OECD/G20 Base Erosion and Profit Shifting Project

EXECUTIVE SUMMARIES

2014 Deliverables

OECD
BETTER POLICIES FOR BETTER LIVES

Table of contents

Action 1: Addressing the Tax Challenges of the Digital Economy

Full version of the report available on line: www.oecd.org/tax/beps-2014-deliverables.htm.

Action 1 of the base erosion and profit shifting (BEPS) Action Plan deals with the tax challenges of the Digital Economy. Political leaders, media outlets, and civil society around the world have expressed growing concern about tax planning by multinational enterprises that makes use of gaps in the interaction of different tax systems to artificially reduce taxable income or shift profits to low-tax jurisdictions in which little or no economic activity is performed. In response to this concern, and at the request of the G20, the Organisation for Economic Co-operation and Development (OECD) published an *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) in July 2013. Action 1 of the BEPS Action Plan calls for work to address the tax challenges of the digital economy. The Task Force on the Digital Economy (TFDE), a subsidiary body of the Committee on Fiscal Affairs (CFA) in which non-OECD G20 countries participate as Associates on an equal footing with OECD member countries, was established in September 2013 to develop a report identifying issues raised by the digital economy and detailed options to address them by September 2014. The Task Force consulted extensively with stakeholders and analysed written input submitted by business, civil society, academics, and developing countries before reaching its conclusions regarding the digital economy, the BEPS issues and the broader tax challenges it raises, and the recommended next steps.

A. The digital economy, its business models, and its key features

The digital economy is the result of a transformative process brought by information and communication technology (ICT). The ICT revolution has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy. For example, *retailers* allow customers to place online orders and are able to gather and analyse customer data to provide personalised service and advertising; the *logistics* sector has been transformed by the ability to track of vehicles and cargo across continents; *financial services* providers increasingly enable customers to manage their finances, conduct transactions and access new products on line; in *manufacturing*, the digital economy has enhanced the ability to remotely monitor production processes and to control and use robots; in the *education* sector, universities, tutoring services and other education service providers are able to provide courses remotely, which enables them to tap into global demand; in the *healthcare* sector, the digital economy is enabling remote diagnosis and the use of health records to enhance system efficiencies and patient experience. The *broadcasting and media industry* have been revolutionised, expanding the role in news media of non-traditional news sources, and expanding user participation in media through user-generated content and social networking.

Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not. As a result, the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by multinational enterprises (MNEs) together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns. Although many digital economy business models have parallels in traditional business, modern advances in ICT have made it possible to conduct many types of business at substantially greater scale and over longer distances than was previously possible. These include several varieties of e-commerce, online payment services, app stores, online advertising, cloud computing, participative networked platforms, and high-speed trading.

The digital economy is in a continuous state of evolution and possible future developments need to be monitored to evaluate their impact on tax systems. The rapid technological progress that has characterised the digital economy has led to a number of emerging trends and potential developments. Although this rapid change makes it difficult to predict future developments with any degree of reliability, these potential developments should be monitored closely as they may generate additional challenges for tax policy makers in the near future. These developments include the *Internet of Things*, referring to the dramatic increase in networked devices; *virtual currencies*, including bitcoin; developments in *advanced robotics and 3D printing*, which have the potential to bring manufacturing closer to consumers, altering where and how value is created within manufacturing supply chains, as well as the characterisation of business income; the *sharing economy* which allows peer- to-peer sharing of goods and services; increased *access to government data*, which has the potential to improve accountability and performance, and to allow participation of third parties in government business; and *reinforced protection of personal data,* which is more widely available in the digital economy.

The digital economy and its business models present some key features which are potentially relevant from a tax perspective. These features include *mobility*, with respect to *(i)* the intangibles on which the digital economy relies heavily, *(ii)* users, and *(iii)* business functions; *reliance on data*, the massive use of which has been facilitated by an increase in computing power and storage capacity and a decrease in data storage cost; *network effects*, which refer to the fact that decisions of users may have a direct impact on the benefit received by other users; *the spread of multi- sided business models*, in which multiple distinct groups of persons interact through an intermediary or platform, and the decisions of each group of persons affect the outcome for the other groups of persons through a positive or negative externality; *tendency toward monopoly or oligopoly* in certain business models relying heavily on network effects; and *volatility* due to lower barriers to entry into markets and rapidly evolving technology, as well as the speed with which customers can choose to adopt new products and services at the expense of older ones.

The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations. In the past, it was common for an MNE group to establish a subsidiary in each country in which it did business to manage the group's business in that country. This structure was dictated by a number of factors, including slow communications, currency exchange rules, customs duties, and relatively high transportation costs that made integrated global supply chains difficult to operate. Advances in ICT, reductions in many currency and custom barriers, and the move to digital products and a service-based economy, however, combined to break down barriers to integration, allowing MNE groups to operate much more as global firms. This integration has made it easier for business to adopt global business models that centralise functions at a regional or global level, rather than at a country-by-country level. Even for small and medium enterprises (SMEs), it has now become possible to be "micro-multinationals" that operate and have personnel in multiple countries and continents. ICT technologies have been instrumental in this major trend, which was further exacerbated by the fact that many of the major digital companies are young and were designed from the beginning to operate on an integrated basis at a global scale.

B. BEPS issues in the digital economy and how to address them

While the digital economy does not generate unique BEPS issues, some of its key features exacerbate BEPS risks. The Task Force discussed a number of tax and legal structures that can be used to implement business models in the digital economy. These structures highlight existing opportunities to achieve BEPS to reduce or eliminate tax in jurisdictions across the whole supply chain, including both market and residence countries. For example, the importance of intangibles in the context of the digital economy, combined with the mobility of intangibles for tax purposes under existing tax rules, generates substantial BEPS opportunities in the area of direct taxes. Further, the ability to centralise infrastructure at a distance from a market jurisdiction and conduct substantial sales of goods and services into that market from a remote location, combined with increasing ability to conduct substantial activity with minimal use of personnel, generates potential opportunities to achieve BEPS by fragmenting physical operations to avoid taxation. Some of the key characteristics of the digital economy also exacerbate risks of BEPS in the context of indirect taxation, in particular in relation to businesses that perform value added tax (VAT) exempt activities (exempt businesses).

These BEPS risks are being addressed in the context of the BEPS Project, which will align taxation with economic activities and value creation. Structures aimed at artificially shifting profits to locations where they are taxed at more favourable rates, or not taxed at all, will be addressed by ongoing work in the context of the BEPS Project. This will help restore taxing rights at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company. Taxation in the market jurisdiction should be restored by preventing treaty abuse (Action 6, due by September 2014) and preventing the artificial avoidance of PE Status (Action 7, due by September 2015). Taxation in the ultimate residence jurisdiction should be restored by strengthening controlled foreign company (CFC) rules (Action 3, due by September 2015). Both market and residence taxation should be restored by neutralising the effects of hybrid mismatch arrangements (Action 2, due by September 2014), by limiting the base erosion via interest deductions and other financial payments (Action 4, due by September 2015), by countering harmful tax practices more effectively (Action 5, due by September 2014 and 2015), and by assuring that transfer pricing outcomes are in line with value creation (Actions 8-10, due by September 2015). In the context of VAT, under certain conditions opportunities for tax planning by businesses and corresponding BEPS concerns for governments may arise to the extent that the OECD's Guidelines on place of taxation for business-to-business (B2B) supplies of services and intangibles are not implemented.

Work on the BEPS Project also must examine a number of issues specifically linked to the digital economy, its business models and its key features. The Task Force has identified certain specific issues generated by the key features of the digital economy that warrant attention from a tax perspective. Work on the actions of the BEPS Action Plan will take these issues into account to ensure that the proposed solutions fully address BEPS in the digital economy. These include:

- **Ensuring that core activities cannot inappropriately benefit from the exception from permanent establishment (PE) status, and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status**. The work on Action 7 (preventing the artificial avoidance of PE Status) should consider whether certain activities that were previously considered preparatory or auxiliary for the purposes of these exceptions may be increasingly significant components of businesses in the digital economy. If so, the work should also consider the circumstances under which such activities may be considered core activities and whether a reasonable, administrable rule to this effect can be developed. For example, that work should consider whether and under what circumstances the maintenance of a local warehouse may constitute a core activity such that it should be outside the scope of the exceptions in Article 5 of the OECD Model Tax Convention. In addition to broader tax challenges, these issues raise BEPS concerns when the lack of taxation in the market country is coupled with techniques that reduce or eliminate tax in the country of the recipient or of the ultimate parent. The work would also consider whether and how the definition of PE may need to be modified to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company. This would be relevant where, for instance, an online seller of tangible products or an online provider of advertising services uses the sales force of a local subsidiary to negotiate and effectively conclude sales with prospective large clients.
- **The importance of intangibles, the use of data, and the spread of global value chains, and their impact on transfer pricing**: Companies in the digital economy rely heavily on intangibles in creating value and producing income. A key feature of many BEPS structures adopted by participants in the digital economy involves the transfer of intangibles or rights to intangibles to tax-advantaged locations. Further, it is then often argued that these contractual allocations, together with legal ownership of intangibles, justify large allocations of income to the entity allocated the risk even if it performs little or no business activity. Often this is accomplished by arguing that other entities in the group are contractually insulated from risk so that a low-tax affiliate is entitled to all residual income after compensating other low risk group members for their functions even

if this affiliate has no capacity to control the risk. In addition to the existing transfer pricing guidelines, the BEPS work in the area of transfer pricing should take these issues in account and also consider the relationship between that work and the heavy reliance on collection, analysis and monetisation of data that characterises many companies in the digital economy. In addition, work in this area should devote attention to the implications of the increased integration of MNEs and the spread of global value chains, in which various stages of production are spread across multiple countries. In this context, the work should evaluate the need for greater reliance on functional analyses (assets used, functions performed, and risks assumed) and on value chain analyses and should also address situations where comparables are not available because of the structures designed by taxpayers and the unique intangibles involved. In specific situations the functional analysis may show that the use of profit split methods or valuation techniques (e.g. discounted cash flow method) is appropriate. For these situations, it would be helpful to provide simpler and clearer guidance on the application of transfer pricing methods, including profit splits in the context of global value chains.

- **The possible need to adapt CFC rules to the digital economy**: Although CFC rules vary significantly from jurisdiction to jurisdiction, income from digital products and services provided remotely is frequently not subject to current taxation under CFC rules. Such income may be particularly mobile due to the importance of intangibles in the provision of such goods and services and the relatively few people required to carry out online sales activities. Accordingly, a multinational enterprise in a digital business can earn income in a CFC in a low-tax jurisdiction by locating key intangibles there and using those intangibles to sell digital goods and services without that income being subject to current tax, even if the CFC itself does not perform significant activities in its jurisdiction. In developing recommendations regarding the design of CFC rules, consideration should be given to CFC rules that target income typically earned in the digital economy, such as income earned from the remote sale of digital goods and services.
- **Addressing opportunities for tax planning by businesses engaged in VAT-exempt activities**: The digitisation of the economy has greatly facilitated the ability of businesses to acquire a wide range of services and intangibles from suppliers in other jurisdictions around the world and to structure their operations in a truly global manner. These developments have allowed exempt businesses to avoid or minimise the amount of unrecoverable VAT they incur on the inputs used for their exempt activities. The implementation of Guidelines 2 and 4 of the OECD's International VAT/GST Guidelines on place of taxation for B2B supplies of services and intangibles will minimise BEPS opportunities for supplies of remotely delivered services made to exempt businesses, including exempt entities that operate through establishments ("branches") in multiple jurisdictions.

C. Broader tax policy challenges raised by the digital economy

The digital economy also raises broader tax challenges for policy makers. These challenges relate in particular to nexus, data, and characterisation for direct tax purposes. These challenges trigger more systemic questions about the ability of the current international tax framework to deal with the changes brought about by the digital economy and the business models that it makes possible and hence to ensure that profits are taxed in the jurisdiction where economic activities occur and where value is generated. They therefore have a broad impact and relate primarily to the allocation of taxing rights among different jurisdictions. These challenges also raise questions regarding the paradigm used to determine where economic activities are carried out and value is generated for tax purposes, which is based on an analysis of the functions, assets and risks involved. At the same time, when these challenges create opportunities for achieving double non-taxation, for example due to the lack of nexus in the market country under current rules coupled with lack of taxation in the jurisdiction of the income recipient and of that of the ultimate parent company, they also generate

BEPS issues. In addition, in the area of indirect taxes, the digital economy raises policy challenges regarding the collection of VAT.

The challenges related to nexus, data and characterisation overlap with each other to a certain extent. Although the challenges related to direct tax are distinct in nature, they often overlap with each other. For example, the collection of data from users located in a jurisdiction may trigger questions regarding whether that activity should give rise to nexus with that jurisdiction and regarding how data should be treated for tax purposes.

Evolving ways of carrying on business raise questions about whether current nexus rules continue to be appropriate. The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business in a jurisdiction, combined with the increasing role of network effects generated by customer interactions, raise questions as to whether rules that rely on physical presence continue to be appropriate. The number of firms carrying out business transactions over the Internet has increased dramatically over the last decade. According to estimates, the size of total worldwide e-commerce, when global B2B and consumer transactions are added together, equalled USD 16 trillion in 2013.

Increasing reliance on data collection and analysis, and the growing importance of multi-sided business models raise questions about valuation of data, nexus, and profit attribution, as well as characterisation. The appropriate allocation of taxable income among locations in which economic activities take place and value is created may not always be clear in the digital economy, particularly in cases where users and customers become an important component of the value chain, for example in relation to multi-sided business models and the sharing economy. The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, whether remote collection of data should give rise to nexus for tax purposes, and of ownership and how to characterise for tax purposes a person or entity's supply of data in a transaction, for example, as a free supply of a good, as a barter transaction, or some other way.

The development of new business models raises questions regarding characterisation of income. The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models, particularly in relation to cloud computing. Further, to the extent that 3D printing becomes increasingly prevalent, it may raise characterisation questions as well, as direct manufacturing for delivery could effectively evolve into licensing of designs for remote printing directly by consumers.

Cross-border trade in goods, services and intangibles creates challenges for VAT collection, particularly where such products are acquired by private consumers from suppliers abroad. This is partly due to the absence of an effective international framework to ensure VAT collection in the market jurisdiction. For economic actors, and in particular small and medium enterprises, the absence of an international standard for charging, collecting and remitting the tax to a potentially large number of tax authorities creates large revenue risks and high compliance costs. For governments, there is a risk of loss of revenue and trade distortion, and the challenge of managing tax liabilities generated by a high volume of low value transactions, which can create a significant administrative burden but marginal revenues.

The Task Force discussed and analysed a number of potential options proposed by country delegates and other stakeholders to address these challenges. Options discussed regarding nexus and data in particular range from changes to the definition of PE to the introduction of a new nexus based on a "significant presence" in a market, and also include the introduction of a withholding tax on sales of digital goods and services. Because of the overlap between the issues of nexus, data, and characterisation, the options to address each of them would inevitably affect the others. For purposes of evaluating potential options, the Task Force agreed on a framework based on the overarching tax principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability, in light of the proportionality of the changes in relation to the tax challenges they are intended to address in the context of the existing international tax framework.

D. Next steps: Undertake further work to complete evaluation of the broader tax challenges related to nexus, data, and characterisation and potential options to address them, and ensure that BEPS issues in the digital economy are tackled effectively.

Based on its discussion of these challenges and potential options to address them, the Task Force reached the following conclusions:

- The collection of VAT in business-to-consumer (B2C) transactions is a pressing issue that needs to be addressed urgently to protect tax revenue and to level the playing field between foreign suppliers relative to domestic suppliers. Work in this area by the working Party No. 9 of the OECD CFA shall be completed by the end of 2015, with the Associates in the BEPS Project participating on an equal footing with the OECD member countries.
- The work in the context of Action 7 of the BEPS Action Plan (preventing the artificial avoidance of PE Status) shall consider whether activities that once may have been preparatory or auxiliary should be denied the benefit of the exceptions to the permanent establishment definition because they are core components of the business, and whether a reasonable, administrable rule to this effect can be developed.
- Working Party No. 1 of the CFA shall clarify the characterisation under current tax treaty rules of certain payments under new business models, especially cloud computing payments (including payments for infrastructure-as-a-service, software-as-a-service, and platform-as-a-service transactions,) with the Associates in the BEPS Project participating on an equal footing with the OECD member countries.
- The staggered time frame of the BEPS Project and interaction among the various BEPS outputs make it difficult at the time this report is delivered to analyse how effective the work on the BEPS Action Plan will be in addressing BEPS concerns in the digital economy, as well as to evaluate the ultimate scope of the more systemic tax challenges in the area of nexus, data, and characterisation, and potential options to address them.
- In that context, it is important for the Task Force to continue its work in order to ensure that work carried out in other areas of the BEPS Project tackles BEPS issues in the digital economy, and that it can assess the outcomes of that work, continue to work on the broader tax challenges and potential options related to nexus, data, and characterisation, evaluate how the outcomes of the BEPS Project impact their relevance, urgency, and scope, and complete the evaluation of the options to address them. Specifically, the Task Force shall:

    i. Continue to work on the broader tax challenges of the digital economy, including nexus, data, and characterisation, advance the work and refine technical details related to potential options to address those challenges, with appropriate focus on multi-sided business models and the participation of users and consumers in value creation, and evaluate how the outcomes of the BEPS Project affect these broader tax and administrative challenges.

    ii. Act as a centre of expertise on the digital economy throughout the duration of the BEPS Project to ensure that work carried out in other areas of the BEPS Project tackles BEPS issues in the digital economy.

    iii. Assess the degree to which completed work with respect to the other actions of the BEPS Project addresses BEPS with respect to the digital economy.

    iv. Consider the economic incidence of VAT and corporate income taxation and its impact on the options to address the tax challenges raised by the digital economy.

    v. If further actions are necessary in the area of direct taxation to address BEPS concerns with respect to the digital economy, consider limiting the application of potential options to address broader tax challenges (either under tax treaties or through design of domestic law rules) to situations in which such BEPS concerns arise, for example in cases of double non-taxation of income from sales of digital goods and services.

Accordingly, the Task Force will:

- Advance the work on nexus, data, multi-sided business models, characterisation and potential options to address the broader tax challenges of the digital economy to ensure that these options are viable and fair, avoid double taxation, and can be implemented without exacerbating costs of compliance and administration.
- Provide input to the work carried out in the other areas of the BEPS Project to ensure that it appropriately takes into account and addresses the key features of the digital economy that exacerbate BEPS concerns. This work relates in particular to the work on the Artificial Avoidance of PE, on Transfer Pricing and on CFC rules and it will be carried out together with the work on the economic incidence of corporate income tax and VAT.
- Evaluate how the outcomes of the BEPS Project affect the broader tax challenges raised by the digital economy and complete the evaluation of the options to address them.

This work will be completed by December 2015 and a supplementary report reflecting the outcomes of the work will be finalised by that time.

Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements

Full version of the report available on line: www.oecd.org/tax/beps-2014-deliverables.htm.

1. Hybrid mismatch arrangements can be used to achieve double non-taxation including long-term tax deferral. They reduce the collective tax base of countries around the world even if it may sometimes be difficult to determine which individual country has lost tax revenue. Action 2 of the BEPS Action Plan[8] therefore calls for the development of model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect of hybrid instruments and entities.

2. This Report sets out those recommendations in two parts. Part I provides recommendations for domestic rules to neutralise the effect of hybrid mismatch arrangements. Part II sets out recommended changes to the OECD Model Tax Convention[9] to deal with transparent entities, including hybrid entities, and addresses the interaction between the recommendations included in Part I and the provisions of the OECD Model Tax Convention.

3. The Report focuses on hybrid mismatch arrangements which were of the most concern to jurisdictions. Further consideration will be given to refining the rules if there is evidence that the rules are not effective in neutralising hybrid mismatch arrangements that are of concern to jurisdictions.

4. Once translated into domestic law and tax treaties, these recommendations and model provisions will neutralise mismatches and put an end to multiple deductions for a single expense, deductions in one country without corresponding taxation in another or the generation of multiple foreign tax credits for one amount of foreign tax paid.

5. The work will now turn to developing guidance, in the form of a Commentary which will explain how the rules would operate in practice, including via practical examples.

6. Furthermore there are a number of specific areas where the recommended domestic rules in Part I may need to be further refined. This is the case for certain capital market transactions (such as on-market stock lending and repos) and the rules on imported hybrid mismatches.

7. In addition, concerns were raised by a number of countries and by business in the consultation responses over the application of the rules to hybrid regulatory capital that is issued intra-group. These concerns need to be further explored in order to clarify whether a special treatment under the hybrid mismatch rules is justified. Finally, the Report will need to clarify whether or not income taxed under a controlled foreign company (CFC) regime should be treated as included in ordinary income for the purposes of this Report and the related language is in brackets. No consensus has yet been reached on these issues but discussion will continue with a view to reaching agreement and to publishing the outcome together with the Commentary no later than September 2015. Until work on these two issues has been completed and a consensus reached countries are free in their policy choices in these areas.

8. The work on the Commentary and on the outstanding issues will seek input from stakeholders (including the Financial Stability Board on hybrid regulatory capital) to ensure that the rules are clear, operational for both taxpayers and tax administrations and that they strike the right balance between compliance costs and neutralising the tax benefit derived from hybrid mismatch arrangements.

[8] See Action 2 – Neutralise the effects of hybrid mismatch arrangements (OECD, 2013a), pp. 15-16.

[9] OECD (2010), Model Tax Convention on Income and on Capital: Condensed Version 2010, OECD Publishing.

Summary of Part I

9. Part I sets out recommendations for domestic law to address mismatches in tax outcomes where they arise in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity. It also considers the need for rules that address indirect mismatches that arise when the effects of a hybrid mismatch arrangement are imported into a third jurisdiction.

10. The Report sets out some general recommendations for changes to domestic law and also specific recommendations for hybrid mismatch rules designed to neutralise the tax effects of the arrangements referred to above. These hybrid mismatch rules are linking rules that seek to align the tax treatment of an instrument or entity with the tax outcomes in the counterparty jurisdiction but otherwise do not disturb the tax or commercial outcomes. To avoid double taxation and to ensure that the mismatch is eliminated even where not all the jurisdictions adopt the rules, the recommended rules are divided into a primary response and a defensive rule. The defensive rule only applies where there is no hybrid mismatch rule in the other jurisdiction or the rule is not applied to the entity or arrangement.

11. The rules recommended in this Report take into account a number of design principles including the need for comprehensive rules that operate automatically without requiring to establish which jurisdiction has lost tax revenue under the arrangement and that seek to minimise compliance and administration costs for both taxpayers and tax administrations. The recommendations are intended to drive taxpayers towards less complicated and more transparent cross-border investment structures that are easier for jurisdictions to address with more orthodox tax policy tools. Also, there is an interaction with the other action item, particularly Action 3 (dealing with the design of CFC rules)[10] and Action 4 (looking at interest deductions)[11], on which further guidance will be required.

12. The Report recognises the importance of co-ordination in the implementation and application of the hybrid mismatch rules. Such co-ordination includes the sharing of information to help jurisdictions and taxpayers to identify the potential for mismatches and the response required under the hybrid mismatch rule.

13. Part I is divided into seven chapters:

- Chapter 1 defines what a hybrid mismatch arrangement is.
- Chapters 2 to 4 identify and define the hybrid mismatch arrangements targeted by this Report and make recommendations as to the way jurisdictions should respond to them.
- Chapter 5 sets out measures to be taken by jurisdictions in implementing the recommendations and the principles that have informed the design of the recommended domestic rules. Jurisdictions that implement these rules should do so in a way that is consistent with the design principles.
- Chapters 6 and 7 provide definitions of the key terms used in this Report. Common definitions have been included to ensure consistency in the application and scope of these recommendations and to supplement specific definitions within the recommendations themselves.

[10] See Action 3 – Strengthen CFC rules (OECD, 2013a), pp. 16-17.

[11] See Action 4 – Limit base erosion via interest deductions and other financial payments (OECD, 2013a), p. 17.

Summary of Recommendations in Part I

Specific changes to domestic law

14. Part I of the Report recommends specific changes to domestic law to achieve a better alignment between domestic and cross-border tax outcomes. In particular, this Report recommends:

- denial of a dividend exemption for the relief of economic double taxation in respect of deductible payments made under financial instruments;
- the introduction of measures to prevent hybrid transfers being used to duplicate credits for taxes withheld at source;
- improvements to controlled foreign company and other offshore investment regimes to bring the income of hybrid entities within the charge to taxation under the investor jurisdiction and the imposition of information reporting requirements on such intermediaries to facilitate the ability of offshore investors and tax administrations to apply such rules; and
- rules restricting the tax transparency of reverse hybrids that are members of a controlled group.

Hybrid mismatch rules

15. In addition to these specific recommendations on the tax treatment of entities and instruments, which are designed to prevent mismatches from arising, Action 2 calls for hybrid mismatch rules that adjust the tax outcomes in one jurisdiction to align them with the tax consequences in another. Action 2 states that these rules may include domestic law provisions that:

- deny a deduction for a payment that is also deductible in another jurisdiction;
- prevent exemption or non-recognition for payments that are deductible by the payer; and
- deny a deduction for a payment that is not includible in ordinary income by the recipient (and is not subject to taxation under CFC or similar rules).

16. Action 2 therefore calls for domestic rules targeting two types of payment:

- payments under a hybrid mismatch arrangement that are deductible under the rules of the payer jurisdiction and not included in the ordinary income of the payee or a related investor (deduction / no inclusion or D/NI outcomes); and
- payments under a hybrid mismatch arrangements that give rise to duplicate deductions for the same payment (double deduction or DD outcomes).

17. In order to avoid the risk of double taxation, Action 2 also calls for "guidance on the co-ordination or tie breaker rules where more than one country seeks to apply such rules to a transaction or structure." For this reason the rules recommended in this Report are organised in a hierarchy so that a jurisdiction does not need to apply the hybrid mismatch rule where there is another rule operating in the counterparty jurisdiction that is sufficient to neutralise the mismatch. The Report recommends that every jurisdiction introduce all the recommended rules so that the effect of hybrid mismatch arrangement is neutralised even if the counterparty jurisdiction does not have effective hybrid mismatch rules.

(a) D/NI outcomes

18. Both payments made under hybrid financial instruments and payments made by hybrid entities can give rise to D/NI outcomes. In respect of such hybrid mismatch arrangements this Report recommends that the response should be to deny the deduction in the payer's jurisdiction. In the event the payer jurisdiction does not respond to the mismatch this Report recommends the jurisdictions adopt a defensive rule that would require the payment to be included as ordinary income in the

payee's jurisdiction. Recommendations for hybrid mismatch rules neutralising D/NI outcomes are set out in Chapter 2.

(b) DD outcomes

19. As well as producing D/NI outcomes, payments made by hybrid entities can, in certain circumstances, also give rise to DD outcomes. In respect of such payments this Report recommends that the primary response should be to deny the duplicate deduction in the parent jurisdiction. A defensive rule, that would require the deduction to be denied in the payer jurisdiction, would only apply in the event the parent jurisdiction did not adopt the primary response. Recommendations for hybrid mismatch rules neutralising DD outcomes are set out in Chapter 3.

(c) Indirect D/NI outcomes

20. Once a hybrid mismatch arrangement has been entered into between two jurisdictions without effective hybrid mismatch rules, it is a relatively simple matter to shift the effect of that mismatch into a third jurisdiction (through the use of an ordinary loan, for example). Therefore in order to protect the integrity of the recommendations, this Report further recommends that a payer jurisdiction deny a deduction for a payment where the payee sets the payment off against expenditure under a hybrid mismatch arrangement (i.e. the payment is made under an imported mismatch arrangement that results in an indirect D/NI outcome). Recommendations for hybrid mismatch rules neutralising indirect D/NI outcomes are set out in Chapter 4.

(d) Scope

21. Overly broad hybrid mismatch rules may be difficult to apply and administer. Accordingly, each hybrid mismatch rule has its own defined scope, which is designed to achieve an overall balance between a rule that is comprehensive, targeted and administrable.

22. Table 1 provides a general overview of the recommendations in this Report.

Table 1. General overview of the recommendations

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
D/NI	Hybrid financial instrument	No dividend exemption for deductible payments Proportionate limitation of withholding tax credits	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
	Disregarded payment made by a hybrid		Deny payer deduction	Include as ordinary income	Controlled group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque	Deny payer deduction	-	Controlled group and structured arrangements
DD	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response, defensive rule applies to controlled group and structured arrangements
	Deductible payment made by dual resident		Deny resident deduction	-	No limitation on response.
Indirect D/NI	Imported mismatch arrangements		Deny payer deduction	-	Members of controlled group and structured arrangements

Summary of Part II

23. Part II complements Part I and deals with the parts of Action 2 that indicate that the outputs of the work on Action 2 may include "changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly" and that stress that "[s]pecial attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention."[12]

24. Part II is divided into three chapters:

- Chapter 8 examines issues related to dual-resident entities with a view to ensuring that dual-resident entities are not used to obtain the benefits of treaties unduly.
- Chapter 9 examines issues related to transparent entities and proposes a new treaty provision dealing with such entities and a detailed Commentary on that provision.
- Chapter 10 discusses the interaction between the recommendations in Part I and the provisions of the OECD Model Tax Convention.

Chapter 8 - Dual-resident companies

25. Chapter 8 of Part II addresses the part of Action 2 that refers expressly to possible changes to the OECD Model Tax Convention to ensure that dual resident entities are not used to obtain the benefits of treaties unduly. The change to Art. 4(3) of the OECD Model Tax Convention[13] that is recommended as part of the work on Action 6 will address some of the BEPS concerns related to the issue of dual-resident entities by providing that cases of dual treaty residence would be solved on a case-by-case basis rather than on the basis of the current rule based on place of effective management of entities.

26. This change, however, will not address all BEPS concerns related to dual-resident entities. It will not, for instance, address avoidance strategies resulting from an entity being a resident of a given State under that State's domestic law whilst, at the same time, being a resident of another State under a tax treaty concluded by the first State. The solution to these avoidance strategies must be found in domestic law. Also, the change to Art. 4(3) will not address BEPS concerns that arise from dual-residence where no treaty is involved.

Chapter 9 - Proposed treaty provision on transparent entities

27. The 1999 OECD report on *The Application of the OECD Model Tax Convention to Partnership*[14] (the Partnership Report) contains an extensive analysis of the application of treaty provisions to partnerships, including in situations where there is a mismatch in the tax treatment of the partnership. The Partnership Report, however, did not expressly address the application of tax treaties to entities other than partnerships. In order to address that issue, as well as the fact that some countries have found it difficult to apply the conclusions of the Partnership Report, this Report proposes to include in the OECD Model Tax Convention a new provision and detailed Commentary that will ensure that income of transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the Partnership Report. This will not only ensure that the benefits of tax treaties are granted in appropriate cases but also that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity as the income of one of its residents.

[12] See Action 2 – Neutralise the effects of hybrid mismatch arrangements (OECD, 2013a), pp. 15-16.

[13] OECD (2010), *Model Tax Convention on Income and on Capital: Condensed Version 2010*, OECD Publishing.

[14] OECD (1999), *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation, No. 6, OECD Publishing.

Chapter 10 - Interaction between Part I and tax treaties

28. Chapter 10 of Part II discusses potential treaty issues that could arise from the recommendations in Part I.

29. The first issue is whether treaty issues could arise from the recommended hybrid mismatch rule under which “the payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/NI outcome” to neutralise the effect of hybrid mismatches. The Report notes that, apart from the rules of Articles 7 and 24 of the OECD Model Tax Convention, provisions of tax treaties do not govern whether payments are deductible or not and whether they are effectively taxed or not, these being matters of domestic law.

30. The proposed recommendations in Part I also include “defensive” rules under which “[i]f the payer jurisdiction does not neutralise the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome”. The provisions of tax treaties could be implicated if such a rule would seek the imposition of tax on a non-resident whose income would not, under the provisions of the relevant tax treaty, be taxable in that State. The Report concludes, however, that because the definition of “taxpayer” that is applicable for the purposes of the recommendations contemplates the imposition of tax by a jurisdiction only in circumstances where the recipient of the payment is a resident of that jurisdiction or maintains a permanent establishment in that jurisdiction and because the allocative rules of tax treaties generally do not restrict the taxation rights of the State in such circumstances, treaties should not impact the right of countries to apply the recommendation and any interaction between the recommendation and the provisions of tax treaties should therefore relate primarily to the rules concerning the elimination of double taxation.

31. The Report then proceeds to discuss two recommendations included in Part I that deal with the elimination of double taxation. It first examines the impact of these recommendations with respect to the exemption method and concludes that since it is the credit method, and not the exemption method, that is applicable to dividends under Article 23 A of the OECD Model Tax Convention, no problems should arise from the recommendation that “a dividend exemption that is provided for relief against economic double taxation should not be granted under domestic law to the extent the dividend payment is deductible by the payer”.

32. The Report also recognises, however, that a number of bilateral tax treaties provide for the application of the exemption method with respect to dividends received from foreign companies in which a resident company has a substantial shareholding. It notes that problems arising from the inclusion of the exemption method in tax treaties with respect to items of income that are not taxed in the State of source have long been recognised and that because paragraph 4 of Article 23 A may address some situations of hybrid mismatch arrangements where a dividend would otherwise be subject to the exemption method, States that enter into tax treaties providing for the application of the exemption method with respect to dividends should, at a minimum, consider the inclusion of that paragraph in their tax treaties. The Report suggests that a more complete solution would be for States to consider including in their treaties rules that would expressly allow them to apply the credit method, as opposed to the exemption method, with respect to dividends that are deductible in the payer State. These States may also wish to consider a more general solution to the problems of non-taxation resulting from potential abuses of the exemption method, which would be for States not to include the exemption method in their treaties.

33. As regards the application of the credit method, the Report concludes that the recommendation under which relief should be restricted “in proportion to the net taxable income under the arrangement” appears to conform to the domestic tax limitation provided by the credit method described in Article 23 B of the OECD Model Tax Convention. As regards treaties that either supplement, or depart from, the basic approach of Article 23 B, the Report suggests that Contracting

States should ensure that their tax treaties provide for the elimination of double taxation without creating opportunities for tax avoidance strategies.

34. The Report finally discusses whether the recommendations in Part I could raise issues with respect to the provisions of Article 24 of the OECD Model Tax Convention concerning non-discrimination. It concludes that, subject to an analysis of the detailed explanations that will be provided in the proposed commentary and the precise wording of the domestic rules that would be drafted to implement the recommendations set out in Part I, these recommendations would not appear to raise concerns about a possible conflict with the provisions of Article 24 of the OECD Model Tax Convention.

Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

Full version of the report available on line: www.oecd.org/tax/beps-2014-deliverables.htm.

More than 15 years have passed since the publication of the OECD's 1998 Report *Harmful Tax Competition: An Emerging Global Issue* but the underlying policy concerns expressed in the 1998 Report as regards the "race to the bottom" on the mobile tax base have not lost their relevance. In certain areas, current concerns may be less about traditional ring-fencing but instead relate to across the board corporate tax rate reductions on particular types of income. The fact that preferential regimes continue to be a pressure area is highlighted by their inclusion in *Addressing Base Erosion and Profit Shifting* (BEPS Report) and *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan).

To counter harmful tax practices more effectively, taking into account transparency and substance, Action Item 5 of the BEPS Action Plan commits the Forum on Harmful Tax Practices (FHTP) to:

"Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework."

Under Action Item 5, the FHTP is to deliver three outputs: first, finalisation of the review of member country preferential regimes; second, a strategy to expand participation to non-OECD member countries; and, third, consideration of revisions or additions to the existing framework.

This report outlines the progress made on the delivery of these outputs under Action 5. It shows progress made and identifies the next steps towards completion of this work, in particular on the first output. As regards the review of the existing preferential regimes, the emphasis has been put on (i) elaborating a methodology to define a substantial activity requirement in the context of intangible regimes and (ii) improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes. Finally, it provides a progress report on the review of the regimes of OECD member and associate countries in the OECD/G20 Project on BEPS (associate countries)[15].

Countries have agreed on the need to strengthen the substantial activity requirement and several approaches have been explored with the common goal of realigning taxation of profits with substantial activities. Discussions are continuing to agree an approach, and once the approach has been agreed, the preferential regimes identified in this report will be assessed. As regards transparency, a detailed framework has been developed and agreed and is set out in the report. The agreed framework will be applied to the preferential regimes identified in this report and to other preferential regimes. Finally, the FHTP has started reviewing regimes of member and associate countries. The review of associate country regimes takes place on an equal footing with the review of member country regimes, but more time is being allowed for the completion of the review for associate country regimes.

This report contains six chapters. Chapter 1 introduces Action Item 5 of the BEPS Action Plan and covers background on the 1998 Report. Chapter 2 gives an overview of the OECD's work on harmful tax practices. Chapter 3 sets out the framework under the 1998 Report for determining

[15] The following are associate countries in the OECD/G20 Project on BEPS: Argentina, Brazil, China, Colombia, India, Indonesia, Latvia, Russia, Saudi Arabia and South Africa.

whether a regime is a harmful preferential regime. Chapter 4 describes progress by the FHTP on the requirements of Action Item 5 to revamp the work on harmful tax practices by requiring substantial activity for any preferential regime. It also contains the agreed framework for improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes. Chapter 5 presents the status of the review of member country regimes and the progress made on the review of preferential regimes of associate countries. Finally, Chapter 6 deals with next steps.

Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Full version of the report available on line: www.oecd.org/tax/beps-2014-deliverables.htm.

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 work to be carried on in order to:

A. Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.

B. Clarify that tax treaties are not intended to be used to generate double non-taxation.

C. Identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

This report includes the proposed changes to the OECD Model Tax Convention that are the results of that work. These changes reflect the agreement that the OECD Model should be amended to include provisions to prevent treaty abuse. Given the variety of approaches, a number of treaty provisions recommended in this report offer alternatives and a certain degree of flexibility. There is agreement, however, that these alternatives aim to reach a common goal, i.e. to ensure that States incorporate in their treaties sufficient safeguards to prevent treaty abuse, in particular as regards treaty shopping. For that reason, the report recommends a minimum level of protection that should be implemented (see below).

Indeed, when examining the model treaty provisions included in this report, it is important to note that these are model provisions that need to be adapted to the specificities of individual States and the circumstances of the negotiation of bilateral conventions. For example, some countries may have constitutional or EU law restrictions that prevent them from adopting the exact wording of the model provisions that are recommended in this report, some countries may have domestic anti-abuse rules or their courts may have developed various interpretative tools that effectively prevent some of the treaty abuses described in this report and the administrative capacity of some countries may prevent them from applying certain detailed anti-abuse rules and require them to adopt more general anti-abuse provisions.

Whilst there is agreement that the minimum level of protection against treaty abuse, including treaty shopping, described in this Executive summary and in paragraph 14 of the report should be included in the OECD Model, it is recognised that further work will be needed with respect to the precise contents of the model provisions and related Commentary included in Section A of this report, in particular the LOB rule. Further work is also needed with respect to the implementation of the minimum standard and with respect to the policy considerations relevant to treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds. The model provisions and related Commentary included in Section A of this report should therefore be considered as drafts that are subject to improvement before their final versions are released in September 2015.

A. Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances

Section A of the report includes recommendations intended to prevent the granting of treaty benefits in inappropriate circumstances. For that purpose, a distinction is made between two types of cases:

1. Cases where a person tries to circumvent limitations provided by the treaty itself.
2. Cases where a person tries to circumvent the provisions of domestic tax law using treaty benefits.

Since the first category of cases involves situations where a person seeks to circumvent rules that are specific to tax treaties, it is recommended to address these cases through anti-abuse rules to be included in treaties. The situation is different with respect to the second category of cases: since these cases involve the avoidance of domestic law, they cannot be addressed exclusively through treaty provisions and require domestic anti-abuse rules, which raises the issue of possible conflicts between these domestic rules and the provisions of tax treaties.

1. Cases where a person tries to circumvent limitations provided by the treaty itself

The recommendations for new treaty anti-abuse rules included in the report first address treaty shopping strategies through which a person who is not a resident of a Contracting State attempts to obtain benefits that a tax treaty grants to a resident of that State. Additional recommendations address other strategies aimed at satisfying different treaty requirements with a view to obtain inappropriately the benefit of certain provisions of tax treaties.

a) Recommendations related to treaty shopping

The report recommends that a three-pronged approach be used to address treaty shopping arrangements:

- First, it is recommended that treaties include, in their title and preamble, a clear statement that the Contracting States, when entering into a treaty, intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements (this recommendation is included in Section B of the report).
- Second, it is recommended to include in tax treaties a specific anti-abuse rule based on the limitation-on-benefits provisions included in treaties concluded by the United States and a few other countries (the "LOB rule"). Such a specific rule will address a large number of treaty shopping situations based on the legal nature, ownership in, and general activities of, residents of a Contracting State.
- Third, in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule described above (such as certain conduit financing arrangements), it is recommended to add to tax treaties a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or "PPT" rule).

The combination of the LOB and the PPT rules proposed in the report recognises that each rule has strengths and weaknesses and may not be appropriate for all countries. Also, these rules may require adaptations (*e.g.* to take account of constitutional or EU law restrictions). As already noted, as long as the approach that countries adopt effectively addresses treaty abuses along the lines of the report, some flexibility is allowed in implementing the report's recommendations. At a minimum, however, countries should agree to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements; they should also implement that common intention through either the combined approach described above, the inclusion of the PPT rule or the LOB rule supplemented by a mechanism (such as a restricted PPT rule applicable to conduit financing arrangements or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties.

The LOB rule included in the report restricts the general scope of the treaty rule according to which a treaty applies to persons who are residents of a Contracting State. Paragraph 1 of the LOB rule provides that a resident of a Contracting State shall not be entitled to the benefits of the Convention unless it constitutes a "qualified person" under paragraph 2 or unless benefits are granted under the provisions of paragraphs 3, 4 or 5. Paragraph 2 determines who constitutes a "qualified person" by reference to the nature or attributes of various categories of persons; any person to which that paragraph applies is entitled to all the benefits of the Convention. Under paragraph 3, a person is entitled to the benefits of the Convention with respect to an item of income even if it does not constitute a "qualified person" under paragraph 2 as long as that item of income is derived in connection with the active conduct of a trade or business in that person's State of residence (subject to certain exceptions). Paragraph 4 is a "derivative benefits" provision that allows certain entities owned by residents of other States to obtain treaty benefits that these residents would have obtained if they had invested directly. Paragraph 5 allows the competent authority of a Contracting State to grant treaty benefits where the other provisions of the LOB rule would otherwise deny these benefits. Paragraph 6 includes a number of definitions that apply for the purposes of the Article. A detailed Commentary explains the various provisions of the LOB rule.

The PPT rule included in the report incorporates principles already recognised in the Commentary on Article 1 of the Model Tax Convention. It provides a more general way to address treaty abuse cases, including treaty shopping situations that would not be covered by the LOB rule (such as certain conduit financing arrangements). That rule reads as follows:

Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

That rule is accompanied by a Commentary and examples that explain and illustrate its application.

b) Recommendations dealing with other treaty limitations

The report includes additional recommendations for new specific treaty anti-abuse rules that seek to address strategies, other than treaty shopping, aimed at satisfying treaty requirements with a view to obtain inappropriately the benefit of certain provisions of tax treaties. These targeted rules, which are supplemented by the PPT rule described above, address (1) certain dividend transfer transactions; (2) transactions that circumvent the application of the treaty rule that allows source taxation of shares of companies that derive their value primarily from immovable property; (3) situations where an entity is resident of two Contracting States, and (4) situations where the State of residence exempts the income of permanent establishments situated in third States and where shares, debt-claims, rights or property are transferred to permanent establishments set up in countries that do not tax such income or offer preferential treatment to that income.

2. Cases where a person tries to abuse the provisions of domestic tax law using treaty benefits

The last part of Section A deals with situations where a person tries to abuse the provisions of domestic tax law using treaty benefits. The report recognises that the adoption of anti-abuse rules in tax treaties is not sufficient to address tax avoidance strategies that seek to circumvent provisions of domestic tax laws; these must be addressed through domestic anti-abuse rules, including through rules that may result from the work on other aspects of the Action Plan. Work aimed at preventing the granting of treaty benefits with respect to these strategies seeks to ensure that treaties do not inadvertently prevent the application of such domestic anti-abuse rules: granting the benefits of treaty provisions in such cases would be inappropriate to the extent that the result would be the avoidance of domestic tax.

The report refers to the parts of the Commentary of the OECD Model Tax Convention that already deal with this issue. It indicates that further work may be needed to take account of recommendations for the design of new domestic rules that may result from the work on various

Action items, in particular Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing.

The report adds that the recommendation to include a PPT rule in treaties, which will incorporate the principle already included in paragraph 9.5 of the Commentary on Article 1 of the OECD Model Tax Convention, will provide a clear statement that the Contracting States intend to deny the application of the provisions of their treaties when transactions or arrangements are entered into in order to obtain the benefits of these provisions in inappropriate circumstances. The report recommends the inclusion of additional guidance in the Commentary included in the OECD Model Tax Convention in order to clarify that the incorporation of that principle into tax treaties will not affect the existing conclusions concerning the interaction between treaties and domestic anti-abuse rules.

The report also addresses two specific issues related to the interaction between treaties and specific domestic anti-abuse rules. The first issue relates to the application of tax treaties to restrict a Contracting State's right to tax its own residents. The report recommends that the principle that treaties do not restrict a State's right to tax its own residents (subject to certain exceptions) should be expressly recognized through the addition of a new treaty provision based on the so-called "saving clause" already found in United States tax treaties. The second issue deals with so-called "departure" or "exit" taxes, under which liability to tax on some types of income that has accrued for the benefit of a resident (whether an individual or a legal person) is triggered in the event that the resident ceases to be a resident of that State. The report recommends changes to the Commentary included in the Model Tax Convention in order to clarify that treaties do not prevent the application of these taxes.

B. Clarification that tax treaties are not intended to be used to generate double non-taxation

Section B of the report addresses the second part of Action 6, which required that work be done in order to "clarify that tax treaties are not intended to be used to generate double non-taxation". This clarification is provided through a reformulation of the title and preamble of the Model Tax Convention that will clearly state that the joint intention of the parties to a tax treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance. Given the particular concerns arising from treaty shopping arrangements, such arrangements are expressly mentioned as one example of tax avoidance that should not result from tax treaties. Under applicable rules of international public law, this clear statement of the intention of the signatories to a tax treaty will be relevant for the interpretation and application of the provisions of that treaty.

C. Tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country

Section C of the report addresses the third part of the work mandated by Action 6, which was "to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country". The policy considerations that are described in Section C should help countries explain their decisions not to enter into tax treaties with certain low or no-tax jurisdictions; these policy considerations will also be relevant for countries that need to consider whether they should modify (or, ultimately, terminate) a treaty previously concluded in the event that a change of circumstances (such as changes to the domestic law of a treaty partner) raises BEPS concerns related to that treaty. It is recognised, however, that there are many non-tax factors that can lead to the conclusion, amendment or termination of a tax treaty and that each country has a sovereign right to decide whether it should do so.

Action 8: Guidance on Transfer Pricing Aspects of Intangibles

Full version of the report available on line: www.oecd.org/tax/beps-2014-deliverables.htm.

This document contains guidance on the Transfer Pricing Aspects of Intangibles. It contains final revisions to Chapters I, II and VI of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) which have been developed in connection with Action 8 of the *Action Plan on Base Erosion and Profit Shifting* (OECD, 2013). These changes to the Guidelines clarify the definition of intangibles under the Guidelines, provide guidance on identifying transactions involving intangibles, and provide supplemental guidance for determining arm's length conditions for transactions involving intangibles. These final modifications to the Guidelines also contain guidance on the transfer pricing treatment of local market features and corporate synergies. The guidance is supplemented with numerous examples illustrating the application of the principles contained in the revised text of the Guidelines.

The final guidance contained in this document represents the first instalment of the transfer pricing work mandated by the BEPS Action Plan.

The Action Plan directs the OECD to address a number of transfer pricing issues, as follows:

Action 8 – Intangibles

Develop rules to prevent BEPS by moving intangibles among group members. This will involve (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard to value intangibles; and (iv) updating the guidance on cost contribution arrangements.

Action 9 – Risks and capital

Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense deductions and other financial payments.

Action 10 – Other high-risk transactions

Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.

Under the Action Plan, the second phase of the work on these actions is to be completed in 2015.

Inevitably, some transfer pricing issues relating to intangibles are closely related to issues that are to be addressed during 2015 under the Action Plan. Most notably, strong interactions exist between the work on ownership of intangibles under Action 8 and the work on risk, recharacterisation of transactions, and hard to value intangibles. Because of those interactions it is challenging to finalise guidance in one area without also addressing other issues in an integrated manner.

Because the interactions between work on ownership of intangibles, hard to value intangibles, risk and recharacterisation are particularly pronounced, a decision has been made not to finalise the work on some sections of this document at this time. Accordingly, bracketed and shaded portions of this document should be viewed as interim drafts of guidance, not yet fully agreed by delegates, that will be finalised in 2015 in connection with other related BEPS work. The sections setting out interim guidance include (i) Sections B.1 and B.2 of Chapter VI of the Transfer Pricing Guidelines relating to ownership of intangibles, (ii) Section D.3. of Chapter VI relating to intangibles whose valuation is uncertain at the time of the transaction, (iii) paragraph 2.9 of the Guidelines relating to the use of other methods, (iv) guidance on the application of profit split methods contained in paragraphs 6.145 to 6.149, and (v) certain examples relating to the foregoing provisions.

It is the intention of the countries involved in the BEPS project to complete these sections of the revised intangibles guidance during 2015 in conjunction with the BEPS work on risk, recharacterisation and hard to value intangibles. This 2015 BEPS work will likely include revisions to portions of Chapters I, II, VI, VIII, and IX of the Guidelines and will include finalising the bracketed and shaded portions of this draft. In completing the 2015 BEPS transfer pricing work, issues will be addressed in an integrated manner in order to provide coherent and consistent transfer pricing guidance across issues that involve intangibles and those that do not.

In completing the transfer pricing work required by the BEPS Action Plan, the OECD will, as directed by the Action Plan, consider both the application of the arm's length principle and special measures in order to identify effective responses to the concerns raised in the BEPS Action Plan. Discussions on the special measures required to address the concerns identified in the Action Plan are ongoing. Among the special measures that will be considered during the course of the 2015 work are the following:

- Providing tax administrations with authority in appropriate instances to apply rules based on actual results to price transfers of hard to value intangibles and potentially other assets;
- Limiting the return to entities whose activities are limited to providing funding for the development of intangibles, and potentially other activities, for example by treating such entities as lenders rather than equity investors under some circumstances;
- Requiring contingent payment terms and / or the application of profit split methods for certain transfers of hard to value intangibles; and
- Requiring application of rules analogous to those applied under Article 7 and the Authorised OECD Approach to certain situations involving excessive capitalisation of low function entities.

Work on these transfer pricing measures will be co-ordinated with other BEPS work on the deductibility of interest, the permanent establishment definition, controlled foreign company (CFC) rules, digital economy issues, and work on dispute resolution. In this way delegates will seek to come to a coherent set of rules that will effectively address transfer pricing concerns related to BEPS. It should be emphasised that no decisions have yet been made regarding which special measures will be adopted or whether such measures are consistent with Article 9 of the OECD Model Tax Convention. The foregoing listing is not necessarily comprehensive and other measures may also be considered.

As the topics covered by the transfer pricing measures in the BEPS Action Plan have clear implications for work in other areas of the BEPS project, it is the intention of the OECD to move forward expeditiously with the work on risk, recharacterisation, hard to value intangibles, and possible special measures.

Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting

Full version of the report available on line: [www.oecd.org/tax/beps-2014-deliverables.htm.](www.oecd.org/tax/beps-2014-deliverables.htm)

Action 13 of the *Action Plan on Base Erosion and Profit Shifting* (OECD, 2013) recognises that enhancing transparency for tax administrations by providing them with adequate information to conduct transfer pricing risk assessments and examinations is an essential part of tackling the base erosion and profit shifting (BEPS) problem. This document contains revised standards for transfer pricing documentation and a template for country-by-country reporting of income, earnings, taxes paid and certain measures of economic activity.

The country-by-country report requires multinational enterprises (MNEs) to report annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their total employment, capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.

The guidance on transfer pricing documentation requires MNEs to provide tax administrations high-level global information regarding their global business operations and transfer pricing policies in a "master file" that would be available to all relevant country tax administrations. It also requires that more transactional transfer pricing documentation be provided in a local file in each country, identifying relevant related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.

Taken together, these three documents (country-by-country report, master file and local file) will require taxpayers to articulate consistent transfer pricing positions, will provide tax administrations with useful information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries. This information should make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments. The countries participating in the BEPS Project agree that these new reporting provisions, and the transparency they will encourage, will contribute to the objective of understanding, controlling, and tackling BEPS behaviours.

The specific content of the various documents reflects an effort to balance tax administration information needs, concerns about inappropriate use of the information, and the compliance costs and burdens imposed on business. Some countries would strike that balance in a different way by requiring reporting in the country-by-country report of additional transactional data (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) regarding related party interest payments, royalty payments and especially related party service fees. Countries expressing this view are primarily those from emerging markets (Argentina, Brazil, China, Colombia, India, Mexico, South Africa, and Turkey) who state they need such information to perform risk assessment and who find it challenging to obtain information on the global operations of an MNE group headquartered elsewhere. Other countries expressed support for the way in which the balance has been struck in this document. Taking all these views into account, it is mandated that countries participating in the BEPS project will carefully review the implementation of these new standards and will reassess no later than the end of 2020 whether modifications to the content of these reports should be made to require reporting of additional or different data.

Effective implementation of the new reporting standards and reporting rules will be essential. Additional work will be undertaken over the next several months to identify the most appropriate means of filing the required information with and disseminating it to tax administrations. In that work, due regard will be given to considerations related to protection of the confidentiality of the information required by the reporting standards, the need for making the information available on a timely basis to all relevant countries, and other relevant factors.

Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

Full version of the report available on line: www.oecd.org/tax/beps-2014-deliverables.htm.

The endorsement of the Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan, OECD, 2013) by the Leaders of the G20 in Saint-Petersburg in September 2013 shows unprecedented political support to adapt the current international tax system to the challenges of globalisation. Tax treaties are based on a set of common principles designed to eliminate double taxation that may occur in the case of cross-border trade and investments. The current network of bilateral tax treaties dates back to the 1920s and the first soft law Model Tax Convention developed by the League of Nations. The Organisation for Economic Co-operation and Development (OECD) and the United Nations have subsequently updated model tax conventions based on that work. The contents of those model tax conventions are reflected in thousands of bilateral agreements among jurisdictions.

Globalisation has exacerbated the impact of gaps and frictions among different countries' tax systems. As a result, some features of the current bilateral tax treaty system facilitate base erosion and profit shifting (BEPS) and need to be addressed. Beyond the challenges faced by the current tax treaty system on substance, the sheer number of bilateral treaties makes updating the current tax treaty network highly burdensome. Even where a change to the Model Tax Convention is consensual, it takes a substantial amount of time and resources to introduce it into most bilateral tax treaties. As a result, the current network is not well-synchronised with the model tax conventions, and issues that arise over time cannot be addressed swiftly. Without a mechanism to swiftly implement them, changes to Models only make the gap between the content of the Models and the content of actual tax treaties wider. This clearly contradicts the political objective to strengthen the current system by putting an end to BEPS, in part by modifying the bilateral treaty network. Doing so is necessary not only to tackle BEPS, but also to ensure the sustainability of the consensual framework to eliminate double taxation. For this reason, governments have agreed to explore the feasibility of a multilateral instrument that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.

Action 15 of the BEPS Action Plan provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable countries that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested countries will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution. The goal of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures. This is an innovative approach with no exact precedent in the tax world, but precedents for modifying bilateral treaties with a multilateral instrument exist in various other areas of public international law. Drawing on the expertise of public international law and tax experts, the present report explores the technical feasibility of a multilateral hard law approach and its consequences on the current tax treaty system. The report identifies the issues arising from the development of such an instrument and provides an analysis of the international tax, public international law, and political issues that arise from such an approach. It concludes that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly.