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THE OECD BEPS PROJECT, PART II: IMPACT OF BEPS EFFORTS – A COUNTRY-SPECIFIC REVIEW

This article is the second in a series of three discussing the impact of the Organisation for Economic Co-operation and Development's (OECD) efforts to address the perceived global tax problem of base erosion and profit shifting (BEPS). The first article provided an overview of the key aspects of the OECD's BEPS efforts and an analysis of the current political environment in which these efforts are being shaped. The third article of this series will discuss how the OECD's BEPS efforts are affecting international tax reform in the US and what impact global decisions on BEPS might have in shaping US tax policy.

This article provides an overview of various legislative and regulatory measures that individual countries are developing and implementing to address BEPS while at the same time remaining aligned with developing international norms. Specifically, BEPS-related efforts in the following jurisdictions are addressed: the European Union (EU), the UK, Germany, France, Spain, Australia and China.

EU

Although corporate tax harmonization does not yet exist throughout the EU, the European Commission has taken several initiatives that focus on BEPS.

In 2014, the European Commission started investigating the tax arrangements of Amazon and Fiat in Luxembourg, Starbucks in the Netherlands and Apple in Ireland. In each case, the basis for the investigation was that these countries may have struck preferential tax deals that, under EU law, constituted "state aid" prohibited under EU treaties. In short, state aid is support provided to a company by an EU country that inappropriately provides a competitive advantage to that company. State aid investigations can result in serious consequences as the recipient company may be required to repay such aid. The investigations are ongoing, but may already have had effects in the marketplace. For example, Amazon announced that from May 1, 2015, its Luxembourg company that transacts with its EU customers will report some of its profits in Germany, Italy, Spain and the UK, taking the approach that the Luxembourg company has a taxable presence in those countries.

On May 28, 2015, the European Commission re-launched a proposal to establish a common consolidated corporate tax base across the EU. This will involve groups calculating EU-wide profits on a consolidated basis, with the profits then being allocated on a formulaic basis amongst the EU countries in which they do business. Each country will continue to charge the profits allocated to it at its normal domestic tax rate (so that there would still not be true tax harmonization with an enforced uniform tax rate across the EU).

The system will be optional, but is being sold as both a deregulatory measure (because it will, in theory, reduce tax compliance costs) and as a way to address intra-EU BEPS. Further details are expected to be announced on June 17, 2015, but, because this system will require all EU countries to agree to the proposal, the chances of its being implemented are likely low at present, given the expected resistance of countries such as the UK and Ireland.

UK

The UK has been an active and enthusiastic participant in the OECD BEPS program but, rather than wait for the outcome of the OECD deliberations, a diverted profits tax (DPT) was rushed through Parliament, effective April 1, 2015. Further details can be found in our previous alert on the issue but, in essence, UK DPT targets two specific areas:

- Arrangements under which a non-UK company avoids a taxable presence in the UK, despite carrying on business with UK customers; and
- Arrangements that effectively strip profits out of the UK into low tax jurisdictions, which are not fully caught by existing transfer pricing rules.

Profits caught by the DPT are taxed at a higher rate compared to the UK's standard rate of taxation on corporate profits. So, given that a somewhat low yield is projected from the tax, it seems as though the UK government expects companies to proactively change their business structures, rather than simply pay the DPT in all cases. Amazon's move to allocate profits of its Luxembourg company to a UK branch may be the first of many such responses to the DPT.

The UK has also introduced legislation permitting implementation of country-by-country reporting in line with OECD guidelines. This will enable the UK to introduce a revised reporting regime quickly once an international agreement has been reached.

The newly-elected UK government remains focused on tackling tax avoidance so, with a special budget scheduled for July 8, 2015, the UK may soon make further announcements on its ongoing actions in relation to BEPS.

Germany

The new Coalition Government took office in late 2013. One of its main strategic tax objectives – as laid out in its Coalition Agreement on November 27, 2013 – is to combat tax evasion and tax avoidance. The Coalition Agreement explicitly expressed support for the following positions:

- The OECD BEPS initiative generally;
- Implementation of domestic BEPS legislation if the objectives of the OECD initiative are not met on an international level;
- Limitations on tax deductibility of royalties;
- Limitations on tax deductibility of expenses remitted to offshore locations;
- Prevention of "white income" (i.e., income that is neither taxed in the country of source, nor in the country of residence);
- Implementation of country-by-country reporting for certain industries to facilitate the international exchange of tax relevant information.

The Coalition has repeatedly voiced its position that BEPS is most efficiently addressed by means of internationally coordinated and harmonized standards. It principally regards uncoordinated unilateral actions as detrimental to achieving internationally harmonized standards, which could provide room for tax loopholes.

Consequently, the Coalition has thus far refrained from passing unilateral or domestic legislation regarding any of the 15 action points set out in the OECD's Action Plan. In this context, the Coalition has even rejected a legislative initiative by Germany's second legislative body (*Bundesrat*) regarding hybrid structures and referred the matter to an expert committee that was established in April 2015.

Notwithstanding the foregoing, the last two years have seen several intra-government statements regarding the OECD's BEPS action points (e.g., the German/French statement from February 2014 reinforcing their commitment to and support of the OECD's BEPS initiative and the UK/German statement from November 2014 on patent boxes).

Interestingly, the Federal Counsel on Macroeconomic Developments (*Wirtschaftsweisen*) in its latest annual report from November 2014 has estimated the tax leakage resulting from BEPS to be less than €1 billion per year in Germany, far lower than previous estimates.

France

France is very active with regard to its efforts on BEPS and has already implemented several preventative tax measures.

First, France has established a list of non-cooperative States and Territories with which France has no tax treaty, including no automatic exchange of information, from January 1, 2010. For transactions with these States or Territories, France introduced restrictive measures, such as higher withholding tax rates or prohibitive taxation rates on capital gains realized by beneficiaries located in such States or Territories.

Second, changes were made to the compulsory transfer pricing documentation requirements first introduced in 2010 for companies: (1) whose turnover or total balance sheet exceeds €400 million; or (2) which own more than 50% or are owned more than 50% by entities meeting that threshold. In 2013, those rules were supplemented with an additional requirement of an annual transfer pricing declaration to be submitted to the French tax authorities. The declaration is a summary of transactions with other non-French related parties classified by type of transaction and amount, when the aggregated amount per type of transaction exceeds €100,000.

Third, an anti-hybrid measure regarding the deductibility of interest was introduced by the Finance Act for 2014. Under this new rule, interest deductions are allowed only if the French borrower demonstrates that the related lender is, for the current tax year, subject to corporate tax on the interest income at a rate that equals 25% or more of the corporate tax that would be due under French tax rules.

In sum, BEPS issues are at the heart of tax discussions in France and the country is likely to further strengthen its BEPS-related legislation in the near future.

Spain

Over the past several years, Spain has approved new regulations in line with the OECD BEPS Action Plan in the following areas. A major tax reform has been passed with effects from January 1, 2015, approving a new Corporate Income Tax law (CIT).

Deductibility of Financial Expenses

The deductibility of net financial expenses exceeding €1 million is limited to 30% of a Spanish company's earnings before interest, tax, depreciation and amortization (EBITDA). There are additional limitations for financial expenses derived from leveraged acquisitions. Moreover, financial expenses derived from intragroup profit participating loans (PPLs) are not deductible because they are treated as equity, rather than debt. This rule does not apply to PPLs signed prior to June 20, 2014.

Hybrid Mismatches

In Spain, under the new CIT law, transactions with related parties will not be allowed to create deductible expenses where, as a result of a different tax characterization of the payment: (1) the counterparty does not have an income inclusion; (2) the income is exempt; or (3) the income is subject to a nominal tax rate of 10% or less. In addition, the Spanish company will not be able to apply the participation exemption to any dividend income that has been treated as a deductible expense in the paying entity, unless a double tax treaty provides otherwise.

CFC Rules

The Spanish controlled foreign corporation (CFC) rules have been broadened under the 2015 tax reform to include new categories of passive income, such as income derived from intangible assets, image rights, and financial instruments. Additionally, these rules are generally applicable where the foreign entity does not have economic substance.

Transfer Pricing

According to the draft version of the CIT regulations currently being considered in the Parliament, multinational companies with a turnover of at least €750 million in the preceding tax period are obliged to file a country-by-country report. Country-by-country reports shall include, among other things, the following information:

- Group gross revenue, identifying the amount derived from related parties;
- CIT paid (including withholding taxes);
- Average workforce; and
- Material assets and real estate assets, other than liquid assets and receivables.

The information to be included in the master file has been extended to include:

- Description of the supply chain of goods and services representing at least 10% of the group's turnover;
- More detailed description of the information regarding intangible assets; and
- More detailed description of the information regarding the financial activity.

Likewise, the local file information has also been expanded to include the Spanish company's main competitors and a detailed functional analysis.

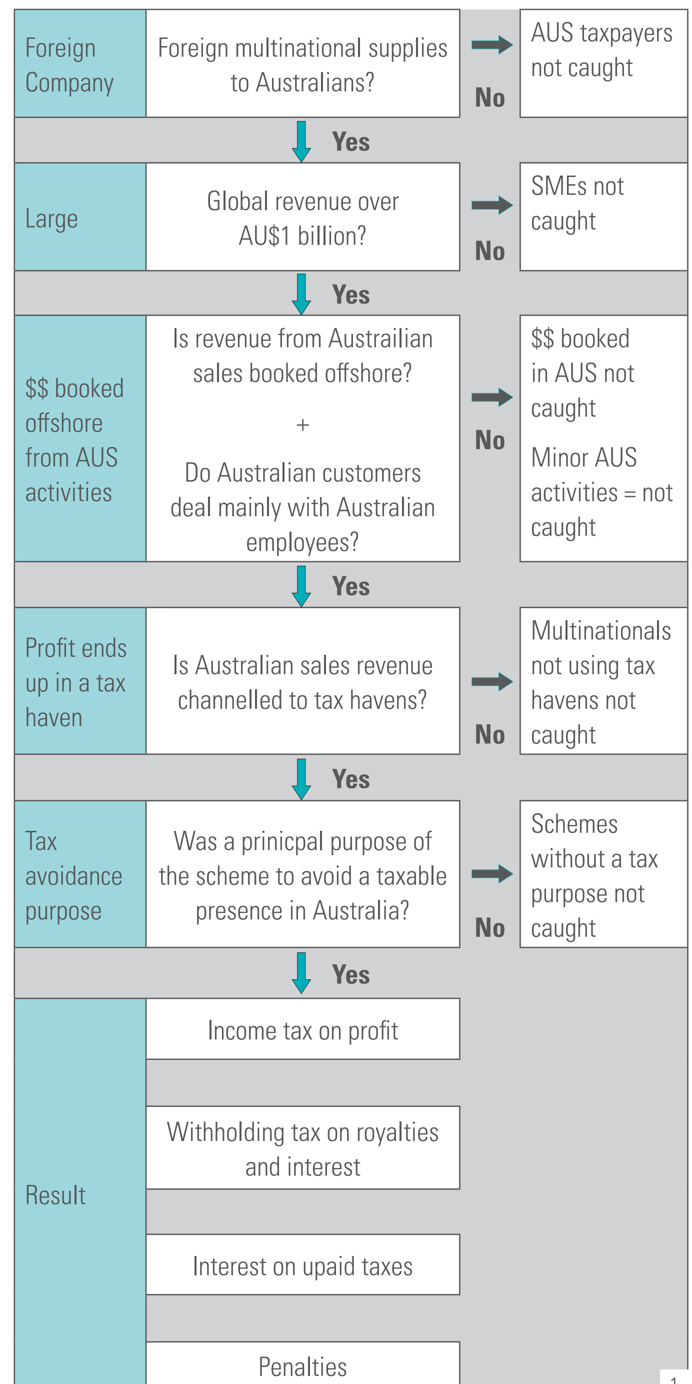
Permanent Establishments (PEs)

Although no changes have yet been legislated in Spain regarding PEs, the Spanish tax authorities and courts have over the past several years developed a comprehensive interpretation of the PE concept under a functional approach with regard to post-restructuring schemes and commissioner dealings (e.g., *Roche* and *Dell* court cases).

Australia

After initially considering a DPT similar to that in the UK earlier in 2015, the Australian government has announced that instead it will be tightening the existing anti-avoidance provisions "to stop multinational entities using artificial or contrived arrangements to avoid a taxable presence in Australia." The changes are aimed only at a narrow range of multinational companies supplying goods and services to Australia. Specifically, only those companies with global revenues in excess of AU$1 billion will be caught if Australian customers deal with Australian employees. It is estimated that only 30 companies will be affected. The below chart summarizes the application of the rules.

Application of the Multinational Anti-Avoidance Law



Furthermore, in an effort to combat tax avoidance by multinationals, the Australian government has stated that it is committed to working towards modifying language in their income tax treaties to more broadly define a taxable presence, as well as further tightening of the already strict transfer pricing rules.

[1]The Honorable Joe Hockey, *Treasurer's Media Release* (May 11, 2015).

China

Since China began enforcing the new CIT law in 2008, BEPS concepts have played a role in developing China's tax-related legislation, even though OECD's BEPS initiative had not been formally launched at that time. Chinese policymakers have been focused on certain key issues, including transfer pricing adjustments, tax treaty benefits and the deductibility of inter-company expenses, while tax audits have raised issues of treaty shopping and unreasonable allocation of profits among related parties. In February 2015, the State Administration of Tax (SAT) held the National Working Conference on International Taxation, which is likely to result in amendments regarding special tax adjustments for transfer pricing. It is likely that evidence of business substance for cross-border payments and transfer pricing issues generally will remain a focal point for Chinese tax authorities. In addition, a few other important points are noted below.

GAAR Measures

The concept of a general anti-avoidance rule (GAAR) was first introduced to the Chinese tax system in 2008 in the CIT law. On December 2, 2014, SAT released the GAAR Measures, which set out comprehensive guidance for local tax authorities to implement GAAR to address tax avoidance arrangements. Tax avoidance is defined in the GAAR Measures as an arrangement with the sole or primary purpose of obtaining a tax benefit, and which is not consistent with the principles of economic substance. It is believed that the GAAR Measures will bring more predictability as to how GAAR cases will be handled by the tax authorities going forward.

Indirect Equity Transfers

In 2009, SAT issued Guoshuihan [2009] No. 698 (Circular 698) in an effort to combat indirect transfer structures where holding companies were used to indirectly transfer Chinese companies to avoid Chinese capital gains tax. Circular 698 requires reporting and, if applicable, imposes capital gains tax on any transfer by a nonresident of an offshore holding company that owns a Chinese company if such transfer lacks a reasonable commercial purpose. Therefore, the holding company will be ignored and the nonresident transferor will be subject to Chinese capital gains tax as if the transfer of the Chinese company was made directly.

On February 3, 2015, the Announcement Concerning Corporate Income Tax on Indirect Transfer of Properties by Non-Resident Enterprises (Announcement No. 7) was issued and became effective. While partly abolishing a seller's filing obligation as detailed in Circular 698, Announcement No. 7 expands the scope of tax filings to cover the transfers of real estate and permanent establishments in China. In addition, it further details rules on how an indirect transfer should be evaluated for its "reasonable commercial purpose" and introduces a "Safe Harbor" rule.

The new regulation in Announcement No. 7 greatly affects how the Chinese tax authorities use GAAR to guard against the offshore transfer of Chinese assets by nonresident investors.

Outbound Payments to Overseas Related Parties

In September 2014, SAT had initiated a nationwide examination of significant outbound service fee and royalty fee payments to related parties. On March 18, 2015, SAT released the public notice on Issues Relating to CIT on Expenses Paid by an Enterprise to its Overseas Related Party (Notice No. 16), in which SAT strengthened the administration of cross-border charges among related parties. Notice No. 16 is regarded as an important enforcement measure used by SAT to address BEPS concerns.

According to Notice No. 16, any expense paid by an enterprise to its overseas related party, which fails to perform functions or bear risks and which has no substantial business activities, shall not be deductible for CIT purposes. More importantly, SAT formulates the rules on royalty payments for intangible assets by partly taking into consideration Guidance on Transfer Pricing Aspects of Intangibles. According to Notice No. 16, for cross-border royalty payments it is necessary to determine the economic interests to which each related party is entitled by taking into account the degree of contribution made by each related party to the value of the intangible asset.

Conclusion

As evidenced above, there are numerous BEPS-related measures being implemented by individual countries around the globe in an effort to protect their tax bases. Now is the time for companies to review their structures and identify areas where existing arrangements should be revised and updated before they are negatively impacted by such BEPS-related iniatives.

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