



OECD's recommendations on BEPS project has wider indirect tax implications

Executive summary

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final recommendations on tax policies and treaties as part of its Base Erosion and Profit Shifting (BEPS) project. The BEPS package is designed to be implemented through changes in domestic law and practices, and through treaty provisions, with negotiations for a multilateral instrument under way and expected to be finalized in 2016. The exact timeline for new rules entering into force depends on the length of time needed to negotiate these agreements and for the subsequent domestic law procedures to ratify the treaties.

Only BEPS Action 1 (Tax challenges in the digital economy) specifically refers to Value added tax/Goods and sales tax (VAT/GST) in the context of effective tax collection with respect to the cross-border supply of digital goods and services. However, there are several important interactions between direct and indirect taxation across other BEPS action points. For example, Action 7 could influence the application of VAT/GST on supplies of goods and services, and BEPS actions that have an impact on tangible product pricing, additions to value and supporting documentation also will be likely to have an effect on customs duty.

While any links between VAT/GST and BEPS outside of Action 1 may have been unintended, these links do require careful consideration by businesses to manage their impact, which could be significant within a supply chain.

Detailed discussion

Action 1 - address tax challenges of the digital economy

Action 1 addresses the rapid change in the digital economy and emphasizes the need to change the tax system to enable efficient tax collection but also to level the relationship between the domestic and foreign suppliers. The global economy is undergoing a tremendous change with technology shaping the way that businesses



operate, people work and customers consume. The OECD's Action 1 report concludes that the digital economy cannot be ring-fenced as it is increasingly becoming the economy itself.

Rules and implementation mechanisms have been developed to help collect VAT according to the destination principle, i.e., where consumption takes place. This has proven to be particularly challenging in business to consumer (B2C) transactions, for remote supplies to exempt businesses, for remote digital supplies to multinational enterprises and for low-value imports. The Action 1 measures are intended to level the playing field between domestic and foreign suppliers and facilitate the efficient collection of VAT due on these transactions. Technical options to deal with the broader tax challenges raised by the digital economy (such as nexus and data) have also been discussed and analyzed by the OECD. As both the challenges and the potential options raise systemic issues regarding the existing framework for the taxation of cross-border activities that go beyond BEPS issues, the OECD and G20 countries have agreed to monitor developments and analyze data that will become available over time. On the basis of the future monitoring work, a determination also will be made as to whether further work should be carried out. The OECD stresses that this determination should be based on a broad look at the ability of existing international tax standards

to deal with the tax challenges raised by developments in the digital economy.

While a big step towards indirect taxation of the digital economy was made in the European Union (EU) by implementing the 2015 place of supply rules, many other countries have less sophisticated rules around indirect tax. With countries adopting BEPS recommendations on Action 1 in conjunction with Action 7 (see below), companies' existing operating and pricing models may need to be re-designed, leading to a significant impact on the entire business infrastructure.

Indirect taxes are inherently impacted by such business transformations. Therefore a timely examination of potential actions is advisable, keeping in mind the significant resources and lead-times required for any operational and structural business changes.

Action 7 - prevent the artificial avoidance of PE status

Tax treaties generally provide that the business profits of a foreign enterprise are taxable in a state only to the extent that the enterprise has a permanent establishment (PE) in that state to which the profits are attributable. The definition of PE included in tax treaties is therefore crucial in determining whether a nonresident enterprise must pay income tax in another state. The final BEPS report includes changes to the definition of PE contained in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties.

Action 7 aims to prevent the avoidance of PE status, including through the use of commissionaire arrangements and the specific activity exemptions in treaties, such as warehousing, purchasing and "preparatory and auxiliary" activities. In addition, the Report, [Addressing the Tax Challenges of the Digital Economy](#), identified further issues in the digital economy where core activities "inappropriately" benefit from PE exceptions. The overall effect of the OECD BEPS actions appears to be to lower the threshold for finding a PE from a corporate tax perspective and to reduce exemptions from PE status.

The indirect tax definition of a fixed establishment (FE) is different from a PE and it is not directly affected by the BEPS initiative. Therefore, any changes to the definitions of a PE for BEPS are likely to lead to a greater gap between the definitions used for "establishment" for direct (PE) and indirect tax (FE) purposes, leading to some businesses facing challenges of re-defining their transactional models and systems environments.

At the same time, some countries do not accept the absence of an FE once a PE has been established, so that there is also a risk that an increased number of FEs will be assumed to exist. This risk would require addressing the following aspects in the business, possible questions include:

- ▶ Is there a mismatch in the recognition of business establishments for direct and indirect tax purposes? If so, sales/

purchases transaction may need to be accounted for in different countries for direct and indirect taxes. This would immediately impact accounting and systems, including tax determination logic, accounting and reporting.

- ▶ Should the existing business model be reconsidered to accommodate the new PE environment (e.g., moving away from a commissionaire structure)?
- ▶ Do transactions need to be re-mapped for indirect taxes? In addressing this, it is important to consider the “force of attraction” impact for indirect taxes of newly created PEs.
- ▶ Does the business need to obtain rulings in countries with an unclear distinction between PE and FE? Also consider new indirect tax registrations and compliance obligations, different procedures for input tax deduction etc. in countries where an FE is deemed to apply.
- ▶ What is the likely impact of regulatory and contractual changes, and changes in the layout of commercial documents?
- ▶ Are there any operational or customs benefits from establishing a PE for non-EU entities operating in the EU?

Action 8 - Intangibles

Action 8 looks at transfer pricing issues relating to controlled transactions involving intangibles. The OECD comments that misallocation of the profits generated by valuable intangibles has heavily contributed to base

erosion and profit shifting.

Action 8, therefore, aims to develop the rules to prevent BEPS by moving intangibles among group members. This Action also involves the adoption of a broad and clearly delineated definition of “intangibles.”

The final report explicitly excludes any impact of Action 8 on the definition of “royalties” set out in Article 12 OECD Model Tax Convention in general, and its relevance for the purpose of customs valuation in particular. Nevertheless, Action 8 proposes a change in the allocation and valuation of intangibles which represent relevant additions for the purpose of determining customs value.

Coupled with the upcoming Union Customs Code (UCC) in the EU,¹ any revision is likely to impact the customs duty bill for industries that have a strong focus on product-related intellectual property, royalties, license fees and trademarks. Therefore, businesses should start looking at their arrangements for intangibles and evaluate the impact and possibilities for optimization, which will strongly depend on the facts in each case, for example, the particular industry sector, the corporate structure, the IP location and the contractual relationships between the parties.

Similar concerns apply to multinational enterprises that are subject to any VAT/GST partial exemption schemes (because some of their activities are taxable and some are exempt for VAT/GST purposes). If a company’s only

taxed supplies (or a significant part of them) arise from intercompany transactions involving intangibles, a reduction in the valuation of such supplies (e.g., as a result of any clarification or and strengthening of the arm’s length principle as a result of the OECD BEPS project) could have a significant impact on input VAT deduction.

In general, companies in all sectors should be aware that BEPS Actions 8 to 10 may lead to a much greater focus on transfer pricing (and adjustments) by tax authorities, which may have an impact on the valuation of related-party transactions for customs and for VAT/GST.

Action 13 - country-by country reporting

Action 13 provides a template for multinational enterprises to report annually and for each tax jurisdiction in which they do business a range of information in the Country-by-Country (CbC) Report).

The requirements set out in this report relate to the disclosure of revenue figures and other key figures on a country-by-country basis. Cbc reporting will provide a great deal of additional data, making outliers very obvious and it is likely to trigger investigations by direct tax authorities and discussions about any perceived differences and discrepancies. It is likely that indirect tax authorities also will show an interest in these data and will use the Cbc information for their own purposes (e.g., related to valuation of related-party transactions).

Implications

The ultimate aim of the BEPS action plan is to reform taxes across the OECD countries so that, as far as possible, tax is paid in the country where economic activity and value creation occurs. For indirect taxes, that may be effectively the country of consumption. These initiatives are particularly relevant for businesses interacting with the digital economy, for businesses with establishments in other countries or that use a supplier's infrastructure in another countries and for multinational enterprises.

Multinational enterprises should proactively consider the impact of BEPS on their VAT/GST and customs positions and include indirect taxes in any BEPS-related discussions and action plans and in any business transformation processes.

The above is based on our interpretation of current tax legislation and case law published to date. This Indirect Tax Alert provides general information with no pretence of completeness, and it is not a tax advice.

Endnote

1. See EY Global Tax Alert, [Implementation of EU Customs Code to bring substantial changes to customs valuation](#), dated 2 October 2015.

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