CHAPMAN TRIPP

brief counsel

TAX

2 OCTOBER 2014

The BEPS Project – OECD keeps tax reform pot boiling

The OECD led Base Erosion and Profit Shifting (*BEPS*) Project is aimed at updating corporate tax systems around the world to reduce the tax minimisation opportunities created by the global economy.

If the Project is successful, all countries will be required to make significant changes to their domestic tax law and treaty networks with the aim of ensuring that multi-national businesses are paying their "fair share" of the income tax burden.

Background

The BEPS Project originated in 2012/13 as a response by European governments to two legacies of the GFC: a dramatic worsening of their public finances, and public hostility to the financial sector and, to a lesser extent, the general business sector for the economic disruption the GFC caused and continues to cause – particularly in Europe.

Although the GFC provided the ignition, the fuel for the BEPS Project is the inability of nationally focused income tax and GST systems to deal with globalisation.

The US FATCA initiative implemented in July this year is just a small taste of what governments need to do to ensure that they can still collect income tax in a world where cross-border investment is an ordinary part of economic activity for a greater and greater percentage of the population, both in the private and business sectors.

The BEPS Project has at least two features which mean it has to be taken seriously.

- **A high level of political buy-in.** Although the technical work is being done by the OECD, the Project is being undertaken at the request of the G20. Between them, the OECD and the G20 comprise 44 countries, estimated to make up around 90% of the world economy.

- **A comprehensive agenda.** The BEPS Project has 15 action points. Reports on seven of these were approved at the Cairns G20 meeting on 19 and 20 September. The remaining eight will be reported on by December 2015. Although that may sound like a leisurely timetable, achieving consensus on fundamental tax issues among so many countries will be a major achievement. Assuming a majority of the recommendations are adopted, the BEPS Project could prove just as influential as the work of the League of Nations in the 1920s, which led to the emergence of bilateral tax treaties as the dominant international income tax co-ordination mechanism.

Global tax challenges

Bilateral tax treaties were designed to address the risk of double taxation when residents of one state derive income from another (the source or market state). In double tax agreements, countries agree the principles that determine when and how much the source state can tax, and how the residence state will give relief for the tax so imposed (by exempting the income or giving a credit).

But, while tax treaties have been very successful in solving this problem, changes in technology and the economic landscape over the past 100 years pose some new challenges, and reshape some of the old ones. Perhaps the most significant issues are:

- the rise and rise of multi-national, vertically integrated companies, with operations dispersed around the world. These are problematic because it is difficult to determine how much of their global income should be attributed for tax purposes to the different countries in which they operate. There is also a risk that some of that income may slip between the cracks. This is often conceptualised as a problem of transfer pricing, though there are other approaches that can be taken to solving it
- increased mobility of just about everything. This makes it easier for companies to play countries off against each other – if the tax regime where they are operating does not measure up to what is on offer elsewhere, they can simply move
- the importance of intangibles. This is an extreme example of mobility. Moving the ownership of intangibles, which are often the jewels in a multi-national enterprise's crown, to a tax haven can be little more than a paper shuffling exercise, yet can produce a massive shift in the location and taxation of income
- hybrid mismatch arrangements. The problem here arises from differences in the ways domestic tax regimes treat different forms of financing, and different types of business entities. For example, it may make perfect sense at a domestic level for Australia to have a rule which treats fixed rate shares as debt for tax purposes. However, if New Zealand tax respects them as equity, then the scene is set for double non-taxation, achieved by having a New Zealand company fund its Australian subsidiary by way of fixed rate shares, the dividend on which is deductible in Australia and not taxable in New Zealand (in fact the New Zealand tax regime does have a rule which taxes in-bound deductible dividends, but that is a rare example of cross-border co-ordination), and
- the digitisation of the economy. This makes it possible for companies to derive significant revenue from activities in a foreign country without meeting the threshold, developed in a more innocent age, which has been agreed as necessary to allow income taxation by that country. This is at least part of the story behind the low rates of tax paid by companies such as Amazon and Facebook. The gradual lowering or elimination of tariffs over the past 50 years means that market countries may be left collecting no revenue at all from non-residents who are profiting from the existence of the market.

The BEPS Project aims to address all of these challenges with minimal disturbance to the underlying principles of source versus residence taxation, and without giving rise to double taxation, unwarranted compliance burdens, or other tax restrictions to legitimate cross border activity.

Progress so far

The seven reports presented to the G20 Finance Ministers in Cairns represent a somewhat uneven degree of progress. In a few areas there are firm recommendations, but in many the process of consensus building is still very much underway.

Firm recommendations

Hybrid mismatches

The recommended response to double non-taxation arising from hybrid mismatch arrangements is for countries to adopt rules which either:

- deny deductions for cross border payments which are not taxable to the payee in its jurisdiction, or
- tax incoming payments if they are deductible to the payer in its jurisdiction.

This proposal is radical in that it requires countries selectively to over-ride their usual tax rules to bring them into alignment with another country's rules. It could even require a jurisdiction to tax payments which it would ordinarily not even recognise, let alone exempt.[1]

It would largely eliminate the benefit of global businesses entering into complex cross border financing arrangements with the effect that such activities would return to more "normal" and globally tax-benign channels.

Treaty abuse

A second set of recommendations is directed to preventing tax treaties being used to create double non-taxation.

These measures are aimed particularly at treaty shopping, which is essentially the use of a shell company set up in country A by residents of country B mainly to benefit from country A's favourable tax treaty network with countries C and D.

But they are also aimed more generally at denying treaty benefits to arrangements whose principal purpose is to obtain those benefits in circumstances contrary to the object and purpose of the Treaty (whatever that means). Among the proposals are that the preamble to tax treaties include the prevention of non-taxation as one of the objectives, and that the potential applicability of domestic anti-avoidance rules to the interpretation of treaties is clarified.

Transfer pricing

The third firm set of recommendations is that countries tighten their transfer pricing rules, particularly by:

- improving and standardising transfer pricing documentation
- requiring "country-by-country" reporting by multi-nationals so that the tax authority in each jurisdiction has a much more comprehensive tool to assess the risk that the multi-national is not reporting the full share of its profit from activity in that jurisdiction, and
- enacting rules which reduce or eliminate any tax benefits gained from transferring intangibles to another jurisdiction to take advantage of more favourable tax rules. This has the potential to go much further than the traditional "arms' length pricing" approach. An intangible might be treated for tax purposes as transferred in consideration for a royalty stream based on the future performance of that intangible, even where the actual transaction provides for a (potentially much lower) fixed up-front price. In this area in particular, the September report is more tentative, and it seems clear that achieving a consensus will be more difficult.

The transfer pricing work has been closely watched by business, since this is a space where the OECD is particularly influential, and where its proposals are perhaps closest to being implemented at a practical level. Businesses also have concerns about the commercial sensitivity of the country-by-country reporting information being requested.

Preliminary recommendations

Multilateral instrument to amend tax treaties

More than 3,000 bilateral tax treaties are estimated to exist. The need to renegotiate these on an individual treaty basis makes implementation of changes to the treaty network extremely slow.

The BEPS Project has focussed the OECD's attention on whether it is possible to amend the treaties more speedily. Under discussion is the development of a multilateral instrument which would enable countries to amend their bilateral tax treaties without having to conduct separate negotiations with each of their treaty partners. This kind of instrument would represent a substantial advance on the already radical Convention on Mutual Administrative Assistance in Tax Matters, to which New Zealand is a signatory and which means that New Zealand tax obligations are enforceable in most jurisdictions around the world.

Digital economy

In relation to the impact of information technology, the September report is more tentative, perhaps because the challenge to the underpinning of the current international tax consensus is more fundamental.

The only clear recommendation is that something does need to be done in the near term about collecting GST on cross border internet shopping transactions. Work done in this area will feed into the recommendations on things such as whether an adjustment is needed to the rules determining when source countries (also referred to as market countries) can tax the business income of non-residents.

Harmful tax competition

The Report on Harmful Tax Competition, which focusses on the practice whereby countries provide companies with income tax incentives to locate intellectual property in their jurisdiction, is also not final.

It seems to recommend improvements to the definition of when a preferential tax regime is harmful (generally where it does not require substantial activity in the country providing the regime, and is not transparent), extension of the review of harmful tax practices to non-OECD countries, and the development of a requirement for the automatic exchange of information on rulings given by tax administrations.

Next Steps

The complete package of BEPS recommendations will not be available until December 2015. During this period, further guidance will be developed on how countries can change their tax treaties and domestic laws to implement the seven reports completed in 2014.

Implications for New Zealand

The BEPS changes are not likely to impinge directly on most Kiwis' tax obligations or concerns (a possible exception being the development of a system to collect GST on in-bound business-to-consumer shopping), though they will require changes to legislation and IRD practice.

More significantly, they bear on the share of the overall income tax burden that should be paid by the corporate sector and by capital. That makes them controversial, and will ensure that officials, advisors, corporates and pundits have plenty of tax to talk about for at least the next three years.

Footnotes

1. For those familiar with the recent Alesco case, for instance, the new rules would have required Australia to tax interest deemed to exist only under New Zealand tax rules.

Our thanks to Casey Plunket for writing this Brief Counsel.

CASEY PLUNKET – PARTNER
T: +64 9 357 9027
M: +64 27 561 0013
E: casey.plunket@chapmantripp.com

GRAEME OLDING – PARTNER
T: +64 9 357 9259
M: +64 27 591 6103
E: graeme.olding@chapmantripp.com

DAVID PATTERSON – CONSULTANT
T: +64 4 498 6330
M: +64 27 610 2031
E: david.patterson@chapmantripp.com

AUCKLAND
23 Albert Street
PO Box 2206, Auckland 1140
New Zealand
T: +64 9 357 9000
F: +64 9 357 9099

WELLINGTON
10 Customhouse Quay
PO Box 993, Wellington 6140
New Zealand
T: +64 4 499 5999
F: +64 4 472 7111

CHRISTCHURCH
245 Blenheim Road
PO Box 2510, Christchurch 8140
New Zealand
T: +64 3 353 4130
F: +64 3 365 4587

www.chapmantripp.com

CTBD182014PUBBC