



OECD/G20 Base Erosion and Profit Shifting Project

2015 Final Reports

Executive Summaries

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Action 1

Addressing the Tax Challenges of the Digital Economy

Action 1 of the base erosion and profit shifting (BEPS) Action Plan deals with the tax challenges of the Digital Economy.

Political leaders, media outlets, and civil society around the world have expressed growing concern about tax planning by multinational enterprises (MNEs) that makes use of gaps in the interaction of different tax systems to artificially reduce taxable income or shift profits to low-tax jurisdictions in which little or no economic activity is performed. In response to this concern, and at the request of the G20, the Organisation for Economic Co-operation and Development (OECD) published an *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) in July 2013. Action 1 of the BEPS Action Plan calls for work to address the tax challenges of the digital economy.

The Task Force on the Digital Economy (TFDE), a subsidiary body of the Committee on Fiscal Affairs (CFA) in which non-OECD G20 countries participate as Associates on an equal footing with OECD countries, was established in September 2013 to develop a report identifying issues raised by the digital economy and detailed options to address them by September 2014. The TFDE consulted extensively with stakeholders and analysed written input submitted by business, civil society, academics, and developing countries. It issued an interim report in September 2014 and continued its work in 2015. The conclusions regarding the digital economy, the BEPS issues and the broader tax challenges it raises, and the recommended next steps are contained in this final report.

The digital economy is the result of a transformative process brought by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy.

Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. The digital economy and its business models present however some key features which are potentially relevant from a tax perspective. These features include mobility, reliance on data, network effects, the spread of multi-sided business models, a tendency toward monopoly or oligopoly and volatility. The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services. The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations.

BEPS issues in the digital economy

While the digital economy and its business models do not generate unique BEPS issues, some of its key features exacerbate BEPS risks. These BEPS risks were identified and the work on the relevant actions of the BEPS Project was informed by these findings and took these issues into account to ensure that the proposed solutions fully address BEPS in the digital economy. Accordingly,

- It was agreed to modify the list of exceptions to the definition of PE to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a “preparatory or auxiliary” character, and to introduce a new anti-fragmentation rule to ensure that it is not possible to benefit from these exceptions through the fragmentation of business activities among closely related enterprises. For example, the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a permanent establishment for that seller under the new standard.
- It was also agreed to modify the definition of PE to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company. For example, where the sales force of a local subsidiary of an online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modification by the parent company, this activity would result in a permanent establishment for the parent company.
- The revised transfer pricing guidance makes it clear that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible, but that the group companies performing the important functions, contributing the important assets and controlling economically significant risks, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return. Specific guidance will also ensure that the transfer pricing analysis is not weakened by information asymmetries between the tax administration and the taxpayer in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement.
- The recommendations on the design of effective CFC include definitions of CFC income that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent company.

It is expected that the implementation of these measures, as well as the other measures developed in the BEPS Project (e.g. minimum standard to address treaty shopping arrangements, best practices in the design of domestic rules on interest and other deductible financial payments, application to IP regimes of a substantial activity requirement with a “nexus approach”), will substantially address the BEPS issues exacerbated by the digital economy at the level of both the market jurisdiction and the

jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so-called stateless income.

Broader tax challenges raised by the digital economy

The digital economy also raises broader tax challenges for policy makers. These challenges relate in particular to nexus, data, and characterisation for direct tax purposes, which often overlap with each other. The digital economy also creates challenges for value added tax (VAT) collection, particularly where goods, services and intangibles are acquired by private consumers from suppliers abroad. The TFDE discussed and analysed a number of potential options to address these challenges, including through an analysis of their economic incidence, and concluded that:

- The option to modify the exceptions to PE status in order to ensure that they are available only for activities that are in fact preparatory or auxiliary in nature that was adopted as a result of the work on Action 7 of the BEPS Project is expected to be implemented across the existing tax treaty network in a synchronised and efficient manner via the conclusion of the multilateral instrument that modifies bilateral tax treaties under Action 15.
- The collection of VAT/GST on cross-border transactions, particularly those between businesses and consumers, is an important issue. Countries are thus recommended to apply the principles of the International VAT/GST Guidelines and consider the introduction of the collection mechanisms included therein.
- None of the other options analysed by the TFDE, namely (i) a new nexus in the form of a significant economic presence, (ii) a withholding tax on certain types of digital transactions, and (iii) an equalisation levy, were recommended at this stage. This is because, among other reasons, it is expected that the measures developed in the BEPS Project will have a substantial impact on BEPS issues previously identified in the digital economy, that certain BEPS measures will mitigate some aspects of the broader tax challenges, and that consumption taxes will be levied effectively in the market country.
- Countries could, however, introduce any of these three options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties. Adoption as domestic law measures would require further calibration of the options in order to provide additional clarity about the details, as well as some adaptation to ensure consistency with existing international legal commitments.

Next steps

Given that these conclusions may evolve as the digital economy continues to develop, it is important to continue working on these issues and to monitor developments over time. To these aims, the work will continue following the completion of the other follow-up work on the BEPS Project. This future work will be done in consultation with a broad range of stakeholders, and on the basis of a detailed mandate to be developed during 2016 in the context of designing an inclusive post-BEPS monitoring process. A report reflecting the outcome of the continued work in relation to the digital economy should be produced by 2020.

Action 2

Neutralising the Effects of Hybrid Mismatch Arrangements

Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness.

With a view to increasing the coherence of corporate income taxation at the international level, the OECD/G20 BEPS Project called for recommendations regarding the design of domestic rules and the development of model treaty provisions that would neutralise the tax effects of hybrid mismatch arrangements. This report sets out those recommendations: Part I contains recommendations for changes to domestic law and Part II sets out recommended changes to the OECD Model Tax Convention. Once translated into domestic and treaty law, these recommendations will neutralise hybrid mismatches, by putting an end to multiple deductions for a single expense, deductions without corresponding taxation or the generation of multiple foreign tax credits for one amount of foreign tax paid. By neutralising the mismatch in tax outcomes, the rules will prevent these arrangements from being used as a tool for BEPS without adversely impacting cross-border trade and investment.

This report supersedes the interim report *Neutralising the Effect of Hybrid Mismatch Arrangements* (OECD, 2014) that was released as part of the first set of BEPS deliverables in September 2014. Compared to that report, the recommendations in Part I have been supplemented with further guidance and practical examples to explain the operation of the rules in further detail. Further work has also been undertaken on asset transfer transactions (such as stock-lending and repo transactions), imported hybrid mismatches, and the treatment of a payment that is included as income under a controlled foreign company (CFC) regime. The consensus achieved on these issues is reflected in the report. As indicated in the September 2014 report, countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intra-group hybrid regulatory capital. Where one country chooses not to apply the rules to neutralise a hybrid mismatch in respect of a particular hybrid regulatory capital instrument, this does not affect another country's policy choice of whether to apply the rules in respect of the particular instrument.

Part I

Part I of the report sets out recommendations for rules to address mismatches in tax outcomes where they arise in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity. It also recommends rules to address indirect mismatches that arise when the effects of a hybrid mismatch arrangement are imported into a third jurisdiction. The recommendations take the form of linking rules that align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction but

otherwise do not disturb the commercial outcomes. The rules apply automatically and there is a rule order in the form of a primary rule and a secondary or defensive rule. This prevents more than one country applying the rule to the same arrangement and also avoids double taxation.

The recommended primary rule is that countries deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction. If the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch.

The report recognises the importance of co-ordination in the implementation and application of the hybrid mismatch rules to ensure that the rules are effective and to minimise compliance and administration costs for taxpayers and tax administrations. To this end, it sets out a common set of design principles and defined terms intended to ensure consistency in the application of the rules.

Part II

Part II addresses the part of Action 2 aimed at ensuring that hybrid instruments and entities, as well as dual resident entities, are not used to obtain unduly the benefits of tax treaties and that tax treaties do not prevent the application of the changes to domestic law recommended in Part I.

Part II first examines the issue of dual resident entities, i.e. entities that are residents of two States for tax purposes. It notes that the work on Action 6 will address some of the BEPS concerns related to the issue of dual resident entities by providing that cases of dual residence under a tax treaty would be solved on a case-by-case basis rather than on the basis of the current rule based on the place of effective management of entities. This change, however, will not address all BEPS concerns related to dual resident entities, domestic law changes being needed to address other avoidance strategies involving dual residence.

Part II also deals with the application of tax treaties to hybrid entities, i.e. entities that are not treated as taxpayers by either or both States that have entered into a tax treaty (such as partnerships in many countries). The report proposes to include in the *OECD Model Tax Convention* (OECD, 2010) a new provision and detailed Commentary that will ensure that benefits of tax treaties are granted in appropriate cases to the income of these entities but also that these benefits are not granted where neither State treats, under its domestic law, the income of such an entity as the income of one of its residents.

Finally, Part II addresses potential treaty issues that could arise from the recommendations in Part I. It first examines treaty issues related to rules that would result in the denial of a deduction or would require the inclusion of a payment in ordinary income and concludes that tax treaties would generally not prevent the application of these rules. It then examines the impact of the recommendations of Part I with respect to tax treaty rules related to the elimination of double taxation and notes that problems could arise in the case of bilateral tax treaties that provide for the application of the exemption method with respect to dividends received from foreign companies. The report describes possible treaty changes that would address these problems. The last issue dealt with in Part II is the possible impact of tax treaty rules concerning non-discrimination on the recommendations of Part I; the report concludes that, as long as the domestic rules that will be drafted to implement these

recommendations are properly worded, there should be no conflict with these non-discrimination provisions.

Action 3

Designing Effective Controlled Foreign Company Rules

Controlled foreign company (CFC) rules respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries by shifting income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation.

Since the first CFC rules were enacted in 1962, an increasing number of jurisdictions have implemented these rules. Currently, 30 of the countries participating in the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project have CFC rules, and many others have expressed interest in implementing them. However, existing CFC rules have often not kept pace with changes in the international business environment, and many of them have design features that do not tackle BEPS effectively.

In response to the challenges faced by existing CFC rules, the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) called for the development of recommendations regarding the design of CFC rules. This is an area where the OECD has not done significant work in the past, and this report recognises that by working together countries can address concerns about competitiveness and level the playing field.

This report sets out recommendations in the form of building blocks. These recommendations are not minimum standards, but they 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 sets out the following six building blocks for the design of effective CFC rules:

- **Definition of a CFC** – CFC rules generally apply to foreign companies that are controlled by shareholders in the parent jurisdiction. The report sets out recommendations on how to determine when shareholders have sufficient influence over a foreign company for that company to be a CFC. It also provides recommendations on how non-corporate entities and their income should be brought within CFC rules.
- **CFC exemptions and threshold requirements** – Existing CFC rules often only apply after the application of provisions such as tax rate exemptions, anti-avoidance requirements, and *de minimis* thresholds. The report recommends that CFC rules only apply to controlled foreign companies that are subject to effective tax rates that are meaningfully lower than those applied in the parent jurisdiction.
- **Definition of income** – Although some countries' existing CFC rules treat all the income of a CFC as "CFC income" that is attributed to shareholders in the parent jurisdiction, many CFC rules only apply to certain types of income. The report recommends that CFC rules include a definition of CFC income, and it sets out a

non-exhaustive list of approaches or combination of approaches that CFC rules could use for such a definition.

- **Computation of income** – The report recommends that CFC rules use the rules of the parent jurisdiction to compute the CFC income to be attributed to shareholders. It also recommends that CFC losses should only be offset against the profits of the same CFC or other CFCs in the same jurisdiction.
- **Attribution of income** – The report recommends that, when possible, the attribution threshold should be tied to the control threshold and that the amount of income to be attributed should be calculated by reference to the proportionate ownership or influence.
- **Prevention and elimination of double taxation** – One of the fundamental policy issues to consider when designing effective CFC rules is how to ensure that these rules do not lead to double taxation. The report therefore emphasises the importance of both preventing and eliminating double taxation, and it recommends, for example, that jurisdictions with CFC rules allow a credit for foreign taxes actually paid, including any tax assessed on intermediate parent companies under a CFC regime. It also recommends that countries consider relief from double taxation on dividends on, and gains arising from the disposal of, CFC shares where the income of the CFC has previously been subject to taxation under a CFC regime.

Because each country prioritises policy objectives differently, the recommendations provide flexibility to implement CFC rules that combat BEPS in a manner consistent with the policy objectives of the overall tax system and the international legal obligations of the country concerned. In particular, this report recognises that the recommendations must be sufficiently adaptable to comply with EU law, and it sets out possible design options that could be implemented by EU Member States. Once implemented, the recommendations will ensure that countries will have effective CFC rules that address BEPS concerns.

Action 4

Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

It is an empirical matter of fact that money is mobile and fungible. Thus, multinational groups may achieve favourable tax results by adjusting the amount of debt in a group entity. The influence of tax rules on the location of debt within multinational groups has been established in a number of academic studies and it is well known that groups can easily multiply the level of debt at the level of individual group entities via intra-group financing. Financial instruments can also be used to make payments which are economically equivalent to interest but have a different legal form, therefore escaping restrictions on the deductibility of interest. Base Erosion and Profit Shifting (BEPS) risks in this area may arise in three basic scenarios:

- Groups placing higher levels of third party debt in high tax countries.
- Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense.
- Groups using third party or intragroup financing to fund the generation of tax exempt income.

To address these risks, Action 4 of the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) called for recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense. This report analyses several best practices and recommends an approach which directly addresses the risks outlined above. The recommended approach is based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA). As a minimum this should apply to entities in multinational groups. To ensure that countries apply a fixed ratio that is low enough to tackle BEPS, while recognising that not all countries are in the same position, the recommended approach includes a corridor of possible ratios of between 10% and 30%. The report also includes factors which countries should take into account in setting their fixed ratio within this corridor. The approach can be supplemented by a worldwide group ratio rule which allows an entity to exceed this limit in certain circumstances.

Recognising that some groups are highly leveraged with third party debt for non-tax reasons, the recommended approach proposes a group ratio rule alongside the fixed ratio rule. This would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group. Countries may also apply an uplift of up to 10% to the group's net third party interest expense to prevent double taxation. The earnings-based worldwide group ratio rule can also be replaced by different group ratio rules, such as the "equity escape" rule (which

compares an entity's level of equity and assets to those held by its group) currently in place in some countries. A country may also choose not to introduce any group ratio rule. If a country does not introduce a group ratio rule, it should apply the fixed ratio rule to entities in multinational and domestic groups without improper discrimination.

The recommended approach will mainly impact entities with both a high level of net interest expense and a high net interest/EBITDA ratio, in particular where the entity's ratio is higher than that of its worldwide group. This is a straightforward approach and ensures that an entity's net interest deductions are directly linked to the taxable income generated by its economic activities. An important feature of the fixed ratio rule is that it only limits an entity's net interest deductions (i.e. interest expense in excess of interest income). The rule does not restrict the ability of multinational groups to raise third party debt centrally in the country and entity which is most efficient taking into account non-tax factors such as credit rating, currency and access to capital markets, and then on-lend the borrowed funds within the group to where it is used to fund the group's economic activities.

The recommended approach also allows countries to supplement the fixed ratio rule and group ratio rule with other provisions that reduce the impact of the rules on entities or situations which pose less BEPS risk, such as:

- A *de minimis* threshold which carves-out entities which have a low level of net interest expense. Where a group has more than one entity in a country, it is recommended that the threshold be applied to the total net interest expense of the local group.
- An exclusion for interest paid to third party lenders on loans used to fund public-benefit projects, subject to conditions. In these circumstances, an entity may be highly leveraged but, due to the nature of the projects and the close link to the public sector, the BEPS risk is reduced.
- The carry forward of disallowed interest expense and/or unused interest capacity (where an entity's actual net interest deductions are below the maximum permitted) for use in future years. This will reduce the impact of earnings volatility on the ability of an entity to deduct interest expense. The carry forward of disallowed interest expense will also help entities which incur interest expenses on long-term investments that are expected to generate taxable income only in later years, and will allow entities with losses to claim interest deductions when they return to profit.

The report also recommends that the approach be supported by targeted rules to prevent its circumvention, for example by artificially reducing the level of net interest expense. It also recommends that countries consider introducing rules to tackle specific BEPS risks not addressed by the recommended approach, such as where an entity without net interest expense shelters interest income.

Finally, the report recognises that the banking and insurance sectors have specific features which must be taken into account and therefore there is a need to develop suitable and specific rules that address BEPS risks in these sectors.

Further technical work will be conducted on specific areas of the recommended approach, including the detailed operation of the worldwide group ratio rule and the specific rules to address risks posed by banking and insurance groups. This work is expected to be completed in 2016.

The amount of intragroup interest and payments economically equivalent to interest is also affected by transfer pricing rules. Revisions to Chapter I of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations under Actions 8-10 of the BEPS Action Plan (OECD, 2013), contained in the OECD Report *Aligning Transfer Pricing Outcomes with Value Creation* (OECD, 2015), limit the amount of interest payable to group companies lacking appropriate substance to no more than a risk-free return on the funding provided and require group synergies to be taken into account when evaluating intragroup financial payments. Further work on the transfer pricing aspects of financial transactions will be undertaken during 2016 and 2017.

A co-ordinated implementation of the recommended approach will successfully impact on the ability of multinational groups to use debt to achieve BEPS outcomes. To ensure the recommended approach remains effective in tackling BEPS involving interest, the implementation, operation and impact of the approach will be monitored over time, to allow for a comprehensive and informed review as necessary.

Action 5

Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

More than 15 years have passed since the publication of the Organisation for Economic Co-operation and Development's (OECD) 1998 Report *Harmful Tax Competition: An Emerging Global Issue* and the underlying policy concerns expressed then are as relevant today as they were then. Current concerns are primarily about preferential regimes that risk being used for artificial profit shifting and about a lack of transparency in connection with certain rulings. The continued importance of the work on harmful tax practices was highlighted by the inclusion of this work in the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013), whose Action 5 committed the Forum on Harmful Tax Practices (FHTP) to:

Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

In 2014, the FHTP delivered an initial progress report, which is incorporated into and superseded by this final report. The main focus of the FHTP's work has been on agreeing and applying a methodology to define the substantial activity requirement to assess preferential regimes, looking first at intellectual property (IP) regimes and then other preferential regimes. The work has also focused on improving transparency through the compulsory spontaneous exchange of certain rulings that could give rise to BEPS concerns in the absence of such exchanges.

Requiring substantial activity for preferential regimes

Countries agreed that the substantial activity requirement used to assess preferential regimes should be strengthened in order to realign taxation of profits with the substantial activities that generate them. Several approaches were considered and consensus was reached on the "nexus approach". This approach was developed in the context of IP regimes, and it allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying research and development (R&D) expenditures that gave rise to the IP income. The nexus approach uses expenditure as a proxy for activity and builds on the principle that, because IP regimes are designed to encourage R&D activities and to foster growth and employment, a substantial activity requirement should ensure that taxpayers benefiting from these regimes did in fact engage in such activities and did incur actual expenditures on such activities. This same principle can also be

applied to other preferential regimes so that such regimes would be found to require substantial activities where they grant benefits to a taxpayer to the extent that the taxpayer undertook the core income-generating activities required to produce the type of income covered by the preferential regime.

Improving transparency

In the area of transparency, a framework covering all rulings that could give rise to BEPS concerns in the absence of compulsory spontaneous exchange has been agreed. The framework covers six categories of rulings: (i) rulings related to preferential regimes; (ii) cross border unilateral advance pricing arrangements (APAs) or other unilateral transfer pricing rulings; (iii) rulings giving a downward adjustment to profits; (iv) permanent establishment (PE) rulings; (v) conduit rulings; and (vi) any other type of ruling where the FHTP agrees in the future that the absence of exchange would give rise to BEPS concerns. This does not mean that such rulings are *per se* preferential or that they will in themselves give rise to BEPS, but it does acknowledge that a lack of transparency in the operation of a regime or administrative process can give rise to mismatches in tax treatment and instances of double non-taxation. For countries which have the necessary legal basis, exchange of information under this framework will take place from 1 April 2016 for future rulings and the exchange of certain past rulings will need to be completed by 31 December 2016. The Report also sets out best practices for cross-border rulings.

Review of preferential regimes

A total of 43 preferential regimes have been reviewed, out of which 16 are IP regimes. The Report contains the results of the application of the existing factors in the 1998 Report, as well as the elaborated substantial activity and transparency factors, to the preferential regimes of members and associates. However, the elaborated substantial activity factor has so far only been applied to IP regimes. In respect of substantial activity the IP regimes reviewed were all considered inconsistent, either in whole or in part, with the nexus approach as described in this report. This reflects the fact that, unlike other aspects of the work on harmful tax practices, the details of this approach were only finalised during the BEPS Project while the regimes had been designed at an earlier point in time. Countries with such regimes will now proceed with a review of possible amendments of the relevant features of their regimes. The FHTP's work on reviewing preferential regimes will continue, recognising also that regimes that were assessed before the substantial activity requirement was elaborated may need to be reassessed.

Next steps

The elements of a strategy to engage with countries other than OECD Members and BEPS Associates in order to achieve a level playing field and avoid the risk that the work on harmful tax practices could displace regimes to third countries is outlined in the Report, together with the status of discussions on the revisions or additions to the existing framework. These aspects of the work will be taken forward in the context of the wider objective of designing a more inclusive framework to support and monitor the implementation of the BEPS measures.

An ongoing monitoring and review mechanism covering preferential regimes, including IP regimes, and the transparency framework has been agreed and will now be put in place.

Action 6

Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Action 6 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns.

Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues. Countries have therefore agreed to include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping. They also agree that some flexibility in the implementation of the minimum standard is required as these provisions need to be adapted to each country's specificities and to the circumstances of the negotiation of bilateral conventions.

Section A of this report includes new treaty anti-abuse rules that provide safeguards against the abuse of treaty provisions and offer a certain degree of flexibility regarding how to do so.

These new treaty anti-abuse rules first address treaty shopping, which involves strategies through which a person who is not a resident of a State attempts to obtain benefits that a tax treaty concluded by that State grants to residents of that State, for example by establishing a letterbox company in that State. The following approach is recommended to deal with these strategies:

- First, a clear statement that the States that enter into a tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements will be included in tax treaties (this recommendation is included in Section B of the report).
- Second, a specific anti-abuse rule, the limitation-on-benefits (LOB) rule, that limits the availability of treaty benefits to entities that meet certain conditions will be included in the OECD Model Tax Convention. These conditions, which are based on the legal nature, ownership in, and general activities of the entity, seek to ensure that there is a sufficient link between the entity and its State of residence. Such limitation-on-benefits provisions are currently found in treaties concluded by a few countries and have proven to be effective in preventing many forms of treaty shopping strategies.
- Third, in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule described above, a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or "PPT" rule) will be included in the

OECD Model Tax Convention. Under that rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.

Action 7

Preventing the Artificial Avoidance of Permanent Establishment 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 in that State a permanent establishment (PE) to which the profits are attributable. The definition of PE included in tax treaties is therefore crucial in determining whether a non-resident enterprise must pay income tax in another State.

The *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013a) called for a review of that definition to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition, such as arrangements through which taxpayers replace subsidiaries that traditionally acted as distributors by *commissionnaire* arrangements, with a resulting shift of profits out of the country where the sales took place without a substantive change in the functions performed in that country. Changes to the PE definition are also necessary to prevent the exploitation of the specific exceptions to the PE definition currently provided for by Art. 5(4) of the OECD Model Tax Convention (2014), an issue which is particularly relevant in the digital economy.

This report includes the changes that will be made to the definition of PE in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties, as a result of the work on Action 7 of the BEPS Action Plan.

Together with the changes to tax treaties proposed in the Report on Action 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, OECD, 2015a), the changes recommended in this report will restore taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates as result of the provisions of tax treaties. Taken together, these tax treaty changes will enable countries to address BEPS concerns resulting from tax treaties, which was a key focus of the work mandated by the BEPS Action Plan.

Artificial avoidance of PE status through *commissionnaire* arrangements and similar strategies

A *commissionnaire* arrangement may be loosely defined as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot

be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). A foreign enterprise that uses a *commissionnaire* arrangement does not have a permanent establishment because it is able to avoid the application of Art. 5(5) of the OECD Model Tax Convention, to the extent that the contracts concluded by the person acting as a *commissionnaire* are not binding on the foreign enterprise. Since Art. 5(5) relies on the formal conclusion of contracts in the name of the foreign enterprise, it is possible to avoid the application of that rule by changing the terms of contracts without material changes in the functions performed in a State. *Commissionnaire* arrangements have been a major preoccupation of tax administrations in many countries, as shown by a number of cases dealing with such arrangements that were litigated in OECD countries. In most of the cases that went to court, the tax administration's arguments were rejected.

Similar strategies that seek to avoid the application of Art. 5(5) involve situations where contracts which are substantially negotiated in a State are not formally concluded in that State because they are finalised or authorised abroad, or where the person that habitually exercises an authority to conclude contracts constitutes an "independent agent" to which the exception of Art. 5(6) applies even though it is closely related to the foreign enterprise on behalf of which it is acting.

As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business. The changes to Art. 5(5) and 5(6) and the detailed Commentary thereon that are included in section A of the report address *commissionnaire* arrangements and similar strategies by ensuring that the wording of these provisions better reflect this underlying policy.

Artificial avoidance of PE status through the specific exceptions in Art. 5(4)

When the exceptions to the definition of permanent establishment that are found in Art. 5(4) of the OECD Model Tax Convention were first introduced, the activities covered by these exceptions were generally considered to be of a preparatory or auxiliary nature.

Since the introduction of these exceptions, however, there have been dramatic changes in the way that business is conducted. This is outlined in detail in the Report on Action 1 (*Addressing the Tax Challenges of the Digital Economy*, OECD, 2015b). Depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities. In order to ensure that profits derived from core activities performed in a country can be taxed in that country, Article 5(4) is modified to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character. The modifications are found in section B of the report.

BEPS concerns related to Art. 5(4) also arise from what is typically referred to as the "fragmentation of activities". Given the ease with which multinational enterprises (MNEs) may alter their structures to obtain tax advantages, it is important to clarify that it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory

or auxiliary activities that benefit from the exceptions of Art. 5(4). The anti-fragmentation rule proposed in section B will address these BEPS concerns.

Other strategies for the artificial avoidance of PE status

The exception in Art. 5(3), which applies to construction sites, has given rise to abuses through the practice of splitting-up contracts between closely related enterprises. The Principal Purposes Test (PPT) rule that will be added to the OECD Model Tax Convention as a result of the adoption of the Report on Action 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*)¹ will address the BEPS concerns related to such abuses. In order to make this clear, the example put forward in section C of this report will be added to the Commentary on the PPT rule. For States that are unable to address the issue through domestic anti-abuse rules, a more automatic rule will be included in the Commentary as a provision that should be used in treaties that do not include the PPT or as an alternative provision to be used by countries specifically concerned with the splitting-up of contracts issue.

Follow-up, including on issues related to attribution of profits to PEs

The changes to the definition of PE that are included in this report will be among the changes proposed for inclusion in the multilateral instrument that will implement the results of the work on treaty issues mandated by the BEPS Action Plan.

Also, in order to provide greater certainty about the determination of profits to be attributed to the PEs that will result from the changes included in this report and to take account of the need for additional guidance on the issue of attribution of profits to PEs, follow-up work on attribution of profits issues related to Action 7 will be carried on with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument.

¹ See paragraph 14 of the Commentary on the PPT rule included in paragraph 26 of that Report.

Actions 8-10

Aligning Transfer Pricing Outcomes with Value Creation

Over several decades and in step with the globalisation of the economy, world-wide intra-group trade has grown exponentially. Transfer pricing rules, which are used for tax purposes, are concerned with determining the conditions, including the price, for transactions within an MNE group resulting in the allocation of profits to group companies in different countries. The impact of these rules has become more significant for business and tax administrations with the growth in the volume and value of intra-group trade. As the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) identified, the existing international standards for transfer pricing rules can be misapplied so that they result in outcomes in which the allocation of profits is not aligned with the economic activity that produced the profits. The work under Actions 8-10 of the BEPS Action Plan has targeted this issue, to ensure that transfer pricing outcomes are aligned with value creation.

The arm's length principle is used by countries as the cornerstone of transfer pricing rules. It is embedded in 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* (hereafter: "Transfer Pricing Guidelines") first published as the *Report on Transfer Pricing and Multinational Enterprises* in 1979, revised and published as *Guidelines* in 1995, with a further update in 2010. The principle requires that transactions between associated enterprises are priced as if the enterprises were independent, operating at arm's length and engaging in comparable transactions under similar conditions and economic circumstances. Where the conditions of the transaction are different to those between third parties in comparable circumstances, adjustments to the profits may be needed for tax purposes. The arm's length principle 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. However, with its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group. Therefore, the BEPS Action Plan required the guidance on the arm's length principle to be clarified and strengthened and, furthermore, if transfer pricing risks remain after clarifying and strengthening the guidance, the BEPS Action Plan foresaw the possibility of introducing special measures either within or beyond the arm's length principle.

This work on transfer pricing under the BEPS Action Plan has focused on three key areas. Work under Action 8 looked at transfer pricing issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting. Work under Action 9 considered the

contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. Work under Action 9 also addressed the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company. Work under Action 10 focused on other high-risk areas, including the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation), the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.

This Report contains revised guidance which responds to these issues and ensures that the transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them. It represents an agreement of the countries participating in the OECD/G20 BEPS Project. For countries that formally subscribe to the Transfer Pricing Guidelines, the guidance in this Report takes the form of amendments to the Transfer Pricing Guidelines. Therefore this Report also reflects how the changes will be incorporated in those Guidelines.²

To achieve this objective, the revised guidance requires careful delineation of the actual transaction between the associated enterprises by analysing the contractual relations between the parties in combination with the conduct of the parties. The conduct will supplement or replace the contractual arrangements if the contracts are incomplete or are not supported by the conduct. In combination with the proper application of pricing methods in a way that prevents the allocation of profits to locations where no contributions are made to these profits, this will lead to the allocation of profits to the enterprises that conduct the corresponding business activities. In circumstances where the transaction between associated enterprises lacks commercial rationality, the guidance continues to authorise the disregarding of the arrangement for transfer pricing purposes.

The revised guidance includes two important clarifications relating to risks and intangibles.

Risks are defined as the effect of uncertainty on the objectives of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return. This economic notion that higher risks warrant higher anticipated returns made MNE groups pursue tax planning strategies based on contractual re-allocations of risks, sometimes without any change in the business operations. In order to address this, the Report determines that risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, or does

² Brazil provides for an approach in its domestic legislation that makes use of fixed margins derived from industry practices and considers this in line with the arm's length principle. Brazil will continue to apply this approach and will use the guidance in this report in this context. When Brazil's Tax Treaties contain Article 9, paragraph 1 of the OECD and UN Model Tax Conventions and a case of double taxation arises that is captured by this Treaty provision, Brazil will provide access to MAP in line with the minimum standard of Action 14.

not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks.

For intangibles, the guidance clarifies that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions. Specific guidance will ensure that the analysis is not weakened by information asymmetries between the tax administration and the taxpayer in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement.

The revised guidance also addresses the situation where a capital-rich member of the group provides funding but performs few activities. If this associated enterprise does not in fact control the financial risks associated with its funding (for example because it just provides the money when it is asked to do so, without any assessment of whether the party receiving the money is creditworthy), then it will not be allocated the profits associated with the financial risks and will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies.

Finally, the guidance ensures that pricing methods will allocate profits to the most important economic activities. It will no longer be possible to allocate the synergistic benefits of operating as a group to members other than the ones contributing to such synergistic benefits. For example, discounts that are generated because of the volume of goods ordered by a combination of group companies will need to be allocated to these group companies. As part of the Report, a mandate is included for follow-up work to be done on the transactional profit split method, which will be carried out during 2016 and finalised in the first half of 2017. This work should lead to detailed guidance on the ways in which this method can usefully and appropriately be applied to align transfer pricing outcomes with value creation, including in the circumstances of integrated global value chains.

The guidance is linked in a holistic way with other Actions. As mentioned above, this guidance will ensure that capital-rich entities without any other relevant economic activities (“cash boxes”) will not be entitled to any excess profits. The profits the cash box is entitled to retain will be equivalent to no more than a risk-free return. Moreover, if this return qualifies as interest or an economically equivalent payment, then those already marginal profits will also be targeted by the interest deductibility rules of Action 4. In addition, it will become extremely difficult to structure the payments to the country where the cash box is tax-resident in a way that avoids withholding taxes, due to the guidance provided on preventing treaty abuse (Action 6). Finally, a cash box with limited or no economic activities is likely to be the target of CFC rules (Action 3). With that, the holistic approach provided by the BEPS Action Plan will secure that the role of cash boxes in BEPS strategies is seriously discouraged.

This holistic approach to tackling BEPS behaviour is supported by the transparency requirements agreed under Action 13. Transfer pricing analysis depends on access to relevant information. The access to the transfer pricing documentation provided by Action 13 will enable the guidance provided in this Report to be applied in practice, based on relevant information on global and local operations in the master file and local file. In addition, the Country-by-Country Report will enable better risk assessment

practices by providing information about the global allocation of the MNE group's revenues, profits, taxes, and economic activity.

In addition to improving access to relevant transfer pricing information through Action 13, this report also contains guidance on transactions involving commodities as well as on low value-adding intra-group services. As BEPS creates additional transfer pricing challenges for developing countries and these two areas were identified by them as being of critical importance, this guidance will be supplemented with further work mandated by the G20 Development Working Group, which will provide knowledge, best practices, and tools for developing countries to use to price commodity transactions for transfer pricing purposes and to prevent the erosion of their tax bases through common types of base-eroding payments.

Transfer pricing depends on a facts and circumstances analysis and can involve subjective interpretations of these facts and circumstances. In order to address the risk of double taxation, the work under Action 14 to improve the effectiveness of dispute resolution mechanisms includes a new minimum standard providing for access to the Mutual Agreement Procedure of Article 25 of the Model Tax Convention for all transfer pricing cases. In addition, the 20 countries which have made the commitment to mandatory binding arbitration under Action 14 have specified that they will allow access to arbitration for transfer pricing cases so that double taxation will be eliminated.

The work under Actions 8-10 of the BEPS Action Plan will ensure that transfer pricing outcomes better align with value creation of the MNE group. Moreover, the holistic nature of the BEPS Action Plan will ensure that the role of capital-rich, low-functioning entities in BEPS planning will become less relevant. As a consequence, the goals set by the BEPS Action Plan in relation to the development of transfer pricing rules have been achieved without the need to develop special measures outside the arm's length principle. Further work will be undertaken on profit splits and financial transactions. Special attention is given in the Report to the needs of developing countries. This new guidance will be supplemented with further work mandated by the G20 Development Working Group, following reports by the OECD on the impact of base erosion and profit shifting in developing countries. Finally, the interaction with Action 14 on dispute resolution will ensure that the transfer pricing measures included in this Report will not result in double taxation.

Action 11

Measuring and Monitoring BEPS

The adverse fiscal and economic impacts of base erosion and profit shifting (BEPS) have been the focus of the OECD/G20 BEPS Project since its inception. While anecdotal evidence has shown that tax planning activities of some multinational enterprises (MNEs) take advantage of the mismatches and gaps in the international tax rules, separating taxable profits from the underlying value-creating activity, the *Addressing Base Erosion and Profit Shifting* report (OECD, 2013) recognised that the scale of the negative global impacts on economic activity and government revenues have been uncertain.

Although measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, today we know that the fiscal effects of BEPS are significant. The findings of the work performed since 2013 highlight the magnitude of the issue, with global corporate income tax (CIT) revenue losses estimated between 4% and 10% of global CIT revenues, i.e. USD 100 to 240 billion annually. Given developing countries' greater reliance on CIT revenues, estimates of the impact on developing countries, as a percentage of GDP, are higher than for developed countries.

In addition to significant tax revenue losses, BEPS causes other adverse economic effects, including tilting the playing field in favour of tax-aggressive MNEs, exacerbating the corporate debt bias, misdirecting foreign direct investment, and reducing the financing of needed public infrastructure.

Six indicators of BEPS activity highlight BEPS behaviours using different sources of data, employing different metrics, and examining different BEPS channels. When combined and presented as a dashboard of indicators, they confirm the existence of BEPS, and its continued increase in scale in recent years.

- ***The profit rates of MNE affiliates located in lower-tax countries are higher than their group's average worldwide profit rate.*** For example, the profit rates reported by MNE affiliates located in lower-tax countries are twice as high as their group's worldwide profit rate on average.
- ***The effective tax rates paid by large MNE entities are estimated to be 4 to 8½ percentage points lower than similar enterprises with domestic-only operations,*** tilting the playing-field against local businesses and non-tax aggressive MNEs, although some of this may be due to MNEs' greater utilisation of available country tax preferences.
- ***Foreign direct investment (FDI) is increasingly concentrated.*** FDI in countries with net FDI to GDP ratios of more than 200% increased from 38 times higher than all other countries in 2005 to 99 times higher in 2012.

- ***The separation of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomenon has grown rapidly.*** For example, the ratio of the value of royalties received to spending on research and development in a group of low-tax countries was six times higher than the average ratio for all other countries, and has increased three-fold between 2009 and 2012. Royalties received by entities located in these low-tax countries accounted for 3% of total royalties, providing evidence of the existence of BEPS, though not a direct measurement of the scale of BEPS.
- ***Debt from both related and third-parties is more concentrated in MNE affiliates in higher statutory tax-rate countries.*** The interest-to-income ratio for affiliates of the largest global MNEs in higher-tax rate countries is almost three times higher than their MNE's worldwide third-party interest-to-income ratio.

Along with new empirical analysis of the fiscal and economic effects of BEPS and hundreds of existing empirical studies that find the existence of profit shifting through transfer mispricing, strategic location of intangibles and debt, as well as treaty abuse, these BEPS indicators confirm that profit shifting is occurring, is significant in scale and likely to be increasing, and creates adverse economic distortions. Furthermore, empirical analysis indicates that BEPS adversely affects competition between businesses, levels and location of debt, the location of intangible investments, and causes fiscal spillovers between countries and wasteful and inefficient expenditure of resources on tax engineering. The empirical analysis in this report, along with several academic studies, confirms that strong anti-avoidance rules reduce profit shifting in countries that have implemented them.

However, these indicators and all analyses of BEPS are severely constrained by the limitations of the currently available data. The available data is not comprehensive across countries or companies, and often does not include actual taxes paid. In addition to this, the analyses of profit shifting to date have found it difficult to separate the effects of BEPS from real economic factors and the effects of deliberate government tax policy choices. Improving the tools and data available to measure BEPS will be critical for measuring and monitoring BEPS in the future, as well as evaluating the impact of the countermeasures developed under the BEPS Action Plan.

While recognising the need to maintain appropriate safeguards to protect the confidentiality of taxpayer information, this report makes a number of recommendations that will improve the analysis of available data. Some of the information needed to improve the measurement and monitoring of BEPS is already collected by tax administrations, but not analysed or made available for analysis. The focus of the report's recommendations in this area is on improved access to and enhanced analysis of existing data, and new data proposed to be collected under Actions 5, 13 and, where implemented, Action 12 of the BEPS Project.

The report recommends that the OECD work with governments to report and analyse more corporate tax statistics and to present them in an internationally consistent way. For example, statistical analyses based upon Country-by-Country Reporting data have the potential to significantly enhance the economic analysis of BEPS. These improvements in the availability of data will ensure that governments and researchers will, in the future, be better able to measure and monitor BEPS and the actions taken to address BEPS.

Action 12

Mandatory Disclosure Rules

The lack of timely, comprehensive and relevant information on aggressive tax planning strategies is one of the main challenges faced by tax authorities worldwide. Early access to such information provides the opportunity to quickly respond to tax risks through informed risk assessment, audits, or changes to legislation or regulations. Action 12 of the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) recognised the benefits of tools designed to increase the information flow on tax risks to tax administrations and tax policy makers. It therefore called for recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules.

This Report provides a modular framework that enables countries without mandatory disclosure rules to design a regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes and their users. The recommendations in this Report do not represent a minimum standard and countries are free to choose whether or not to introduce mandatory disclosure regimes. Where a country wishes to adopt mandatory disclosure rules, the recommendations provide the necessary flexibility to balance a country's need for better and more timely information with the compliance burdens for taxpayers. The Report also sets out specific recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations.

Design principles and key objectives of a mandatory disclosure regime

Mandatory disclosure regimes should be clear and easy to understand, should balance additional compliance costs to taxpayers with the benefits obtained by the tax administration, should be effective in achieving their objectives, should accurately identify the schemes to be disclosed, should be flexible and dynamic enough to allow the tax administration to adjust the system to respond to new risks (or carve-out obsolete risks), and should ensure that information collected is used effectively.

The main objective of mandatory disclosure regimes is to increase transparency by providing the tax administration with early information regarding potentially aggressive or abusive tax planning schemes and to identify the promoters and users of those schemes. Another objective of mandatory disclosure regimes is deterrence: taxpayers may think twice about entering into a scheme if it has to be disclosed. Pressure is also placed on the tax avoidance market as promoters and users only have a limited opportunity to implement schemes before they are closed down.

Mandatory disclosure regimes both complement and differ from other types of reporting and disclosure obligations, such as co-operative compliance programmes, in that they are specifically designed to detect tax planning schemes that exploit vulnerabilities in the tax system, while also providing tax administrations with the flexibility to choose thresholds, hallmarks and filters to target transactions of particular interest and perceived areas of risk.

Key design features of a mandatory disclosure regime

In order to successfully design an effective mandatory disclosure regime, the following features need to be considered: who reports, what information to report, when the information has to be reported, and the consequences of non-reporting. In relation to the above design features, the Report recommends that countries introducing mandatory disclosure regimes:

- impose a disclosure obligation on both the promoter and the taxpayer, or impose the primary obligation to disclose on either the promoter or the taxpayer;
- include a mixture of specific and generic hallmarks, the existence of each of them triggering a requirement for disclosure. Generic hallmarks target features that are common to promoted schemes, such as the requirement for confidentiality or the payment of a premium fee. Specific hallmarks target particular areas of concern such as losses;
- establish a mechanism to track disclosures and link disclosures made by promoters and clients as identifying scheme users is also an essential part of any mandatory disclosure regime. Existing regimes identify these through the use of scheme reference numbers and/or by obliging the promoter to provide a list of clients. Where a country places the primary reporting obligation on a promoter, it is recommended that they also introduce scheme reference numbers and require, where domestic law allows, the production of client lists;
- link the timeframe for disclosure to the scheme being made available to taxpayers when the obligation to disclose is imposed on the promoter; link it to the implementation of the scheme when the obligation to disclose is imposed on the taxpayer;
- introduce penalties (including non-monetary penalties) to ensure compliance with mandatory disclosure regimes that are consistent with their general domestic law.

Coverage of international tax schemes

There are a number of differences between domestic and cross-border schemes that make the latter more difficult to target with mandatory disclosure regimes. International schemes are more likely to be specifically designed for a particular taxpayer or transaction and may involve multiple parties and tax benefits in different jurisdictions, which can make these schemes more difficult to target with domestic hallmarks. In order to overcome these difficulties, the Report recommends that:

- Countries develop hallmarks that focus on the type of cross-border BEPS outcomes that cause them concern. An arrangement or scheme that incorporates such a cross-border outcome would only be required to be disclosed, however, if that arrangement includes a transaction with a domestic taxpayer that has material

tax consequences in the reporting country and the domestic taxpayer was aware or ought to have been aware of the cross-border outcome.

- Taxpayers that enter into intra-group transactions with material tax consequences are obliged to make reasonable enquiries as to whether the transaction forms part of an arrangement that includes a cross-border outcome that is specifically identified as reportable under their home jurisdictions' mandatory disclosure regime.

The application of these recommendations is illustrated in the Report with an example dealing with an imported hybrid mismatch arrangement of the type covered in the 2015 OECD/G20 BEPS report *Neutralising the Effects of Hybrid Mismatch Arrangements* (OECD, 2015).

Enhancing information sharing

Transparency is one of the three pillars of the OECD/G20 BEPS Project and a number of measures developed in the course of the Project will give rise to additional information being shared with, or between, tax administrations. The expanded Joint International Tax Shelter Information and Collaboration Network (JITSIC Network) of the OECD Forum on Tax Administration provides an international platform for an enhanced co-operation and collaboration between tax administrations, based on existing legal instruments, which could include co-operation on information obtained by participating countries under mandatory disclosure regimes.

Action 13

Transfer Pricing Documentation and Country-by-Country Reporting

This report contains revised standards for transfer pricing documentation and a template for Country-by-Country Reporting of income, taxes paid and certain measures of economic activity.

Action 13 of the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) requires the development of “*rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template*”.

In response to this requirement, a three-tiered standardised approach to transfer pricing documentation has been developed.

First, the guidance on transfer pricing documentation requires multinational enterprises (MNEs) to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a “master file” that is to be available to all relevant tax administrations.

Second, it requires that detailed transactional transfer pricing documentation be provided in a “local file” specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company’s analysis of the transfer pricing determinations they have made with regard to those transactions.

Third, large MNEs are required to file a Country-by-Country Report that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs 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 engages in.

Taken together, these three documents (master file, local file and Country-by-Country Report) will require taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries. This information should make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments. The

countries participating in the BEPS project agree that these new reporting provisions, and the transparency they will encourage, will contribute to the objective of understanding, controlling, and tackling BEPS behaviours.

The specific content of the various documents reflects an effort to balance tax administration information needs, concerns about inappropriate use of the information, and the compliance costs and burdens imposed on business. Some countries would strike that balance in a different way by requiring reporting in the Country-by-Country Report of additional transactional data (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) regarding related party interest payments, royalty payments and especially related party service fees. Countries expressing this view are primarily those from emerging markets (Argentina, Brazil, People's Republic of China, Colombia, India, Mexico, South Africa, and Turkey) who state they need such information to perform risk assessment and who find it challenging to obtain information on the global operations of an MNE group headquartered elsewhere. Other countries expressed support for the way in which the balance has been struck in this document. Taking all these views into account, it is mandated that countries participating in the BEPS project will carefully review the implementation of these new standards and will reassess no later than the end of 2020 whether modifications to the content of these reports should be made to require reporting of additional or different data.

Consistent and effective implementation of the transfer pricing documentation standards and in particular of the Country-by-Country Report is essential. Therefore, countries participating in the OECD/G20 BEPS Project agreed on the core elements of the implementation of transfer pricing documentation and Country-by-Country Reporting. This agreement calls for the master file and the local file to be delivered by MNEs directly to local tax administrations. Country-by-Country 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 such as the multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties or tax information exchange agreements (TIEAs). In limited circumstances, secondary mechanisms, including local filing can be used as a backup.

These new Country-by-Country Reporting requirements are to be implemented for fiscal years beginning on or after 1 January 2016 and apply, subject to the 2020 review, to MNEs with annual consolidated group revenue equal to or exceeding EUR 750 million. It is acknowledged that some jurisdictions may need time to follow their particular domestic legislative process in order to make necessary adjustments to the law.

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 Country-by-Country 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 with a view to accommodating the electronic exchange of Country-by-Country Reports.

It is recognised that the need for more effective dispute resolution may increase as a result of the enhanced risk assessment capability following the adoption and implementation of a Country-by-Country Reporting requirement. This need has been

addressed when designing government-to-government mechanisms to be used to facilitate the automatic exchange of Country-by-Country Reports.

Jurisdictions endeavour to introduce, as necessary, domestic legislation in a timely manner. They are also encouraged to expand the coverage of their international agreements for exchange of information. Mechanisms will be developed to monitor jurisdictions' compliance with their commitments and to monitor the effectiveness of the filing and dissemination mechanisms. The outcomes of this monitoring will be taken into consideration in the 2020 review.

Action 14

Making Dispute Resolution Mechanisms More Effective

Eliminating opportunities for cross-border tax avoidance and evasion and the effective and efficient prevention of double taxation are critical to building an international tax system that supports economic growth and a resilient global economy. Countries agree that the introduction of the measures developed to address base erosion and profit shifting pursuant to the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) should not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation. Improving dispute resolution mechanisms is therefore an integral component of the work on BEPS issues.

Article 25 of the OECD Model Tax Convention (OECD, 2014) provides a mechanism, independent from the ordinary legal remedies available under domestic law, through which the competent authorities of the Contracting States may resolve differences or difficulties regarding the interpretation or application of the Convention on a mutually-agreed basis. This mechanism – the mutual agreement procedure (MAP) – is of fundamental importance to the proper application and interpretation of tax treaties, notably to ensure that taxpayers entitled to the benefits of the treaty are not subject to taxation by either of the Contracting States which is not in accordance with the terms of the treaty.

The measures developed under Action 14 of the BEPS Action Plan aim to strengthen the effectiveness and efficiency of the MAP process. They aim to minimise the risks of uncertainty and unintended double taxation by ensuring the consistent and proper implementation of tax treaties, including the effective and timely resolution of disputes regarding their interpretation or application through the mutual agreement procedure. These measures are underpinned by a strong political commitment to the effective and timely resolution of disputes through the mutual agreement procedure and to further progress to rapidly resolve disputes.

Through the adoption of this Report, countries have agreed to important changes in their approach to dispute resolution, in particular by having developed a minimum standard with respect to the resolution of treaty-related disputes, committed to its rapid implementation and agreed to ensure its effective implementation through the establishment of a robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20. The minimum standard will:

- Ensure that treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that MAP cases are resolved in a timely manner;
- Ensure the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and
- Ensure that taxpayers can access the MAP when eligible.

The minimum standard is complemented by a set of best practices. The monitoring of the implementation of the minimum standard will be carried out pursuant to detailed terms of reference and an assessment methodology to be developed in the context of the OECD/G20 BEPS Project in 2016.

In addition to the commitment to implement the minimum standard by all countries adhering to the outcomes of the BEPS Project, the following countries have declared their commitment to provide for mandatory binding MAP arbitration in their bilateral tax treaties as a mechanism to guarantee that treaty-related disputes will be resolved within a specified timeframe: Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States.³ This represents a major step forward as together these countries were involved in more than 90 percent of outstanding MAP cases at the end of 2013, as reported to the OECD.⁴

3. The Leaders' Declaration issued following the 7-8 June 2015 G7 Summit (available at www.g7germany.de/Content/DE/Anlagen/G8_G20/2015-06-08-g7-abschluss-eng.pdf?_blob=publicationFile) contained the following statement regarding MAP arbitration:

Moreover, we will strive to improve existing international information networks and cross-border cooperation on tax matters, including through a commitment to establish binding mandatory arbitration in order to ensure that the risk of double taxation does not act as a barrier to cross-border trade and investment. We support work done on binding arbitration as part of the BEPS project and we encourage others to join us in this important endeavour.

4. See www.oecd.org/ctp/dispute/map-statistics-2013.htm.

Action 15

Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

The endorsement of the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) by the Leaders of the G20 in Saint-Petersburg in September 2013 shows unprecedented political support to adapt the current international tax system to the challenges of globalisation. Tax treaties are based on a set of common principles designed to eliminate double taxation that may occur in the case of cross-border trade and investments. The current network of bilateral tax treaties dates back to the 1920s and the first soft law Model Tax Convention developed by the League of Nations. The Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN) have subsequently updated model tax conventions based on that work. The contents of those model tax conventions are reflected in thousands of bilateral agreements among jurisdictions.

Globalisation has exacerbated the impact of gaps and frictions among different countries' tax systems. As a result, some features of the current bilateral tax treaty system facilitate base erosion and profit shifting (BEPS) and need to be addressed. Beyond the challenges faced by the current tax treaty system on substance, the sheer number of bilateral treaties makes updating the current tax treaty network highly burdensome. Even where a change to the OECD Model Tax Convention is consensual, it takes a substantial amount of time and resources to introduce it into most bilateral tax treaties. As a result, the current network is not well-synchronised with the model tax conventions, and issues that arise over time cannot be addressed swiftly. Without a mechanism to swiftly implement them, changes to models only make the gap between the content of the models and the content of actual tax treaties wider. This clearly contradicts the political objective to strengthen the current system by putting an end to BEPS, in part by modifying the bilateral treaty network. Doing so is necessary not only to tackle BEPS, but also to ensure the sustainability of the consensual framework to eliminate double taxation. For this reason, governments have agreed to explore the feasibility of a multilateral instrument that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.

Action 15 of the BEPS Action Plan provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable countries that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested countries will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution. The goal of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures. This is an innovative approach with no exact precedent in the tax world, but precedents for

modifying bilateral treaties with a multilateral instrument exist in various other areas of public international law. Drawing on the expertise of public international law and tax experts, the 2014 Report, which is reproduced hereafter, explored the technical feasibility of a multilateral hard law approach and its consequences on the current tax treaty system. It identified the issues arising from the development of such an instrument and provided an analysis of the international tax, public international law, and political issues that arise from such an approach.

The 2014 Report also concluded that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly. Based on this analysis, a mandate for the formation of an ad hoc Group (“the Group”) to develop a multilateral instrument on tax treaty measures to tackle BEPS, which is reproduced hereafter, was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015. The Group is open to participation from all interested countries on an equal footing and is served by the OECD Secretariat. The Group began its work in May 2015 with the aim to conclude its work and open the multilateral instrument for signature by 31 December 2016. Participation in the development of the multilateral instrument is voluntary and does not entail any commitments to sign such instrument once it has been finalised.

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