

The OECD's 3 Major Tax Initiatives

1. The Global Forum on Transparency and Exchange of Information for Tax Purposes

- Peer review of ~ 100 countries
- International standard for transparency and exchange of information

2. The Global Model for Automatic Exchange of Information: Common Reporting Standards ("CRS")

- Standardized multilateral approach based on FATCA Model 1 IGA (intergovernmental agreement)

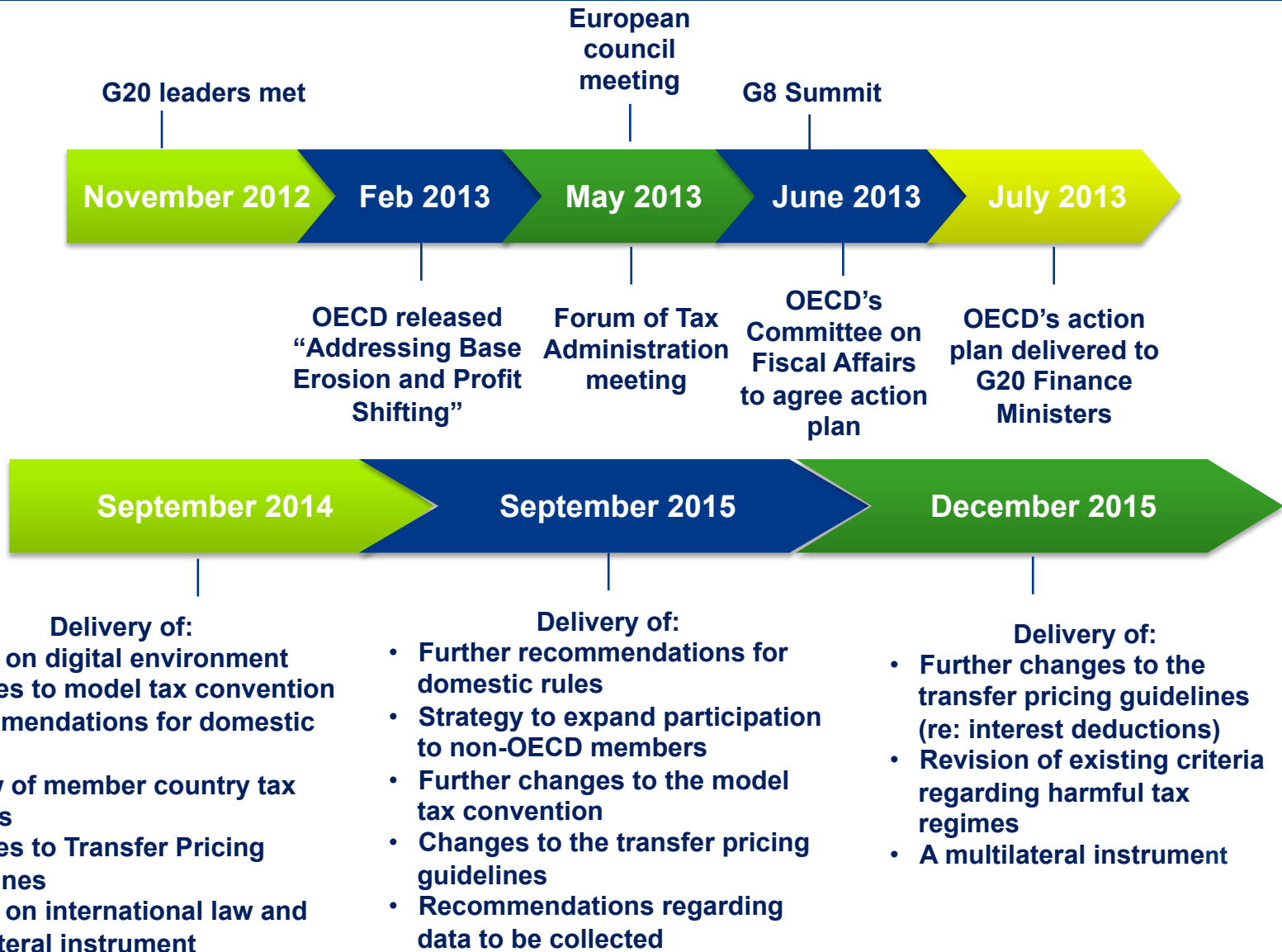
3. Base Erosion and Profit Shifting ("BEPS")

- These initiatives have the strong support of the G-20
- Each initiative will likely have significant implications for financial institutions

Background of BEPS Initiative

- **Political and media focus on tax strategies by multinational enterprises (“MNEs”) to minimize their tax burden:**
 - Governmental and press reports highlighting sophisticated techniques of many MNEs to avoid taxes (“double Irish,” “Dutch sandwich” structures, ...)
 - “Name and Shame” trend in the press and governmental hearings focusing on low worldwide effective tax rates of MNEs, especially in technology and pharmaceutical industries (e.g., in Britain, Germany, US)
- **The OECD (with the support of the G-20) has embarked on a project to address base erosion and profits shifting (“BEPS”) by multinational groups. This project is seeking to develop a harmonized multilateral approach to deal with:**
 - Base erosion through the use of arrangements to generate “stateless income” that is not subject to meaningful taxation in any jurisdiction.
 - Profit-shifting from high-tax to low-tax jurisdictions through the transfer of intangibles, transfer pricing, cost-sharing agreements, commissionaire and risk assumption arrangements, etc.
 - Strategies that make it possible to derive very substantial revenues from a country without maintaining a traditional taxable presence there.

BEPS History and Timeline



OECD Action Plan on BEPS

- **OECD Action Plan**

- Committee on Fiscal Affairs – Action Plan published July 30, 2013
- Secretary-General Report to the G20 Leaders for September 5-6, 2013 meeting
- 15 actions to address BEPS
- Ambitious implementation timeline
- Ultimate outcome unclear, but at least some important changes likely

- **Action Items 1-5: Establishing international coherence of corporate income taxation**

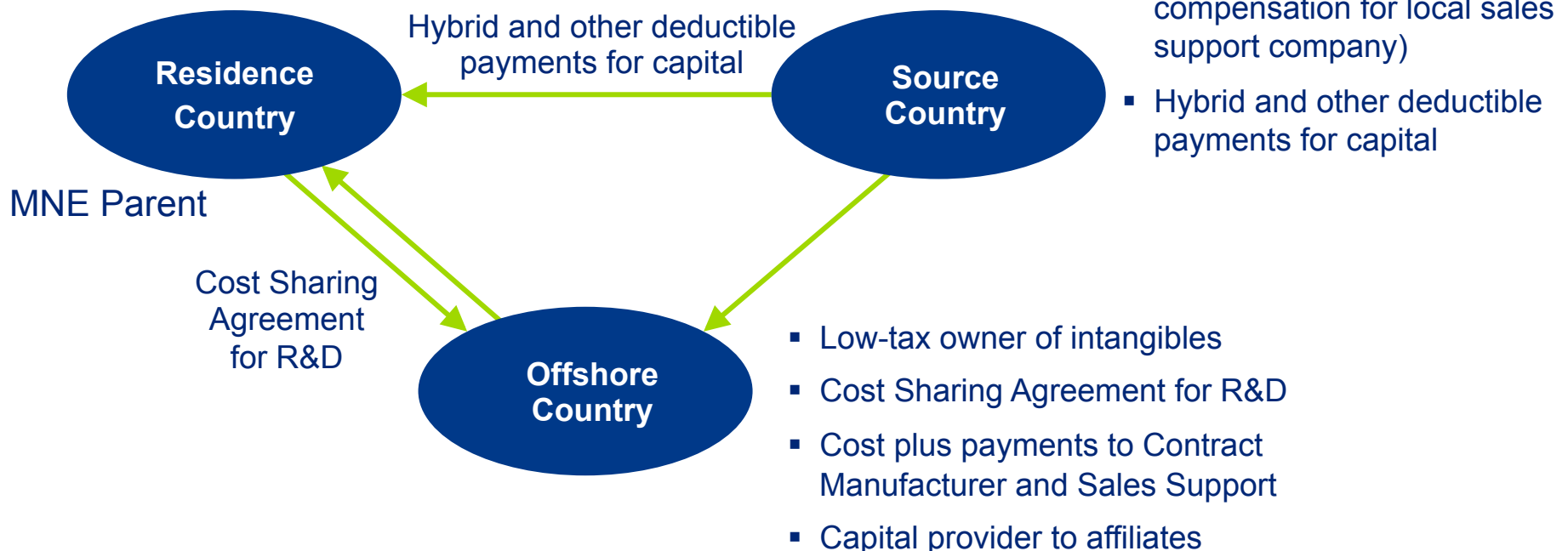
1. Address the tax challenges of the digital economy. March 2014 draft report on the digital economy and BEPS challenges that it presents, including sourcing and nexus issues, and effective collection of VAT/GST on cross-border supply.
2. Neutralize the effects of hybrid mismatch arrangements. March 2014 draft report. Changes focused on treaty relationships and domestic law.
3. Strengthen CFC (controlled foreign corporation) rules. Recommend best practices for domestic law.
4. Limit base erosion via interest deductions and other financial payments. OECD intends to provide best practice recommendations, and develop transfer pricing guidance for financial transactions.
5. Counter harmful tax practices more effectively, taking into account substance and transparency (including compulsory spontaneous exchange on rulings relating to preferential regimes, and requiring substantial activity for any preferential regime).

OECD Action Plan on BEPS (cont'd)

- **Action Items 6-10: Restoring the full effects and benefits of international standards; aligning taxation with substance**
 6. Prevent treaty abuse. April 2014 draft report. Clarify model treaty rules to ensure no double non-taxation. Coordinate with work on hybrids. Strengthen LOB (limitation on benefits) clauses.
 7. Prevent the artificial avoidance of PE (permanent establishment) status. Develop changes to PE definition. Commissionaire arrangements expected to be a focus.
 - 8-10. Assure that transfer pricing outcomes are in line with value creation (intangibles, risk and capital, other high-risk transactions).
- **Action Items 11-15: Ensuring transparency while promoting increased certainty and predictability**
 11. Collect and analyze data.
 12. Require taxpayers to disclose aggressive tax planning arrangements. Focus on international tax schemes, and recommendations on domestic rules.
 13. Re-examine transfer pricing documentation. Potential to develop a common template to require multinationals to provide all relevant governments with more global information. Jan. 2014 draft report on country-by-country reporting.
 14. Make dispute resolution mechanisms more effective.
 15. Develop a multilateral instrument to amend income tax treaties *en masse*.

A 3-Country Tug-of-War: Source vs. Offshore Country of Residence

- **Much of BEPS is about Residence and Source countries seeking to revise tax rules that allow Offshore country to capture a large share of MNE's profits**
 - Offshore country: typically, a low-tax country in which MNE subsidiary owns intangibles, provides capital, takes risks
- **But also potentially an effort by Source country to assert broader taxing jurisdiction vs. Residence country**
 - US Treasury generally resisting such efforts



The PE Concept – Pulling Towards Greater Source Country Taxation (Action Items 1 and 7)

- **Are e-commerce and the digital economy (sufficiently) different so as to warrant revising the PE rules?**
- **Will the discussions expand to service PEs, dependent agent PEs?**
 - Commissionaire arrangements
 - Distinction between dependent and independent agents?
 - Exempted preparatory or auxiliary activities
- **Developed vs. emerging countries: bridging the different perspectives**
- **Possible implications for financial institutions:**
 - Possible changes in scope of “dependent agent” PEs?
 - Electronic banking?

Strengthening CFC Rules–Pulling Toward Greater Residence Country Taxation (Action Item 3)

- **To what extent is the intention to direct Residence countries to assert taxing jurisdiction (“use it or lose it”) vs. simply providing tools and guidance as to international “best practices” for doing so?**
- **Possible implications for financial institutions:**
 - Many countries have weak CFC rules, facilitate generation of profits in low-tax jurisdictions

Pulling Away From Offshore Country Tax Jurisdiction Over Profits (Action Items 5, 6, 8-10)

- **Assuring that transfer pricing outcomes are in line with value creation (dealing with intangibles, risks and capital, other intercompany payments; Items 8–10):**
 - These items seem to depart to one extent or another from arm's length transfer pricing standards (the Action Plan contemplates “special measures, either within or beyond the arm's length principle”): Are these controversial items a concession that the arm's length standard isn't working?
 - Item 8, regarding ownership of intangibles, contemplates that profits would be allocated “in accordance with value creation”: What does that mean? How to reconcile with ownership and exploitation of intangibles by Offshore country? Offshore countries: How does this fit with OECD Transfer Pricing Guidelines and Report on Attribution of Profits to PEs, as well as US tax rules (section 482 and proposed 475 risk transfer agreement regulations)? Similar question re: Item 10 concern regarding management fees and head office expenses

- **Possible implications for financial institutions:**
 - Potential tension with OECD Report on Attribution of Profits to PEs?
 - Management fees, head office expenses?

Pulling Away From Offshore Country Tax Jurisdiction Over Profits (Action Items 5, 6, 8-10) (cont'd)

- **Counter harmful tax practices – resisting the “race to the bottom” (Item 5)**
 - Re: compulsory spontaneous exchange on rulings relating to preferential regimes, note that EU Commission has begun inquiries of Gibraltar, Ireland, The Netherlands and Luxembourg regarding possibly unlawful State Aid through favorable tax rulings.
 - Broader challenge to low tax rates or favorable regimes (e.g., UK patent box) seems more complicated politically.

- **Prevent treaty abuse that results in double non-taxation (Item 6)**
 - Traditional tension between specific technical rules (e.g., LOB provisions) and general anti-abuse principles.

- **Possible implications for financial institutions:**
 - Reduced flexibility to use treaty networks, conduit arrangements?

Targeting Arbitrage and Deductible Payments (Action Items 2, 4)

- Hybrid instruments and entities (Item 2)
- Interest deductions and other financial payments (Item 4)
- Potentially significant implications for financial institutions; see discussion below

Actions Relating to Process (Action Items 11 – 15)

- **Disclosure, transparency and exchange proposals generally to be expected**
 - Jan. 2014 draft report
 - Industry concerned about burdens; would be particularly averse to public disclosure of country-by-country financial and tax information

- **Multilateral instrument (Item 15) is a very interesting idea – How will it work and will it be legally effective?**

BEPS Action 2 – Neutralize the Effect of Hybrid Mismatch Arrangements

OECD action plan focus:

- **Domestic law changes to ensure matching tax treatment of cross-border payments, namely:**
 - No dividend exemption for payments that are deductible by the payor under foreign law;
 - No deduction for payments that are not included in taxable income of the recipient under foreign law;
 - No deduction for payments that are deductible in another country; and
 - Coordination rules to prevent double taxation, if more than one country seeks to apply an anti-hybrid rule to the same payment.

Report will be presented to the G20 finance ministers in September 2014

Hybrid Mismatches (continued)

- **OECD discussion drafts and consultations, March-May 2014**
- **Proposed rules would cover structured transactions (yet to be defined), and related-party transactions**
- **Issues:**
 - Definition of hybrid financial instrument
 - Scope
 - Top-down vs. bottom-up approach
 - Debt vs equity only, or potentially broader (e.g., insurance premiums, service fees)?
 - Is income inclusion with indirect foreign tax credit the same as exemption?
 - Timing and rate arbitrage are not covered

Hybrid Mismatch Issues (continued)

- **Definition of related party**

- Discussion Draft said 10%+ ownership; commentators argued for 50%+; compromise 25% test is likely for hybrid instruments
- 50+% test is likely for hybrid entity payments

- **Suggested carveouts**

- Hybrid regulatory capital instruments
 - UK Treasury is leading an effort to craft a safe harbor for related-party instruments attributable to an external issuance of hybrid instruments by a single point of entry
- Repos and stock loans
 - Unclear whether consensus will be reached on a safe harbor for related-party transactions in the ordinary course of business
- Collective investment vehicles
 - Suggested exemption from related-party rule, given low risk of tax motivation and difficulty of compliance

Preventing Treaty Abuse

- **Discussion draft on Treaty Abuse published 03/14/2014**
- **The concern which should be addressed by this Action is the abusive use of treaties, and, in particular, treaty shopping**
- **There are 3 parts to the discussion draft:**
 - A. Suggested treaty rules and/or domestic rules to prevent the granting of treaty benefits in inappropriate circumstances
 - B. Clarification that tax treaties are not intended to be used to generate double non-taxation
 - C. Tax policy considerations that countries should consider before entering into a tax treaty with another country
- **Of most interest are the suggestions under part A:**
 - A limitation on benefits (“LOB”) provision to be included in the OECD Model treaty, similar to the provision in the US Model treaty
 - An explicit anti-avoidance rule in treaties looking at the purpose of the transaction
 - Removal of the effective management tie-breaker in the residence article, so the competent authority must be referred to in the case of any residency dispute

Preventing Treaty Abuse

▪ Application to Financial Services Business:

- The practical impact of a main purpose test on a withholding tax; use of a treaty is clearly tax motivated; how much is necessary to rebut a challenge under the main purpose test?
 - While not likely to be adopted by the United States, the impact is in the application of treaty benefits to financing of lower tier subsidiaries.
 - In a withholding context, treaty benefits should not be subject to a subjective main purpose test; certainty is required.

➤ **LOB restrictions:**

- U.S. has extensive LOB provisions
- Likely to have the most impact in the application of treaties to payments made between lower tier subsidiaries

International Tax and the Digital Economy

The evolution of business models in general, and growth of digital ways of doing business have resulted in multinational companies operating in a fundamentally different manner today than at the time international tax rules were designed

Four main policy challenges

Nexus	The continual increase in the potential of digital technologies and the reduced need for extensive physical presence in order to carry on business.
Data	The issue of how to attribute value created from the generation of data through digital products and services, and how to characterise for tax purposes.
Characterisation	The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models.
VAT collection	Cross-border trade in both goods and services creates challenges for VAT systems. In particular imports of low-value parcels from online sales and cross-border supplies of remotely delivered digital services.

OECD Discussion Draft - Digital Economy

- Discussion draft on Digital released on 03/24/2014
- Challenges of this area are Nexus, data, characterization and VAT
- Discussion draft notes the difficulty of separating “Digital” businesses from traditional businesses
- **The solution to the “digital” problem mostly likely lies in the other areas of focus of the BEPS working groups.**
 - PE definition work will be key - potential changes to dependent agent and removal of certain PE exemptions could mean more digital businesses have a PE in future than today
 - Interest deductibility work is likely to affect how digital businesses can tax-effectively fund their operations
 - Changes regarding countering harmful tax practices could disproportionately impact digital companies (e.g., if preferential IP regimes are more closely scrutinised or removed)
 - Transfer pricing changes, especially regarding how value is attributed to IP, and changes to CFC rules could have a significant impact on digital companies
- **Changes to domestic law or treaties in relation to these actions could mean that digital businesses have:**
 - a) a taxable presence in the future in countries where they do not have a taxable presence today; and/or
 - b) potentially a need to allocate more taxable profit to territories in which they currently only recognize a low amount of profit

Digital Economy (cont'd)

- **Greater visibility, due to Country by Country reporting, may also lead to more enquiries as Tax Authorities identify where staff are located and turnover is being recorded compared to where customers are located.**
- **Additional options specifically to deal with digital issues have been put forward but no conclusions reached. Options include:**
 - Creation of a PE where there is “significant digital presence” even where there are no people activities
 - A “virtual PE” concept
 - A withholding tax on payments made for digital goods or services
 - Lowering the threshold for import duties and requiring all to register for VAT in the jurisdiction of importation
- **Next steps: Finalization intended to be in September 2014**

- **Impact to Financial Services Business Models**
 - Credit card fees – will this impact sourcing for fees?
 - Mobile trading services – where does the trading occur? Customer? Exchange? How transparent is the exchange? How should the source and location of the trading platform be determined? Where should the related commissions be booked?
 - Impact of related financial services that are provided in a remote digital context

Appendix

OECD Action Plan

Action Item	Description	Timing
Action 1 - Address the tax challenges of a digital economy	<ul style="list-style-type: none"> • The ability to have a significant digital presence without being liable to tax • The attribution of value from the generation of marketable location-relevant data • Characterisation of income • Application of related source rules 	September 2014
Action 2 - Neutralize the effects of hybrid mismatch arrangements	<ul style="list-style-type: none"> • Hybrid entities and hybrid instruments that result in deductions without inclusions in income 	September 2014
Action 3 - Strengthen CFC rules	<ul style="list-style-type: none"> • Creating affiliated non-resident taxpayers and routing income of a resident enterprise through the non-resident affiliate 	September 2015
Action 4 – Limit base erosion via interest deductions	<ul style="list-style-type: none"> • Design rules to prevent base erosion through the use of related and non-related party debt to achieve excessive deductions or generate exempt income 	September 2015 & December 2015
Action 5 – Counter harmful tax practices	<ul style="list-style-type: none"> • The OECD will revamp the work on harmful tax practices with a priority on improving transparency, including compulsory exchange on rulings related to preferential regimes and on requiring substantial activity for any preferential regime 	September 2014, September 2015 & December 2015

OECD Action Plan

Action Item	Description	Timing
Action 6 – Prevent treaty abuse	<ul style="list-style-type: none"> • Clarify that treaties are not intended to create double non-taxation • Identify tax policy issues that countries should consider before entering into a tax treaty 	September 2014
Action 7 – Prevent the artificial avoidance of PE status	<ul style="list-style-type: none"> • Broaden the definition of PE to include commissionaire relationships and limit specific exemptions such as the exemption for preparatory and auxiliary activities 	September 2015
Actions 8, 9 and 10 – Assure that transfer pricing outcomes are in-line with value creation	<ul style="list-style-type: none"> • Develop rules with respect to IP • Develop rules that to not inure benefits solely to contractually assumed risks or provided capital. • Restrict benefits of transactions that would not occur between third parties 	September 2014, September 2015
Action 11 – Establish methodologies to collect and analyze data on BEPS	<ul style="list-style-type: none"> • Identify whether BEPS is occurring and if so, to what extent is it occurring 	September 2015

OECD Action Plan

Action Item	Description	Timing
Action 12 – Require taxpayers to disclose their aggressive tax planning	<ul style="list-style-type: none"> • Design mandatory disclosure rules for aggressive or abusive transactions, arrangements or structures • Create models for sharing of tax schemes between authorities 	September 2015
Action 13 – Re-examine transfer pricing documentation	<ul style="list-style-type: none"> • Design rules that require multinational entities to provide all relevant governments with information on their global allocation of income, economic activity and taxes paid among countries 	September 2014
Action 14 – Make dispute resolution mechanisms more effective	<ul style="list-style-type: none"> • Develop solutions that enable countries to solve treaty related disputes under MAP • Include arbitration provisions in treaties 	September 2015
Action 15 – Develop a multilateral instrument	<ul style="list-style-type: none"> • Analyze tax and international law issues related to the development of a multilateral instrument to enable jurisdiction to implement the measures developed in the course of the work on BEPS and amend tax treaties • Interested parties will then develop the instrument 	September 2014 & September 2015