

TAX STRATEGY GROUP

OECD BEPS Project The impact on Irish corporate tax policy

1. Introduction

- 1.1 The OECD's Base Erosion and Profit Shifting (BEPS) project is nearing its conclusion. The main output of the project will be the publication by the OECD in October 2015 of reports on 14 of the 15 actions set out in the July 2013 BEPS Action Plan. The timetable for the approval of the reports is:
- Endorsement by the OECD's Committee on Fiscal Affairs (CFA) on 21/22 September. Ireland will be represented at the CFA by officials from the Department of Finance and the Revenue Commissioners.
 - Published publicly on 5 October.
 - Endorsement by the G20 Finance Ministers on 8 October.
 - Endorsement by the G20 leaders at their Turkey summit on 15/16 November 2015.
- 1.2 At a high level, our assessment is that the direction of the reports is broadly acceptable from an Irish point of view. Many of the high risk actions have either been amended in a manner which is favourable for Ireland or have moved from a minimum standard approach (mandatory) to best practice (discretionary).
- 1.3 The purpose of this paper is to provide an overview of the background to and the purpose of the BEPS project, a high level summary of the outcome of each of the actions set out in the BEPS Action Plan, and to set out some of the options for Ireland as regards the implementation of recommendations arising from the BEPS Actions.

2. What is BEPS?

- 2.1 Base erosion and profit shifting refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid.
- 2.2 Corporate tax is levied at a domestic level. When activities cross border, the interaction of domestic tax systems means that an item of income can be taxed by more than one jurisdiction, thus resulting in double taxation. The interaction can also leave gaps, which result in income not being taxed anywhere. BEPS strategies employed by companies take advantage of these gaps between tax systems in order to achieve double non-taxation.

3. Objectives of the BEPS project

- 3.1 The overall aims of the BEPS project are to prevent double non-taxation from arising due to mismatches in international tax rules and to better align the right to tax with real economic substance and activity. As such, the BEPS project is one which aligns with Ireland's own tax strategy.
- 3.2 The BEPS project is not about Ireland's 12.5% rate or about tax rates generally. The work is not aimed at restricting the sovereignty of countries over their own tax rates; rather, it is aimed at restoring and strengthening sovereign taxing rights by ensuring that countries can tax the economic activities that take place in the country. It aims to do so by addressing tax regimes that apply to mobile activities and that unfairly erode the tax bases of other countries, potentially distorting the location of capital and services.
- 3.3 As set out above, many BEPS strategies take advantage of the interaction between the tax rules of different countries, which means that action by individual countries will not fully address the problem. While some actions have been taken by countries, such as the UK's introduction of the Diverted Profits Tax, the issues can only be fully addressed through a coordinated approach.
- 3.4 As such, the BEPS project was designed to provide this internationally coordinated approach which would facilitate and reinforce domestic actions to protect tax bases and provide comprehensive international solutions. The OECD BEPS Action Plan which was published in July 2013 provided a consensus-based plan to address these issues and is part of the OECD's ongoing efforts to ensure that the global tax architecture is equitable and fair.
- 3.5 The Action Plan stated that fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it. The Action Plan set out 15 actions to deal with the problems of tax base erosion and profit shifting and set an ambitious timeline for the work to be completed by the end of 2015.
- 3.6 Since its launch by the OECD, the work on BEPS received strong and consistent support by the G20 and it is a key item on the Finance Ministers' and Leaders' agendas. All G20 countries have participated in the development of the work. The OECD met the first deadlines set in its 2013 BEPS Action Plan by delivering reports on seven of the fifteen Actions on 16 September 2014. The G20 leaders welcomed this progress and reiterated their commitment to finalising work on the BEPS project in 2015.

4. OECD Process and the role of the Committee on Fiscal Affairs (CFA)

- 4.1 The technical work on the 15 actions of the BEPS Project is being undertaken by the CFA through its subsidiary bodies.
- 4.2 The overarching objective of the CFA is to contribute to the shaping of globalisation for the benefit of all through the promotion and development of effective and sound tax policies and guidance that will foster growth and allow governments to provide better

services to their citizens. Its work is intended to enable OECD and non-OECD governments to improve the design and operation of their national tax systems, to promote co-operation and co-ordination among them in the area of taxation and to reduce tax barriers to international trade and investment.

- 4.3 Ireland is represented at the CFA by officials from the Department of Finance and the Revenue Commissioners.
- 4.4 The reports for fourteen out of the fifteen actions have been finalised or are close to being finalised by the relevant working parties and task forces. The CFA will be asked to endorse the reports at its next meeting on 21 - 22 September. It is intended that the reports will be published publicly on 5 October 2015.
- 4.5 A number of the reports to be agreed and published in October 2015 will recognise that further work is needed at OECD level on a range of issues. This work will continue through the CFA and its subsidiary bodies. The Department of Finance and Revenue will continue to fully engage in this process.
- 4.6 A further subsidiary group of the CFA, the Ad hoc group on the Multilateral Instrument, has been established to negotiate the development of a multilateral instrument under Action 15 by the end of 2016. Ireland, along with 86 other countries, has opted to join this group. XX.

5. BEPS Actions

- 5.1 An overview of the work carried out under each of the BEPS actions is set out below. A number of the reports set out a minimum standard (and therefore will need to be implemented) which Ireland will sign up to whereas others set out best practice recommendations which can be taken into account by Ireland if a decision is made to amend our tax law with respect to such actions.
- 5.2 Our high level assessment is that the direction of the reports is broadly acceptable from an Irish point of view. Many of the high risk actions have either been amended in our favour or have moved from a minimum standard approach (mandatory) to best practice (discretionary).

6. Minimum standard actions

- 6.1 A minimum standard will be set out under Actions 5 (harmful tax practices), 6 (treaty abuse), 7 (artificial avoidance of PE status), 8, 9 and 10 (aligning transfer pricing outcomes with value creation), 13 (transfer pricing documentation), and 14 (dispute resolution).

- *Action 5 – Harmful Tax Practices*

- 6.2 In the context of IP regimes (patent boxes), the “modified nexus” approach has been agreed to. This approach uses expenditure as a proxy for activity and allows a taxpayer

to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying research and development expenditures that gave rise to the IP income.

6.3 Ireland intends to introduce a patent box regime, the Knowledge Development Box (KDB), in Finance Bill 2015. The KDB will be designed in line with the modified nexus approach as set out in Action 5 (see Corporation Tax Policy Paper for further details on the KDB).

6.4 In the area of transparency, the report sets out an agreed framework for the mandatory spontaneous exchange of information on rulings that could give rise to BEPS concerns in the absence of such exchange. For countries which have the necessary legal basis, exchange of information under this framework will take place from 1 April 2016. The European Commission are also working on rules for the automatic exchange of rulings between taxing authorities (DAC3) and the Luxembourg Presidency intend to secure agreement on DAC3 before the end of 2015.

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- *Action 6 – Tax Treaty Abuse*

6.6 Under the Action 6 minimum standard, countries are required to include in all tax treaties either:

- 1) a robust Limitation on Benefits (LOB) clause which is modelled on the US model LOB clause,
- 2) a Principal Purposes Test (PPT), or
- 3) a simplified LOB test with a PPT test.

6.7 Access to tax treaties is a significant part of Ireland's tax offering and, at the time of publication of the interim Action 6 report in September 2014, business was concerned that the new rules could have unintended consequences, particularly in the area of financial services. In the main, these concerns have been addressed through changes to the proposed wording of the anti-abuse clauses since the 2014 interim report was published.

6.8 It is intended that the minimum standard will be implemented by signing up to the multilateral instrument which will be developed under Action 15 by the end of 2016. There is further work to be carried out in relation to Action 6, including the commentary on the LOB test, in early 2016¹. Ireland will continue to participate in this work and in the work on developing the multilateral instrument. It is not yet clear how the

¹ On 20 May 2015, the U.S. released some components of their proposed changes to the US model treaty. This included a modified version of the special tax regime and change in law provisions that were included in the May discussion draft on Action 6. Given that the U.S. are in the process of a public consultation on these provisions, it was decided that they could not be adopted into the final Action 6 report at this time as it is likely that there will be changes in the US following the consultation process. As such, all of the commentary on the robust and the simplified LOB will remain in square brackets in the final report with a comment that it will be considered further in October 2015.

multilateral instrument will operate to take account of the various options which may be adopted under the Action 6 minimum standard.

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- *Action 7 – Permanent Establishment Status*

6.10 Permanent Establishment rules determine how much presence a company must have in a country before it becomes subject to corporation tax in that country.

6.11 The Action 7 report proposes changes to the PE definition commonly used in tax treaties. The primary change is aimed at ensuring that commissionaire structures may no longer be used to avoid PE status. Commissionaire structures are arrangements through which an entity sells products in a state in its own name but on behalf of a foreign enterprise that is the owner of the products in a manner which does not create a PE in the country where the sale happens (and therefore does not create a local tax liability). Commissionaire structures are more typically a feature of civil law jurisdictions rather than in common law jurisdictions like Ireland.

6.12 Other changes to the PE definition will be included in the report including narrowing some existing exemptions and introducing an anti-fragmentation rule which prevents the artificial avoidance of a PE by fragmenting a cohesive operating business into several small operations.

6.13 At the time of publication of Discussion Drafts on Action 7 earlier this year, business were concerned that the new rules could have unintended consequences by overly widening the definition of a PE. This could have created uncertainty and greater administrative costs for businesses. In the main, these concerns have been addressed through changes to the proposals since the Discussion Draft was published.

6.14 The measures that will be set out in the final Action 7 report will represent a minimum standard and as with Action 6, it is intended that the minimum standard will be implemented by signing up to the multilateral instrument.

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- *Actions 8 / 9 / 10 – Transfer Pricing Guidance*

6.16 The BEPS Action Plan identified that the existing international standards for transfer pricing rules can be misapplied so that they can result in outcomes whereby the allocation of profits is not aligned with the economic activity that produced the profits. The work under Actions 8, 9 and 10 of the BEPS Action Plan has specifically targeted this issue, to ensure that transfer pricing outcomes are aligned with value creation.

- 6.17 In particular the work focused on transactions involving intangibles, on the basis that the misallocation of profits arising from profits generated from intangibles has been identified as one of the biggest culprits of BEPs. The other main consideration was the contractual allocation of risks, and the resultant profits allocated to those risks.
- 6.18 In tackling both of these issues the OECD was specifically able to address the issue of “Cash Boxes” located in havens which has been identified as one of the most significant BEPs issues.
- 6.19 The guidance on intangibles clearly states that legal ownership, by itself, does not necessarily generate a right to all, or indeed any of the return generated by the exploitation of the intangible. Additionally, the guidance will clarify that a risk contractually assumed by a party, who cannot control the risk, or does not have the financial capacity to assume the risk, will be allocated to a party that does control the risk and who does have the financial capacity to assume the risk. The guidance also states that a party who provides funding, but performs few, if any activities, and who does not control the financial risk will be entitled to no more than a risk-free return (i.e. “Cash Box” or a typical Irish registered, non-resident company “IRNR” located in a haven).
- 6.20 Under the guidance, a legal owner of intellectual property, (who does not perform any of the key functions in developing and exploiting the intangible) who performs the key functions with respect to the investment/funding of the intangible and controls the associated financial risk, will be entitled to a risk-adjusted return e.g. akin to a return on investment. Such a return is vastly different to the significant royalties that would have previously been attributed to such entities.
- 6.21 The impact of these new rules could have wide consequences, particular for companies with minimal functionality and who do not control the associated risk. For example, these new rules could significantly reduce the profits that are attributed to certain treasury and captive companies operating in Ireland who do not perform the key functions nor control the associated risks.
- 6.22 The guidance in the report on Actions 8 – 10 that will form part of the final BEPS report in October 2015 will be incorporated into revised OECD Transfer Pricing Guidelines (“TPG”) when they are approved by the OECD Council during 2016. Ireland has subscribed to the TPG and references it in its legislation. XXXXXXXXXXXXXXXXXXXX
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- *Action 13 – Country by Country Reporting & Transfer Pricing Documentation*
- 6.23 The final Action 13 report will contain revised standards for transfer pricing documentation and a template for country by country reporting of income, taxes paid and certain measures of economic activity.
- 6.24 The country by country reporting proposals will require large MNEs to file a report annually of the number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction in which they do business. The report will be filed with the tax authority where the group parent is tax resident and then shared among interested tax authorities. The reports will not however be made public.

- *Action 2 – Hybrid mismatches*

- 7.2 Hybrid arrangements take advantage of differences between the tax laws of two countries which create a mismatch between the two tax systems to the benefit of a taxpayer. The focus of the OECD’s work in this area has been on arrangements that involve multiple deductions for a single expense, deductions in one country without corresponding income inclusions in another country, or generation of multiple foreign tax credits for one amount of tax paid. Hybrid entities and arrangements are not a significant feature of the Irish tax landscape and Ireland is supportive of work to combat hybrids.
- 7.3 The Action 2 report will recommend a system of “linking rules” that relate the tax treatment of a payment with respect to a hybrid entity or arrangement in one jurisdiction to the tax treatment of such payment in the counter-party jurisdiction. The proposed system of interconnected domestic law rules generally would provide for the denial of deductions by the payer country as the primary response to hybrid arrangements, with the denial of exemption by the payee country as the secondary response in situations where the payer country does not deny the deduction.
- 7.4 The EU are also considering anti-hybrid rules as part of an anti-BEPS directive that has been signalled by the Commission in its June 2015 Action Plan for Fair and Efficient Corporate Taxation in the EU. Ireland will actively engage in this work at EU level.

- *Action 3 - Controlled foreign corporation (CFC) rules*

- 7.5 Controlled foreign corporation (CFC) rules generally operate to tax a portion of the income of controlled foreign subsidiaries as it arises.
- 7.6 Ireland does not have CFC rules and the income of subsidiaries of Irish parent companies is taxable when it is remitted by way of a dividend and not as it arises.
- 7.7 Many countries already have some form of CFC rules in place which usually target the passive income of low tax subsidiaries. The final report on CFCs will set out guidance based on best practices for the building blocks of effective CFC rules, while recognising that the policy objectives of these rules vary among jurisdictions. The report will allow for many different types of CFC rules to reflect these policy objectives. Some of the approaches included in the report (most notably the “excess profits” approach) would not be welcome by Ireland if ultimately adopted by countries.
- 7.8 The fact that the CFC report will be best practice is a positive outcome for Ireland as it reduces the likelihood of imminent changes to other countries’ rules. There will also not be an obligation on Ireland to introduce CFC rules at this time.
- 7.9 The EU are also considering CFC rules as part of an anti-BEPS directive that has been signalled by the Commission in its June 2015 Action Plan for Fair and Efficient Corporate Taxation in the EU. Ireland will actively engage in this work at EU level.

- *Action 4 – Interest deductibility*

- 7.10 Action 4 seeks to prevent BEPS concerns arising from the use of interest deductions. It has been agreed that the final Action 4 report will contain best practice recommendations for countries that consider that they need anti base erosion measures by placing a general cap on interest deductions. There had been proposals to introduce a worldwide group test that posed significant concerns for business. This proposal has not been adopted.
- 7.11 The final recommended approach will include a primary fixed ratio rule which limits net interest deductions to a fixed percentage (between 10% and 30%) of an entity's earnings. There would also be a secondary group ratio rule which allows an entity with net interest expense above a country's fixed ratio percentage to deduct interest up to a relevant financial ratio of its worldwide group.
- 7.12 Ireland does not currently have fixed ratio rules. However, Ireland does not generally permit deductions for interest against non-trading income and has a number of anti-avoidance provisions in respect of interest deductibility, in particular, in respect of section 247 TCA 1997.
- 7.13 The EU are also considering interest limitation rules as part of an anti-BEPS directive that has been signalled by the Commission in its June 2015 Action Plan for Fair and Efficient Corporate Taxation in the EU. Ireland will actively engage in this work at EU level.

- *Action 12 – Mandatory Disclosure rules*

- 7.14 Mandatory disclosure rules are designed to enable tax authorities to obtain early information on aggressive or abusive tax planning schemes and their users. Ireland are one of a small number of countries to already have mandatory disclosure rules in operation.
- 7.15 The final Action 12 report will outline best practice recommendations for mandatory disclosure rules for countries which seek to design a regime. The framework is also intended as a reference for countries that already have mandatory disclosure regimes, in order to enhance the effectiveness of those regimes. It also sets out specific best practice recommendations for rules targeting international tax schemes.
- 7.16 The recommendations contained in the report do not represent a minimum standard and countries are free to choose whether or not to introduce mandatory disclosure regimes. Ireland already has a mandatory disclosure regime in place which meets most of the key design features of a mandatory disclosure system which are set out in the report.

8. Other reports

- *Action 1 – Digital Economy*

8.1 No specific measures will be recommended from a direct tax perspective by the OECD Task Force on the Digital Economy under Action 1. Rather, it will conclude that the digital economy cannot be ring-fenced from the rest of the economy for tax purposes and that the BEPS challenges in the digital economy are to be addressed in the work under the other Actions. This conclusion is welcome and aligns with the principles of the Irish regime; a fair, open and transparent regime offering similar terms to all industry groups.

8.2 The Action 1 report considers a number of options for taxing digital businesses differently (such as a withholding tax on digital supplies) but no consensus has been reached on any of these options and none have been recommended.

- *Action 11 – Monitoring BEPS*

8.3 The Action 11 report will recommend that the OECD works with governments to report and analyse more corporate tax statistics and to present them in an internationally consistent way. Statistical analyses based on country-by-country reporting data should also enhance the economic analysis of BEPS. The intention is for these improvements in the availability of data to ensure that governments and researchers will, in the future, be better able to measure and monitor BEPS and the impact of actions taken to address BEPS concerns.

9. Ongoing work and the Multilateral Instrument

9.1 As outlined above, some technical work remains to be carried out under some of the Actions (such as continued work on transfer pricing guidelines).

9.2 Work on implementation of BEPS will focus on the development and agreement of a multilateral instrument. The interim Action 15 report published last September concluded that a multilateral instrument is desirable and feasible under public international law.

9.3 Based on this analysis, a mandate has been developed for an ad-hoc group, open to the participation of all countries, to develop the multilateral instrument and open it for signature in 2016. So far, 87 countries, including Ireland, are participating in the work with the next meetings scheduled for November 2015.

10. Conclusion

10.1 While work remains on some technical aspects of the BEPS reports, the main focus of BEPS project after October will be on the implementation of the BEPS proposals. Ireland is supportive of the BEPS actions and will look to implement the minimum standard actions which will be agreed in September. This work will begin with the introduction of Country by Country reporting in Finance Bill 2015.

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| 10.2 | Actions 6, 7 and 14 will be implemented through the multilateral instrument and the transfer pricing changes will implemented through Revenue guidance on documentation and by recognising the new OECD transfer pricing guidelines (once finalised) in the Taxes Consolidation Act 1997. |
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| 10.4 | The EU is also examining the issues considered under Actions 2, 3 and 4 with a view to how these best practice recommendations could be implemented consistently across the EU (whether in a Directive or as soft law recommendations). The Department of Finance and Revenue will continue to be actively engaged in the EU's work in this area. |