The forces and tensions shaping BEPS

1 April 2014

The BEPS project is significant and has the potential to change the international taxation system forever. Already, even before the first ‘outputs’ are delivered in September 2014, the BEPS project has driven change and created reactions in the international tax world, with some countries taking unilateral action. The agenda for the BEPS project is ambitious, the participation broad, and the stakes high. Given this, the project faces many challenges and it is not clear how much will be achieved, including whether some of the outcomes are desirable. As follows is a brief overview of the forces and tensions that will shape activity over the next couple of months and years.

Where are we now?

It is less than a year since the Organisation for Economic Cooperation and Development (OECD) issued its Action Plan on Base Erosion and Profit Shifting (BEPS) on 16 July 2013 (‘Action Plan’). However, already there have been significant developments in the international tax space. In terms of the Action Plan, the OECD has issued discussion drafts, requested input, and held public consultations on a number of the outputs proposed in the Action Plan. For example, we have seen the discussion drafts and public consultation on transfer pricing regarding transfer of intangibles, documentation and country by country reporting; request for input on the tax challenges of the digital economy; and discussion drafts on tax treaty abuse and hybrid mismatch arrangements. At the time of writing the discussion draft on the tax challenges of the digital economy was close to release. All in all, the OECD appears to be maintaining the momentum envisaged by the tight time-frames in the Action Plan.

At the same time, for some the momentum has not been fast enough, with a number of countries taking unilateral action to address BEPS, even before the outputs from the Action Plan are finalised. Examples include not just the introduction of specific anti-avoidance rules (e.g. Austria introducing a special rule which denies a deduction for interest and royalties paid to related parties resident in low tax jurisdictions), but also the administration of tax laws (e.g. Mexico has been invalidating some advance pricing agreements and tax rulings previously issued to taxpayers). At the time of writing, there were close to 30 unilateral actions which had been taken by countries in relation to BEPS.

Where are we going?

By September 2014, approximately half of the outputs in the Action Plan are expected to be completed, with the remainder due for completion by September/December 2015. The OECD has published a calendar for planned stakeholders’ input for 2013-2014, which sets out the proposed dates for the release of discussion drafts and consultation/input, over the next couple of months. During this period, the focus is on tax treaty abuse, hybrid mismatches, tax challenges of the digital economy and Country-by-Country Reporting and Transfer Pricing.

Table 1 sets out the proposed dates for BEPS project consultation, in the near-term, from the OECD calendar.
**Table 1: BEPS project consultation dates**

<table>
<thead>
<tr>
<th>Document/Event</th>
<th>Topic</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discussion Draft</td>
<td>The Tax Challenges of the Digital Economy</td>
<td>24 March 2014</td>
</tr>
<tr>
<td>Public Consultation</td>
<td>Tax Treaty Abuse</td>
<td>14-15 April 2014</td>
</tr>
<tr>
<td>Public Consultation</td>
<td>Hybrid Mismatch Arrangements</td>
<td>23 April 2014</td>
</tr>
<tr>
<td>Public Consultation</td>
<td>The Tax Challenges of the Digital Economy</td>
<td>15 or 16 May 2014</td>
</tr>
<tr>
<td>Public Consultation</td>
<td>Country-by-Country Reporting and Transfer Pricing</td>
<td>19 May 2014</td>
</tr>
</tbody>
</table>

Table 2 sets out the expected completion dates of the outputs from the Action Plan (AP).

**Table 2: Expected completion dates of outputs from the Action Plan**

<table>
<thead>
<tr>
<th>Coherence</th>
<th>Substance</th>
<th>Transparency</th>
<th>New World</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hybrid mismatch (AP2)</td>
<td>Treaty abuse (AP6)</td>
<td>Collect and analyse BEPS data (AP11)</td>
<td>Digital economy challenges (AP1)</td>
</tr>
<tr>
<td>CFC rules (AP3)</td>
<td>PE status (AP7)</td>
<td>Disclose aggressive tax planning (AP12)</td>
<td></td>
</tr>
<tr>
<td>Limit base erosion via interest deductions (AP4)</td>
<td>Intangibles (AP8)</td>
<td>TP documentation (AP13)</td>
<td></td>
</tr>
<tr>
<td>Risk and capital (AP9)</td>
<td>High risk transactions (AP10)</td>
<td>Dispute resolution (AP14)</td>
<td></td>
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<tr>
<td>Counter harmful tax practices (AP5)</td>
<td></td>
<td>Multilateral instrument (AP15)</td>
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</tbody>
</table>

**Challenges facing the BEPS project**

The outcomes and success of the BEPS project are far from certain or clear. Some are sceptical of how much will be achieved, despite the current momentum and stakeholder participation. There is a danger of inconsistent adoption of outputs and recommendations, as countries push-back on proposed changes which are inconsistent with their national interests, cherry-pick and/or use the BEPS project to push their own agenda and interests onto others. For many countries, including the United States of America (USA), it is not even clear what is the national position.

The tension points are not just around the ‘mechanics’ of how to deal with BEPS, such as whether we should have specific or general anti-avoidance rules in tax treaties and the way in which these rules should be implemented (e.g. via amendments to the Model Tax Convention or a specific BEPS multilateral treaty). Rather, the tension extends to the very foundations of the international tax system, including the allocation of taxing rights, sovereignty and tax administration.
The issues are compounded by the changing economic and political dynamics and the digital economy.

One area of tension is around the balance between source and residence taxation. In terms of the positions, generally, developed countries rely on residence taxation – looking to tax income in their jurisdiction, where the global companies are based, rather than at source. In contrast, less-developed countries (‘LDCs’) are pushing for greater taxation of income/profits in their jurisdictions and therefore looking for greater taxation at source.

The actions in the Action Plan are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income. However, the issue of allocation of taxing rights indirectly impacts on most aspects of the international tax system and the BEPS project. By way of example, this is relevant to:

- the question of what should constitute a taxable presence in a foreign jurisdiction (i.e. the requirements for a ‘permanent establishment’ and whether these should be extended to cover a broader set of circumstances – the position preferred by LDCs);
- allocation of profits to a taxable presence (e.g. should we modify or replace the arm’s length principle and move to some form of global formulary apportionment?)
- Should greater value be attributed to location specific advantages – as strongly advocated by China and now included in the intangibles discussion draft;
- operation of anti-deferral controlled foreign company (CFC) rules including on what basis and in what circumstances should income be taxed on a residual basis in the home jurisdiction; and
- taxation of the digital economy, including determining ‘digital taxable presence’ and the source of ‘digital income’ (e.g. is this the location where the customer lives, where the contract is concluded or where the web site is hosted?).

There is also tension as to how the BEPS project outputs and responses should be implemented. There is general consensus that it cannot take the next 20 years to implement the required changes and there is some support for the view that a multi-lateral instrument will be required. However, obtaining consensus on the scope and terms of such an instrument and then ensuring that a sufficient number of countries sign-up to and ratify this, will be difficult. There is a question whether a key argument for supporting the OECD position will get sufficient traction, namely that the ‘arm’s length principle’ in tandem with the BEPS changes, will result in a level playing field that it is in the national interest of all countries to support.

Other challenges will lie in the domestic political sphere such as in the USA where passage of tax changes in Congress has been difficult for some time, and enactment of BEPS changes face the same difficulties in the near-term.

Rather, there is a risk that more countries will take unilateral action and only implement those recommendations that suit their national interest or adopt divergent positions. The reality of this risk is evident from the fact that the BRIC countries (i.e. Brazil, Russia, India and China) although members of the G20 are not members of the OECD and follow the United Nations (UN) Transfer Pricing Manual, which differs in a number of respects from the OECD Transfer Pricing Guidelines. Furthermore, Chapter 10 of the UN Transfer Pricing Manual sets out the specific country experiences in dealing with transfer pricing by Brazil, China, India and South Africa, which do not reflect a consensus view.

In the case of the BEPS project, this risk is somewhat tempered, as the BRIC countries are also part of the G20 which is driving the BEPS project and so they
could be expected to adopt the outputs. Nevertheless, this divergent treatment reflects the risks to the process and building consensus more generally.

The risk of unilateral and divergent responses to BEPS almost certainly will increase disputes between tax authorities of different jurisdictions. Therefore, as envisaged by Action 14 of the Action Plan, there will be a greater need for a mechanism for the efficient and effective resolution of disputes. Any solution which requires an external third party to resolve disputes (e.g. the Action Plan suggests mandatory and binding arbitration) may be met with resistance by some countries, which may view this as an infringement of their sovereign rights. This is evident from the fact that ‘baseball style’ arbitration clauses are currently not common in tax treaties and their introduction will require a change in mind-set, including increased ‘trust’ in the international tax system.

**What to look for in the near-term**

The next couple of months are going to be busy, with numerous discussion drafts and public consultations, in the lead-up to September 2014 and beyond. While there appears to be limited scope for consultation/input, the next couple of months allow a glimpse of the OECD/G20 thinking and the direction of changes which may affect the international tax system over the next couple of years or decades.

September 2014 will see the first outputs from the BEPS project and will provide an opportunity to assess the effectiveness of the process and the likelihood that the outputs will evolve and be broadly implemented by the international community.

**Questions without answers**

As noted at the start of this article, the BEPS project is significant and has the potential to change the international taxation system forever – as with most things, for better or worse.

The outcomes and success are far from certain or clear and there is a significant degree of uncertainty as to where this will end:

- Will the OECD/G20 build the required consensus to design and implement global changes or will there be a perpetuation of unilateral action and multiple approaches to international taxation?
- Will the outputs create a ‘better’ international tax system, which is more equitable and effective from the perspective of all stakeholders?
- Will the pendulum swing too far and the current ‘pockets’ of double non-taxation be replaced with double taxation?
- Will the currently ubiquitous income tax be replaced with an indirect transactional tax to address the challenges of the digital economy, thereby rendering the majority the outputs from the BEPS project redundant?

**Let’s talk**

For a deeper discussion of how these issues might affect your business, please contact:

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