



## OECD releases final reports on BEPS Action Plan

### Executive summary

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released final reports on all 15 focus areas in its Action Plan on Base Erosion and Profit Shifting (BEPS). In an accompanying explanatory statement, the OECD described the next steps in its work on BEPS, including additional work on technical matters and plans for monitoring with respect to the implementation of the BEPS recommendations. In conjunction with the release of the reports, the OECD held a press conference followed by a technical briefing, both by webcast, to provide an overview of the final BEPS output.

The OECD described the final BEPS packages as containing recommendations that fall in several different categories:

- ▶ Agreed minimum standards: the recommendations on harmful tax practices (Action 5), treaty abuse (Action 6), country-by-country reporting (Action 13) and dispute resolution (Action 14)
- ▶ Reinforced international standards: the revised OECD Transfer Pricing Guidelines (Actions 8-10) and the revised OECD Model Tax Convention (including Action 7 on permanent establishment status)
- ▶ Common approaches and best practices for domestic law: hybrid mismatch arrangements (Action 2), controlled foreign company rules (Action 3), interest limitations (Action 4) and disclosure of aggressive tax planning (Action 12)
- ▶ Analytical reports: tax challenges of the digital economy (Action 1), data and analysis with respect to BEPS (Action 11) and the multilateral instrument for implementing treaty based recommendations (Action 15)

The OECD also briefly discussed the “post-BEPS environment,” stressing the importance of focusing on implementation of the BEPS recommendations in a consistent and coherent manner, monitoring the impact on both double non-taxation and double taxation. The explanatory statement indicates that OECD and G20 countries have agreed to continue to work together on BEPS until 2020. The

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intention is to develop “a more inclusive framework to support and monitor the implementation of the BEPS package.” The G20 has requested a proposal for such a framework by its February 2016 meeting. At the same time, the OECD will complete additional work with respect to several of the Actions, including several follow-on projects on transfer pricing.

The final reports are to be presented at the upcoming G20 Finance Ministers’ meeting in Lima, Peru on 8 October 2015. After review by the finance ministers, the BEPS package will go to the G20 leaders for their approval at the summit meeting scheduled for 15-16 November in Antalya, Turkey.

This Alert provides a high-level overview of the documents released by the OECD on 5 October with respect to the BEPS Action Plan. Further EY Global Tax Alerts will be issued with more detailed analysis of the final reports on each of the 15 Actions.

In addition, EY is hosting a series of eight tax webcasts that will provide a comprehensive review of the final BEPS reports and the outlook for country action:

- ▶ OECD BEPS Project Outcomes: Highlights and Next Steps - 15 October, 10am EDT
- ▶ New Reporting under BEPS Action 13 - 20 October, 10am EDT
- ▶ Digital Economy Developments and BEPS Action 1 - 27 October, 12 noon EDT

- ▶ Permanent Establishment Developments and BEPS Action 7 - 5 November, 10am EST
- ▶ Transfer Pricing and BEPS Actions 8-10 - 12 November, 10am EST
- ▶ Anti-abuse Measures under BEPS Actions 3, 5, 6 and 12 - 19 November, 10am EST
- ▶ Financial Payments and BEPS Actions 2 and 4 - 3 December, 10am EST
- ▶ Dispute Resolution and BEPS Action 14 - 10 December, 10am EST

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#### Detailed discussion

Below is an overview of each of the BEPS Final Reports.

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

The final report on Action 1, *Addressing the Tax Challenges of the Digital Economy*, largely follows the initial Action 1 deliverable on the digital economy released by the OECD in September 2014<sup>1</sup> (the 2014 report). Like the 2014 report, the final report provides conclusions regarding the digital economy and recommended next steps to address the tax challenges presented by the evolving digital economy. The final report acknowledges that special rules designed exclusively for the digital economy would prove unworkable, broadly stating that the digital economy “cannot be ring-fenced as it is increasingly the economy itself.” The final report summarizes

key features of evolving digital business models that the OECD considers relevant for the overall BEPS analysis; in addition, the final report considers broader direct and indirect tax challenges raised by the digital economy.

As an update to the 2014 report, the final report recommends: (i) modification of the list of exceptions to the definition of Permanent Establishment (PE) regarding preparatory or auxiliary activities as they relate to a digital environment and introduction of new anti-fragmentation rules to deny benefits from these exceptions through fragmentation of certain business activities; (ii) modification of the definition of a PE to address artificial arrangements through certain “conclusion of contracts” arrangements (See Action 7); (iii) a correlative update to the OECD Transfer Pricing Guidelines (see Actions 8-10); and (iv) changes to controlled foreign company (CFC) rules to address identified challenges of the digital economy.

The final report also addresses the indirect tax treatment of certain digital transactions, recommending that countries should apply the principles of the OECD’s International Value-added Tax/ Goods and Services Tax (VAT/GST) Guidelines and should consider introduction of the collection mechanisms included therein.

Future work in the area of Action 1 will be conducted in consultation with a broad range of stakeholders, and on the basis of a detailed mandate

to be developed by the OECD during 2016 in the context of designing an inclusive post-BEPS monitoring process. A supplementary report reflecting the outcome of continued work on the overall taxation of the digital economy should be released by 2020. The OECD also intends to develop a coordinated implementation mechanism with respect to the International VAT/GST Guidelines.

### **Action 2 - Neutralizing the effects of hybrid mismatch arrangements**

The final report on Action 2, *Neutralizing the Effect of Hybrid Mismatch Arrangements*, supersedes the interim report that was released in September 2014<sup>2</sup> (the 2014 report). Similar to the 2014 report, the final report consists of two parts with detailed recommendations to address hybrid mismatch arrangements and reflects the consensus achieved on these issues. Part I contains recommendations on domestic law rules to address hybrid mismatch arrangements. Part II contains recommended changes to the OECD Model Tax Convention.

The recommendations in Part I include “Specific Recommendations” and “Hybrid Mismatch Rules.” The Specific Recommendations are modifications to provisions of domestic law aimed at avoiding hybrid mismatches and achieving alignment between those laws and their intended tax policy outcomes (e.g., by not applying a dividend exemption at the level of the payee for payments that are deductible at the level of the payer).

The Hybrid Mismatch Rules are linking rules aimed at neutralizing one of the following three mismatches in tax outcomes arising out of certain hybrid mismatch arrangements:

- ▶ Payments that give rise to a deduction with no taxable inclusion arising from a hybrid financial instrument (including a hybrid transfer), a disregarded payment made by a hybrid entity or a payment made to a reverse hybrid
- ▶ Payments that give rise to a double deduction arising from a deductible payment made by a hybrid entity or a dual resident
- ▶ Payments that give rise to an indirect deduction with no inclusion arising from an imported mismatch

The Hybrid Mismatch Rules are divided into a primary response and, where applicable, a secondary or defensive rule. The defensive rule only applies where there is no Hybrid Mismatch Rule in the counterparty jurisdiction or where the rule is not applied to the particular entity or arrangement. Furthermore, each of the Hybrid Mismatch Rules has its own scope of application.

In a significant expansion from the 2014 report, the recommendations in Part I of the final report have been supplemented with further guidance and a wide array of detailed examples to explain the operation of the rules. Some outstanding issues that were

identified in the 2014 report are addressed, such as the treatment of stock lending and sale and repurchase transactions, the treatment of non-interest bearing loans and the treatment of branch structures within the hybrid mismatch arrangement category for hybrid financial instruments. Furthermore, there is detailed guidance on how to treat a payment that is included under a CFC regime. Significant new guidance on the operation of the imported mismatch rule is provided as well, which includes three tracing and priority rules to determine the extent to which a payment should be treated as set-off against a deduction under an imported mismatch arrangement.

The recommendations in Part II with respect to the OECD Model Tax Convention are similar to those included in the 2014 Report, namely: (i) a change to Article 4 of the Model Tax Convention to deal with dual resident entities; (ii) a new provision in Article 1 and changes to the Commentary to address fiscally transparent entities; and (iii) various proposed changes to address treaty issues that may arise from the recommended domestic law changes.

The final report recommends that every jurisdiction should introduce all the rules contained in the report and that jurisdictions should cooperate on measures to ensure these rules are implemented and applied consistently and effectively.

### **Action 3 - Strengthening CFC rules**

The final report on Action 3, *Designing Effective Controlled Foreign Company Rules*, provides recommendations in the form of “building blocks” with respect to the constituent elements that are necessary for effective CFC rules. The final report notes that the recommendations are not minimum standards, but instead are designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries. The report indicates that the recommended building blocks “would allow countries without CFC rules to implement recommended rules directly and countries with existing CFC rules to modify their rules to align more closely with the recommendations.”

The six building blocks for the design of effective CFC rules are:

- ▶ Definition of a CFC (including the definition of control)
- ▶ CFC exemptions and threshold requirements
- ▶ Definition of CFC income
- ▶ Computation of income
- ▶ Attribution of income
- ▶ Prevention and elimination of double taxation

The final report recognizes that there are shared policy considerations for jurisdictions in the context of Action 3 (e.g., providing a backstop to transfer pricing and balancing effectiveness with compliance

burden and with avoidance of double taxation), as well as different policy objectives that relate to the overall domestic tax systems of individual jurisdictions. Thus, because each country prioritizes specific policy objectives differently (e.g., the balance between taxing foreign income and maintaining competitiveness), the recommendations provide flexibility to implement CFC rules in a manner consistent with the policy objectives of the overall tax system and the international legal obligations of the specific country concerned. In particular, with respect to the definition of CFC income, the final report recognizes that countries should be allowed flexibility in the design of CFC rules that are consistent with their domestic policy frameworks. As a result, similar to the Action 3 discussion draft, *Strengthening CFC rules*, released in April 2015,<sup>3</sup> the final report sets out a non-exhaustive list of approaches that could be used for the definition of CFC income that raises BEPS concerns.

### **Action 4 - Limiting base erosion via interest deductions and other financial payments**

The final report on Action 4, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, recommends that countries implement a “fixed ratio” rule that would limit net interest deductions claimed by an entity (or a group of entities operating in the same country) to a fixed percentage of earnings before interest, taxes, depreciation and amortization (EBITDA). The

final report provides that this ratio should be somewhere between 10% and 30% of applicable EBITDA, levels that are described as having been designed to provide meaningful caps on net (not gross) interest expense, while still allowing most multinationals to deduct all their third party interest.

The final report further recommends that countries adopt a “group ratio” rule to supplement (but not replace) the fixed ratio rule, and to provide additional flexibility for highly-leveraged groups or industry sectors. Under the group ratio rule, for example, an entity with net interest expense above a country’s fixed ratio could deduct such interest expense up to the level of the net third-party interest/EBITDA ratio of the worldwide group to which it belongs. Countries could also apply an uplift of up to 10% to the group’s net third party interest expense to prevent double taxation. An alternative group ratio rule also could be considered such as an “equity escape” rule, which would allow interest expense so long as an entity’s debt-to-equity ratio does not exceed that of its worldwide group.

Beyond this basic framework, the final report recommends that countries consider the following: (i) using an average of EBITDA for the current year and prior years, to minimize the impact of earnings volatility on interest deductions; (iii) providing for carryforward and/or carryback of disallowed interest expense and/or unused interest capacity, within limits;

(iv) providing for exclusions for interest paid to third party lenders on loans used to fund public-benefit (infrastructure) projects and for entities with net interest expense below de minimis thresholds; and (v) providing targeted rules that would close down any remaining BEPS opportunities.

The final report indicates that limitations on interest deductions arising under hybrid mismatch arrangements as described in Action 2 should be applied before the interest limitations under Action 4, and the final report suggests that other limitations on interest expense, such as those arising under a country's application of the arm's-length principle or thin capitalization rules, also should be applied first. Moreover, interest disallowed under Action 4 should be subject to withholding tax.

The final report reflects the choices made by the OECD, having considered the pros and cons of the various alternatives discussed in the discussion draft, *BEPS Action 4: Interest Deductions and Other Financial Payments*, released in December 2014.<sup>4</sup> In particular, the final report elevates the fixed ratio rule above the group ratio rule. However, while the final report provides clear direction on the basic framework for limiting net interest expense deductions, a number of questions remain. Many of these relate to implementation of the group ratio rule. For example, the final report does not conclude on whether group EBITDA should include tax-advantaged income

such as dividend income that is either exempt or sheltered from home country tax due to foreign tax credits, or how to accommodate groups that have members with losses rather than positive EBITDA. In addition, no concrete suggestions are provided for applying the limitations on net interest expense to banks and insurance companies, which the report indicates have specific features that must be taken into account. These remaining items are to be addressed in work to be completed in 2016. Beyond that, the final report leaves open the timetable for adopting the new rules, but recommends that countries introducing the fixed ratio rule and group ratio rule should give taxpayers reasonable time to restructure existing financing arrangements, and that any grandfathering provisions should primarily apply to third party loans.

#### **Action 5 - Countering harmful tax practices**

The final report on Action 5, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*, covers two main areas, (i) defining a "substantial activity" criterion to be applied when determining whether tax regimes are harmful; and (ii) improving transparency. In doing so, it touches on a wide variety of topics, including substance requirements for intellectual property (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 best practices for cross-border rulings (process of granting rulings, terms, publication).

In the first instance, the final report defines the substantial activity requirement in relation to IP regimes by presenting the "nexus approach" as the agreed approach. Under this approach, the application of an IP regime should be dependent on the level of research and development (R&D) activities carried out by the taxpayer itself. In addition, IP regimes should essentially be limited to patents (under a broad definition) and copyrighted software. Sixteen existing IP regimes<sup>5</sup> were reviewed and found not to meet the nexus approach. No new entrants should be permitted to these regimes (or any other IP regime that does not meet the substantial activity requirement) after 30 June 2016 (or the effective date of a new regime consistent with the nexus approach if this is introduced before that date). The grandfather period may not be longer than five years after the date the regime is closed to new entrants. Enhanced transparency requirements will apply to new entrants into an IP regime after 6 February 2015 and the benefits of an IP regime should not be granted in respect of IP acquired directly or indirectly from related parties after 1 January 2016 (except in cases of acquisitions as a result of a domestic or international business restructuring).

When applying the nexus approach to activities other than IP, there would also need to be a link between the income qualifying for benefits and the core activities necessary to earn the income. The final report lists types of core activities that are necessary to earn the income under different types of regimes focused on financial and other service activities, such as headquarters regimes, distribution and service centers, financing or leasing, fund management, banking and insurance and shipping. With respect to holding activities, the final report states that there may not in fact be much substance required but many of the concerns raised by holding regimes may be dealt with through existing factors that indicate a regime is harmful or through the recommendations under other aspects of the BEPS project (e.g., through the recommendations under Actions 2 and 6).

The second priority area is improving transparency through a framework for the compulsory spontaneous exchange of information on certain rulings. This framework will apply to taxpayer-specific rulings that are (i) rulings on preferential regimes, (ii) unilateral Advance Pricing Agreements (APAs) or other cross-border unilateral rulings in respect of transfer pricing, (iii) cross-border rulings providing for a downward adjustment of taxable profits (in particular excess profit and informal capital rulings), (iv) PE rulings or (v) related party conduit rulings. The framework may be expanded

to other types of ruling in the future. The information exchange requirement would not relate to the ruling itself, but to certain information with respect to the ruling as contained in a template included in the final report. The framework also deals with questions such as time limits, legal basis, confidentiality and the countries with which such information would have to be exchanged. Information exchange is to apply not only to future rulings, but also to rulings that were issued on or after 1 January 2010 and were still in effect as from 1 January 2014. An ongoing monitoring and review mechanism, including annual review, is to be put in place to ensure countries' compliance.

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

The final report on Action 6, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, which supersedes the interim version issued in September 2014,<sup>6</sup> contains changes to the OECD Model Tax Convention and related changes to the Model Commentary to address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios. The final report notes that a number of changes have been made to the report that was issued in September 2014 and that further work will be required with respect to certain provisions, including the limitation on benefits (LOB) rule.

The final report is organized in three sections. Section A includes anti-abuse provisions that provide safeguards against the abuse of treaty provisions and offers flexibility in implementation. In this regard, the final report notes that countries have committed to a "minimum standard" to provide a minimum level of protection against treaty shopping. Under the minimum standard, countries would implement: (i) the combined approach of a principal purpose test (PPT) rule and LOB rule; (ii) a PPT rule alone; or, (iii) an LOB rule, supplemented by specific rules targeting conduit financing arrangements. In cases where a country decides to use a combination of the PPT and LOB rules, the final report includes a variation on the LOB rules referred to as the "simplified version," details of which are outlined in the Model Commentary. In addition to the minimum standard, the final report includes targeted rules to be included in tax treaties that would address other forms of treaty abuse, including situations of dual resident entities, and rules that apply to permanent establishments situated in third states.

Section B of the final report contains revisions to the title and preamble of the OECD Model Tax Convention so that it is clear that the intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion and avoidance, including through treaty shopping arrangements. Section C identifies

tax policy considerations relevant to the decision to enter into a tax treaty with another country, which would also be relevant in determining whether to modify (or ultimately terminate) a treaty if there has been a change in circumstances.

Finally, as indicated above, the final report outlines further work that will be required under Action 6. In particular, the final report refers to the proposals by the United States to modify the LOB rule in the US Model Treaty. It is noted that the LOB rule, and Commentary related thereto, contained in the final report should be considered as draft and subject to change pending further review that will take into account the finalization of the proposed revisions to the LOB rule in the US Model Treaty. Final versions of the LOB rule and Commentary are expected to be completed in the first part of 2016. In addition, the final report specifies that further work is needed with respect to the treaty entitlement of non-collective investment vehicles (non-CIVs) and pension funds and indicates that such work would benefit from consultation with stakeholders. Further work would need to be completed in the first part of 2016 in order to be relevant for the negotiation of the multilateral instrument under Action 15, which is expected to be finalized in 2016.

### **Action 7 - Preventing the artificial avoidance of PE status**

The final report on Action 7, *Preventing the Artificial Avoidance of Permanent Establishment*

*Status*, proposes changes to the PE definition in Article 5 of the OECD Model Tax Convention to prevent the use of the following arrangements and strategies that are considered to enable 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 such that each part is able to benefit from the use of such specific activity exemptions

The final report also proposes the use of the PPT rule that will be included in the OECD Model Tax Convention under Action 6 to deal with strategies involving the splitting-up of contracts between closely related enterprises in the context of construction contracts, and an alternative provision in the Commentary consisting of an automatic rule requiring the aggregation of time spent by closely related enterprises at the same building site or construction or installation project to calculate the 12 month threshold.

The final report, compared to the revised discussion draft, *BEPS Action 7: Preventing Artificial Avoidance of PE Status*, issued in May 2015,<sup>7</sup> contains no major changes in terms of the position taken by the OECD on the perceived BEPS abuses arising from the artificial avoidance of PE status.

However, the final report reflects some refinements to the proposed amendments to Article 5(5) as well as Article 5(6). Currently, Article 5(5) requires a person (other than an independent agent) acting on behalf of a foreign enterprise to have the “authority to conclude contracts in the name of the enterprise” in order to create a PE. The final Action 7 report would refer to persons (other than an independent agent) that habitually conclude contracts or “habitually play the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise,”<sup>8</sup> while the discussion draft referred to “persons that habitually concluded contracts or negotiated the material elements of contracts.” Changes also were made to the proposed wording to tighten the definition of independent agent in Article 5(6) by replacing the concept of “connected parties” with “closely related enterprises;” the final report now includes for this purpose cases where a person possesses directly or indirectly more than 50% of the beneficial interest in the other or, if a company, more than 50% of the aggregate vote and value of the company’s shares or the beneficial equity interests.<sup>9</sup>

### **Actions 8-10 - Transfer pricing aspects**

The OECD has included its updated transfer pricing guidance in one report under Actions 8-10, covering:

- ▶ Amended guidance on applying the arm’s length principle (revisions to section D of chapter I of the

OECD Transfer Pricing Guidelines), notably providing guidance on the identification of the actual transaction undertaken, on what is meant by control of a risk, and on the circumstances in which the actual transaction undertaken may be disregarded for transfer pricing purposes

- ▶ Guidance on comparability factors in transfer pricing, including location savings, assembled workforce, and MNE group synergies (additions to chapter I of the OECD Transfer Pricing Guidelines). This guidance remains unchanged from the guidance issued as part of the 2014 report on transfer pricing for intangibles
- ▶ New guidance on transfer pricing for commodity transactions (additions to chapter II of the OECD Transfer Pricing Guidelines)
- ▶ A new version of chapter VI of the OECD Transfer Pricing Guidelines addressing intangibles, including new guidance on the return to funding activities and on hard-to-value intangibles
- ▶ New guidance on low-value adding intragroup services (revisions to chapter VII of the OECD Transfer Pricing Guidelines)
- ▶ An entirely new version of chapter VIII of the OECD Transfer Pricing Guidelines, covering cost contribution arrangements

In addition, the Actions 8-10 package describes additional work to be conducted by the OECD to produce new guidance on the application of the transactional

profit split method. The aim is to produce a discussion draft in 2016 and final guidance during the first half of 2017.

### *Intangibles*

The intangibles final report consists of a new version of chapter VI, which builds on the version issued in September 2014.<sup>10</sup>

The structure of the final report is the same, containing four sections providing guidance on: (i) identifying intangibles for transfer pricing purposes, including a definition of intangibles for transfer pricing purposes; (ii) identifying and characterizing transactions involving intangibles, including the determination which entity or entities should share in the costs and risks of intangible development and the economic returns from the intangibles; (iii) identifying types of transactions involving intangibles; and (iv) determining arm's length conditions and pricing in cases involving intangibles, in particular addressing intangible valuation, and arm's length conditions for hard-to-value intangibles.

The key features of the final report, and key differences from earlier reports on intangibles, are:

- ▶ Guidance on which entity or entities are entitled to share in the economic return from exploiting intangibles. The final report clarifies and confirms previous work, stating that mere legal ownership of an intangible does not confer any right to the return from its exploitation. Instead, the economic return from intangibles will accrue to the entities that

perform the important value-creating functions of developing, enhancing, maintaining, protecting and exploiting the intangible, and that assume and manage the risk associated with those functions.

- ▶ New guidance on determining the arm's length return for providing funding for intangible development. Where the entity providing the funding exercises control over the financial risk assumed, that entity is entitled to an expected rate of return commensurate with the risk (for example, based on the rate of return that might be achieved by investing in comparable alternative investments). Where the entity does not exercise control over the financial risk, it is entitled to (no more than) a risk-free return only.
- ▶ Guidance on valuation methods. The final report confirms that database comparables are seldom appropriate for pricing intangible transactions, and provides guidance on the use of other valuation techniques that may be more applicable.
- ▶ Guidance on hard-to-value intangibles. Where intangibles are transferred or licensed in development or where their value is highly uncertain, the tax administration is entitled to use the *ex post* evidence about financial outcomes to inform the determination of the arm's length pricing arrangements, including any contingent pricing arrangements, that would have

been made between independent enterprises at the time of the transaction. The taxpayer can prove the original pricing was based on reasonable forecasts taking into account all reasonably foreseeable eventualities. There are some similarities with the US "Commensurate with Income" standard.

The guidance on intangibles is effectively final, although one small section within part D on the application of the transactional profit split method for pricing intangibles transactions is likely to be revised when the OECD completes its new guidance on this transfer pricing method.

#### *Cost contribution arrangements*

The section on cost contribution arrangements (CCAs) replaces existing chapter VIII of the OECD Transfer Pricing Guidelines in its entirety. The objective of the final report is to align the guidance on CCAs with the new guidance elsewhere in the final report on control of risk and on intangibles transactions. The guidance contained in the final report is similar to the guidance in the discussion draft issued in April 2015,<sup>11</sup> although some aspects have been refined in light of the OECD consultations with business representatives.

The key points contained in the final report are:

- ▶ CCAs are contractual arrangements among business enterprises for sharing contributions and risks associated with the joint

development, production or obtaining of intangibles, tangible assets or services, in the expectation of mutual benefit from the pooling of resources and skills.

- ▶ The expectation of mutual benefit is a pre-requisite for participating in a CCA. Participants must expect to benefit from the output of the CCA, for example by being able to exploit the rights acquired or services developed in their own businesses.
- ▶ Control is a pre-requisite to be considered as a participant in a CCA. Participants must have the functional capacity to exercise control over the risks taken in the CCA. This means they must be capable of making the decision to take on the initial financial risk of participation in the CCA, and must have the ongoing decision-making capacity to decide on whether or how to respond to the risks associated with the CCA.
- ▶ The value of the contributions made by CCA participants must be in proportion to their reasonably anticipated benefits from the CCA. Where contributions are not in proportion to reasonably anticipated benefits, true-up payments may be required.
- ▶ The value of each participant's contribution should be determined in line with the value that would be placed on it by independent enterprises in comparable circumstances. While contributions should be measured based on value, the

final report recognizes that it may be more practical for taxpayers to compensate current contributions at cost. However, this approach may not be appropriate where the contribution of different participants differ in nature (for instance, where some participants contribute services and others provide intangibles or other assets).

#### *Hard to value intangibles*

The final report contains a specific transfer pricing approach with respect to hard-to-value intangibles (HTVI). The guidance finalizes an earlier discussion draft released June 2015.<sup>12</sup>

HTVI are defined as intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist; and (ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.

The approach is intended to ensure that tax administrations can determine in which situations the pricing arrangements with respect to a HTVI as set by the taxpayers are at arm's length and are based on an appropriate weighting of the foreseeable developments or events that are relevant for the

valuation of certain HTVI and in which situations this is not the case. Under this approach, ex post evidence provides presumptive evidence as to the existence of uncertainties at the time of the transaction, whether the taxpayer appropriately took into account reasonably foreseeable developments or events at the time of the transaction, and the reliability of the information used ex ante in determining the transfer price for the transfer of such intangibles or rights in intangibles. Such presumptive evidence may be subject to rebuttal if it can be demonstrated that it does not affect the accurate determination of the arm's length price.

Compared to the discussion draft, the final report provides more detailed exemptions and safe harbors when a transfer does not fall within the rules on HTVI.

### *Risk & Capital*

The final report also contains revisions to Section D of Chapter I of the OECD Transfer Pricing Guidelines following the work under Action 9 (transferring risks or allocating excessive capital) and Action 10 (clarifying circumstances to re-characterize transactions). More specifically, the revisions include the following main guidance to consider in conducting a transfer pricing analysis:

- ▶ The importance of accurately delineating the actual transactions between associated enterprises through analyzing the contractual relations between the parties together with evidence of the actual conduct of the parties.

- ▶ Detailed guidance on analyzing risks as part of a functional analysis, including a six-step analytical framework. This framework considers the identification of the economically significant risks with specificity, the determination of contractual allocation of these risks and the functions relating to these risks. For transfer pricing purposes, the associated enterprise assuming a risk should control the risk and have the financial capacity to assume the risk.
- ▶ A capital-rich MNE group member without any other relevant economic activities (a "cash box") that provides funding, but cannot control financial risks in relation to the funding, will attain no more than a risk-free return, or less if the transaction is commercially irrational.
- ▶ In exceptional circumstances of commercial irrationality, a tax administration may disregard the actual transaction. The main question is whether the actual transaction has the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances.

With respect to risk and recharacterization, the final report contains significant changes compared to the discussion draft in December 2014,<sup>13</sup> including the inclusion of guidance on risk as an integral part of a functional analysis, the new six-step analytical framework to analyze risk, the inclusion of a materiality threshold

by considering economically significant risks with specificity, the importance of financial capacity to assume risk, which was generally ignored in the discussion draft, and elimination of the moral hazard concept.

### *Low value added services*

The guidance on low value adding services under Action 10 finalizes an earlier discussion draft released in November 2014.<sup>14</sup> It takes the form of a rewrite of chapter VII of the OECD Transfer Pricing Guidelines on services. The updated guidance has the stated aim of achieving a balance between appropriate charges for low value adding services and head office expenses and the need to protect the tax base of payor countries.

Key features of the proposed guidance include:

- ▶ A standard definition of low value-adding intra-group services as being supportive in nature, not being part of the MNE's core business, not requiring or creating valuable intangibles and not involving significant risks.
- ▶ A list of services that would typically meet the definition. In essence the services listed are back-office services.
- ▶ An elective simplified approach to determine arm's length charges for low value-adding services:
  - A process for determining the costs associated with low value adding services
  - Allowing general allocation keys
  - A simplified benefits test
  - A standard 5% mark-up

- ▶ Prescriptive guidance on documentation and reporting that should be prepared for the MNE to be able to apply the simplified approach.
- ▶ The ability for tax administrations to include a threshold above which the simplified approach may be denied. Further work on the threshold will be performed as part of step two mentioned below.

Implementation will take place in two steps. As step one, a large group of countries has agreed to endorse the elective simplified mechanism by 2018. The second step looks to provide comfort to other countries that the elective simplified mechanism will not lead to base-eroding payments. It will entail further work in relation to a potential threshold above which the elective simplified mechanism will not apply and other implementation issues.

Finally, the revised guidance encourages tax administrations to limit any withholding taxes on low value-adding services to the profit element in the charge only.

### ***Profit split***

One of the objectives of Action 10 was to prepare transfer pricing rules or special measures to clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains. In order to determine for which matters additional clarification would be useful, the OECD released a discussion draft in December 2014.<sup>15</sup> That discussion draft did not include revised guidance. The final report

released in respect of Actions 8-10 includes a “scope of work for guidance on the transactional profit split method” which explains, among others, that the revised and improved guidance should:

- ▶ Clarify the circumstances in which transactional profit splits are the most appropriate method for a particular case and describe what approaches can be taken to split profits in a reliable way
- ▶ Take into account changes to the transfer pricing guidance in pursuit of other BEPS actions and take into account the conclusions of the Report on *Addressing the Tax Challenges of the Digital Economy*, developed in relation to BEPS Action 1
- ▶ Reflect further work being undertaken to develop approaches to transfer pricing in situations where the availability of comparables is limited, for example due to the specific features of a controlled transaction, and clarify how in such cases, the most appropriate method should be selected

This scope of work as included in the final report will form the basis for draft guidance to be developed by the OECD during 2016 and expected to be finalized in the first half of 2017. A discussion draft will be released for public comments and a public consultation will be held in May 2016.

### ***Commodities***

The new guidance on commodity transactions under Action 10 finalizes an earlier discussion draft

released in December 2014<sup>16</sup> and includes additional paragraphs to be inserted immediately following paragraph 2.16 of the OECD Transfer Pricing Guidelines. The stated aim is an improved framework for the analysis of commodity transactions from a transfer pricing perspective which should lead to greater consistency in the way that tax administrations and taxpayers determine the arm’s length price for commodity transactions and should ensure that pricing reflects value creation.

The key features of the released guidance on commodity transactions include:

- ▶ Clarification of the existing guidance on the application of the comparable uncontrolled price (CUP) method to commodity transactions and the use of publicly quoted prices to apply the CUP.
- ▶ Recommendation that taxpayers document their price-setting policy for commodity transactions to assist tax authorities in conducting informed examinations.
- ▶ Guidance regarding the adoption of a deemed pricing date for controlled commodity transactions in the absence of evidence of the actual pricing date agreed by the parties to the transactions.

Compared to the discussion draft, the final guidance has minor changes, including a more specific list of the types of adjustments applicable when using a CUP method and clarification that the

functions performed, assets used and risk assumed by other entities in the supply chain need to be compensated properly.

### **Action 11 - Collecting and analyzing data on BEPS**

Action 11 is different from the other BEPS Actions because it is concerned with measuring BEPS activity rather than addressing it. Action 11 is intended to estimate the size of BEPS, identify indicators of BEPS, and provide recommendations for improving the measurement of BEPS. The final report on Action 11, *Measuring and Monitoring BEPS*, estimates that global corporate income tax revenue is reduced by 4% to 10% (i.e., US\$100 billion to US\$240 billion annually).

The six indicators of BEPS identified in the final report are: (i) the concentration of foreign direct investment in low tax countries; (ii) the profit rates of MNE affiliates in low tax countries compared to those in high tax countries; (iii) the profit rates of MNE affiliates in low tax countries compared with the profit rate of their own global groups; (iv) the effective tax rates of MNEs compared to those of domestic-only enterprises; (v) the separation of intangible assets from the location of their production; and (vi) the concentration of debt in MNE affiliates located in higher-tax rate countries.

The final report recommends greater cooperation between the OECD and taxing authorities in the collection and sharing of data. It also identifies several additional

measures of BEPS that will become possible using the data collected under Actions 5, 12, and 13.

### **Action 12 - Disclosing aggressive tax planning arrangements**

The final report on Action 12, *Mandatory Disclosure Rules*, makes a series of recommendations about the design of mandatory disclosure regimes. The objectives of such a regime are to increase transparency through providing early information to tax authorities, deter the implementation of potentially aggressive schemes and early identification of promoters and taxpayers associated with abusive schemes which are considered to pose BEPS-related tax risks. Countries are free to choose whether or not to adopt a mandatory disclosure regime and the recommendations set out within the Action 12 final report do not constitute a minimum standard.

Countries can elect whether to place the primary responsibility for disclosure either on the promoter or on both the promoter and the taxpayer. To the extent a promoter has the primary obligation to disclose a reportable scheme or transaction, the OECD suggests that the burden to disclose switches to the taxpayer in situations where the promoter is offshore, there is no promoter, or the promoter has legal privilege. A promoter should disclose a scheme at the time it is made available to the taxpayer; whereas if the onus for disclosure rests with the taxpayer, the taxpayer should disclose at the time of implementation of the scheme.

Hallmarks are used to test what types of arrangements should be disclosed, with the recommendation being that a mixture of generic (e.g., confidentiality, premium fee) and specific (to target specific transactions such as loss schemes or leasing transactions) hallmarks are used, although just one hallmark needs to be met to trigger a disclosure obligation. In order to reduce the burden of compliance, the final report recommends that certain thresholds are introduced (i.e., a main benefit test and/or a de minimis filter). It should only be necessary to consider the hallmarks if such an initial threshold is exceeded.

The main amendments to the final report compared to the discussion draft issued in March 2015<sup>17</sup> relate to how the mandatory disclosure regimes should be implemented in order to capture international tax schemes which have a material tax revenue risk in the reporting jurisdiction. The final report emphasizes that the hallmarks introduced in relation to such schemes should focus on BEPS-related risks in particular (as opposed to general tax planning risks as stated in the discussion draft). The OECD recommends that these schemes should require disclosure where the domestic taxpayer (or the taxpayer's adviser) could reasonably have expected to have been aware of the cross-border outcome of an arrangement, and they should make reasonable inquiries at the time of entering into such arrangements to determine whether they include cross-border

outcomes (such recommendations were not originally contemplated in discussion draft).

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

The final report on Action 13, *Transfer Pricing Documentation and Country-by-Country Reporting*, sets out a three-tiered standardized approach to transfer pricing documentation and country-by-country (CbC) reporting, in line with the report issued in September 2014.<sup>18</sup> This standardized approach consists of:

- ▶ A “master file” that provides tax administrations with high-level information regarding a multinational enterprise’s (MNE’s) global business operations and transfer pricing policies
- ▶ A specific “local file” that provides a local tax administration with information regarding material related party transactions, the amounts involved, and the company’s analysis of the transfer pricing determinations they have made with regard to those transactions
- ▶ A CbC reporting template that requires large MNEs to report the amount of revenue (related and unrelated party), profits, income tax paid and taxes accrued, employees, stated capital and retained earnings, and tangible assets annually for each tax jurisdiction in which they do business. In addition, MNEs are required to identify each entity within the group doing business

in a particular tax jurisdiction and to provide an indication of the business activities each entity conducts

The master file and the local file are to be delivered directly to local tax administrations. CbC reports should be filed in the jurisdiction of tax residence of the ultimate parent entity and shared between jurisdictions through automatic exchange of information, pursuant to government-to-government mechanisms under the multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties or tax information exchange agreements.

The new CbC reporting requirements are to be implemented for fiscal years beginning on or after 1 January 2016 and apply to MNEs with annual consolidated group revenue equal to or exceeding €750 million.

In order to facilitate the implementation of the new reporting standards, an implementation package has been developed consisting of model legislation, which could be used by countries to require MNE groups to file the CbC report and competent authority agreements that are to be used to facilitate implementation of the exchange of those reports among tax administrations. As a next step, it is intended that an XML Schema and a related User Guide will be developed by the end of 2015 with a view to accommodating the electronic exchange of CbC reports.

The OECD states it is mandated that countries participating in the BEPS project carefully monitor the implementation of these new standards and reassess no later than the end of 2020 compliance and effectiveness of the new three-tier approach.

### **Action 14 - Making dispute resolution mechanisms more effective**

The final report on Action 14, *Making Dispute Resolution Mechanisms More Effective*, reflects the commitment of participating countries to implement substantial changes in their approach to dispute resolution. The final report contains measures aimed at strengthening the effectiveness and efficiency of the mutual agreement procedure (MAP) mechanism, such as specific actions to be taken by countries, suggested changes to legislation and administrative practices, and changes to the OECD Model Tax Convention and its Commentary. The main objectives of the measures are (i) to allow taxpayers access to the MAP process when the requirements for taxpayers to access the MAP process are met; (ii) to ensure that domestic administrative procedures don’t block access to the MAP process; and (iii) to ensure that countries implement Article 25 of the OECD Model Tax Convention in good faith.

A number of these measures constitute a minimum standard on treaty-based dispute resolution to which all OECD BEPS and G20 countries have agreed to adhere.

Compliance with this standard will be subject to peer based monitoring that will be executed through the Forum on Tax Administration's MAP Forum. The minimum standard is complemented with additional measures designated as best practices to which only some of the OECD BEPS and G20 countries were willing to commit. Finally, the report lists 20 countries that have agreed to implement mandatory binding MAP arbitration in their bilateral tax treaties. According to the OECD, the countries that have made that commitment were involved in more than 90% of the outstanding MAP cases at the end of 2013.

### **Action 15 - Developing a multilateral instrument to modify bilateral tax treaties**

Action 15 explores the technical feasibility of a multilateral instrument to implement the treaty-related measures developed during the course of the BEPS project and to amend bilateral tax treaties.

The final report on Action 15, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties*, provides an overview of the current status of this multilateral instrument and mainly reproduces the report issued in September 2014 (the 2014 report).<sup>19</sup>

Drawing on the expertise of public international law and tax experts, the report explores the technical feasibility and desirability of a multilateral instrument and its consequences on the current tax system. This report considered that such an instrument is desirable as it would achieve swift and consistent

implementation of the measures developed during the course of BEPS by avoiding the need to individually renegotiate existing bilateral tax treaties. The report also identifies several obstacles to a multilateral instrument from a technical (public international law and international tax law) and political perspective. Drawing from numerous examples of multilateral treaties in areas other than tax, it describes that these obstacles can nevertheless be overcome, thereby concluding that a multilateral instrument also appears feasible. The report suggests that the scope of such a multilateral instrument should initially only include the treaty-based measures of the BEPS project once finalized (e.g., multilateral mutual agreement procedure, provisions on dual-residence structures, hybrid mismatch arrangements, triangular cases involving PEs in third states and treaty abuse).

Based on the analysis in the 2014 report, a mandate for the formation of an ad hoc Group to develop the multilateral instrument was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015. This Mandate also was reproduced in the final report on Action 15. The Group is open to all interested countries, including non-OECD or G20 members, with all participating on an equal basis. The Group began its work in May 2015 with the aim to finalize the multilateral instrument and to open

it for signature by 31 December 2016. To date, approximately 90 countries are participating. Participation in the development of the multilateral instrument is voluntary and does not require any commitments to sign such instrument, once it has been finalized.

### **Implications**

These final reports represent the culmination of work on the BEPS project. These reports include recommendations for significant changes in key elements of the international tax architecture. Such changes are reflected in revisions to the OECD Transfer Pricing Guidelines and the OECD Model Tax Convention and in recommended domestic law provisions. Participating in the discussions that led to these consensus recommendations were all OECD and G20 countries and about a dozen developing countries.

With the release of the OECD final reports, attention will now turn to countries, which must determine whether, when and how to implement the various recommendations. Countries have already begun taking action in anticipation of the OECD recommendations, and there has been significant BEPS-driven legislative and tax administration activity around the world since the OECD issued its Action Plan on BEPS in July 2013. Moreover, the G20 Finance Ministers have asked the OECD to develop an inclusive framework for monitoring the

implementation by countries of the BEPS recommendations. That framework is to be developed by early 2016. At the same time, the OECD will be completing follow-on technical work related to several of the BEPS focus areas, including interest limitations under Action 4, treaty abuse under Action 6, permanent establishment under Action 7 and transfer pricing under Actions 8-10.

Companies must evaluate the implications of the recommendations contained in the final reports for their business models and operating structures. Companies also need to closely monitor legislative and tax administrative developments in the countries where they operate or are considering investing. In addition, companies should focus on the new

reporting requirements, including the requirement for CbC reporting, in order to assess whether the necessary data is available, what must be done to gain access to such data in the required form, and how tax administrations are likely to interpret such data. Now is the time for companies to be preparing for significant potential changes in the international tax environment.

## Endnotes

1. See EY Global Tax Alert, [OECD issues report on the tax challenges of the digital economy under Action 1](#), dated 21 September 2014.
2. See EY Global Tax Alert, [OECD releases report under BEPS Action 2 on hybrid mismatch arrangements](#), dated 24 September 2014.
3. See EY Global Tax Alert, [OECD releases discussion draft on CFC rules under BEPS Action 3](#), dated 10 April 2015.
4. See EY Global Tax Alert, [OECD releases discussion draft on interest deductions under BEPS Action 4](#), dated 23 December 2014.
5. Belgium, China, Colombia, France, Hungary, Israel, Italy, Luxembourg, Netherlands, Portugal, Spain, Spain (Basque Country), Spain (Navarra), Switzerland (Canton of Nidwalden), Turkey and the UK.
6. See EY Global Tax Alert, [OECD releases report under BEPS Action 6 on preventing treaty abuse](#), dated 24 September 2014.
7. See EY Global Tax Alert, [OECD releases revised discussion draft on preventing artificial avoidance of PE status under BEPS Action 7](#), dated 21 May 2015.
8. Action 7, *Preventing the Artificial Avoidance of Permanent Establishment Status*, page 16. Proposed new paragraph 5 of Article 5.
9. Action 7, *Preventing the Artificial Avoidance of Permanent Establishment Status*, page 16. Proposed new paragraph 6(b) of Article 5.
10. See EY Global Tax Alert, [OECD issues updated guidance under BEPS Action 8 on transfer pricing aspects of intangibles](#), dated 21 September 2014.
11. See EY Global Tax Alert, [OECD releases discussion draft on cost contribution arrangements under BEPS Action 8](#), dated 4 May 2015.
12. See EY Global Tax Alert, [OECD releases discussion draft on hard-to-value intangibles under BEPS Action 8](#), dated 8 June 2015.
13. This discussion draft is titled, *BEPS Actions 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation and special measures)*.
14. See EY Global Tax Alert, [OECD releases discussion draft on low value-adding intra-group services](#), dated 5 November 2014.
15. See EY Global Tax Alert, [OECD releases discussion draft on use of profit split method in global value chains under BEPS Action 10](#), dated 18 December 2014.
16. See EY Global Tax Alert, [OECD releases Discussion Draft on cross-border commodity transactions under BEPS Action 10](#), dated 22 December 2014.
17. See EY Global Tax Alert, [OECD issues discussion draft on mandatory disclosure rules under BEPS Action 12](#), dated 3 April 2015.
18. See EY Global Tax Alert, [OECD releases report under BEPS Action 13 on Transfer Pricing Documentation and Country-by-Country Reporting](#), dated 23 September 2014.
19. See EY Global Tax Alert, [OECD releases report under BEPS Action 15 on feasibility of developing multilateral instrument to amend bilateral tax treaties](#), dated 19 September 2014.

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