a comparison between projections and actual results

1.1.2 BMR Point of View*

The draft guidance on CCA's updates the existing guidance on CCA's to take into account guidance released under BEPS action items 8-10 i.e. guidance on Risk in Chapter I[2] and Transfer Pricing Aspects of Intangibles in Chapter VI[3] of the OECD transfer pricing guidelines.

While emphasising on the fact that the contribution of each participant should be determined on the basis of their 'value' rather than cost incurred, the discussion draft brings out the fact that cost is not a dependable variable to assess contribution and share of each participant. The draft, however, provides for one exception to this rule for low value added services wherein contribution can be assessed at cost. The guidance that contributions be based on 'value' aligns the chapter with the general guidance on intangibles found in the proposed revisions to Chapter VI of the OECD Transfer Pricing Guidelines. However, this may lead to more disputes, as determining the 'value' could itself be a matter of significant debate. Also, there is ambiguity on how this approach of 'value instead of cost' will fall into place with the arm's length principle, as in practice, it is common for joint developments etc. where resources and skills are pooled in order to reduce overall costs, that contributions of participants are often assessed based on their cost.

Further, the Discussion Draft also precisely states that each participant must be in a position to control and manage the risks associated with the development of the intangible in order to be considered a party to the CCA. In the illustrations annexed with the discussion draft, example 5 discusses that an entity only providing funding would not be allowed to be a participant in a development CCA. Example 4 covers a situation wherein, a participant that participates in control and management but only provides funding may have its returns limited to a risk-adjusted return on its funding activities which is consistent with the general Intangibles discussion draft guidance.

**By Suchint Majmudar (Partner) and Neha Arora (Director) from BMR Advisors.*

[2]Released in December 2014
[3]Released in September 2014

1 DISSECTING BEPS ACTION PLANS

1.1 ACTION PLAN 8: COST CONTRIBUTION ARRANGEMENTS

The Discussion Draft moreover distinguishes between the two types of CCAs i.e. Service CCA (creating current benefits) and Development CCA (creating future benefits). For both, the value of contribution in the development of an intangible or providing a service should be recognized and should be commensurate with the expected benefits.

One of the points to consider is cases where a CCA for services could result in creation of intangibles. For instance, the LG ruling in India (I.T.A. Nos. 3823 & 3729/DEL/2009) which involved sponsorship of the cricket tournament and the relative contribution was made by the group entities based on relative proportion of populations of cricket playing countries. A comment for consideration would be the treatment of CCAs for service being converted into a CCA for marketing intangibles. For instance, in the LG case, this situation could take place if an enterprise sponsors tournaments over an extended period of time. Then, questions can arise on whether the CCA is one of service, or one of development of intangibles. Valuation issues could arise in such situations and it may be useful to have guidance in this context.

Also, can an entity be recharacterised from being a service provider in a CCA to being a participant in a CCA, especially if the conduct of the parties suggests that the service provider actually assumes risks of development, or performs significant people functions? This is another situation where guidance from OECD would be helpful.

> While emphasising on the fact that the contribution of each participant should be determined on the basis of their 'value' rather than cost incurred, the discussion draft brings out the fact that cost is not a dependable variable to assess contribution and share of each participant.

A further concern regarding the measurement and assessment of contributions is the difficulty of monitoring and re-valuing the contributions of each participant after a period(s) of time. This would create a substantial compliance burden. Moreover, with the benefit of hindsight – in the context of a tax audit conducted many years later – the original contributions might be considered to be inappropriate, even though they might have been assessed as reasonable at the time of the conclusion of the CCA. Also, there could be situations wherein valuation is highly uncertain at the time of the transaction. In such case, the arm's length pricing guidance provided by OECD in the discussion draft on hard-to-value intangibles would need to be considered.

India Impact

CCA activity has historically not been popular form of intangible development in India. However, given that India's increasing participation in global trade and increasing importance of intangibles[4], as well as availability of appropriate skill sets at affordable prices and tax incentives for R & D, making India a preferred location for the development of intangibles, the prominence of CCA's in India is likely to increase in the near future.

Presently, Indian Transfer Pricing Regulations do not have separate guidance with respect to the CCAs. In India, Section 92(2) of the Income Tax Act, 1961 is a single compiled provision dealing with

[4]Released in June 2015

intra-group arrangements for services, cost allocations, cost contributions, etc. Further, the definition of international transaction, section 92B(2) covers a mutual agreement or arrangement between associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred.

Furthermore, the Circular 6 on R & D services issued by the CBDT, has recognized the concept of development centres which are based on cost-sharing arrangements, although have been defined to be cover whose functions, assets and risk would fall between first (entrepreneurial – i.e. undertaking important functions and assuming substantial risks) and third (contract – minimal functions and risks) cases. However, it does not contain detailed guidance on such arrangements.

Treatment of CCAs for service being converted into a CCA for marketing intangibles: For instance, in LG case (involving cricket tournament contributions), this situation could take place if an enterprise sponsors tournaments over an extended period of time. Then, questions can arise on whether the CCA is one of service, or one of development of intangibles.

Since there is limited guidance in the Indian Transfer Pricing Regulations on the CCA's, resort has had to be made to the OECD guidelines and US Regulations. Further, such reference to the OECD guidelines in matters where Indian regulations lack guidance has obtained judicial approval in the pronouncements of the Indian judiciary.

Presently, Indian Transfer Pricing Regulations do not have separate guidance with respect to the CCAs.

Conclusion

It is clear that the discussion draft is aimed to bring harmony amongst the various BEPS action plans, however, guidance is sought from OECD, in particular regarding computation of "value" for determining the contribution. The multinationals who have existing CCA's should review their existing transfer pricing arrangements on CCA's in line with the recommendations of the OECD and keep track of final rules/developments to ascertain the impact on their existing CCA's.

1.2 ACTION PLAN 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

TAXSUTRA BRIEF ON ARTIFICIAL PE AVOIDANCE

One of the crux to double taxation or double non-taxation is "Permanent Establishment" (PE), the medium which creates the artificial presence of an enterprise. OECD had noticed inherent limitations in the PE provisions way back in 2011 when it sought to amend the guidelines. Bringing it under the banner of the BEPS project, one can say that it will plug the loopholes and end double non-taxation.

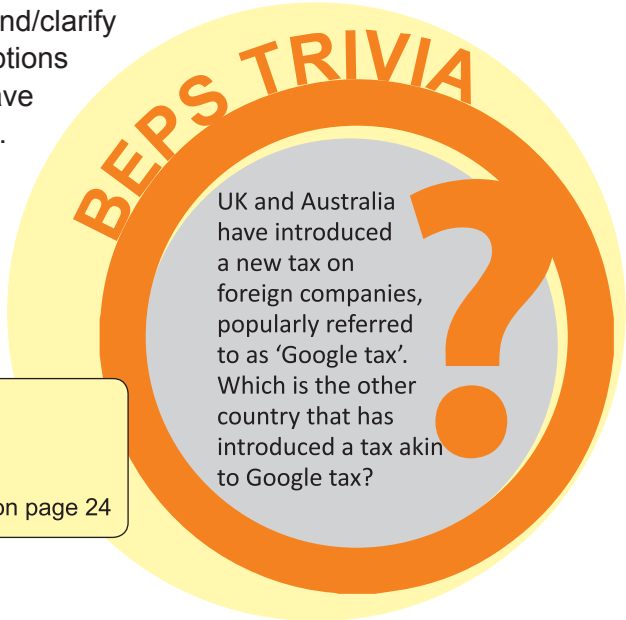
In the initial Discussion Draft on Action Plan 7: Preventing the artificial avoidance of PE Status, OECD had provided several options to address each of the identified issues by suggesting modifications to Article 5 of the OECD Model Tax Convention.

The first draft[5] released on 31 October 2014 provided:

- 4 options for modifications to the definition of dependent agent (Article 5(5)) and independence of agent (Article 5(6))
- 4 options for modifications to the definition on specific activity exemptions (Article 5(4))
- 2 options to address artificial fragmentation of activities to qualify for exemption under Article 5(4) as being preparatory and auxiliary activities
- 2 options on addressing splitting up of contracts to benefit from Article 5(3)
- 2 options to deal with insurance companies that sell insurance in local market without having a PE in the market

After stakeholder consultations, OECD has released the Revised Discussion Draft[6] (Revised Draft) on May 15, 2015 proposing the shortlisted options for comments.

The focus of the Revised Draft is primarily to amend/clarify PE guidelines pertaining to agency, specific exemptions and splitting up of activities. Several changes have been proposed to the model tax convention. Wherever required, changes have also been made to the model tax commentary for better clarification. OECD has also recognized that changes to the PE guidelines would give rise to newer categorization and thus challenges in attribution of profits. The Revised Draft concludes by assuring that follow up work on attribution of profits would be released by end of 2016.



(a) Ireland
(b) Spain
(c) Australia
See answer on page 24

[5]http://www.oecd.org/ctp/treaties/action-7-pe-status-public-discussion-draft.pdf
[6]http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-7-pe-status.pdf

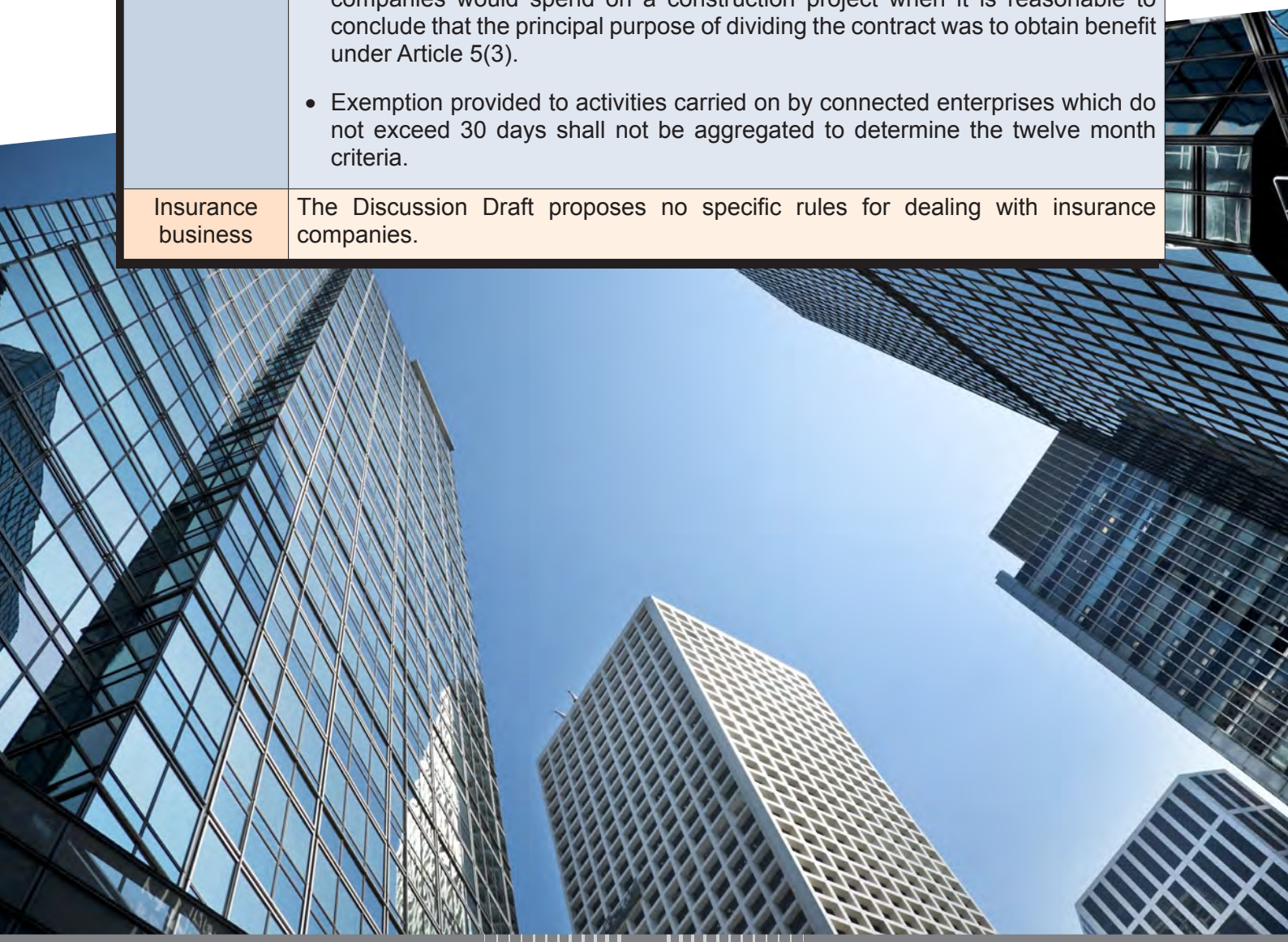
1.2 ACTION PLAN 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

The changes to the PE guidelines are sure to have a far reaching impact on many of the business structures. Here are the top ten takeaways from the Revised Draft.

Changes to agency PE rule	Agency PE is created not only when a person habitually concludes controls, but also when such person 'negotiates material elements of the contract'. • Material elements of contracts have been explained to typically include the determination of the parties between which the contract will be concluded as well as the price, nature and quantity of the goods or services to which the contract applies. • The contract herein could be one in the name of the enterprise, or also for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.
Standard form contracts could also lead to agency PE	As explained in the commentary, even standard form contracts could give rise to agency PE even though no negotiation is involved with respect to the terms of the contract. • In other words, where a local agent solicits customers to enter into standard form contracts designed by the foreign enterprise or where such local agent obtains standard form contracts for conclusion by the foreign enterprise; it could qualify as a PE if it satisfies the general agency PE rule.
Independent Agents	Independent agents do not qualify for exemption if they act exclusively or on behalf of one or more enterprises to which it is connected.
Who are Connected Persons?	A 50% ownership threshold has been provided to qualify as connected person. In any case, two persons are said to be connected if one has control of the other or both are under common control determined based on actual facts. This is a new definition inserted in the Revised Draft. The original draft meant connected persons to be the same as 'associated enterprises' as referred in Article 9 to the OECD Model Tax Convention, which was significantly wider in covering any direct or indirect participation in management, control or capital without any threshold.
Qualification for PE general exemption [Article 5(4)]	All exempted activities listed under Article 5(4) shall now be required to satisfy the test of being preparatory or auxiliary in nature to retain the exemption.
What is a Preparatory activity?	An activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole.
What is an Auxiliary activity?	An activity that has an auxiliary character generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole.

1.2 ACTION PLAN 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

Anti-fragmentation rule	New Anti-fragmentation rule to prevent an enterprise or a group of connected enterprises from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity. The rule disqualifies an enterprise from the exemptions provided in Article 5(4) where the subject enterprise or its connected enterprise carries on business activities at the same place or another place in the contracting state and such place constitutes a permanent establishment. The enterprise is also disqualified from availing the exemption where the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or connected enterprises at the two places, is not of a preparatory or auxiliary character.
Addressing splitting up of contracts	The Discussion Draft does not propose any amendments to the text of the Model Convention but seeks to address the issue of splitting up of contracts through the general 'Principle Purpose Test' as described in September 2014 report under BEPS Action 6 (preventing treaty abuse). • Additionally an example has been introduced to the Model commentary to illustrate a scenario where it is necessary to aggregate the time that two related companies would spend on a construction project when it is reasonable to conclude that the principal purpose of dividing the contract was to obtain benefit under Article 5(3). • Exemption provided to activities carried on by connected enterprises which do not exceed 30 days shall not be aggregated to determine the twelve month criteria.
Insurance business	The Discussion Draft proposes no specific rules for dealing with insurance companies.



1.3.1 REVISED DRAFT OF ACTION PLAN 6: PREVENTING TREATY ABUSE

The crux of the BEPS project and one of the highly debated Action Plan is the Action Plan 6: Prevent Treaty Abuse[8]. OECD in November 2014 released its first draft on Action Plan 6.

Recap from November 2014 Draft

- **Three-pronged approach to address treaty shopping arrangements - Clear statement of intent in treaty, limitation of benefits (LOB) clause and the principal purpose test (PPT)**
- **Multiple alternatives to reach the goal of ending treaty shopping**
- **Countries to agree on minimum level of protection that should be implemented**
- **Address specific treaty entitlement issues with respect to collective investment vehicles (CIV) and non-CIV funds**

On 22 May 2015, OECD has issued a Revised Discussion Draft on this Action Plan ('Revised Draft'). The Revised Draft sets out the conclusions and proposals arising from the previous meetings and public comments. The Revised Draft is divided into two parts: Part 1 dealing with an alternative "simplified" LOB rule and Part 2 dealing with the outcome of discussions on issues identified in discussion draft of 21 November 2014 including certain new proposals.

Alternative Simplified LOB Rule

- The LOB rule is modified by removing most of the complexities in the previous definition of 'qualified person'. In case of companies and person other than companies, it just requires that the shares or beneficial interests are traded on recognized stock exchanges or more than 50% of the beneficial interests is owned by qualified persons. The test of control and management has now been removed. However, the Revised Draft proposes to amend the commentary to prescribe qualifications for 'recognized stock exchange'.

- Derivative benefits test threshold has been reduced from 95% to 75% with no prescribed number of equivalent beneficiaries.

Specific Issues

- Proposals relating to CIV as contained in the September 2014 report are to be retained as the same is in line with the 2010 OECD Report, The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles.

- The issues in relation to non-CIV funds are still to be deliberated. The Revised Draft however proposes inclusions in relation to Real Estate Investment Trusts (REITs): by adding reference of 2008 REIT Report (Tax Treaty Issues related to REITs) to commentary on 2(f) of the LOB Rule and pension funds (to be considered as residents).

- Proposal for a consultation process under which the competent authority of the country to which the request is made must consult with the other competent authority before rejecting a request to grant benefits under the treaty.

[8]The earlier editions (**Issue 2** & **Issue 3**) covered the developments on this Action Plan.

[9]http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-6-prevent-treaty-abuse.pdf

- The New LOB rule dealing with indirect ownership does not provide that intermediate owners are required to be resident in the contracting state. However, the Revised Draft observes that this issue would be addressed by the PPT rule and would warrant further discussion.
- Guidance to countries to formulate appropriate administrative process to ensure that PPT rule is applied to any case only after approval from a senior level within the tax administration.
- Providing discretionary relief powers to competent authority

New concept of 'Special tax regime' introduced, whereby it is proposed to remove treaty benefits to Interest, Royalties and Other Income in cases where:

- Such income is beneficially owned by residents benefiting from a "special tax regime" in their country of residence at any time during the taxable year in which such income was paid.
- Any future change in the domestic tax laws results in exemption from taxation to resident companies for substantially all foreign source income. This provision shall also apply to Dividends.

Public comments[10] running to around 350 pages were received on the Revised Draft in June 2015. The Action Plan is expected to be discussed at the Working Party 1 meeting of 22-26 June 2015 and thereafter a final report is expected to be released by September 2015.

[10] http://www.oecd.org/ctp/treaties/public-comments-revised-beps-action-6-follow-up-prevent-treaty-abuse.pdf

1.3.2 ACTION PLAN 3: STRENGTHENING CFC RULES

OECD released a Discussion Draft[11] on 3 April 2015 Action Plan 3: Strengthening CFC Rules on April 3, 2015 (Discussion Draft). The Discussion Draft witnessed a lot of comments from stakeholders which proceeded on to a public consultation on 12 May 2015. The Discussion Draft primarily sets out to provide guidance to countries to introduce or improvise the CFC rules by identifying the key building blocks of CFC and also the major policy considerations in this way. OECD also notes that unlike other deterrent tax measures, CFC rules are intended to play a preventive role by preventing tax avoidance and are not aimed at collecting additional revenue.

BUILDING BLOCKS OF CFC

Building Block	Recommendation
Definition of CFC	• Define entities broadly so as to include non-corporate structures and also Permanent Establishments when those entities are owned by CFCs or treated in the parent jurisdiction as separate taxable entities. • Introducing a modified hybrid mismatch rule (i.e. taking into account intra group payments) that would prevent entities from circumventing CFC rules by being treated differently in different jurisdictions.
Threshold Requirements for Application of CFC	• An entity shall qualify as a CFC if the effective tax rate (ETR) is lesser than the benchmark tax rate, which is recommended to be 75% or lower of the parent jurisdiction's tax rate.
Definition of Control	• Control can be legal, economic, de facto control or based on consolidation under accounting. • Recommended threshold of more than 50%, whether by single or group of related persons or persons acting in concert.
Definition of CFC Income	• Two types of approach identified – Categorical: specific categories of passive income such as dividends, interest etc are included identified using form analysis or substance analysis. • Excess Profits: Profits earned in a low tax jurisdiction that exceeds the determined rate of return.
Rules for Computing Income	• Parent Jurisdiction's laws of taxation shall apply. Provision needs to be made for losses arising in CFCs that can be set off against future profits.
Rules for Attributing Income	• Attribution can be linked to minimum control threshold limit and based on proportion and period of ownership. Income can be treated as deemed dividend or earned directly by shareholder. Tax rate and timing of taxation shall be as per the rules of the Parent Jurisdiction. Top-up tax could also be considered i.e. tax rate equal to the difference between the ETR of the CFC and the benchmark rate at the Parent Jurisdiction.
Rules to Prevent or eliminate double taxation	• Providing credit for foreign taxes actually paid. • Exempting dividends and gains on shares of CFC previously subject to taxation.

[11] http://www.oecd.org/ctp/aggressive/discussion-draft-beps-action-3-strengthening-CFC-rules.pdf

Stakeholder Reactions[12]

- Unhappy with recommendations on 'minimum standard' requiring all countries to adopt CFC Rules, opine that such choice best left to each country
- BIAC expressed concern that the Draft fails to complete transfer pricing rules and reduce harmful competition
- Draft departs from the common active/passive income structure by bringing in new concepts
- Risk of inappropriate shifting of tax rights from source state to residence state
- Extremely subjective and be burdensome on businesses. Request for a much simpler and mechanical approach

The final report after considering stakeholder inputs is expected to be released by September 2015.

BEPS TRIVIA

How many countries have agreed to participate in the development of multilateral instruments?

34, 44 or 83
See answer on page 33

[12] http://www.oecd.org/tax/aggressive/public-comments-beps-action-3-strengthening-cfc-rules.htm
http://www.oecd.org/tax/aggressive/public-consultation-beps-action-3-strengthening-cfc-rules.htm

SHOOTING STRAIGHT

PHILIP BAKER

Mr. Philip Baker, Queen's Counsel, UK

The final stages of the BEPS Project: How will the US react?

The end of the BEPS Project is almost within sight. The second round of deliverables is due in September/October this year. However, because of the need to secure approval from the OECD Committee on Fiscal Affairs, plus the non-OECD countries, plus the G20, and factoring in that work in Paris usually stops during August, the reports and recommendations have effectively to be completed by the end of July. This is one of the consequences of the project being led by the OECD. So, frenetic work is being undertaken at a heroic rate to complete the reports and recommendations in time.

Once the Project is completed, there will be time for reflection whether the scope of the Project and the timetable were simply too tight for the work to be carried out to an adequate standard. In principle, this timetable was explained to be necessary because of the desire of the G20 leaders to see the problem of tax avoidance by multinational companies resolved within 2 – 3 years. The political attention span of the world's leaders is explained to be limited to such a period.

> "The US clearly has fundamental difficulties with some of the BEPS proposals, such as the Principal Purpose Test as an alternative to an LOB Clause. US officials will have been aware from the outset that a severe clawback on base erosion or profit shifting was likely to have a significant and adverse impact on the amount of tax paid overseas by US multinationals….. The political scene in Washington is not conducive to a positive outcome for all of the BEPS proposals in the short term".

There are still some final reports to be delivered for December 2015, and the drafting of the proposed Multilateral Instrument will stretch well into 2016. However, to all intents and purposes, the main conclusions of the Project are expected for this September/October.

The impending completion of the Project brings into high profile, therefore, one of the issues that has been raised from the start of the process: will the United States adopt the outcomes of the Project?

The US buy-in to the outcomes is not simply important because of the size of the US economy. Many people will say that one of the prime causes of the base erosion and profit shifting problem is the dysfunctional nature of the US system for taxing overseas profits of US multinationals, caused by changes to the US tax system over the last 20 years. The introduction of the "check-the-box" rules, and the effective dismantling of much of the US CFC legislation, has created a situation where some US multinationals suffer little or no tax on the profits earned outside the United States. These multinationals have been abetted to a large extent by attractive tax regimes created by tax competition in Europe and elsewhere. That in turn creates a clear divergence of views across the Atlantic (perhaps across the

Pacific as well) as to what is the primary cause of base erosion and profit shifting, and what is merely secondary. Outside the United States, the primary cause is often seen to be these changes to the US tax system and the opportunities it creates for US multinationals to pay little or no tax. Within the United States, so far as one can tell, the primary cause seems to be seen as tax competition and the increasingly attractive tax regimes offered by other countries.

In this context, the recent behaviour of the US and some of its officials with regard to the BEPS Project have been difficult to fathom. Perhaps most significant, the United States has decided not to participate initially in the working group towards the drafting of the Multilateral Instrument. The official explanation is that the resources available to deal with international tax issues are stretched, and that the US already insists upon certain measures in its tax treaties – such as a limitation on benefits clause – which will be inserted, one anticipates, by the Multilateral Instrument. However, it is a little difficult to accept that US resources are so stretched that the US would not even wish to participate in the drafting of the Multilateral Instrument.

More recently, the US officials have indicated that they may be more interested in a Multilateral Instrument if it contains provisions for compulsory arbitration of international tax disputes. Frankly, it would be a totally wasted opportunity if the Multilateral Instrument did not insert measures for compulsory arbitration into those bilateral tax treaties where the countries concerned are agreeable to arbitration. Hopefully, this suggests that the US will participate in the Multilateral Instrument and, perhaps when political circumstances change in the US, will go ahead with some or all of the BEPS outcomes.

The US clearly has fundamental difficulties with some of the BEPS proposals, such as the Principal Purpose Test as an alternative to an LOB Clause. US officials will have been aware from the outset that a severe clawback on base erosion or profit shifting was likely to have a significant and adverse impact on the amount of tax paid overseas by US multinationals. One can assume that those multinationals have been lobbying actively in Washington to preserve, in whole or in part, the status quo.

The political scene in Washington is not conducive to a positive outcome for all of the BEPS proposals in the short term. A Democrat President does not control the legislative process in either house of Congress, which is necessary to ensure the passage of domestic legislation to reform the US tax system for overseas income. That position is unlikely to change until after both Presidential and Congressional elections. There are proposals coming from some Congressmen, who recognise the necessity of changing the US rules on taxation of international business. However, the political environment seems far from conducive to anticipate the implementation of those proposals.

There is a real problem if the US does not buy-in to the BEPS outcomes, and does not implement within a reasonable period of time. That would sustain and intensify the current position by which US based multinationals have a huge competitive advantage in international trade and investment by comparison with those countries that go ahead and implement the outcomes of the BEPS Project. To a certain degree, countries that proceed with the BEPS outcomes will be enacting legislation that potentially increases the tax burden on companies based in those jurisdictions. In that scenario, there must be a worry that countries that have gone along with the BEPS outcomes will adopt measures that have, in effect, a form of retaliatory impact on business based in countries that do not align themselves with the BEPS outcomes. It would be too extreme to talk about an international tax conflict, but it is hard to imagine a future where some countries impose upon corporate groups based in those countries measures to combat base erosion and profit shifting, while other countries maintain a tax system which almost encourages those practices.

The last months of the BEPS Project are likely to be particularly critical. There is a story that a notice in the delivery ward of a hospital said “the first few minutes of a life are critical for survival and long-term health”. Underneath it, someone had written: “the last few minutes are pretty critical too”.

EXPERT GAZE:

Consensus, Sovereignty and Certaity Considerations: By Paul Morton, Head of Group Tax, Relx Group PLC (Previously Known As Rees Elsevier)

Paul Morton, Head of Group Tax, Relx Group PLC (Previously known as Rees Elsevier)

The author writes about experiences with multilateral instruments prevailing in international law (other than taxes). The author also writes about US's reservations on multilateral instruments. He also provides interesting aspects that weigh in bilateral treaty negotiations and apprehensions of countries of sacrificing its sovereignty. The author at the end lists down areas arising from BEPS where multilateral consensus is necessary .

The G20/OECD BEPS Action Plan, aimed at tackling Base Erosion and Profit Shifting, will, if successful, transform the international tax system from that designed in the early part of the 20th century to a system fit for the 21st century and the digital economy. The OECD, however, can only recommend and advise on best practice. It is for individual states to implement the recommendations.

Measures designed to avoid double taxation and, to some extent, double non-taxation, are unlikely to be effective unless they are implemented on a bilateral or a multilateral basis and there exist more than 3000 bilateral tax treaties worldwide. It has been recognised from the outset of the BEPS project that updating all 3000 treaties would be an extremely lengthy process which would effective render BEPS ineffective for a very long time. Action 15 of the Action Plan therefore proposed that "interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature the global economy and the need to adapt quickly to this evolution".

What is the experience so far with multilateral instruments? There are numerous such instruments in international law dealing with areas such as Human Rights, scientific matters, legal jurisdiction, the law of the sea and trade and investment etc. Many of these function very well. The experience in direct tax law is rather more limited. There are several such instruments within the European Union such as the Arbitration Convention and various agreements on administrative matters, withholding taxes etc. Tax directors in business consider the Arbitration Convention to have been rather successful. This is not so much because it has proven to be effective in practice, although there have been a small number of successful cases, but rather because the cost, complexity and uncertainty from a tax administration point of view has served as an encouragement for tax administrations to reach agreement as an alternative to formal arbitration proceedings.

In other cases, proposed European multilateral instruments have been less successful. For example, discussions over many decades have failed to provide a mechanism for cross-border loss relief and the negotiation of a Common Consolidated Corporate Tax Base (CCCTB) has produced some excellent technical materials but nothing of legislative effect.

In fact, the European Union Treaty has proven to be highly effective in relation to indirect taxes, such as VAT, where a uniform system exists throughout Europe but rather less effective in relation to direct taxes. Perhaps this reflects the practical and political imperative for a uniform indirect tax system, without which trade would be seriously impeded, while the case for a uniform direct tax system is rather less clear and the implications for the surrender of national sovereignty more controversial.

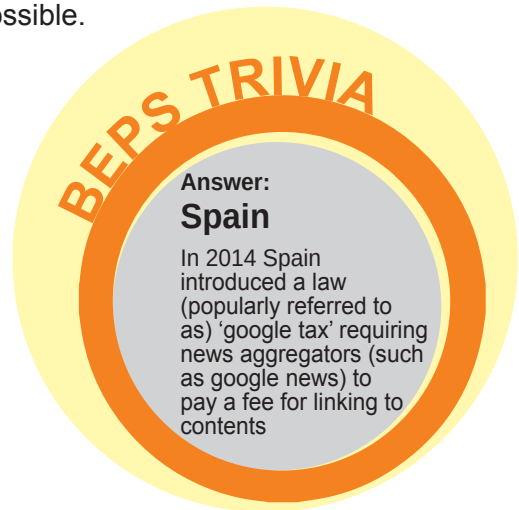
The Discussion Draft on Action 15 of the BEPS Action Plan concluded that a multilateral instrument was technically feasible and indeed desirable to facilitate the implementation of the Plan in general. At the January 2015 meeting of the Committee on Fiscal Affairs a mandate was agreed to develop the proposal, starting work by July 2015 and concluding with the opening of the instrument for signature by the end of 2016. On 28th May the OECD issued a Press Release indicating that an ad hoc group had been established with over 80 countries participating. Notably, the US has not yet signed up to the process and this must raise some concerns about the effectiveness of the outcome.

> "There are numerous such instruments in international law dealing with areas such as Human Rights, scientific matters, legal jurisdiction, the law of the sea and trade and investment etc. Many of these function very well. The experience in direct tax law is rather more limited".

On 9th June the Chairmen of the Senate Finance Committee and the House Ways & Means Committee of Congress (the chairmen of the two tax law writing committees) wrote to the US Treasury Secretary about the need for the Treasury Department to remain engaged with Congress in relation to the BEPS process. They noted that “Regardless of what the Treasury Department agrees to as part of the BEPS project, Congress will craft the tax rules that it believes work best for U.S. companies and the U.S. economy.”

The US Senate has failed to ratify any double tax treaties for several years because of concerns by just one Senator about the treatment of confidential information. Whether or not the US could sign up to a multilateral instrument in these circumstances must be a matter of some doubt.

Perhaps this illustrates a concern at the heart of this Action Item which is whether entering into a multilateral instrument involves a yielding of national sovereignty to others or whether it represents the collective exercise of national sovereignty for the common benefit. This may be a question for academic lawyers but from a business point of view it would be highly beneficial to remove obstacles to cross border trade and investment wherever possible.



EXPERT GAZE:

Consensus, Sovereignty and Certaity Considerations

Double tax treaties are negotiated with great care between states on the basis of detailed and thoughtful analysis of the economic consequences of the decisions reflected in the text. **The total number of treaties in existence is perhaps less than 20% of the total number of treaties which might be theoretically negotiated if every relevant jurisdiction had a treaty with every other.** The existing treaty network has developed piecemeal over around 100 years, albeit based on a small number of widely accepted model treaties. This, perhaps, illustrates the scale of the challenge. Can a single multilateral instrument reflect the needs and preferences of so many independent states, so precisely, that it can supersede or superimpose itself on 3000 unique and painstakingly negotiated individual treaties?

In relation to BEPS it is clear that many points of principle need to be agreed. The precise definition of permanent establishment, the application of the many transfer pricing rules and principles, the application of anti-avoidance rules in double tax treaties, the deductibility and taxation of interest and so many others need to be crystal clear if we are to avoid disputes at best and double or multiple taxation at worst. We will also need an effective dispute resolution mechanism.

For these practical reasons the business community most hope that good progress is made on the multilateral instrument, hopefully, with the full support and active participation of the US. Today, it rather looks that this may be a long process!

BEPS QUOTES

"In 2008 there were 14 bilateral tax agreements, now there are 3000. We aim at replacing all of these by one multilevel convention"

Pascal Saint-Amans, Director, Centre for Tax policy and Administration, OECD…

EXPERT GAZE:

- Is Consensus on Multilateral Instrument elusive? : By Garett R. Rose, Esq., Covington and Burling LLP, Washington D.C.

Garett R. Rose, Esq., Covington and Burling LLP, Washington D.C.

The author writes about US's ambivalent stand on BEPS Action 15 on Multilateral Instrument. He believes that BEPS appears to have largely increased the uncertainty in the international tax system and driven countries to pursue unilateral measures. The author also writes that the refusal of the U.S. to participate seems unlikely to derail the multilateral instrument, but that refusal, coupled with the demands that America is making (e.g. on mandatory arbitration), could lead to a substantially different final product.

Action 15 of the OECD's BEPS project addresses the development of a multilateral instrument for implementing treaty-dependent portions of the BEPS program. In this fashion, it is somewhat removed from the other BEPS Actions, which interface more directly with substantive BEPS issues. This is not to say that Action 15 is unimportant, of course—in addressing a primary mechanism through which BEPS is to be implemented, it plays a critical role in the project's overall impact. This paper will look at the scope and status of Action 15, the United States' position on Action 15, and then offer some commentary on the foregoing.

According to the 2013 document initiating the BEPS project, the focus of Action 15 is to create an efficient mechanism for swiftly implementing certain of the BEPS recommendations and to thus bypass the often cumbersome bilateral treaty process[13]. Consistent with this directive, in September 2014, the OECD published the Action 15 "deliverable" and, in February 2015, issued a related mandate. The 2014 deliverable essentially outlined the benefits of developing a multilateral instrument and provided an overview of the legal mechanisms available for crafting the instrument, concluding that it is both "desirable and feasible."[14] Additionally, it provided a brief sketch of the other parts of BEPS that would naturally fit into the instrument. The 2015 mandate established and defined an ad hoc group responsible for continuing work on Action 15[15]. Over 80 countries are currently participating in the ad hoc group, which is scheduled to begin its work in earnest in early November[16]. The world awaits the results of these labors.

> "The U.S., however, is not simply walking away from the table—it appears to be utilizing negotiations over the instrument in order to achieve mandatory arbitration, which, along with clarity, has been a high priority for the U.S. and for the business community throughout the BEPS project".

[13]See Organisation for Economic Co-operation and Development [OECD], Action Plan on Base Erosion and Profit Shifting, at 24 (July 2013).

[14]See OECD, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties—Action 15: 2014 Deliverable (Sept. 2014).

[15]See OECD, Action 15: A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS (Feb. 2014).

[16]See Kevin A. Bell, OECD on Schedule with Remaining BEPS Deliverables, Saint-Amans Says, 24 T.M.T.R. 153 (June 11, 2015).

Even before the group was formed, however, the U.S. had signaled its ambivalence about Action 15, with Treasury Associate International Tax Counsel Quyen Huynh saying that the U.S. would be wary of the instrument "if [for example] it includes a definition that transactions with 'a principal purpose of tax avoidance' will be targeted."[17] This ambivalence hardened into a firm position when the U.S. was not among the countries listed in the May announcement of the ad hoc group. Treasury officials have subsequently explained this choice. Treasury international tax counsel Danielle Rolfes indicated that there did not appear to be much in the instrument for the U.S. and that participation wasn't worth the resources (which, to be fair, are stretched quite thin at the moment).[18] Additionally, Rolfes noted that the U.S. had already addressed issues that would be included in the instrument, such as the Action 2 work on hybrids and the Action 6 work on treaty shopping.[19] Interestingly, though, Rolfes also indicated that the U.S. would sign such an instrument if mandatory binding arbitration were included.[20]

The key to the multilateral instrument's success is the degree to which it offers precision and clarity as to the obligations of taxpayers and the positions of governments. The current status of the BEPS project does not inspire confidence in this regard. Indeed, BEPS appears to have largely increased the uncertainty in the international tax system and driven countries to pursue unilateral measures. Thus, the BEPS project might shatter what consensus existed among developed countries, without providing a comprehensive, consensus replacement. The instrument could exacerbate this tendency if pursued improperly. For example, a multilateral instrument that allows countries to swiftly insert ill-defined language from the other Action Items (in particular, loose anti-avoidance language from the Action 6 work on preventing treaty abuse)could cause that vagueness to spread throughout the international tax system like a virus. **It is understandable, given the urgency associated with the BEPS work, that the OECD seeks to bypass the often cumbersome bilateral treaty process, but that process has been fairly successful over the years in establishing a workable, nuanced international tax regime.** Grafting a multilateral option that lacks precision and clarity and that doesn't have the buy-in of all the relevant parties could prove disastrous.

America's refusal to participate in the multilateral instrument thus far is not particularly surprising. As Rolfes indicated, the U.S. believes that it has resolved many of the issues that would otherwise be resolved through the instrument (such as the use of effective, if complex, limitations on benefits provisions). Moreover, other officials have indicated a deep disappointment with most of the BEPS project thus far.[21] As such, there is no compelling reason for the U.S. to join the multilateral instrument's bandwagon. The U.S., however, is not simply walking away from the table—it appears to be utilizing negotiations over the instrument in order to achieve mandatory arbitration, which, along with clarity, has been a high priority for the U.S. and for the business community throughout the BEPS project.[22] Given recent movement by certain countries toward this position, withholding assent on the multilateral instrument could be a shrewd stance.[23] Ultimately, the refusal of the U.S. to participate seems unlikely to derail the multilateral instrument, but that refusal, coupled with the demands that America is making, could lead to a substantially different final product.

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[17]Alison Bennett, U.S. Official Says U.K.'s Diverted Profits Tax Undercuts BEPS Work, 90 D.T.R. G-12 (May 11, 2015).

[18]Lee A. Sheppard and Stephanie Soong Johnston, U.S. Disappointed in U.K. Profits Tax and BEPS Output, Stack Says, 147 Tax Notes 1218 (June 15, 2015).

[19]Id.

[20]Id.

[21]See id.

[22]See Dolores W. Gregory, U.S. Exploring Multilateral Instrument to Expand Arbitration Network, Rolfes Says, 23 T.M.T.R. 1443 (Mar. 19, 2015).

[23]See Dolores W. Gregory, Push for Arbitration in MAP Gets Boost from G-7's Declaration of Support, 24 T.M.T.R. 220 (June 25, 2015).

PE - The New Avatar


Shefali Goradia


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Is the current concept inadequate?

The relevance of "permanent establishment" ('PE') in the context of cross-border taxation is significant since it defines and establishes the taxing threshold for source countries.

If applied in spirit, a PE should prohibit source state taxation rights in instances where activities in the source state do not create sufficient nexus to be deemed as "taxable presence". Sufficiency of such nexus is being questioned globally by tax authorities of source states. Tax avoidance strategies are in current focus, since opportunities for identifying and applying strategies are compounded where taxable presence for new businesses (especially e-businesses) are determined through a dated concept of PE, which has remained rather static in an environment characterized by rapidly evolving technology and complex business models.

Countries are introducing changes in domestic laws and moving the needle on interpretation of PE concept beyond what the current tax treaties provide. Introduction of "diverted profit tax" by the United Kingdom, revised criteria for dependent agent PE in Vietnam, introduction of draft legislation by Australia to prevent practices used to artificially avoid the attribution of business profits to an Australian PE, are some examples. Approach adopted by the Spanish Court[7] to hold a PE on the basis of the overall profile of activities undertaken in Spain is also well known. This dilutes a country's commitments to bilateral negotiations and subjects taxpayers to uncertainties.

[7]Rulings in the case of Borax and Roche

The need for a PE definition with fairly ambulatory features is recognized internationally. Work on this front has been initiated by the OECD under its "Base Erosion and Profit Shifting" ('BEPS') initiative. Initial proposals have been refined based on public consultation and shortlisted proposals have now been put forth.

Take on the OECD proposals

The "commissionaire" conundrum

The current rules on dependent agent PE provide opportunities to taxpayers to structure their arrangements in a manner that allow a contract for sale of goods belonging to a foreign enterprise to be negotiated in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. This has led enterprises to replace arrangements under which a local subsidiary traditionally acted as a distributor with a resulting shift of profits out of the country where the sales take place, albeit without a substantive change in the functions performed in that country.

Countries are introducing changes in domestic laws and moving the needle on interpretation of PE concept beyond what the current tax treaties provide. Introduction of "diverted profit tax" by the United Kingdom, revised criteria for dependent agent PE in Vietnam, introduction of draft legislation by Australia to prevent practices used to artificially avoid the attribution of business profits to an Australian PE, are some examples.

As a measure against such delocalization of risk and artificial containment of functions, it is proposed that the condition of "habitually concluding contracts" be replaced with "habitually concludes contracts, or negotiates material elements of contracts". The guiding commentary inter alia states that the proposal is aimed at situations where in essence, negotiations are undertaken in the source state and conclusion, possibly with further approval or review, is undertaken outside the source state. Activities that are intended to result in regular conclusion of contracts are now to be covered. This condition will apply to a person who acts as a sales force of the enterprise and in doing so, makes or accepts contractual offers even if standard contracts are used for that purpose – formal finalization of the order should no longer be critical and convincing customers to accept standard terms is parimateria to negotiation.

Negotiation (and even participation in negotiation) as an aspect for determining dependent agent PE has been upheld by courts even under current principles, however only where the negotiation has the effect of binding the non-resident enterprise. Thus to the extent the proposal may stress or clarify this aspect this proposal is a welcome move in order to close loopholes, however the definition and commentary which have now been proposed may not only result in unintended consequences but it may also raise concerns on the general law principle of agency, a key element of which is binding of the principal. **This seems to undermine the fundamental basis for introduction of a dependent agent PE clause ie to ensure taxation and ensure neutrality of a foreign enterprise where it chooses not to do business through a fixed place by itself but through an agent – activities of an agent who does not act "on behalf" of the principal and does not have the**

"powers to bind" is not akin to activities which the foreign enterprise would otherwise chose to undertake through a PE. The issue is aggravated in case of standard form contracts where under the proposals a dependent agent PE would be constituted even though the person in the source state does not have any room to negotiate – in such cases convincing the account holder to accept the standard terms could be considered to lead towards "conclusion" of contracts.

The proposal to extend the scope of PE constitution to pre-conclusion or pre-sale activities changes the fundamental premise of a dependent agent PE by shifting the thrust from conclusion and binding of principal to merely undertaking activities which may lead to contract conclusion. The proposal seems to blur the lines between marketing, information sharing or support activities in the source state and contract negotiation activities – this may in fact become the new tax controversy.

> As a measure against such delocalization of risk and artificial containment of functions, it is proposed that the condition of "habitually concluding contracts" be replaced with "habitually concludes contracts, or negotiates material elements of contracts".

The proposals thus need careful evaluation and should be supplemented with guidance providing for exclusions for pure marketing activities, activities where person in source state is a mere 'messenger' and lacks decision making, such that the proposal only applies to cases where there is an actual abuse – abuse should however not be presumed in all cases.

Strengthening criteria for independence

The proposal excludes from the scope of an independent agent, such persons who act exclusively or almost exclusively for "connected enterprises". It has been provided that independence must not only be demonstrated by acting for one or more unconnected enterprises, but should also be supported by the fact that the agent is carrying on business as an independent agent and is acting in the ordinary course of business. Independent status is not given where the person is acting for more than one unconnected enterprises. For unconnected entities, it is relevant to establish the ability to expand and be independent rather than establishing that in practice the agent is representing more than one enterprise, unless of course such independence is only created on paper to fit within the

stated exception for independent agent. Accordingly, all facts and circumstances should be taken into account for concluding if the agent should be accorded the status of an independent agent.

This change is prima facie desirable since it seeks to counter avoidance practices and in essence seeks to exclude persons who are truly independent of the group of the non-resident enterprise as a whole. However, a general presumption that the test for independence cannot be satisfied in case of connected persons may be too stringent. Since subjective criteria to determine independence in case of connected enterprises is likely to lead to more interpretational and application based issues, a conjunctive objective condition that the agent would be considered as independent if it is paid at an arm's length may be suggested. Once arm's length income has been offered to tax in the source state, there should not be any BEPS concern.

Scope of stated activity exceptions

The exceptions to PE are intended to cover such specific activities which at a holistic level may be considered remote to profit realisation for the non-resident enterprise as a whole, and even if they warrant a profit attribution, it would at best be negligible. The current definition does not require each activity to qualify as "preparatory or auxiliary". However, it was stated in the previous discussion draft that some of these stated exceptions (warehousing, delivery etc) were although perceived as "preparatory or auxiliary" in erstwhile business models, may be an important business function in today's modern businesses – for example warehousing would be a principal business activity for e-commerce. It is thus proposed that all activities stated as exceptions shall fall outside the scope of PE constitution only if they pass the muster of being "preparatory or auxiliary".

> "Such a rule will have radical implications on multinationals with genuine arrangements where functions are housed in different entities to achieve specialization, ring-fencing of liabilities or due to regulatory stipulations, where each function, though inter-related to the entire business, is for all purposes independent."

Alignment to the original intent was called for and hence this proposal is perceived positively. While determination of "preparatory or auxiliary" shall always remain subjective and open to interpretations, the additional guiding commentary provided should be useful.

BEPS QUOTES

The government would like more companies, particularly large multinationals operating in Australia, to publicly disclose their tax affairs

- Australian Treasurer, Joe Hockey

Anti-fragmentation rule

The "preparatory and auxiliary" condition would seem redundant if a non-resident enterprise was able to artificially fragment cohesive activities in the source state into several small operations such that each qualifies as being "preparatory or auxiliary", though such qualification may not be achieved at an aggregate level. The current OECD commentary thus propagates an anti-fragmentation rule to counter such practices. Now the proposal is to extend the anti-fragmentation principle to activities undertaken by the group of the non-residents as a whole. Thus in effect "preparatory or auxiliary" threshold would be applied at a group level and not at an entity level. The rule however fails to acknowledge that for aggregation purposes, the activities of connected parties resident in source states need not be considered since these are already taxed.

This could arguably lead to PE constitution where a foreign enterprise has established say two subsidiaries in source state – one for undertaking R&D activities and one for advertising. Under the current rules, each of these activities may qualify for the stated exceptions, though under the proposed rules, the activities of each of the two subsidiaries i.e. R&D and advertising will have to be viewed in aggregate in the context of the business of the non-resident entity, to determine if the aggregate activity is still within the "preparatory and auxiliary" threshold.

The PE constitution and attribution rules may be easier to apply where one non-resident enterprise has fragmented its activities in the source state. However, it is not entirely clear, if this threshold is exceeded at the group level, a PE would be constituted for which non-resident enterprise and profits of which entity would be subject to attribution in the source state. The concept of a "group PE" which effectively disregards the entity form is not prevalent and current rules (including attribution rules) may not be sufficient to deal with complexities involved in group PE situations.

Such a rule will have radical implications on multinationals with genuine arrangements where functions are housed in different entities to achieve specialization, ring-fencing of liabilities or due to regulatory stipulations, where each function, though inter-related to the entire business, is for all purposes independent. Possibly, such a uniform test should be diluted to exclude instances where fragmentation is justified for commercial or regulatory reasons.

Splitting-up of contracts

It has been recommended that connected activities shall be aggregated if they were split-up to avoid the prescribed threshold for an installation PE. It has been provided that "the conclusion of additional contracts with a person is a logical consequence of a previous contract with that person or related persons". While this anti-abuse rule is also welcome, appropriate caveats and case specific approach is required.

Are we ready for the new avatar of PE?

At an overall level, the proposals are pragmatic with key focus on anti-avoidance. While the focus is well appreciated, anti-avoidance rules which provide for objective criteria rather than subjective, thus not providing the leeway for exclusion for genuine cases, may prove too aggressive and significantly hamper international business growth. Ambiguity in meaning and different interpretations of various terms such as "material elements", "cohesive" etc, may lead to new controversies. These may lead to several PEs and double taxation in bonafide transactions, which is against the basic purpose of tax treaty formulation.

PE - The New Avatar

The specific proposal on dependent agent PE is aimed on the underlying presumption that a restructuring of a sales company to commissionaire structures substantially reduces taxable profits. If so, this is a deficiency in attribution principles rather than PE principles.

The approach of adopting an aggregate view of local activities coupled with no cognizance for activities in resident states, may possibly generate new PE states but such PE states may not be the source states – since source is where the physical and economic activity is undertaken and not the place of money flows or customers. An aggregated approach is also suggestive of a hinge towards a profit split of the global profits which again is an attribution issue which cannot be solved through amendment of PE principles.

A focus shift is required for businesses – from PE avoidance strategies to profit attribution in various source states. This can only be achieved if related rules are largely (though not entirely) uniform, free of disputes and interpretational controversies and administrative burdens are reduced. Where PE rules are sought to be made more stringent in light of avoidance strategies, there is a corresponding need for developing rules on attribution and practical compliances which are uniform across jurisdictions, are clear / easy to comply with and do not result in double taxation. There has been limited progress on the attribution rules under the BEPS initiative. Perhaps it may be desirable to see the outcome on attribution rules before overhauling the PE principles.

4 NEWS WRAP UP

This section provides brief news updates on BEPS from around the world, during the last couple of months.

May 4-5, 2015 – OECD publishes the comments received on the discussion draft on BEPS Action 12 (Mandatory disclosure rules) and BEPS Action 3 (Strengthening CFC rules). Discussion draft on Action 12 has been generally well received, although concerns expressed by stakeholders regarding practical difficulties relating to compliance burden on taxpayers. On Action 3, stakeholders unhappy with recommendations on 'minimum standard' requiring all countries to adopt CFC rules.

May 12, 2015 – Australia's federal budget for 2015-16 was released and is seeking to fast-track measures to counter BEPS. The anti-avoidance measures targeting multinationals is aligned with BEPS Action Plans on PE, CbC reporting and digital economy. Further, the Government has proposed to introduce regime similar to the UK's Diverted profits tax introduced recently to tax multinationals.

May 13, 2015 – OECD publishes the comments received on the discussion draft on BEPS Action 11(Data Analysis). A public consultation was then held on May 18, 2015. Stakeholders have expressed consensus regarding the conclusions that currently available data sources are insufficient and shown support for the general approach presented for the economic analysis i.e. multiple approaches to estimating the fiscal effects. Concerns expressed about confidentiality and compliance costs and that indicator could be influenced by non-BEPS factors.

May 20, 2015 – Proposed revisions to the US Model Income tax convention was released. Comments are invited on the proposals within 90 days. The revisions target exempt permanent establishments, special tax regime, expatriated entities, anti treaty shopping measures of limitation of benefits article and subsequent changes in treaty partner's tax law.

May 28, 2015 – OECD begins work on 'Multilateral Instrument' to implement tax treaty related BEPS Action Plan. First meeting of the adhoc Group held on May 27 with participation of over 80 countries. Countries agree on procedural issues, to discuss substantive issues at inaugural meeting to be held in November 2015.

June 1, 2015 – OECD publishes the comments received on the revised discussion draft on BEPS Action 8 (Cost Contribution Agreements). The related discussion draft was released on 1 June 2015. Stakeholders generally agree that pre-existing contributions to CCA should be at value, but argue that current contributions should continue to be at cost. Strong interest in grandfathering provisions, if proposed changes are made, given the long term nature of CCAs.

June 7-8, 2015 – The 2015 G7 Summit was held in Germany. Amongst other issues, the summit reaffirms commitment to finalize concrete and feasible recommendations for OECD's BEPS Action plan by year end, encourages G20 and OECD to establish targeted monitoring process; focuses on

establishing binding mandatory arbitration to avoid double taxation risk. G7 also looks forward to rapid implementation of the new single global standard for automatic exchange of information by the end of 2017 or 2018.

June 8, 2015 – OECD releases implementation package for BEPS country-by-country (CbC) reporting consisting of model legislation requiring ultimate parent entity of MNE group to file the CbC report in the jurisdiction of its residence. OECD also releases three model competent authority agreements that could be used to facilitate implementation of the exchange of CbC reports.

June 8, 2015 – OECD held the seventh webcast providing update on the BEPS project with respect to the progress on the deliverables and developing countries engagement and input. They also discussed the upcoming drafts and provided a schedule for release of finalized BEPS package by October 2015. More than 83 countries have expressed interest in joining the adhoc group on Multilateral Instrument and OECD aims to have 100 countries. Further arbitration for willing countries will also be included in the Multilateral Instrument.

June 9, 2015 – The US Senate Finance Committee Chairman and the US House Ways and Means Committee Chairman wrote a letter to the US Treasury Secretary about the BEPS project and its impact on US economy. They have expressed concern that what the solution to BEPS envisioned by OECD would create heightened incentives for US companies to relocate R&D and other innovative activities and workers to other countries.

June 10-11, 2015 – The tenth annual OECD International tax conference held in Washington D.C. saw participation from OECD , Government representatives, business representatives and tax practitioners assessing the progress of the BEPS project and discussing the key proposals of BEPS project and laws enforced in countries to tackle BEPS.

June 15, 2015 – OECD publishes the comments received on the revised discussion draft on BEPS Action 7(Prevent the Artificial Avoidance of PE status). The related discussion draft was released on 15 May 2015. Stakeholders express concern over the broad and amorphous language of the proposal. On new PE rules, BIAC recommends that it is crucial that the new rules are very clear, providing the bright line tests that help to promote cross-border trade and investment.

June 17, 2015 – The European Commission presented an Action Plan to fundamentally reform corporate taxation in the EU. The Action Plan sets out a series of initiatives to tackle tax avoidance secure sustainable revenues and strengthen the Single Market for businesses. The measures to be developed complement the work carried out in the OECD/G20 BEPS Project.

June 18, 2015 – OECD publishes the comments received on the revised discussion draft on follow-up work on BEPS Action 6 (Prevent treaty abuse). The related discussion draft was released on 22 May 2015.

June19, 2015 – OECD publishes the comments received on the discussion draft on BEPS Action8 (Hard-to-value Intangibles). The related discussion draft was released on June 4, 2015. This discussion draft sets out an approach to hard-to-value intangibles and proposes revisions to the guidance in Section D.3 of the 2014 BEPS Report “Guidance on Transfer Pricing Aspects of Intangibles”. A public consultation will be held in July 6-7, 2015.

ISSUE 1 RECAP: Just in case you missed the inaugural edition of our special newsletter, which featured an exclusive interview with OECD Tax Policy Director Pascal Saint-Amans as also our dissection of Action Plans 8 & 13, **click here.**

ISSUE 2 RECAP: Dissecting Action Plan 6, Face to Face with Dr. Jeffrey Owens and 'Counter View' from Christian Kaiser of Siemens, **click here.**

ISSUE 3 RECAP: Dissecting Draft OECD guidelines on place of taxation for B2B supplies of services and intangibles, Face to Face with Former VP, Shell International B.V. Theo Keijzer, Expert Gaze by Carol P. Tello, **click here.**

ISSUE 4 RECAP: Dissecting CBCR, Face to Face with William Morris, Philip Baker shoots straight on CFC Rules and more…. **click here.**

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