BEPS in motion: examining the impact of BEPS on the telecommunications sector
The Organisation for Economic Co-operation and Development (OECD) project on base erosion and profit shifting (BEPS), which is supported by the G7 and G20 countries, the European Union (EU) (which is also working on this issue) and certain developing countries, is aimed at responding to the global concern of tax authorities about the perceived potential for multinational companies (MNCs) to reduce their tax liabilities through the shifting of income to no-tax or low-tax jurisdictions.

Driven by the underlying question of whether multinational companies contribute their fair share of tax in each jurisdiction, in October 2015, after lengthy negotiations, the OECD published revisions to tax principles, which are based on a 15-point action plan for BEPS. Over the past 18 months, some of the measures have already taken effect.

The underlying theme of the BEPS Actions is primarily to validate that the right amount of profit is allocated to legal entities in each country in which an organization has operations, based on the functions performed in that country, the risks borne and the capital allocated. This, in turn, requires that the business manage and optimize its people, operations and decision-making across borders, functions and entities.

Governments around the world, as well as the EU, have varying interests and have been moving at different speeds to implement the recommendations, often with different legislative interpretations and striking different enforcement postures. This environment is contributing to a more complex and uncertain tax environment in general, and more specifically in areas such as transfer pricing (TP) and permanent establishment (PE).

Many telecommunications operators have been taking steps to properly position themselves as a result of the BEPS Actions. The BEPS project can change the legal and regulatory framework in many countries and represents one of the most fundamental overhauls of international taxation in a generation. Given the proliferation of domestic law changes, it will be critical for the telecommunications operators to closely monitor the ever-changing and evolving landscape at the specific country level (in both mature and emerging markets). These actions, and their implications for the telecommunications sector, are discussed further in this report.
Ex&ning the impact of BEPS on the telecommunications sector

Contents

Overview of BEPS 3

Impact of BEPS reports on the telecommunications sector 4

Action 5  Countering harmful tax practices more effectively, taking into account transparency and substance 5

Action 7  Preventing the artificial avoidance of permanent establishment status 9

Actions 8-10  Aligning transfer pricing outcomes with value creation 13

Action 13  Guidance on transfer pricing documentation and country-by-country reporting 17

Other relevant Actions 21

Actions 6 and 15: Preventing treaty abuse 22

Action 4: Interest deductions 23

Action 1: Digital 23

Beyond tax: alignment of operational and tax business models 24

Conclusion 25
Overview of BEPS

The OECD Action Plan on base erosion and profit shifting, which is supported by the G7 and G20 countries, the European Union (which is also working on this issue) and certain developing countries, is aimed at responding to governments’ concern around the changing global business environment and the ability of MNCs to reduce tax liabilities through the perceived shifting of income to no-tax or low-tax jurisdictions.

The OECD issued its final reports on 15 specific focus areas in October 2015, with follow-up work continuing and with a recent focus on the so-called multilateral instrument (MLI). An inclusive framework brings together more than 100 countries and jurisdictions to collaborate on the implementation of the BEPS project. Participating countries have committed to the implementation of the BEPS project. The recommendations range from new minimum standards (implementation by participating countries of minimum standards in national laws, tax treaties and other local requirements), to reinforced international standards (tightening of existing OECD Transfer Pricing Guidelines and the OECD Model Tax Convention), to common approaches and leading practices (optional building blocks to help countries implement revisions).

The BEPS reports are “soft law” documents in that they are not legally binding. Rather, countries will need to determine whether and how they will implement the recommendations. However, they are generally expected to be implemented by countries that are part of the consensus. Indeed, many of the BEPS principles, such as the country-by-country (CbC) reporting rules, have become firmly entrenched in many local laws.

All members of the inclusive framework have committed to consistent implementation in the areas of preventing treaty shopping, country-by-country reporting, fighting harmful tax practices and improving dispute resolution. In other areas, such as recommendations on hybrid mismatch arrangements and leading practices on interest deductibility, countries have agreed to a general tax policy direction.1

Some of the measures may be immediately applicable, such as the revised guidance on transfer pricing. Other measures require changes to bilateral tax treaties, and still others require domestic law changes before implementation. Here is a general timetable for effectiveness:

<table>
<thead>
<tr>
<th>Minimum standards</th>
<th>Reinforced standards</th>
<th>Common approaches and leading practices</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Action 5 – Harmful tax practices</td>
<td>• Actions 6 and 15 – Treaty abuse</td>
<td>• Action 2 – Hybrid mismatch arrangements</td>
</tr>
<tr>
<td>• Action 6 – Treaty abuse</td>
<td>• Action 7 – Permanent establishment status</td>
<td>• Action 3 – Controlled foreign company (CFC) rules</td>
</tr>
<tr>
<td>• Action 13 – Country-by-country reporting</td>
<td>• Actions 8-10 – Transfer pricing</td>
<td>• Action 4 – Interest deductions and other financial payments</td>
</tr>
<tr>
<td>• Action 14 – Dispute resolution</td>
<td>• Action 13 – Transfer pricing documentation</td>
<td>• Action 12 – Mandatory disclosure rules</td>
</tr>
<tr>
<td>• Action 14 – Dispute resolution</td>
<td>• Action 14 – Dispute resolution</td>
<td></td>
</tr>
</tbody>
</table>

Immediate impact

<table>
<thead>
<tr>
<th>Treaty-based action</th>
<th>Legislative action</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Action 8 – Transfer pricing for intangibles</td>
<td>• Action 2 – Hybrid mismatch arrangements</td>
</tr>
<tr>
<td>• Action 9 – Transfer pricing for risks and capital</td>
<td>• Action 6 – Treaty abuse</td>
</tr>
<tr>
<td>• Action 10 – Transfer pricing for other high-risk transactions</td>
<td>• Action 7 – Permanent establishment status</td>
</tr>
<tr>
<td>• Action 13 – Transfer pricing documentation and country-by-country reporting</td>
<td>• Action 14 – Dispute resolution</td>
</tr>
<tr>
<td></td>
<td>• Action 15 – Multilateral instrument</td>
</tr>
<tr>
<td>Further development</td>
<td></td>
</tr>
<tr>
<td>• Follow-up work on several Actions</td>
<td>• Action 2 – Hybrid mismatch arrangements</td>
</tr>
<tr>
<td>• Framework for monitoring country implementation and involvement of additional countries</td>
<td>• Action 3 – CFC rules</td>
</tr>
<tr>
<td></td>
<td>• Action 4 – Interest deductions</td>
</tr>
<tr>
<td></td>
<td>• Action 5 – Harmful tax practices</td>
</tr>
</tbody>
</table>

Impact of BEPS Actions on the telecommunications sector

BEPS touches all components of the typical telecommunications organization, including cross-border operations, virtual management teams, sales and channel management, procurement, manufacturing and inventory deployment, and research and development. In addition, BEPS must be viewed in the broader context of a further tightening of the global regulatory framework. Telecommunications operators should align themselves with key themes and outputs associated with BEPS, including (i) revamped transfer pricing principles to reflect activities; (ii) robust documentation requirements; (iii) transparency around global operations; (iv) alignment of functional profiles across the value chain to mitigate tax, audit and reputational risk; and (v) capitalizing on opportunities to manage the group’s effective tax rate.
Countering harmful tax practices more effectively, taking into account transparency and substance

The OECD has been focused on harmful tax practices for over 15 years, beginning with the 1998 report, *Harmful Tax Competition: An Emerging Global Issue*. The BEPS project reviewed this previous work with a focus on requiring substantial activity for any preferential regime and on improving transparency, including compulsory spontaneous exchange of information for certain tax rulings. This project is also closely tied to similar work being undertaken by the European Commission, which has participated in the OECD meetings and has adopted similar approaches, such as the nexus approach for intellectual property (IP) regimes, as well as measures that increase the mandatory exchange of information between Member States’ tax authorities. On October 6, 2015, the EU issued a directive on the Automatic Exchange of Information on tax rulings. On December 8, 2015, an amendment to this directive was adopted that increases the mandatory exchange of information between Member States’ tax authorities. For purposes of the directive, rulings include advance cross-border tax rulings and advance pricing arrangements (APAs). There is a broad definition of rulings that may also encompass any settlement during tax audits. The effective date of implementation was January 1, 2017.

The final report for Action 5 covers two main areas: harmful tax practices and transparency. In doing so, it touches on a wide variety of topics, including substance requirements for IP and other regimes; the determination of which IP regimes are allowable and which need to be phased out; what constitutes a harmful preferential regime; which ruling information is to be mandatorily exchanged and to whom; what qualifies as a “ruling”; and leading practices for cross-border rulings (the process for granting rulings, terms and publication). Transparency of certain rulings is covered under the master file requirements of Action 13, which is discussed further below.

Why is this Action important to telecommunications companies?

Action 5 refocuses the OECD’s work on harmful tax practices, with a priority on improving transparency and on requiring substantial activity for any preferential regime (e.g., patent or innovation box). This work also includes a focus on compulsory spontaneous exchange of information on rulings related to preferential regimes.

As a minimum standard, telecommunications companies need to understand and take into account the fact that the exchange of rulings around cross-border transactions is likely already occurring among participating countries.

Europe-based telecommunications companies that are currently availing themselves of patent box regimes that do not conform to the nexus requirement of Action 5 may have to take additional steps to comply with the new regimes.
Details of Action 5

Harmful tax practices

A preferential regime, as evidenced by a legal provision, an administrative practice or a ruling, may be considered to have been issued under a harmful preferential regime for purposes of Action 5 if the regime, among other factors, does not require substantial activity. The final Action 5 report determines that this substantial activity requirement used to assess preferential regimes should be strengthened to realign taxation of profits with the substantial activities that generate them. Several approaches were considered, and the consensus was to apply the nexus approach. This approach includes R&D activities carried out by the taxpayer itself and uses expenditures as a proxy for determining substantial activities, including outsourced R&D to unrelated parties.

If the regime is found to be harmful, the country will be given the opportunity to abolish the regime or remove the features creating the harmful effect. Additionally, the taxpayer could become subject to defensive measures taken by other countries to counter the effects of the harmful regime. The Forum on Harmful Tax Practices (FHTP) reviewed 43 IP and non-IP regimes in OECD Member States and associate countries in the BEPS project (with the scope to be extended to third countries). Sixteen IP regimes reviewed were identified as inconsistent with the OECD nexus approach to some extent. In response, countries have already agreed to changes or have stated that prospective regimes will conform to the OECD recommendations.

Transparency

Action 5 recommends disclosing summaries of specific rulings with affected tax authorities in the absence of an existing compulsory spontaneous exchange agreement among the jurisdictions. The affected tax authorities include the jurisdiction of the following:

- Direct parent
- Ultimate parent
- Related parties with which the taxpayer entered into a transaction covered by the ruling
- Related parties if the ruling gives rise to income from these parties benefiting from a preferential regime

The framework covers six categories of rulings that would be disclosed:

1. Rulings related to preferential regimes
2. Cross-border unilateral APAs or other unilateral transfer pricing rulings
3. Rulings adjusting profits downward
4. Permanent establishment (PE) rulings
5. Conduit rulings
6. Any other type of ruling where the FHTP agrees in the future that the absence of exchange would give rise to BEPS concerns

Only rulings issued on or after January 1, 2010, that were still valid on January 1, 2014, or new rulings issued on or after April 1, 2016, would be subject to disclosure. This differs from the requirements under the EU directive with respect to the automatic exchange of information, which generally requires mandatory exchange of information within three months following the end of the half of the calendar year during which the advance cross-border rulings or APAs have been issued, amended or renewed. In addition, specific transition rules apply concerning certain rulings issued before January 1, 2017, that, if applicable, require mandatory exchange before January 1, 2018.

---

2. As of the publication date of this article, the jurisdictions with these IP regimes are Belgium, China, Colombia, France, Hungary, Israel, Italy, Luxembourg, the Netherlands, Portugal, Spain, Spain’s Basque Country, Spain’s Navarra region, Switzerland’s Canton of Nidwalden, Turkey and the United Kingdom (UK).
3. Some examples include the UK, which, in October 2016, enacted modifications to the UK patent box regime in line with the recommendations published by the OECD. These changes took effect on July 1, 2016, but with grandfathering until July 1, 2021, for IP that was already within the patent box regime. The changes limit the benefits of the patent box according to a nexus fraction that is based on the amount of direct in-house and externally subcontracted R&D expenditure incurred by the claimant (plus, to a limited extent, R&D subcontracted to related parties and acquired IP). This fraction is applied to profits as calculated in the original regime. Further, Switzerland proposed introducing a license box at the cantonal level that is competitive and compatible with international standards. The license box will still undergo modifications that take the latest international development into consideration, particularly the OECD developments related to the substantial activity requirement and the modified nexus approach.
For countries with the necessary legal basis, the exchange of information under this framework will take place from April 1, 2016, for future rulings (generally within three months after the competent authority of the issuing state becomes aware of the ruling). The exchange of certain past rulings was required to be completed by December 31, 2016. Already, more than 6,000 tax rulings that could give rise to BEPS concerns have been exchanged between tax administrators.

In addition to the industry considerations on IP-related rulings, the disclosure recommendation under Action 5 will also have a great impact on telecommunications multinationals.

What actions should telecommunications companies take with respect to Action 5?

Telecommunications companies should consider undertaking a comprehensive review of select rulings to analyze whether the ruling or regime is harmful and needs to be disclosed under Action 5.

EY has developed a risk assessment framework that aims to identify the level of risk related to certain rulings, including recommendations on whether they should be renewed, withdrawn, renegotiated or further supported by transfer pricing documentation. In addition to the financial impact, telecommunications companies should consider the reputational risks stemming from the transparency recommendations of Action 5.

Further, telecommunications companies should consider aligning current functions across the value chain with the recommended nexus approach, and further consider whether changes are needed to align current IP ownership and substance.
Action 7

Examining the impact of BEPS on the telecommunications sector
The final report on Action 7 proposes changes to the PE definition in Article 5 of the OECD Model Tax Convention. The changes are intended to prevent the use of the following arrangements and similar strategies, which are viewed as an effort by a foreign enterprise to operate in another country without creating a PE:

- Commissionaire arrangements and similar strategies
- The use of specific preparatory or auxiliary activity exemptions, including the artificial fragmentation of so-called cohesive business activities into several smaller operations so that each part can benefit from specific-activity exemptions

The risk of having a PE under the new OECD definition will depend on actual implementation. The multilateral instrument, which was opened for signature from January 1, 2017 (and with respect to which the OECD held an initial signing ceremony on June 7, 2017) will expedite the implementation of the new definition, but individual countries may decide not to implement the new definition.

Why is this Action important to telecommunications companies?

Many activities commonly conducted by telecommunications companies will now need to take into account potential PE exposure, including (i) procurement: operators now need to be mindful of potential PE status when aligning global, regional and local activities; and (ii) sales and channel management, including virtual, cross-border management structures, sales and the operations planning process.

In addition, possible compliance-related consequences and potential penalties will need to be taken into consideration, irrespective of any adjustments that may need to be made from a transfer pricing perspective.
Details of Action 7

Action 7 substantially lowers the threshold under which a host nation can declare a corporate presence as a PE and therefore be subject to income tax. Changes resulting from this Action are modifications to the OECD Model Treaty, which serves as a guide in treaty negotiations between OECD Member States.

When initially entering a jurisdiction, a company may rely on a related representative office or third-party representation, which, under current rules, may not create a PE. The recommended expansion of the definition of PE in treaties may cause companies to have a taxable presence where they do not today.

Commissionaire arrangements

Telecommunications companies may use a commissionaire or sales agent structure – an arrangement through which the commissionaire sells products in a state in its own name but on behalf of a foreign enterprise (principal) that owns the products.

The commissionaire does not take title to the products, as a limited risk distributor would, and it is compensated for its services with a commission from the foreign enterprise principal. Under the 2014 OECD Model Tax Treaty (i.e., the current version), a foreign enterprise that uses such an arrangement generally would not create a PE because the contracts concluded by the commissionaire are not binding on the foreign enterprise. Thus, the PE definition contained in the 2014 OECD Model Tax Treaty relies on the formal conclusion of contracts in the name of the foreign enterprise.

Conversely, under the Action 7 final report, sales and marketing models similar to commissionaire arrangements may create a PE. In the final report, the scope of the PE has been broadened so that a person (other than an independent agent) habitually concluding contracts that are in the name of the enterprise or that are to be performed by the enterprise, or habitually playing the principal role leading to the conclusion of such contracts which are routinely concluded without material modification by the enterprise, may create a PE.

The final report also clarifies that independent agents shall not include a person who acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related (i.e., directly or indirectly controls more than 50% of the beneficial interest or shares). Where commissionaire structures among telecommunications operators are between closely related parties, the commissionaire shall not be considered to be an independent agent.

It should be noted that such changes to the OECD Model Tax Treaty are not intended to address BEPS concerns related to the transfer of risks between related parties through low-risk distributor arrangements.

Preparatory or auxiliary activity exemptions

The 2014 OECD Model Tax Treaty provides a list of exceptions through which a permanent establishment is deemed not to exist where a place of business is used for auxiliary activities listed in Article 5(4) of the OECD Model Tax Treaty. However, not all of the activities listed in Article 5(4) expressly refer to a preparatory or auxiliary activity. The current Article 5(4) reads as follows:

A. The use of facilities solely for storage, display or delivery of goods or merchandise belonging to the enterprise

B. The maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display or delivery

C. The maintenance of a stock of goods or merchandise belonging to the enterprise solely for processing by another enterprise

D. The maintenance of a fixed place of business solely for purchasing goods or merchandise or for collecting information for the enterprise

E. The maintenance of a fixed place of business solely for carrying on, for the enterprise, any other activity of a preparatory or auxiliary character

F. The maintenance of a fixed place of business solely for any combination of activities mentioned above provided that the overall activity resulting from this combination is of a preparatory or auxiliary character
The final report on Action 7 addresses whether the activities that are mentioned in A. to D. are automatic exceptions or whether these exceptions are conditional on the activities being of a preparatory or auxiliary nature. The report concludes that each of the exceptions included in that provision is restricted to activities that are otherwise of a “preparatory or auxiliary” character. However, some countries have considered that BEPS concerns related to Article 5(4) essentially arise where there is fragmentation of activities between closely related parties.

In light of this, the final report included two approaches or options with respect to the list of specific activity exemptions. First, for those countries considering that exceptions are conditional on the activities being of a preparatory or auxiliary nature, the wording would change so that all of the activities listed therein need to be of a preparatory or auxiliary character. Second, for those countries considering that activities referred to in Article 5(4) are intrinsically preparatory or auxiliary, no change to this article was necessary.

The final report also added an anti-fragmentation rule. Under this new rule, operating models that involve various group entities in the same jurisdiction performing complementary business activities as part of a cohesive business operation may give rise to a permanent establishment if these activities, when viewed as a whole, exceed what is considered preparatory or auxiliary.

What actions should telecommunications companies take with respect to Action 7?

Telecommunications companies should conduct in-depth reviews of evolving local laws, keeping in mind the practical approach that is followed by local tax authorities, and in particular the multilateral instrument to implement BEPS measures.

Telecommunications companies should also take a closer look at the preparatory and auxiliary nature of activities and consider whether they otherwise had fragmentation of activities that may now potentially form part of a cohesive business operation. There is now a sensibility toward dependent sales agent characterization and establishing a lower risk profile around existing local distributor arrangements.

Telecommunications companies should closely monitor any future guidance on allocating profits attributable to permanent establishments, be proactive around PE reporting, and consider APAs or other rulings to obtain comfort where appropriate.
Examining the impact of BEPS on the telecommunications sector

Actions 8-10
Aligning transfer pricing outcomes with value creation

The arm’s-length principle is well established, and the BEPS action items do not purport to change that.4 Countries use the principle as the cornerstone of transfer pricing rules, and the OECD report says it has proven useful as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices between associated enterprises and to prevent double taxation.5 However, because of a perceived emphasis on contractual allocations of functions, assets and risks, the OECD believes that the existing guidance on the application of the principle has proven vulnerable to manipulation. Accordingly, the relevant BEPS action items have focused on strengthening guidance on applying the arm’s-length principle to align profits with the value created through underlying economic activities.

The final reports for Actions 8–10 have six interlinked topics: (i) guidance for applying the arm’s-length principle; (ii) guidance on commodity transactions; (iii) guidance on how further work on transactional profit split is scoped; (iv) guidance on intangibles; (v) guidance on low value-adding intragroup services; and (vi) guidance on cost contribution arrangements.

Why are these Actions important to telecommunications companies?

The broad definition of intangibles requires reassessment of intellectual property in the group and on which entity has legal and economic ownership; a review of the value chain in light of new definitions to determine value-contributing entities; and a review of strategies allocating profits among entities.

The OECD proposes that the legal ownership of an intangible by itself does not confer any right to retain the return from exploiting an intangible, even where this return may initially accrue to the legal owner as a result of its legal or contractual rights. Instead, the return ultimately retained by the legal owner depends on the contributions it makes to the anticipated value in the intangibles, relative to the contributions made by other group members, through functions performed, assets used and risks assumed that contribute to the value of the intangible.

---

4. The arm’s-length principle is part of many tax treaties and appears as Article 9(1) of the OECD and UN Model Tax Conventions. A shared interpretation of the principle by many of those countries is set out in the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, first published as Transfer Pricing and Multinational Enterprises in 1979, revised and published as Guidelines in 1995, with a further update in 2010.

Details of Actions 8–10

General

The focus of Action 8 is on developing changes to the OECD Transfer Pricing Guidelines to align operational profits to underlying economic activities. This involves:

• Adopting a broad, clear definition of intangibles
• Adopting measures that seek to appropriately allocate profits associated with the transfer and use of intangibles to value creation

Risk allocation and management

A key concept around IP ownership is whether a party exercises or manages the development, enhancement, maintenance, protection and exploitation (DEMPE) functions with respect to the IP. Only in such cases will IP ownership be recognized with respect to determining an appropriate return to the parties to reflect the value of their contributions. This approach reflects a movement away from mere legal ownership, in and of itself, as conferring any right to the return from its exploitation, and posits that functional management, as well as contractual assumption, of risk is required to allocate financial consequences of risk-bearing to an enterprise.

Risk is defined as the effect of uncertainty on the objectives of the business, and its significance depends on the likelihood and size of potential profits or losses arising from it. The risk (and related returns) should be allocated to the party that contractually assumes the risk unless it does not exercise control over the risk and does not have the financial capacity to assume the risk. To determine whether the contractual assumption of risk is aligned with the conduct of the parties and other factors, companies should analyze whether the parties follow the contractual terms, and whether the party assuming the risk manages the risk and has the financial capacity to assume it.

Risk management is defined as the function of assessing and responding to risk associated with commercial activity. In this regard, risk management primarily refers to (i) the capability to make decisions to take on, lay off or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, and (ii) the capability to make decisions on whether and how to respond to risks associated with the opportunity, together with the actual performance, of that decision-making function.

Along with the principal focus articulated above with respect to Action 8, the corollary focus of Action 9 and Action 10 is to be considered in tandem, as the OECD has combined these Actions.

The focus of Action 9 (consider transfer pricing for risks and capital) is on developing changes to the OECD Transfer Pricing Guidelines to prevent BEPS by transferring risks among, or allocation of excessive capital to, group members. The changes are developed so that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital and will require the alignment of returns with value creation.

The focus of Action 10 is on developing changes to the OECD Transfer Pricing Guidelines to prevent BEPS involving transactions that would not (or would only very rarely) occur between third parties. This will include:

• Adopting rules to clarify the circumstances in which transactions can be recharacterized
• Clarifying the application of transfer pricing methods (profit splits in particular) in the global value chain context
• Providing protection against common types of payments, such as management fees and head-office expenses

Guidance on intangibles

Actions 8-10 also provide guidance for valuing and pricing intangibles, which are defined as “not a physical or financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.” For this purpose, specific local market characteristics and group synergies are not intangibles but should be taken into account in comparable analysis.

The new definition for marketing intangibles is “an intangible ... that relates to marketing activities, aids in the commercial exploitation of a product or services, and/or has an important promotional value for the product concerned.” These can include items such as trademarks, trade names, customer lists and proprietary market data that can aid in marketing and selling goods or services to customers.
The economic return from IP and costs will be allocated to entities that perform and control the DEMPE functions. As discussed above, the contractual assumption of risk associated with the DEMPE functions (financial or legal risk) means that financial consequences of the risk will be allocated to an enterprise as long as it functionally exercises control over the risk. Telecommunications operators should pay close attention to the BEPS language concerning the development, enhancement, maintenance, protection and exploitation of intangibles that appears in Actions 8–10. Potential changes resulting from these Actions may result in a shift of risk (i.e., remuneration) from entities currently having the risk on a contractual basis to entities where the actual value is created.

**What actions should telecommunications companies take with respect to Actions 8-10?**

A significant challenge for many telecommunications companies is how to manage their fast-growing digital businesses within the context of more integrated mobile and fixed line operations. Multiple business-to-consumer (B2C) and business-to-business (B2B) sales channels are now commonplace as groups package their mobile and fixed line connectivity, machine-to-machine and digital services in innovative ways. For some offerings, the revenue stream may be shared between the entity providing connectivity and a business partner under a B2B agreement or a B2C sale from the customer-facing entity with a possible revenue share with a commercial partner.

Looking forward, analyzing which party provided what value and where (including the DEMPE analysis), aggregating income from multiple billing systems and managing BEPS Actions 8 to 10 impacts will continue to be major challenges. For complete transfer pricing structures, a multi-country APA agreement may serve as a means for certainty.
Examining the impact of BEPS on the telecommunications sector
Guidance on transfer pricing documentation and country-by-country reporting

The focus of Action 13 is on developing rules on transfer pricing documentation to enhance transparency for tax administrations, taking into account the compliance costs for business. Many in the telecommunications industry are aware of the general recommendations under Action 13 for the master file, local file and template for CbC reporting, and the line of sight it will provide into a company’s entire global footprint.

The recommendation from the OECD is that the ultimate parent of the group with revenue of EUR750 million or greater should report the CbC forms for fiscal years starting in 2016, filing within 12 months from fiscal year-end. The jurisdictions that have adopted or drafted regulations to implement CbC reporting have generally followed these recommendations.

A large number of telecommunications companies must now complete a country-by-country template that provides high-level information about the jurisdictional allocation of revenues, profits, taxes, assets and employees, to be shared with all tax authorities where the company has operations.

Action 13 recommends that companies use a consistent three-tier framework for providing information on the global allocation of income, economic activity and intercompany pricing across all of a company’s global operations.

A master file will include information about the company’s business, transfer pricing policies and agreements with tax authorities in a single document available to all tax authorities where the company has operations. Detailed information about the local business, including related-party payments and receipts for products, services, royalties and interest, is included in a local file.

Why are these Actions important to telecommunications companies?

BEPS Action 13 requires that all companies stand ready to provide host governments with documentation of their transfer pricing policies in a format that is quite different and in greater depth in certain areas relative to prior OECD and local country guidance. This includes details on their global operations and taxation.

Telecommunications companies should have an appreciation for the increased (and enhanced) transparency that will result from this Action, as well as other potential scrutiny from global tax authorities, who will also be sharing information with one another more frequently.
Details of Action 13

Background

Action 13 had two primary goals. The first was to increase transparency around multinational company (MNC) tax affairs by requiring them to provide information to tax authorities regarding the global allocation of income, taxes paid and certain indicators of the location of economic activity among the tax jurisdictions in which MNC groups operate. This will be done through the CbC template. The second goal was to simplify transfer pricing documentation compliance burdens for taxpayers, while at the same time making the documentation more valuable for tax authorities.

The CbC template will be used as a risk assessment tool by tax authorities. Any inconsistencies in the information provided could raise questions in the authorities’ minds as to whether inappropriate tax planning has taken place, so one could say the template might provide an audit road map for the tax authorities to look into issues addressed under other BEPS action items.

Regarding transfer pricing documentation, the information to be included in the master and local files relates to the substantive changes developed under Actions 8-10 on aligning profits with value creation. The master/local file information is intended to provide tax authorities with details on issues such as intangibles, the functions of asset-owning entities and risk allocation.

Rulings, which are substantively addressed under Action 5 (harmful tax practices), will be provided in the master and local files (a summary of the ruling in the master file, and a copy of the full text in the local file).

TP documentation

Master file

Multinational telecommunications companies should determine which departments (and persons) will be responsible for preparation of the new global master file. Subsequently, through a gap analysis, the main differences as compared with the existing documentation need to be identified. One of the starting questions is the strategic consideration of what information is to be included in the master file and what information to include in the local file. Telecommunications companies should aim for consistency with respect to documents provided to tax authorities across the globe. As such, coordination between different regions when preparing the documentation is critical. The first year of preparation of a master file is crucial, as companies will have to make deliberate choices. One such choice is whether to prepare the master file for the organization as a whole (that is, in one single report) or whether to structure the documentation for each business unit (where necessary, with cross-references to other documents).

Local file

As with the master file, companies need to decide which people in the organization will be responsible for preparing the local files and assess what the main differences are compared with the existing documentation, both from a process and a content perspective. Attention should be paid to the increased level of transactional details required and how the financial data used in applying the TP method may be reconciled to the annual financial statements.

Furthermore, searches for comparables will need to be updated every three years, and financial data on the comparables will have to be updated annually. In addition, the local file needs to be consistent with both the master file and the country-by-country reporting.

Country-by-country reporting

Country-by-country reporting has received a significant amount of attention during the BEPS project. This is not just because it is a new filing requirement that mandates an unprecedented level of global tax transparency, but also because it is a matter of urgency for MNCs.

Following the BEPS guidance, many countries have amended their domestic law requirements, some of which came into force on January 1, 2016.

According to a published EU directive, CbC reporting will be mandatory for all countries in the EU, even when the country of the ultimate parent entity does not require CbC reporting. This means MNCs will have to assess whether there are any vulnerabilities in their operating models that will show up in the CbC (and the master file and the local file), as it takes time for the necessary changes to be implemented. The focus on compliance with the new requirements will not only come from the tax authorities in the countries that have already implemented new documentation requirements; the party auditing the financial statements of an MNC will ask for BEPS-proof documentation during the course of their 2016 (and later) audits in order to perform necessary risk assessments.

Many telecommunications companies are addressing their CbC reporting readiness by splitting the work stream into two functions – one focusing on the data availability and the other on the substance of the content.
Businesses may also wish to consider organizing their project team into one in which the members are fully up to speed on both functions. This will enhance the team’s effectiveness and prevent discordance.

**Transfer pricing documentation**

For transfer pricing documentation, telecommunications companies should perform a gap analysis of what information they already have for the new transfer pricing documents. Companies should also give very careful thought to the structure they choose for the master file, including definitions and what level of aggregation to use. The choice of structure is an important one, as it will serve to minimize the need for subsequent amendments down the road.

Most importantly, companies should not procrastinate. The December 31, 2017, date for filing the first CbC reports is fast approaching, and companies should be preparing to implement the Action 13 requirements. Given the time needed to gather and review all of the information that will be required, companies should not leave anything to the last minute.

**What actions should telecommunications companies take with respect to Action 13?**

It is important for telecommunications companies to gain an appreciation for the increased disclosure and documentation that is required under the CbC reporting rules. Being able to successfully collect, analyze and organize the requested information will require coordination among the various segments of the organization, such as Tax, IT, Finance and HR. New processes and resources may be needed, and accountability will be critical.

Telecommunications companies need to closely monitor implementation of Action 13 in the domestic law of BEPS-participating countries around the world. The new reporting regimes will serve as a mechanism to inform tax authorities around business structures that could elicit concerns underlying many other Actions.
Examining the impact of BEPS on the telecommunications sector

Other relevant Actions
Other relevant Actions

Actions 6 and 15: treaty-related measures (including MLI)

On October 5, 2015, the OECD released its final report on developing a multilateral instrument (MLI) to modify bilateral tax treaties under its BEPS Action Plan (Action 15). This report was released in a package that included final reports on all 15 BEPS Actions. One of the primary aims of the MLI is to enable all jurisdictions to implement the treaty-related recommendations that were agreed to as part of the final BEPS package, including the BEPS minimum standards. These include the minimum standard for the prevention of treaty abuse under Action 6. The MLI is solely focused on how to modify the provisions in bilateral or regional tax treaties in order to align these treaties with the BEPS measures.

The focus of Action 6 is to:

- Provide safeguards against the abuse of treaty provisions by requiring countries to have a minimum level of protection against treaty abuse by including a Principal Purpose Test (PPT) rule or a Limitation on Benefits (LOB) rule supplemented by a mechanism (such as a treaty rule that might take the form of a PPT rule restricted to conduit arrangements or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties
- Clarify that tax treaties are not intended to be used to generate double non-taxation
- Identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country

On November 24, 2016, the OECD announced the completion of negotiations on the MLI, which allows governments to implement the tax treaty-related BEPS measures into existing bilateral or regional tax treaties without having to renegotiate individual treaties. The multilateral instrument was open for signature as of December 31, 2016.

On June 7, 2017, 68 jurisdictions signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting during a signing ceremony hosted by the OECD in Paris, and nine other jurisdictions expressed their intent to sign the MLI in the near future.

At the time of signature, signatories submitted a list of their tax treaties in force that they designate as covered tax agreements (CTAs), i.e., to be amended through the MLI. At this stage, it is expected that more than 1,100 tax treaties will be modified based on matching the specific provisions that jurisdictions wish to add or change within the CTAs nominated by the signatories.

The MLI will enter into force after five jurisdictions have deposited their instrument of ratification, acceptance or approval of the MLI. During the ratification process, the choices made by jurisdictions may still change. With respect to a specific bilateral tax treaty, the measures will only enter into effect after both parties to the treaty have deposited their instrument of ratification, acceptance or approval of the MLI and a specified time has passed. The specified time differs for different provisions. For example, for provisions relating to withholding taxes, the entry into force date is January 1 of the following year after the last party has made notification of its ratification. The first modifications to bilateral tax treaties are expected to enter into effect in early 2018. However, given the anticipated time needed for ratifications, it is expected that most treaty changes will enter into effect after 2019.

Many telecommunications companies may be impacted by these Actions. As such, companies should consider conducting an in-depth analysis, which will first require determining, on an individual country basis, whether and to what extent they may be impacted. Such analysis must consider the enforcement mechanism (e.g., LOB, PPT) that is chosen by the authorities.

Telecommunications companies should further determine the appropriate measures around documentation that need to be taken and the approach of such documentation (e.g., providing additional support for an existing defensible structure or steps needed to correct an existing structure that needs to conform to the new regime).

Lastly, it will be important for telecommunications companies to understand the impact of not being eligible for treaty benefits for interest, royalties, capital gains and business income.
BEPS Action 4: limitation of deduction for net interest expense

The focus of Action 4 is on developing recommendations regarding leading practices in the design of rules to prevent BEPS through the use of interest expense and other economically equivalent financial payments.

The tax treatment of interest and other financial payments has been a focus in many countries, and many have recently enacted, or are currently considering, new limitations on the deductibility of interest. Such limitations include tightened thin cap and earnings stripping rules.

Action 4 is not a minimum standard; countries are not obliged to introduce these measures with respect to measures on interest deductibility. However, as a catalyst, this would require telecommunications companies to closely monitor individual country developments to keep informed around new measures.

BEPS Action 1: tax challenges of the digital economy

The focus of Action 1 is on identifying the main difficulties in applying the current international tax rules to the digital economy and to develop detailed options to address these difficulties. The action involves examination of the following:

- The potential for a digital presence in a country without creation of taxable nexus
- The attribution of value created from the generation of marketable location-relevant data through the use of digital products and services
- The characterization and sourcing of income from new business models
- How to enable the effective collection of value-added tax and goods and services tax with respect to cross-border digital delivery

Potential actions to address the tax challenges of the digital economy include modifications to the exemption from permanent establishment (PE) status, new nexus based on significant digital presence, virtual PE, creation of a withholding tax on digital transactions and consumption tax options. The enactment of such rules may result in international groups having a taxable presence in territories where the MNCs historically have not been subject to tax. The OECD task force decided that ring-fencing the digital economy as a separate sector and applying ad hoc tax rules was neither appropriate nor feasible, and that digital is really a means of delivery. As such, concerns are more appropriately addressed through the application of the other actions (e.g., transfer pricing rules, tax treaties and challenges to artificial arrangements).

Country responses should be closely monitored for potential impact on cloud and other business model transformations. The OECD final report discusses the lack of clarity as to whether cloud transactions should be characterized as the provision of services (and thus business profits for treaty purposes) or as income from rents and royalties, which would be taxable at varying withholding rates.

Of potential concern to telecommunications companies is specific country action, both from a direct tax and indirect tax perspective, around new or expanded definitions for services, driven by information technology, that are delivered over the internet or by an electronic network. As an example, India recently amended its service tax rules related to online information and database access or retrieval services to require (among other things) a levied charge on certain digital services. Israel and Turkey have taken action around the significant economic presence option, and Argentina, Italy and Turkey have taken action around withholding tax. Similar measures by other countries could follow.
Beyond tax: alignment of operational and tax business models

The BEPS effort will bring increased scrutiny around operational substance throughout the value chain, and telecommunications companies need to focus on alignment from both an operational and a tax perspective. This may include, for example, the management and operation of international networks, centralized supply chain operations and developing areas of value creation arising from digital and similar opportunities.

For existing structures that now bear some element of risk under the new regime, operators will need to assess whether documentation should be improved, whether the transfer pricing should be repriced or, if commercially feasible, whether to realign the operational model with the transfer pricing model.

Incentivization and key performance indicators are also driving some evolution of TP models, as telecommunications companies face severe competitive pressure on pricing and seek to incentivize traffic internalization and aggregation to drive value and facilitate price-demand retail plays. Transfer pricing models need to be flexible to adapt to these commercial pressures in areas such as international connections, terminations and roaming, for example.

Similarly, operational transfer pricing processes, systems and outputs will also be under much greater scrutiny, and it will be critical to reduce exposure to transfer pricing adjustments and penalties. This, in turn, will drive a need for tax teams to be well integrated with operations so that transfer pricing may be embedded into operational record-to-report, order-to-pay and order-to-cash systems, with appropriate transfer pricing monitoring and adjusted procedures to deliver the right outcome. This may have an impact on billing, reporting and financial systems, which may potentially need to be upgraded.

Finally, the new business models for the digital future are just taking shape. Transfer pricing models may need to factor in more dispersed value creation, in particular around the creation and ownership of IP, which will need to align with the operational substance and strategy of the business.
Conclusion

Telecommunications companies should understand that BEPS is now a key component of international tax reform and that measures need to be undertaken. For example, the broad definition of intangibles in Action 8 requires reassessment of intellectual property in the group, ownership (legal and economic) and value contributions. Many telecommunications companies should look to the overall business models, including central ownership of IP, shared ownership and shared value creation models, for examples of DEMPE functions and to align with the latest transfer pricing principles.

The legislative framework is developing in a manner that undermines and penalizes limited-function entities, and operating models need to reflect Actions 8–10 and emerging transfer pricing principles. As such, greater emphasis should be placed on the wider impact of controversy management approaches outside the specific country where the controversy arises.

Lastly, we are currently in the middle of the BEPS implementation phase. With the MLI, currently 70 countries are proposing to implement some of the BEPS treaty recommendations. Further, countries are also taking individual action to implement some of the recommendations, in particular, the minimum standards. For example, nearly 70 countries have either implemented or are in the process of implementing country-by-country reporting.

Given that the peer review of the minimum standards has started, there may be additional country activity in order to comply with the agreed minimum standards.
Examining the impact of BEPS on the telecommunications sector

Key EY Telecommunications Tax contacts

Bart Van droogenbroek
Global Telecommunications Tax Sector Leader
+352 42 124 7456
bart.van.droogenbroek@lu.ey.com

Fred Gordon
Executive Director, Industry Center
+1 202 327 7192
fred.gordon@ey.com

ey.com/gl/en/industries/telecommunications
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2017 EYGM Limited.
All Rights Reserved.

EYG no. 05032-174GbI
1707-2356845
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.