BEPS Action 1: Addressing the tax challenges of the digital economy

What is the OECD trying to achieve?
This concern was fuelled by the ability of a business established in one territory to use information and communication technology (ICT) to have a significant participation in the economic life of another territory without paying significant tax in that other territory.

BEPS Action 1 calls for the identification of the difficulties that the ‘digital economy’ poses for the application of existing international tax rules and to develop new approaches to address these difficulties.

What is proposed?
The conclusion of the interim report on Action 1 was that there is no separable ‘digital economy’ but rather that the widespread use of ICT is changing all businesses. This led to the conclusion that the role of Action 1 should be to identify the tax issues which come from digital and then to pass these on to other relevant BEPS workstreams to incorporate them into their work.

The final report on Action 1 now identifies three areas where the digital economy challenges the current international tax system:

- Nexus – whether interacting with customers remotely creates a taxable presence;
- Data – how does it create value and do current approaches tax it appropriately; and
- Characterisation – whether the way in which digital goods and services are delivered changes their tax treatment.

The report also identifies indirect tax (GST/VAT) issues around cross border digital business-to-consumer (B2C) transactions. It concludes that the destination territory should charge VAT and so the issue that remains concerns enforcement: how to collect tax from a digital vendor.

The direct tax issues have all been addressed in the transfer pricing, permanent establishment and controlled foreign company workstreams. However, the report also appears to suggest that countries could bring in unilateral new tax measures, provided that they fit within treaty obligations. These include:

- Digital Nexus – Digital Nexus- this allows for rules to tax profits from remote vendors where there would not otherwise be taxable presence;
- Withholding taxes on digital transactions; and
- Equalisation levies – intended to neutralise the perceived advantages of digital businesses.

There is going to be some mechanism to review whether the problems identified have been solved and a report reflecting this work published in 2020.
What does this mean for business?

Any businesses which have the characteristics identified by Action 1 need to pay close attention to the other Actions (especially permanent establishment and transfer pricing) to see how the output of those workstreams has accommodated Action 1.

The area of particular concern is the suggestion that countries can bring in unilateral taxes. This will greatly complicate the international tax environment.

What should businesses be doing?

Any business which has activities that include the business characteristics summarised below needs to consider how they are affected.

- Providing digital goods or services remotely, particularly where the customer is contracting with an entity in another jurisdiction.
- Business activities which are spread across several jurisdictions, for example, software engineers collaborating on developing intangibles.
- The collection, development and exploitation of data (the role of data in the value chain is becoming a focus of tax authorities and any business which collects data needs to understand what it collects and what intangibles are created from it).
- Changes which may alter the character of income being received, for example, providing a service rather than selling goods.

In addition to these factors, businesses need to monitor unilateral changes which may create taxable income where they have none at the moment, or create withholding taxes on income flows.

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Adapting to a changing environment

BEPS

The OECD, with the backing of the G20, published a 15 point action plan in July 2013 setting out proposals to address base erosion and profit shifting (BEPS). The project has developed in response to concerns that the interaction between various domestic tax systems and double tax treaties can often lead to profits falling outside the charge to tax altogether or be subject to an unduly low rate of tax. The OECD published its final BEPS package in October 2015.

BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements

What is the OECD trying to achieve?

The OECD is concerned that mismatches in the way that different countries treat certain entities or instruments under their domestic laws can result in double non-taxation of the same income, double tax deductions for the same payment, or long-term deferral of income.

For example, if one country treats an instrument as debt whilst another treats it as equity, there is potential for payments under the instrument to be treated as tax deductible interest in the territory of the payer, but as tax exempt dividends in the territory of the recipient.

Similarly, if the territory in which an entity is established treats it as transparent (e.g. as a partnership) for tax purposes, but investors in that entity are resident in a territory which treats it as opaque (e.g. as a company), then income in that entity may not be subject to tax in either territory.

BEPS Action 2 calls for the development of rules to neutralise the effects of such hybrid entities and instruments. The OECD published its initial conclusions in September 2014. Its final report includes the results of further work in certain areas such as the interaction with CFC rules as well as detailed guidance and worked examples.

What is proposed?

Domestic rules

The OECD recommends that countries introduce domestic tax rules to neutralise the impact of arrangements involving hybrid instruments or entities. These should apply automatically (with no motive or purpose test) to situations where the hybrid arrangement results in a deduction with no taxable inclusion (D/NI), double deduction (DD), or imported mismatch (indirect D/NI).

Where a payment is made under a hybrid arrangement and gives rise to a mismatch, then either:

• the payer jurisdiction will be required to deny a tax deduction for the payment; or
• the payee jurisdiction will be required to tax the income, depending on the particular arrangement and its effect.

The rules only apply to ‘payments’, excluding deemed payments (e.g. national interest deductions on equity). Mismatches arising due to tax rate differentials, e.g. no or low tax regimes, rather than any element of hybridity, are also excluded from scope.

The UK has committed to implementation with effect from 1 January 2017. It published a consultation document in December 2014, and it is expected that draft legislation will be published at, or soon after, the 2015 Autumn Statement.
Double taxation treaties
The OECD has also recommended changes to the OECD Model Treaty to address tax mismatches arising from:

- dual resident entities; and
- transparent entities.

What does this mean for business?
The proposed rules, particularly those for imported mismatches, are complex. The impact will depend upon which countries implement these proposals, the precise wording of the legislation, and the timing of implementation.

Many groups have arrangements involving hybrid entities or instruments, including entities which are disregarded (check the box) for US tax purposes. The tax treatment of these arrangements may be impacted by these proposals. However, the wide drafting and absence of a motive test means that there is also the potential for the rules to apply more broadly than might be expected.

What should businesses be doing?
Groups should review the impact of the hybrid mismatch rules on their current arrangements and consider where appropriate the feasibility of potential alternatives. In any review of their arrangements it will also be necessary for groups to consider the other BEPS proposals including those under Action 3 (CFC), Action 4 (interest deductibility) and Action 6 (prevention of treaty abuse).

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Adapting to a changing environment

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BEPS action 3: Strengthening CFC rules

What is the OECD trying to achieve?
Action 3 of the OECD's Base Erosion and Profit Shifting (BEPS) plan stresses the use of Controlled Foreign Company (CFC) rules as an option for preventing profit shifting and long term deferral of tax. The main aim is to encourage more territories to adopt CFC rules and, for those who already have such rules, to amend these rules along the lines of OECD recommendations.

What is proposed?
The paper sets out six different building blocks which are necessary for the implementation of a robust CFC regime. Each of these building blocks contains a recommendation to OECD member states, but none of them have the status of a 'minimum standard'. This means that there is less pressure on territories to introduce CFC rules or, indeed, amend existing regimes along the lines of the paper.

The optionality within the recommendations gives a lot of flexibility in approach, which allows countries to design rules which fit with their tax system and wider policy objectives. There is also a broad acceptance of the need for CFC rules to properly accommodate the obligations imposed on Member States of the European Union.

Compared with the earlier public discussion draft, there have been some significant changes as follows:
- In the discussion draft, there was significant focus on whether the final rules should oblige territories to challenge 'foreign to foreign' profit shifting (as opposed to only tackling diversion of profits from parent territories). The working party have accepted that, whilst CFC rules which prevent 'foreign to foreign' shifting would better meet the objective of confronting BEPS, such an approach would be inappropriate for those with a territorial approach to taxation – such as the UK.
- In the building block on how to define CFC income, the prior draft focused significantly on the 'excess profits' approach, which is a very mechanical approach only exempting a low, flat rate of profits in a CFC. Perhaps recognising that such an approach would not properly exempt profits arising from genuine economic activities – especially in the context of EU Member States – there is much less focus on this approach in the final paper.
The building blocks

**Definition of a CFC**
- A broad definition to include partnerships, trusts and exempt permanent establishments; include a modified hybrid mismatch rule.

**Threshold requirements to exclude low risk entities**
- Whilst the OECD considered de minimis and anti-avoidance exclusions, the only recommendation is an exclusion for entities not subject to a low level of taxation.

**Definition of control**
- Recommend at least a legal and an economic test, with a threshold of 50% or lower (e.g. to catch parties acting in concert or related parties).

**Definition of CFC income**
- Discussion of a variety of methods aimed at targeting highly mobile passive income.
- Two main approaches considered – a categorical approach (e.g. the UK’s rules) and an excess profits approach. The latter attributes any profits over a normal return irrespective of the type of income.
- One recommendation – should apply on an income stream basis and not an entity-by-entity approach.

**Rules for computing income**
- Recommend to use parent territory methods to calculate income and only allow loss offset within a CFC or within the CFC territory.

**Rules for attributing income**
- Attribute income to those persons satisfying the control test.
- Amount determined in proportion to ownership and for actual period of ownership.
- Timing of taxation, treatment of income and tax rate to follow parent territory.

**Rules to prevent or eliminate double taxation**
- Recommended rules should allow credit for actual tax paid by CFC and under CFC rules in intermediate territories.
- Dividends and gains representing profits which have already been apportioned should be exempt.

**What does this mean for business?**

For UK outbound multinationals, the key message is that the UK’s CFC regime is broadly consistent with the recommendations of the final CFC paper. Given that this regime was only introduced in 2013, and has broadly been welcomed by business, we would not expect significant pressure for change to this regime. In particular, the acceptance that CFC rules do not have to challenge ‘foreign to foreign’ profit shifting removes the following two concerns.

- **CFC gateway** – The UK’s current CFC gateway only requires an apportionment of profits of a CFC where, broadly speaking, the majority of the Significant People Functions (SPFs) are in the UK – i.e. the rules do not require the SPFs to be in the territory of residence of the CFC. Rules challenging ‘foreign to foreign’ profit shifting would require that the SPFs are in the CFC’s territory of residence, and hence the removal of this obligation should allow the gateway to continue unchanged.

- **Non-trading finance income exemption** – Similarly, there was a concern that the UK’s partial/full exemption of intra-group financing income would be contrary to the final paper if it required the prevention of ‘foreign to foreign’ shifting. The acceptance of a territorial approach to CFC rules should mean HMRC is free to retain these exemptions, if it so desires. Note though that Actions 8-10 may have implications for the amount of return that financing entities can earn from a transfer pricing perspective in the situation where it is the parent rather than the finance entity that is bearing the risk.

The only area where the UK CFC rules are currently not consistent with the recommendations is in relation to the elimination of double taxation. The UK currently allows a credit against a CFC charge where foreign tax is suffered by a CFC. However, we do not currently allow a credit where tax is suffered (e.g. through a CFC charge) at the level of an intermediate holding company. So we might well see a positive change the UK rules in that respect.

For inbound groups, then clearly the impact will depend on the response of the relevant parent company territories. Given the nature of the final paper and the lack of required minimum standards, however, then there is little direct pressure for change.

**What should businesses be doing?**

In its current form, the discussion draft will make it difficult for many groups to accurately assess the impact of any prospective changes to domestic rules, although it should be possible at this stage to make a preliminary risk assessment. But in a BEPS compliant environment certain issues are clear:

- Any groups who have separated ownership of highly mobile assets and functions such as Intellectual Property (IP), risk insurance and financing from the economic functions which generated them will be at increased risk.
- Where groups are relying on technical solutions to avoid CFC charges (e.g. decontrol strategies, CFC hybrid mismatch methods or inversion) then these are likely to be countered more effectively over time.

Such groups should be reviewing their business and corporate structures to make a fuller assessment of risk.

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BEPS Action 4: Interest deductions and other financial payments

What is the OECD trying to achieve?
The OECD is concerned that multinational groups are able to erode their tax base (i.e. reduce their taxable profits) with interest expense, for example by:

- locating third party debt in high tax countries;
- using intra-group loans to achieve interest deductions in excess of the group’s actual third party interest expense; or
- using related party or third party debt to finance the production of exempt or deferred income.

BEPS Action 4 calls for the development of recommendations for the design of domestic rules to prevent tax base erosion through the use of interest expense and other financial payments that are economically equivalent to interest.

What is proposed?
The final report on Action 4 recommends a best practice approach for limiting tax deductions for interest and other financial payments. It proposes that any rule adopted should deal with all forms of debt, payments equivalent to interest, and expenses related to financing. The recommended approach is the adoption of a fixed ratio rule applied to tax-adjusted earnings. This would restrict an entity’s tax deductions for interest expense and other financial payments to a percentage of its tax-adjusted earnings before interest, taxes, depreciation and amortisation (EBITDA). This approach is already used by a number of countries, including Germany and the USA. The OECD recommends a range of ratios of between 10% and 30% and provides guidance on factors which countries should take into account in setting their fixed ratio within this range.

The report also suggests other optional elements a country may choose to adopt including:

- a group ratio rule which would allow an entity to deduct interest up to the level of the net interest:EBITDA ratio of its worldwide group in circumstances where it exceeded the fixed ratio. Countries may apply an uplift of up to 10% to the group’s net external interest expense. Similar rules operate in Australia, Germany and New Zealand as a carve-out from a fixed ratio test, although these are often based on different ratio mechanisms (e.g. debt:equity ratios).
- a de-minimis limit (with relevant anti-fragmentation rules to prevent abuse);
- an exclusion for interest on loans used to fund public-benefit projects (e.g. PFI);
- carry forward (or potentially carry back) of disallowed interest and/or unused capacity (i.e. where interest in a territory is below the fixed ratio, e.g. if an entity is loss making); and
- specific targeted anti-abuse rules.

Specific rules are to be developed for the banking and insurance sector. Further work on this, as well as on detailed operation of the group ratio rule and transfer pricing aspects of financial transactions, will be completed in 2016. The OECD will revisit the design and content of these best practice rules by 2020, including consideration of whether the fixed ratios have been adequate to target BEPS.
What does this mean for business?

Whilst the paper contains a recommended best practice approach, there are a number of options for individual countries to consider. Countries are also not obliged to implement the recommendations, and there will, therefore, be differences in the approach taken by individual countries. It is, however, clear that these rules are likely to result in a reduction in the tax relief given for interest expense in many multinational corporations (MNCs). This is particularly true where a group has net external finance expense at the parent company level, but is unable to reallocate the debt to operating subsidiaries.

The recommendations are likely to significantly impact MNCs in a number of ways:

• increased effective tax rate (ETR), including the real risk that groups may not be able to deduct the full amount of external interest expense for tax purposes;
• tax rate volatility arising from the annual movements in figures which drive the allocation of interest across a group;
• increased compliance burden in applying the rules across multiple territories; and
• uncertainty in forecasting and decision making. As an example, the recommendations could impact the effective cost of capital, and consequently have an impact for M&A transactions.

What should business be doing?

Given the potential for these rules to significantly impact MNCs, and the level of optionality for various different interest deductibility regimes, we recommend that groups model the impact of the various proposals on their funding and cash management arrangements in order to assess:

• the potential impact of the proposals on their ETR;
• the territories most likely to be significantly impacted; and
• the potential impact after any change in the group’s debt profile (e.g. taking into account potential future key business decisions such as corporate acquisitions or long term contracts).

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Adapting to a changing environment

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BEPS Action 5: Counter harmful tax practices more effectively

What is the OECD trying to achieve?

In 1998 the OECD published a report on harmful tax competition which established criteria for determining whether a preferential tax regime is harmful. The continued importance of the work was highlighted by the inclusion of Action 5 of the BEPS Action Plan, and the creation of the OECD’s Forum on Harmful Tax Practices (FHTP). The priority of the FHTP has been on improving transparency, including compulsory spontaneous exchange of rulings relating to preferential regimes, and on requiring substantial activity for any preferential regime.

What is proposed?

Preferential IP regimes

The focus of the FHTP has been to agree and apply a methodology to define the substantial activity required for preferential regimes, with particular focus on preferential IP regimes. Based on the work performed, countries have agreed to limit tax benefits under preferential IP regimes using the ‘modified nexus’ approach. Under this approach, the amount of income which can benefit from a preferential regime is proportionate to expenditure directly related to development activities that demonstrates real value added by the taxpayer, and acts as a proxy for how much substantial activity the taxpayer undertook.

Taxpayers will need to track and trace expenditure, IP assets and income to ensure that the income receiving benefits does in fact arise from the expenditure that qualified for those benefits. Where tracking would be unrealistic and require arbitrary judgments, countries may allow expenditure to be tracked at the level of the product or product family.

Existing IP regimes which do not comply with the nexus approach (including the UK patent box) will be closed to new entrants after 30 June 2016. Taxpayers already within these regimes may continue to receive benefits for existing IP assets until 30 June 2021, although countries have agreed on safeguards to prevent taxpayers from using the transitional period inappropriately to receive tax benefits under existing IP regimes. In particular, IP transferred directly or indirectly from a related party after 1 January 2016 that did not already qualify for an existing IP regime, will not qualify for grandfathering.
Other preferential regimes
To date, Action 5 has focused on preferential IP regimes. However, the Action 5 report also included initial views on other categories of preferential regimes, and the substantial activity requirements that may be applicable. These include:

- headquarters regimes;
- distribution and service centre regimes;
- financing or leasing regimes;
- fund management regimes;
- banking and insurance regimes;
- shipping regimes; and
- holding company regimes.

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:

1. rulings related to preferential regimes;
2. cross border unilateral advance pricing arrangements (APAs) or other unilateral transfer pricing rulings;
3. rulings giving a downward adjustment to profits;
4. permanent establishment (PE) rulings;
5. conduit rulings; and
6. any other type of ruling where the FHTP agrees in the future that the absence of exchange would give rise to BEPS concerns.

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.

What does this mean for business?
Taxpayers benefiting from the preferential IP regimes (like the UK patent box regime) which only have one IP asset that has been fully self-developed, and that provides all of the IP related income, should not be impacted significantly by the nexus approach. Taxpayers which have IP assets that have only been partly self-developed, will find that the benefits under the nexus approach will be reduced. Furthermore, groups that separate IP asset ownership and R&D activities into separate companies (whether or not the companies are located in the same country) will no longer benefit under the nexus approach without restructuring and aligning IP asset ownership and R&D activities.

Groups benefiting from other preferential regimes could also be impacted in future by the continued work of the FHTP. This will be most relevant where the core income generating activities are not aligned with the income benefiting from the particular regime.

What should businesses be doing?
Taxpayers should consider the impact of the proposed changes.

- How will the nexus approach impact claims under existing preferential IP regimes?
- Are your R&D activities and IP asset ownership sufficiently aligned?
- How will you comply with the tracking and tracing requirements?
Adapting to a changing environment

BEPS

BEPS Action 6: Prevention of treaty abuse

What is the OECD trying to achieve?

Double taxation treaties are agreements between two countries that aim to eliminate the double taxation of income which would otherwise be taxable in both countries under their domestic tax rules. The OECD is concerned that multinational groups may be structuring transactions to take advantage of more favourable treaties (treaty shopping) and/or engaging in tax planning arrangements using treaties in such a way that they may result in double non-taxation. Action 6 of the BEPS Action Plan identified treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns. It called for development of model treaty provisions and recommendations regarding the design of domestic tax rules to prevent the granting of treaty benefits in inappropriate circumstances.

What is proposed?

The OECD recommends countries include anti-abuse provisions in their tax treaties. It proposes a minimum standard to counter treaty shopping, but with some flexibility in the implementation of this minimum standard as follows:

• inclusion of a US-style limitation on benefits (LOB) article (i.e. a provision which limits treaty benefits to claimants who have the requisite links to the countries which are party to the treaty), accompanied by a principal purpose test (PPT) which would deny benefits for transactions which have a main purpose of obtaining a treaty benefit;
• an LOB accompanied by a narrower anti-abuse rule; or
• a stand-alone PPT.

The OECD has also recommended a number of other targeted anti-avoidance provisions to address treaty abuse.

The OECD notes that the US model treaty is in the process of being amended and it will, therefore, revisit some of its recommendations once the update to the US model treaty has been concluded. The treaty entitlement of investment funds will also be revisited in 2016.

All of the required changes to double taxation treaties are to be implemented via the multilateral instrument which is being developed under action 15, and which is due to be completed and open for signature by the end of 2016.
What does this mean for business?

The proposals may restrict or prevent access to treaty benefits, such as the reduction or elimination of withholding tax on dividends, interest and royalty payments. This may impact on a group’s ability to establish group finance companies and/or repatriate cash or reserves to its parent company or shareholders. Particular issues may arise where:

• income is paid to collective investment vehicles (CIVs), pension funds, or other funds;
• there are intermediate holding companies in a group structure;
• companies do not have an active trade or business in their territory of residence;
• income is subject to a preferential tax regime;
• activities are carried on through a branch;
• group finance or holding companies do not have appropriate substance; or
• a country introduces a general exemption from tax for foreign income after a treaty is signed.

Although the multilateral instrument to implement these recommendations is not due to be completed until the end of 2016, some countries are already starting to incorporate BEPS measures into treaties which are currently being negotiated or signed. There is also like to be renewed tax authority focus on treaty access under existing rules (e.g. beneficial ownership requirements).

What should businesses be doing?

Businesses should:

• review their existing holding structure and cash management/repatriation strategies to identify areas which may be susceptible to challenge under the proposed wide anti-abuse rules (LoB/PPT), targeted anti-abuse rules, or more rigorous application of existing rules;
• identify potential exposure to withholding taxes;
• assess the potential impact on cross border financing strategies and consider alternative approaches; and/or
• forecast cash and distributable reserve requirements for shareholder returns and develop contingency plans where shortfalls or incremental tax costs may arise.
What are the OECD trying to achieve?
The permanent establishment (PE) threshold test is contained in many countries’ domestic tax laws and double tax treaties. It determines whether a business has sufficient activity in another territory to create a taxable presence in that other territory from a corporate tax perspective. The existing PE rules were designed many years ago, and the OECD is now reviewing this threshold due to the concern that multinational groups are able to structure arrangements to circumvent the existing PE definition contained in Article 5 of the OECD Model Tax Convention on Income and Capital (treaty definition). BEPS Action 7 requires the OECD to update the treaty definition of PE and associated commentary in order to prevent abuse of that threshold.

What is proposed?
Under the current treaty definition of PE, the threshold of activity of an enterprise in one territory that results in the creation of a PE in another territory is determined by two forms of presence:

- **Fixed place of business test** – An enterprise has a PE in another territory if it has a fixed place of business there through which it carries on its business, subject to a number of specific activity exemptions.

- **Dependent agent test** – An enterprise has a PE in another territory where a person (other than an independent agent) is acting on its behalf, and habitually exercises an authority to conclude contracts in its name, in that other territory.

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The OECD has recommended changes to the treaty definition of PE and the associated commentary to address various PE avoidance strategies.

**Commissionaire arrangements and similar strategies**
The scope of the dependent agent test is to be expanded to include situations where an agent ‘habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the [principal]’. The independent agent exemption is to be narrowed, and in many cases related parties would no longer be considered independent agents.

**Specific activity exemptions and fragmentation of activities**
It is recommended that the specific activity exemptions be restricted to activities that are of a preparatory or auxiliary nature, although there is an alternative option for states that do not favour this approach. Furthermore, the specific activity exemption will not be available if there is an existing PE of the enterprise or an affiliate, or there is no PE but the overall activity of those connected enterprises is not of a preparatory or auxiliary nature. This could remove this exemption when, for instance, there is a local marketing or distribution company as well as the potential PE.

**Splitting-up of contracts**
Currently a construction site or installation project only constitutes a PE if it lasts more than 12 months. The artificial splitting-up of contracts to circumvent this 12 month rule is to be addressed either through an automatic rule that would take account of any activities performed by associated enterprises, or through the application of a wider treaty principal purpose test (proposed as a result of work under Action 6 on treaty abuse).

**Insurance**
The OECD is concerned that foreign insurance companies can use a large network of exclusive agents to sell insurance in a territory without having a PE. However, it has concluded that there should be no special rules applicable to insurance, and these concerns should be addressed by proposed changes to the dependent agent test.

There is no new guidance on the attribution of profits to PEs. Work will continue in this area with updated guidance to be produced by the end of 2016 (the deadline for the negotiation of the multilateral instrument under Action 15, which will implement the results of the work on Action 7).

**What does this mean for business?**
Taken together, the proposals will expand the scope of the existing PE rules, and there could be collateral impact on arrangements which are not specifically targeted. The increased interest in PE rules as a result of these proposals, coupled with recent unilateral initiatives (such as the introduction of the UK Diverted Profits Tax), and media attention on certain business models, is also likely to result in further scrutiny and challenge from tax authorities under the current PE rules.

**What should businesses be doing?**
- Identify arrangements that could give rise to heightened PE risk under both current and proposed rules.
- Develop operating guidelines and processes/controls to monitor and mitigate PE risk.
- Engage with tax authorities to manage both threshold PE issues and profit attribution, for example, through the use of advance pricing agreements.

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Adapting to a changing environment

BEPS

The OECD, with the backing of the G20, published a 15 point action plan in July 2013 setting out proposals to address base erosion and profit shifting (BEPS). The project has developed in response to concerns that the interaction between various domestic tax systems and double tax treaties can often lead to profits falling outside the charge to tax altogether or be subject to an unduly low rate of tax. The OECD published its final BEPS package in October 2015.

BEPS Actions 8-10
Intangibles – Revisions to Chapter VI of the Transfer Pricing Guidelines

What is the OECD trying to achieve?
The revisions to Chapter VI of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (‘Transfer Pricing Guidelines’) provides guidance specifically tailored to determining arm’s length conditions for transactions that involve the use of transfer of intangibles under Article 9 of the OECD Model Tax Convention. The updated chapter continues the focus on aligning the location of profits for tax purposes with the location of the activities giving rise to those profits, with a particular emphasis on the returns associated with risk and capital.

What is proposed?
The revised guidance means that companies performing important functions, controlling economically significant risks and contributing assets will be entitled to an appropriate return reflecting the value of their contribution. Specific guidance seeks to ensure that the analysis is not weakened by information asymmetries between the Tax Administration and the MNE in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement. The guidance also considers the returns associated with financial risk and recommends that the level of return associated with such risk should be commensurate with the degree of control exercised by the finance provider.

In summary, the key themes of the paper are as follows:
- Identification of intangibles, specifically, intangible assets should be capable of being owned and controlled;
- Legal ownership of intangibles, of itself, does not carry with it an entitlement to returns from the exploitation of intangibles;
- Enterprises performing important value-creating functions related to the development, maintenance, enhancement, protection and exploitation of the intangibles should be remunerated appropriately;
- An enterprise assuming risks in relation to an intangible must exercise day to day control over the risks and have the financial capacity to assume those risks if it is to be rewarded with the return associated with the intangible;
- Enterprises providing funding and assuming the related financial risks, but not performing any functions in relation to the intangible, should only expect a risk-adjusted financial return;
- The provision of funding alone will result in no more than a risk-free financial return; and
- Transfer pricing analysis by taxpayers is required to ensure transfers of hard-to-value intangibles are priced at arm’s length. The use of future (ex ante) returns is only appropriate if risks and the probability of reasonably foreseeable events have been accounted for.
What does this mean for business?

The new guidance provides additional tools for Tax Administrations to challenge artificial arrangements or arrangements that lack substance concerning the creation and exploitation of intangibles. The focus of the recommendations puts a far greater emphasis on the functions performed and on evidencing the location in which the control of risks associated with intangibles is exercised. Tax Administrations will also be given a mandate to challenge transfer pricing policies concerning hard to value intangibles where the uncertainty of actual (ex post) returns have not been appropriately considered.

Businesses should therefore ask themselves the following questions:

• What do the changes mean for your intangibles strategy?
• How will you explain your intangibles strategy to tax authorities?
• How will the changes impact current transfer pricing policies?
• What are the risks and opportunities arising from the changes?

What should businesses be doing?

Given the potential impact these new rules are likely to have on business, we would recommend that groups review their intangible arrangements in order to:

• Assess the impact that the new rules will have on their current intangibles strategy;
• Review the global value chain to provide a clear understanding of the groups global business process and its interaction with intangibles;
• Understand how intangibles interact with other functions, risks and assets; and
• Review the impact the changes will have on other BEPS action points, in particular action 13 in relation to the new transfer pricing documentation requirements, which includes a particular focus on intangibles.

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BEPS Actions 8-10: Risks and capital

What is the OECD trying to achieve?
Through its work on risks and capital, the OECD is targeting Base Erosion and Profit Shifting (BEPS) resulting from transferring risks among, or allocating excessive capital to, group members.

The OECD’s work focuses on four principal objectives:
1. to make sure that the legal terms of intragroup transactions match the economic reality;
2. to raise the bar on the level of substance required to support the assumption of risks;
3. to limit the reward to capital, unless it is co-located with the people-based activities required to deploy that capital; and
4. to allow tax authorities a broader remit to disregard transactions where the components noted above are not present.

The mechanism to deliver these objectives is a substantial redraft of the OECD’s Transfer Pricing Guidelines.

What is proposed?
There are four main changes reflected in the revised Guidelines.

1. The first emphasises the need to be transparent in how risks are allocated within a multinational, and to show this is consistent with how the counterparties to a transaction act in practice.

2. Second, there is extensive guidance on identifying the specific, business-critical risks relevant to a transaction. This includes a risk impact assessment so that the right transfer pricing analysis can be performed.

3. The third area is a new framework for analysing risk, covering an approach to evaluating decision-making around control (the capability to assume and respond to risk), and the financial capacity to bear risk (including access to funding and liquidity).

4. The last area addresses the situation where a capital-rich member of a group provides funding but performs few activities associated with that funding (e.g. credit checks etc.). If it does not control the financial risks associated with the funding, then the profit it is entitled to retain will be limited to no more than a risk-free return.
What does this mean for business?

The most immediate consequence is a much stronger focus on the processes that govern risk control, risk mitigation and risk finance.

Groups need to articulate more clearly than ever what the critical risks are for their business and how those risks are managed on a day-to-day basis.

Where risk-mitigation activities are divorced from the location of the risk bearing entity, groups will need to evidence close, careful and frequent supervision of the sub-contractor.

Practically, taxpayers should expect a shift in the onus of proof where risk and capital are key components of the value chain. Tax authorities now have a greater remit to investigate and scrutinise transactions and structures.

The upshot is that there will be more challenges around recharacterisation from tax authorities.

What should businesses be doing?

Now that the guidance is final, groups should re-evaluate the structures or transactions that rely heavily on risk or capital to drive value.

Proving that risks are assumed and controlled in line with contracts will be challenging. At a minimum, groups should revisit their intragroup contracts and update them to reflect the OECD’s approach to risk identification and allocation.

To be on the front foot, groups will need to be able to prove where and how risk-decisions are made. They will need to produce the evidence to support these assertions. In many cases, that will require a change in how decisions are documented, including the evaluation of potential alternatives.

These changes will lead to increased controversy in an area which is already highly subjective. This can only increase the potential for double taxation. It is vital that senior stakeholders understand and plan for the financial consequences of the BEPS programme for their organisation.
The OECD, with the backing of the G20, published a 15 point action plan in July 2013 setting out proposals to address base erosion and profit shifting (BEPS). The project has developed in response to concerns that the interaction between various domestic tax systems and double tax treaties can often lead to profits falling outside the charge to tax altogether, or be subject to an unduly low rate of tax. The OECD published its final BEPS package in October 2015.

BEPS Action 12: Mandatory Disclosure Rules

What is the OECD trying to achieve?
The Base Erosion and Profit Shifting (BEPS) Action Plan suggests that one of the key challenges faced by tax authorities is a lack of timely, comprehensive and relevant information on potentially aggressive tax planning strategies. Action 12 was required to consider:

- Recommendations for the modular design of a mandatory disclosure regime (MDR) to give tax authorities early access to information on aggressive tax arrangements, identify schemes and their users and promoters, and deter the promotion and use of such schemes;
- A focus on how mandatory disclosure can be made more effective in the international context, given that tax administrations believe that relatively few cross-border schemes are disclosed under existing disclosure regimes; and
- Design of enhanced models of information sharing between tax administrations.

What is proposed?
The final report published on 5 October 2015 sets out recommendations for the design of an MDR for those countries who wish to introduce one, but leaves countries free to choose whether or not to introduce an MDR. It also makes recommendations for those countries who have an MDR, to help those rules focus on those international tax outcomes which cause most concern to those countries.

The report discusses a number of existing tax avoidance disclosure regimes, including the rules in force in the UK, the US and Ireland. In looking at the effectiveness of such regimes, the OECD has paid particular attention to the UK’s Disclosure of Tax Avoidance Schemes (DOTAS) rules.
It recommends the following design features, which are all features of the UK's DOTAS rules:

• **Who has to report** – Countries which adopt an MDR will need to decide whether the obligation to disclose should be imposed on both the promoter and the taxpayer, or primarily on the promoter. Where the primary reporting obligation falls on the promoter, the reporting obligation should switch to the taxpayer where the promoter is offshore, where there is no promoter, or where the promoter asserts legal professional privilege.

• **What has to be reported** – A scheme should be reported if it falls within certain ‘hallmarks’. An MDR should include a mixture of specific hallmarks reflecting particular or current concerns of tax authorities (such as the use of losses), and generic hallmarks which target features which are common to promoted schemes (such as the requirement for confidentiality, or the payment of a premium fee). Where a scheme triggers one hallmark that should be sufficient to require disclosure.

• **When information is reported** – Disclosure should be triggered by the scheme being made available to taxpayers if the promoter has the obligation to disclose or by implementation if the taxpayer has the obligation to disclose.

• **Other obligations for promoters or users** – Where the promoter has the obligation to disclose they should provide users with scheme reference numbers and provide tax authorities with client lists.

• **Consequences of compliance/non-compliance** – The fact that a transaction is reportable does not necessarily mean that it involves tax avoidance, but equally disclosure does not imply acceptance of the transaction by the tax authority, and this should be made explicit in MDR legislation. Countries should introduce financial and other penalties for non-compliance.

**International tax schemes**

The OECD makes the following recommendations on the design of a disclosure regime for international tax schemes:

• The regime should build on existing domestic disclosure regimes, with some additional hallmarks to target cross-border tax planning.

• An arrangement that incorporates a cross-border outcome should be treated as reportable in a country if it involves a domestic taxpayer of that country. A domestic taxpayer would be treated as involved in a cross-border arrangement where it has a material impact on the taxpayer’s tax reporting position.

**What does this mean for business?**

From a UK perspective, adoption of an extended disclosure requirement for cross-border transactions and the increase in use of treaty exchange of information powers by the tax authorities would be expected to lead to an increase in the number of enquiries from HMRC, with the potential for an increase in the number of disputes. Depending on the precise scope of the measures this could be burdensome as ordinary commercial transactions might fall within its scope.

There could be considerable difficulties where an entity or advisor is only involved in part of a transaction.

**What should businesses be doing?**

Businesses need to be aware of this development and follow progress, not just in the local jurisdiction, but in all jurisdictions where they operate.

Businesses and advisors will have to think about having suitable procedures in place on cross border transactions to ensure compliance.
BEPS Action 13: Country by country reporting and transfer pricing documentation

What is the OECD trying to achieve?

Action 13 of the BEPS Action Plan calls for the development of rules for transfer pricing documentation to enhance transparency for tax administrations, providing them with the information they need to conduct transfer pricing risk assessments and transfer pricing audits.

What is proposed?

The OECD proposes a three-tied approach to transfer pricing documentation for multinational enterprises (MNEs):

- A **master file** containing specific information relevant for all MNE group members.
- A **local file** referring to material transactions of the local taxpayer.
- A **country-by-country report** (CBCR) containing high-level data on the global allocation of the MNE’s income and taxes, and certain other measures of economic activity.

MNEs with a turnover above 750 million euros (£586 million in the UK) must use the CBCR template for fiscal years beginning on or after 1 January 2016. The ultimate parent entity of an MNE group will be required to file the CBCR in its country of tax residence, and the CBCR will be shared automatically with tax authorities in other jurisdictions in which the MNE group operates. The UK government introduced legislation in Finance Act 2015 to enable implementation of the OECD’s model for CBCR, and draft regulations were published for consultation on 5 October 2015.

The OECD CBCR implementation package also includes:

- Model legislation which may be used by a country to require the ultimate parent entity of an MNE group which is resident in that country to file the CBCR.
- Model Competent Authority Agreements that may be used to facilitate exchange of CBCRs with tax administrations in other jurisdictions.
What does this mean for business?

Even if a group does not exceed the 750 million euros (or £586 million) limit and so is not required to file a CBCR, it will still be required to produce a master file and local files. The OECD have broadened the information required from taxpayers significantly and both the master file and local file require a lot more quantitative analysis than currently required for TP documentation. Many groups expect significant transparency, operational and systems challenges in meeting CBCR and/or master file and local file requirements. For example:

- How will data be interpreted by tax authorities and other stakeholders?
- Do you have the technology and systems in place to gather and report the data required?
- Do you have adequate governance and control frameworks to ensure accurate reporting and execution of transfer pricing policies?

What should businesses be doing?

- Ensure you understand which information you will be required to report – what’s in and what’s out?
- **Dry run and impact assessment**: Undertake a dry-run now to assess the risks that will arise when the group is required to report in 2017.
- **Process and governance**: Consider whether additional resource is required to manage CBCR, master file and local file implementation and ongoing reporting.
- **Data and technology**: Undertake a strategic assessment of your technology capabilities as they relate to CBCR, transfer pricing documentation and wider transparency and tax reporting requirements.

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BEPS Action 14: Making Dispute Resolution Mechanisms More Effective

**What is the OECD trying to achieve?**

Taken together, the BEPS Actions aim to eliminate double non-taxation and align the location of profits with the location of activities. However, the implementation of these actions is expected to lead to an increase in the number of tax disputes, which increases the risk of resultant double taxation.

The paper on Action 14 is aimed at providing effective Mutual Agreement Procedures (MAP) that enable the elimination of double taxation through the resolution of disputes between tax authorities in a timely manner.

**What is proposed?**

The final version of the OECD paper on this Action provides a commitment that countries will implement minimum standards, driven by a strong convergence by countries to have a common direction. The minimum standards should ensure that:

- taxpayers can access MAP when eligible;
- administrative processes promote the timely resolution of treaty-related disputes within a target of 24 months; and
- treaty obligations related to MAP are fully implemented in good faith.

Additionally, 20 countries have committed to provide in their bilateral tax treaties for mandatory binding arbitration to guarantee that cross-border disputes should be resolved within a specified time frame. This is good news, as together these 20 countries were involved in more than 90% of outstanding MAP cases at the end of 2013.
What does this mean for business?

The paper highlights the practical issues that can hinder MAP and the key question is the extent to which countries will implement the recommendations to deliver real improvements in MAP. To help achieve this, a monitoring mechanism will be introduced that will assess the effective implementation of the minimum standards by each country, although the first reports are not expected to be published until the end of 2017.

Also, the paper makes it clear that there is no consensus between countries on the adoption of arbitration as a mechanism to ensure the resolution of MAP cases. Changing bilateral treaties to introduce mandatory binding arbitration will inevitably take some time. So a provision for mandatory binding arbitration is to be developed as part of the negotiation of the multilateral instrument under Action 15, although the OECD has indicated that negotiations on all aspects of that instrument are not expected to conclude before the end of 2016.

What should businesses be doing?

As the number of disputes with tax authorities is inevitably going to increase, businesses should be prepared for the possibility that they may well need to make a MAP claim. They should ensure that their transfer pricing documentation is robust and that other supporting contemporaneous documentary evidence is available.

Businesses should also be proactive, both in terms of applying for MAP as soon as this seems a likely outcome, and therefore not falling foul of time limits, and in keeping in touch with the relevant competent authorities to make sure their case is effectively progressed.

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Adapting to a changing environment

The final recommendations from the OECD’s base erosion and profit shifting (BEPS) project were released on 5 October 2015. The recommendations were endorsed by the G20 Finance Ministers on 8 October 2015 and they renewed their commitment for rapid, widespread and consistent implementation of the measures.

BEPS – Impact for indirect taxes

What are the OECD’s recommendations trying to achieve?

Changes recommended under the BEPS action plan will fundamentally alter international tax rules. The action plan categorised its various areas of focus into three themes: addressing substance; coherence of the international tax system; and transparency.

Substance actions seek to align taxing rights with the relevant value-adding activity. Coherence actions aim to remove gaps and ‘black holes’. Transparency actions look to provide significant additional disclosure.

In addition to the various items grouped under these themes, the action plan also seeks to address digital business, improve dispute resolution and create a multilateral instrument for rapid updating of bilateral tax treaties.

Whilst the vast majority of the recommendations are focused on corporate tax and transfer pricing, there are also specific proposals in respect of indirect tax.

Furthermore, and perhaps less obvious to businesses at this stage, there are, in our view, likely to be considerable knock-on effects for indirect taxes as a result of the wider corporate tax and transfer pricing (TP) proposals and the way businesses respond to these.

What are the specific proposals in respect of indirect taxes?

Action 1 in respect of the Digital Economy, contains specific references to BEPS issues arising with respect to indirect taxation, namely:

2. Remote digital supplies to exempt businesses/remote digital supplies to multi-location enterprises.
3. VAT/GST on low value imports.

Recommendations to address these issues are:

1. The place of supply for B2C services should follow the destination principle i.e. collection of VAT on B2C transactions in customer location. To support this change, a simplified registration and compliance regime, similar to the EU Mini One Stop Shop, should be put in place for non-resident suppliers.

2. For B2B ‘remote digital’ supplies, the place of supply should be where the customer’s business establishment is located (where established in more than one jurisdiction, taxation should accrue to where the establishment using the service is located), with a requirement to apply a reverse charge.

3. Models to improve the efficiency of the collection of VAT on low value goods should be evaluated, with a view to then lower or remove the relevant VAT thresholds.
Avoidance of permanent establishments

The final OECD recommendations on Action Point 7 reduces the permanent establishment (PE) threshold with a focus on expanding the scope of PEs created by dependent agents. As a result, it is likely that businesses will have to recognise more PEs and therefore the question of VAT establishments associated with those PEs and supplies there from will also come to the fore. Many countries outside the EU do not distinguish between a VAT fixed establishment and a PE for corporate tax purposes and therefore the lowering of the PE threshold is likely to result in an increased number of VAT fixed establishments for business operating internationally. For the EU countries, as there is no legislative direct link between VAT fixed establishment and tax permanent establishment under EU VAT law this risk should be lower. But, in a number of Member States, in practice, a PE can already lead to a presumption that there is a VAT establishment. Finally, businesses considering changes to current operating models such as commissionaire structures as a result of the reduced PE threshold, will also have to consider the knock-on VAT implications of any such changes, including:

- Impact on place of supply of (goods &) services;
- Impact on who has to account for local VAT – Intervening and receiving establishment test;
- Systems need to capture additional VAT accounting and invoicing requirements;
- Penalties and interest on under-declarations;
- Cost of negotiations and re-invoicing.

Country by country reporting

BEPS Action 13 recommends a three-tiered approach to transfer pricing documentation for multinational enterprises (MNE), with arguably the most important change being the requirement for a country-by-country report (CBCR) containing data on the global allocation of the MNE’s income and taxes. These requirements will go live from 1 January 2016 and whilst the disclosures are primarily to be made for direct tax purposes the information contained therein could be used to sense check VAT positions and may also bring to light additional transactions which are taxable supplies for VAT purposes or constitute items to be included in the customs duty value of imports.

TP outcomes

The recommendations arising from BEPS actions 8–10 will increase the focus on transfer pricing and the analysis of issues relating to the arm’s length principle, and transfer pricing adjustments will be in the spotlight more than ever. Transfer pricing adjustments are not always neutral for indirect tax purposes and can generate additional VAT and customs duty costs on top of the actual adjustments if not considered carefully.

What next?

- Ensure that the indirect tax impacts of BEPS are recognised and identified.
- Proactively engage with corporate Tax and transfer pricing colleagues regarding the changes.
- Monitor the implementation of the recommendations as relevant to your business – Changes to treaties, TP guidelines, or domestic law-unilateral actions by states.
- Anticipate, plan for and respond to the behavioural impact that these changes will have on business/tax authorities.

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