

TEI-SJSU High Tech Tax Institute

BEPS Update: aka “BEPS 2.0”

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November 14, 2017

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Agenda

1. BEPS Action 7: Discussion Draft on Attribution of Profits to PEs
2. BEPS Actions 14 & 15: Dispute Resolution and the Multilateral Instrument
3. BEPS Actions 8-10: Hard to Value Intangibles and Profit Splits
4. BEPS Action 13: Country-by-Country Reporting
5. BEPS 2.0: Implications for U.S. tax reform?

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2008

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.
4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

2010

BUSINESS PROFITS

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.

4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

2008

[T]here shall . . . be attributed to that permanent establishment the profits which it might be expected to make if it were **a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise** of which it is a permanent establishment.

In determining the profits of a permanent establishment, **there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment**, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

Insofar as it has been customary in a Contracting State **to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts**, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

No profits shall be attributed to a permanent establishment **by reason of the mere purchase** by that permanent establishment **of goods or merchandise** for the enterprise.

2010

[T]he profits that are attributable . . . to the permanent establishment . . . are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were **a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise**.

- Functionally separate entity approach
- 2008 Report: [T]he authorised OECD approach is that the profits to be attributed to a PE are the profits that the PE would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle under Article 7(2).
- 2010 Report: The authorised OECD approach is that the profits to be attributed to a PE are the profits that the PE would have earned at arm's length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

- First step: Perform a functional and factual analysis, conducted in accordance with the guidance found in the Guidelines, to hypothesise appropriately the PE and the remainder of the enterprise as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks, and entering into dealings with each other and transactions with other related and unrelated enterprises.
- Second step: Determine the remuneration of any dealings between the hypothesised enterprises by applying by analogy the Article 9 transfer pricing tools by reference to the functions performed, assets used and risk assumed by the hypothesised enterprises.
- Dependent agent enterprise (DAE) vs. dependent agent PE (DAPE)

- 2016 Discussion Draft
 - Guidance via examples with numbers and specific facts on people functions
 - Gaps in AOA analysis
 - Article 9 vs Article 7 ordering
 - Based on 2010 Article 7 – “full AOA” vs. more widely applicable “partial AOA”
- 2017 Discussion Draft
 - Guidance via high-level general principles
 - No numbers and no real detail on how to attribute profits
 - Gaps in AOA analysis

- Where do we now stand on guidance on attribution of profits to a PE?
- Implications for adoption of revised PE thresholds by countries?
- Application of AOA under US tax treaty network?
- Implications for competent authority cases?
- Planning strategies for multinational companies

OECD BEPS: Actions 14 & 15

- *Improving Dispute Resolution, including the Mutual Agreement Procedure*
 - *Multilateral Instrument*



BEPS Actions 14 & 15: MAP Process and MLI

- Multilateral Instrument (MLI)
 - Developed to quickly implement BEPS treaty-related actions
 - Action 6 Treaty Abuse – preamble, LOB or principal purpose test (PPT)*
 - Action 7 Artificial Avoidance of PE Status – commissionaire, splitting up contracts, preparatory & auxiliary
 - Action 14 Improve Dispute Resolution – Mutual agreement procedure
- MLI statistics (from OECD 17 October Webcast)
 - 71 signatories, 1,136 “matched agreements”
 - Action 6: >1,100 preamble and PPT; >40 PPT and simplified LOB
 - Action 7: >300 PE changes (low?)
 - *Action 14: >160 arbitration*
 - Need 5 ratifications to go into effect; expected early 2018



Mutual Agreement Procedure (Action 14)

- A BEPS “minimum standard”
- Provides for best practices to make dispute resolution mechanisms, including MAP, more effective
- Also calls for peer review
 - Eight batches from December 2016 to April 2019
 - U.S. in the first batch, report issued in September
- Results of U.S. peer review report
- Current U.S. MAP Process update
- U.S. Japan/Korea Developments



OECD developments - Actions 8-10

The October 2015 BEPS final reports left some transfer pricing-related issues open for later guidance

Actions 8-10

- Implementation guidance on HTVI
- Guidance on the application of profit splits

OECD discussion drafts

Discussion Draft	Release Date	Comments Due
HTVI	May 23, 2017	June 30, 2017
Profit Splits	June 22, 2017	September 15, 2017

HTVI – background

Final report on Actions 8-10 (October 2015) provided guidance on transfer pricing of HTVI

Definition of HTVI – intangibles for which:

- no reliable comparables exist, and
- at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.

Information asymmetry between taxpayers and tax administrations may be acute for HTVI making it difficult for a tax administration to establish or verify their arm's length pricing

HTVI approach – tax administration can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements

- Four exemptions to the HTVI approach



OECD implementation guidance on HTVI

Implementation principles

- Tax administrations can consider applying the HTVI approach if the exemptions to the HTVI approach do not apply
- The *ex post* outcomes inform the determination of the valuation that would have been made at the time of the transaction; however, it would be incorrect to base the revised valuation on the actual income or cash flows without taking into account the probability of achieving such income or cash flows at the time of the transfer of the HTVI.
- Where a revised valuation shows that the intangible has been transferred below or above the arm's length price, the revised value of the transferred intangible may be structured using contingent payments and price adjustment clauses, irrespective of the payment profiles asserted by the taxpayer.
- Tax administrations should apply audit practices to ensure that presumptive evidence based on *ex post* outcomes is identified and acted upon as early as possible

Three examples to illustrate the implementation principles



Practical considerations

How much consensus or divergence will there be among tax authorities about the interpretive issues?

Addressing hindsight bias

- HTVI approach creates a presumption, not a rule
- Taxpayer should be able to rebut presumption – how?

Use of contingency clauses under HTVI approach

- Consistency with Chapter I on risk allocation
- Application of contingency clauses even without the use of HTVI approach?

Dispute resolution

- Statute of limitations
- How effective will MAP be at resolving differences?



Profit splits - background

BEPS Action 10: "...clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains..."

Revisions to OECD Transfer Pricing Guidelines Chapter II on transactional profit split method (TPSM)

Prior discussion draft on profit splits issued July 4 2016

- Significant changes from prior guidance



Profit splits – OECD guidance

When is a TPSM likely to be the most appropriate method?

- Strengths and weaknesses of TPSM
- Nature of transaction
 - Unique and valuable contributions by each party
 - Highly integrated business operations
 - Shared assumption of economically significant risks, separate assumption of closely related risks

Guidance for application of a TPSM

- Approaches to splitting profits – contribution analysis, residual analysis
- Determining the profits to be split – measures of profit, anticipated vs actual profit
- Splitting the profits

Ten examples illustrating the TPSM principles

Three questions posed to commentators from the OECD



Practical implications

How will tax authorities interpret the profit split guidance?

- What is meant by unique and valuable contributions, highly integrated operations?

Selection of the most appropriate method – *relative* reliability important

Relationship with other guidance from BEPS action plan

- DEMPE
- Control over risks
- Role of contracts
- Attribution of profit to PE



OECD BEPS – CbC Update

- *Handbook on Effective Tax Risk Assessment*
- *Guidance on Appropriate Use of Information Contained in CbC Reports*

OECD Handbook on Effective Risk Assessment

- ~90 page document re: how tax authorities should use CbC info
- Key Elements
 - Brief description of how certain countries currently use risk assessment (e.g., Brazil, Canada, India, others)
 - 19 tax risk factors based on information contained in CbC reports
 - Each factor has 2-3 paragraph explanation of the factor
 - *Including* – suggested explanations for why an entity of an MNE may *not* be engaged in BEPS even in the presence of the factor
 - Ratios that tax authorities may want to use to assess tax risk
 - Lengthy example in Annex 3

OECD CbC Handbook: Risk Factors

1. A group's footprint in a particular jurisdiction
2. Activities in a jurisdiction are limited to those that pose less risk
3. A high value or high proportion of related party revenues in a particular jurisdiction
4. The results in a jurisdiction deviate from potential comparables
5. The results in a jurisdiction do not reflect market trends
6. Jurisdictions with significant profits but little substantial activity
7. Jurisdictions with significant profits but low levels of tax accrued
8. Jurisdictions with significant activities but low levels of profit (or losses)
9. Activities in jurisdictions that pose a BEPS risk
10. "Mobile" activities in jurisdictions where the group pays a lower rate or level of tax
11. Change in group structure, including location of assets
12. IP ownership separated from related activities within a group
13. Marketing entities in jurisdictions outside of key markets
14. Procurement entities in jurisdictions outside of key manufacturing locations
15. Year to year, income tax paid is consistently lower than income tax accrued
16. Dual resident entities
17. Entities with no tax residence / stateless status
18. Stateless revenues
19. Information in a group's CbC Report does not correspond with information previously provided by a constituent entity



Potential tax risk indicator	What this could mean	How else it might be explained
The footprint of a group in a jurisdiction	A group with a small footprint may have less potential to pose significant tax risk	A low footprint on a CbC Report could be misleading if the activities in a jurisdiction are more significant. This should be corroborated against other information and the experience of the tax compliance team.
A group's activities in a jurisdiction are limited to those that pose less risk	A group's activities in a jurisdiction may be of a type that are subject to a lower level of tax (e.g. where dividends and gains earned by a holding entity benefit from a participation exemption)	An entity whose main activity would typically pose lower tax risk may still engage in BEPS. Other available information should be considered for indicators that taxable income in the jurisdiction should be higher.
There is a high value or high proportion of related party revenues in a particular jurisdiction	A high value or proportion of related party revenues might mean that even a small transfer pricing error could have a significant tax impact.	Groups may include entities that deal wholly or mainly with related parties for commercial reasons
The results in a jurisdiction deviate from potential comparables	Differences between a jurisdiction and the chosen comparable could be driven by BEPS	The chosen comparable may be unreliable, or there may be commercial factors to explain any difference
The results in a jurisdiction do not reflect market trends	Results may be being distorted by BEPS activity	Results may be being impacted by commercial considerations
There are jurisdictions with significant profits but little substantial activity	Profits may have been shifted away from the jurisdiction where the underlying economic activity is occurring	There may be commercial reasons why results in a jurisdiction may seem high relative to the activity measures in a CbC Report (e.g. due to tangible assets being heavily depreciated, or intangible assets that are not disclosed)
There are jurisdictions with significant profits but low levels of tax accrued	A low effective tax rate to indicate that a group is using BEPS to shelter taxable income	Non-BEPS reasons may explain low levels of tax accrued (e.g. accelerated tax depreciation)
There are jurisdictions with significant activities but low levels of profit (or losses)	Profits that are attributable to a jurisdiction may be being shifted to a jurisdiction where they are taxed more favourably	Some activities within a group may be more asset-intensive or staff-intensive than others (e.g. administrative functions may have a low profit per employee compared to the group)
A group has activities in jurisdictions which pose a BEPS risk	A group may be engaged in a known BEPS-related activity	There may be non-BEPS reasons to explain why a group has activities in a particular jurisdiction

Potential tax risk indicator	What this could mean	How else it might be explained
A group has mobile activities located in jurisdictions where the group pays a lower rate or level of tax	A group may have shifted mobile activities to a jurisdiction to benefit from a favourable tax regime	Profit from mobile activities may be correctly attributable to the low tax jurisdiction so long as there is sufficient activity, transfer prices are at arm's length and there is no other indicator of BEPS
There have been changes in a group's structure, including the location of assets	Changes in a group's structure may be an opportunity for a group to engage in BEPS and could mean a need to revisit existing transfer pricing policies and methodologies, and re-consider the identification and pricing of related party transactions	Changes in a group's structure may be driven wholly by commercial considerations, even where the result is less tax paid in a particular jurisdiction.
IP is separated from related activities within a group	Valuable IP may be used to strip taxable profit from other jurisdictions	IP may be held in a particular jurisdiction for non-BEPS purposes. So long as the royalties paid for use of IP are arm's length and there are no other indicators of BEPS, the tax risk to a jurisdiction may be low.
A group has marketing entities located in jurisdictions outside its key markets	Marketing entities could be earning profits that are not attributable to the jurisdictions where they are resident	Historic or commercial factors may explain the use of marketing entities in particular jurisdictions
A group has procurement entities located in jurisdictions outside its key manufacturing locations	Procurement entities could be earning profits that are not attributable to the jurisdictions where they are resident	Historic or commercial factors may explain the use of procurement entities in particular jurisdictions
Income tax paid is consistently lower than income tax accrued	A group may be making high tax accruals for uncertain tax positions, which could indicate BEPS-related behaviour	Non-BEPS factors such as tax losses carried forward or legitimate uncertainty in a tax position could explain differences between current year tax accrued and tax paid
A group includes dual resident entities	Dual resident entities can be used for a number of BEPS purposes	Most entities that list different jurisdictions of residence and incorporation in Table 2 will not be dual resident (due to the operation of a tie-breaker in the applicable tax treaty)
A group includes entities with no tax residence	No residence entities can be used for a number of BEPS purposes	In many cases, an entity that is not tax resident anywhere will be transparent for tax purposes, and its profit may be taxable on a constituent entity elsewhere in the group
A group discloses stateless revenues in Table 1	Stateless revenue may indicate a BEPS risk if the revenue is not taken into account for tax purposes in any jurisdiction	In many cases, the revenue may be taxable on a constituent entity elsewhere in the group
Information in a group's CbC Report does not correspond with information previously provided by a constituent entity	This could question the accuracy of both the CbC Report and the information previously provided by a constituent entity	Other reasons may be identified to explain a potential difference, such as changes in a group's structure or activities since information was previously provided to a tax authority

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OECD CbC Risk Assessment Handbook: Ratios

- Handbook includes ratios it suggests might be of use, including
 - *Revenue/employee & pre-tax profit/employee*
 - Unrelated party revenues/Total Revenues
 - Related party revenues/total revenues
 - Total Revenues/Tangible Assets
 - Profit before tax/tangible assets
 - Profit before tax/(stated capital + accumulated earnings)
 - *Profit before tax/total revenues (Profit Margin)* – for comparison b/t jurisdictions
 - Income tax accrued/Profit before tax (Effective tax rate)
- Comment: ETR does not include deferred tax items in income tax accrued
- Handbook has long example – illustrates type of analysis that tax authorities may undertake (use of ratios, year over year analysis)

OECD CbC: Guidance on Appropriate Use

- CbC reports only to be used for:
 - high level transfer pricing risk assessment
 - assessment of other base erosion and profit shifting related risks
 - economic and statistical analysis, where appropriate
- CbC reports not to be used:
 - As a “substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and a full comparability analysis”
 - “to propose transfer pricing adjustments based on a global formulary apportionment of income”
 - To “propose adjustments to the income of any taxpayer on the basis of an income allocation formula based on the data from the” CbC report
- Guidance: (1) as a defense; (2) to ensure appropriate use; (3) measures to restrict access/keep confidential (4) consequences for misuse



OECD and IRS CbC Web Resources

- OECD:
 - Compilation: <http://www.oecd.org/tax/beps/country-by-country-reporting.htm>
 - Handbook on Risk Assessment: <http://www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-tax-risk-assessment.pdf>
 - Guidance on Appropriate Use of CbC Info: <http://www.oecd.org/ctp/beps/beps-action-13-on-country-by-country-reporting-appropriate-use-of-information-in-CbC-reports.pdf>
- IRS:
 - Guidance: <https://www.irs.gov/businesses/international-businesses/country-by-country-reporting-guidance>
 - FAQs: <https://www.irs.gov/businesses/international-businesses/frequently-asked-questions-faqs-country-by-country-reporting>
 - *Reporting Inappropriate Use:* lbi.exchange.of.information.disclosure@irs.gov
 - <https://www.irs.gov/businesses/corporations/reporting-unauthorized-disclosure-or-misuse-of-tax-information-exchanged-under-an-international-agreement>



BEPS 2.0: Implications for U.S. Tax Reform

