Post-BEPS tax controversy

Preparing for new rules, new risks
Introduction

During the final quarter of 2017, multinational enterprises (MNEs) watched as U.S. tax reform legislation went from longshot to enacted legislation in the course of a few months. MNEs are rightly focused on the sweeping changes wrought by the new law. However, savvy tax directors should also be preparing for the coming wave of tax controversy spawned by the Organisation for Economic Co-operation and Development’s (OECD) Base Erosion and Profit Shifting (BEPS) project—from which global tax law changes have continued apace.

Many countries have adopted, or are in the process of adopting, changes to their international tax systems in response to the OECD’s BEPS project, which KPMG LLP (KPMG) expects will drive significant tax controversy for MNEs. In June 2017, approximately 70 nations signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), an agreement that allows countries to quickly adopt key treaty-related measures of the OECD/G20’s BEPS tax avoidance guidance without the need for lengthy renegotiations of the thousands of bilateral double tax treaties in existence today between members of the OECD/G20. The most significant and widely adopted treaty-related measures include the introduction of a principal purpose test (PPT) to avoid treaty abuse under Action 6 of the OECD BEPS project and revised permanent establishment (PE) standards under Action 7 of the OECD BEPS project.¹ It is expected that the MLI will enter into force January 1, 2019, and we anticipate the resulting treaty changes will be catalysts for significant increases in global tax controversy.

In addition to the MLI, the OECD’s recommended changes to rules on transfer pricing and allocation of profit under Actions 8–10,² along with the advent of country-by-country (CbyC) reporting under Action 13, introduce new rules and require new data reporting that will also serve as catalysts for controversy. CbyC reporting provides tax administrators with a wealth of data to scrutinize in order to more easily and effectively identify audit targets.³ MNEs will see their own data being used to pinpoint risk areas, and many MNEs may see a substantial increase in the number of tax audits as a result.

As jurisdictions steadily progress towards implementation of these new BEPS-related measures, a recent KPMG study⁴ found that most MNEs are not fully prepared for these changes (see Figure 1).

¹ See below for further discussion.
² Id.
⁴ See BEPS Controversy Readiness, November 2017, KPMG LLP
Further, the scope and breadth of disruption in the global tax landscape will be significant as multiple regulatory changes compete for attention. This has placed incredible pressure upon MNEs’ tax departments.

Many MNEs have considered CbyC reporting to be the most applicable change stemming from the BEPS project (see Figure 2), and while we agree CbyC reporting is a fundamental shift in global tax reporting, it is merely one of many new tools in the hands of tax authorities which create an evolving set of tax controversy risks for MNEs. As described above, we also believe changes under Actions 6 (PPT test), 7 (revised PE standards), and 8–10 (updated transfer pricing rules) of the OECD BEPS project will spur increased global tax controversy for MNEs. Below we explore how those changes will be catalysts for increased global tax controversy and what MNEs can do to prepare.

![Figure 1: When asked “How would you rate your organisation’s preparedness for an increase in BEPS-related audit inquiries?” survey participants responded as follows:](image)

Source: BEPS Controversy Readiness, November 2017, KPMG LLP
BEPS Action 6: The introduction of the PPT

To address perceived treaty abuse, the final report on BEPS Action 6 recommends that a “principal purpose test” be added to tax treaties. The proposed article would generally provide that a treaty benefit shall not be granted if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of the arrangement or transaction that directly or indirectly resulted in that benefit, unless it is established that granting the benefits would be in accordance with the object and purpose of the provisions of the treaty. The article is intended to address issues such as treaty shopping, splitting up of contracts, hiring-out of labor cases, and other situations of perceived treaty abuse.

The MLI includes this PPT by default, although signatories may elect to opt out of the MLI’s PPT with respect to treaties that already contain a similar test, or may elect to opt out generally if they elect instead to satisfy the minimum standard set by Action 6 by adopting detailed limitation of benefit and domestic anticonduit rules. To date, all signatories have opted for the PPT.

Because the PPT casts a wide net by asking whether obtaining a treaty benefit was “one of the principal purposes,” rather than “the principal purpose,” tax authorities have considerable discretion to deny treaty benefits where a purpose of the arrangement or transaction was to obtain the benefit. Taxpayers can, however, find some solace in the second half of the PPT, which provides that taxpayers may still obtain the benefit if the granting of that benefit is in accordance with the object and purpose of the treaty. Although the object and purpose of tax treaties is typically to provide for administrative cooperation and the prevention of double taxation, it may be difficult for taxpayers to argue that a benefit is in accordance with any specific treaty provision.

The PPT’s broad authority essentially provides MLI signatories with the power to attack any arrangement or transaction on the grounds of the PPT, regardless of whether that jurisdiction has adopted any particular provision of the MLI. For example, a country may choose not to sign on to the revised PE standards under Action 7 discussed immediately below, yet tax administrators in that country may still attack an MNE’s arrangement on the grounds that the arrangement was designed to avoid PE status and for the MNE to avail itself of the associated treaty benefits.

The revised PE standards recommended under Action 7 of the OECD BEPS project are aimed at addressing what the OECD considers to be strategies used to artificially avoid having a taxable presence in a treaty jurisdiction and are included in Articles 12–14 of the MLI.

Article 12 of the MLI expands the dependent agent permanent establishment (DAPE) standard to include arrangements in which a dependent agent habitually and routinely plays a principal role in the conclusion of contracts in the name of a related enterprise without material modification by the related enterprise. This revised DAPE standard is designed to attack principal-company and remote-seller structures in which the principal company does not have sufficient substance to justify local country nontaxation. Similar to existing tax treaty limitation on benefits clauses and triangular provisions, Article 12 of the MLI seeks to empower treaty partners to prevent form trumping substance in the application of treaty benefits.

Article 13 of the MLI provides signatories an option for modifying the application of the specific activity exemptions in the current OECD model treaty. This modification limits the availability of exemptions to circumstances where the activity is “preparatory or auxiliary” in nature. In addition, this article includes an antifragmenta provision. This provision serves to deny the specific activity exemptions when an enterprise or a closely related enterprise carries on business activities in the same State and either: i) those business activities constitute a PE for a related enterprise in the State or ii) the overall combined activity resulting in the State is not of a preparatory or auxiliary character.

Finally, Article 14 of the MLI addresses the splitting up of contracts and requires generally that, for purposes of determining whether the period of time after which specific activities shall constitute a PE has been exceeded, time spent (in excess of 30 days in the aggregate) by the enterprise at a building site or construction or installation project and connected activities at that same site by closely related enterprises (during periods that exceed 30 days) must be aggregated.

By expanding the DAPE standard, narrowing the scope of the specific activity exemptions and providing that activities of related entities within a MNE’s group will be aggregated, Articles 12–14 of the MLI will require MNEs to reassess their global structures to ensure that this does not result in unexpected PEs. This is particularly true where local sales and marketing activities have historically been carried out by a different local country entity than is the seller and/or importer of record within a specific jurisdiction (as is common in principal company and similar structures).

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BEPS Actions 8-10: Changes to rules on transfer pricing and allocation of profit

As part of its stated goal of ensuring that transfer pricing outcomes better align with value creation, the OECD provided revised transfer pricing guidance on the allocation of profits under Actions 8–10. Specifically, the guidance provides new frameworks for analyzing allocations of profits in the context of risk and intangibles.

With respect to risk and the arm’s-length principle, the key concept from the final report on Actions 8–10 is that an entity must have both control over risk and the capacity to assume risk in order to receive the reward or profits associated with the risk allocated to such entity. The guidance defines control over risk as i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, and ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function. If an entity does not have control and financial capacity with respect to a risk, profits associated with that risk must be reallocated to the entity that does have control and financial capacity.

With respect to determining control over risk in relation to intangibles, the final report clarifies that members of a MNE group are to be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection, and exploitation of those intangibles (DEMPE functions).

Actions 8–10 emphasize that legal ownership alone of an intangible does not determine entitlement to returns from the exploitation of that intangible; where an enterprise that is not the legal owner of an intangible performs DEMPE functions in relation to the intangible, it can expect arm’s-length remuneration. The nature of this remuneration will take into account which enterprises assume and control the risks associated with the DEMPE functions, in accordance with the general guidance on control over risk discussed above.

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Actions 8–10 are designed to reinforce the spirit of the arm’s-length standard by clarifying the extent to which economic and operational substance must align with contractual allocations of risk within a multinational group in order to justify a particular profit allocation. By nature, such an analysis is highly qualitative and will require MNEs to document how particular functions and activities drive profit within their organisation.

MNEs will face increasing risk if they rely solely on contractual assumptions of risk to determine the appropriate allocation of profits. If MNEs do not examine their businesses to determine whether the form of their contractual assignments of risk aligns with the substance of what is in fact occurring, they risk a tax authority examining and reallocating profits associated with certain risks. This may result in double taxation of these profits.

Likewise, legal ownership alone of an intangible may not entitle a party to returns from the exploitation of that intangible. Instead, the OECD rules consider which entities perform DEMPE functions, have control over the relevant risks, and have financial capacity for those risks to determine entitlement to returns from the exploitation of that intangible. In this new framework, an MNE relying on legal ownership of intangibles to determine the appropriate allocation of profits associated with exploitation of an intangible may be surprised by tax authority examinations and re-allocations, resulting again in possible double taxation.

Figure 2: When asked “Over the past three years the OECD’s project on BEPS has placed an unprecedented focus on a number of areas of perceived tax abuse. Of the following focus areas, which THREE are the most applicable to your organisation?”; survey participants responded as follows:

<table>
<thead>
<tr>
<th>Focus Area</th>
<th>Number of Participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>CbyC Reporting</td>
<td>29</td>
</tr>
<tr>
<td>Lowered PE Threshold</td>
<td>24</td>
</tr>
<tr>
<td>HQ / SSC allocations</td>
<td>17</td>
</tr>
<tr>
<td>Hybrid Entities / Instruments</td>
<td>16</td>
</tr>
<tr>
<td>Return to IPCos</td>
<td>14</td>
</tr>
<tr>
<td>Antiabuse Rules (e.g., PPT)</td>
<td>13</td>
</tr>
<tr>
<td>Intercompany Loan Pricing</td>
<td>11</td>
</tr>
<tr>
<td>ProcurementCo Return</td>
<td>8</td>
</tr>
<tr>
<td>R&amp;DCo Return</td>
<td>4</td>
</tr>
<tr>
<td>Location Savings</td>
<td>2</td>
</tr>
<tr>
<td>Cash Box Return</td>
<td>2</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: BEPS Controversy Readiness, November 2017, KPMG LLP

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BEPS Action 13: CbyC reporting

Action 13 of the OECD BEPS project aims to enhance transparency for tax administration by introducing a CbyC framework and template reporting mechanism for MNEs to share information with tax authorities in each of the countries in which they have a tax presence. This framework provides for a multitiered standardized approach to transfer pricing documentation.

The first of these tiers is a “master file,” which would be made available to all relevant tax administrations that adopt the master file requirement. The OECD master file standard would require MNEs to provide high-level information regarding their global business operations and transfer pricing policies.

The second tier is a “local file” specific to each country, containing detailed transactional transfer pricing documentation and identifying material related-party transactions, the amounts involved in those transactions, and the company’s transfer pricing analysis.

The third tier is the actual “Country-by-Country Report,” which provides a template that large MNEs (combined revenue of euros 750 million or more) are to complete and file annually for each tax jurisdiction in which they do business. MNEs are to provide information on revenue, profit before income tax, and income tax paid and accrued in their CbyC Report. They also report their number of employees, stated capital, retained earnings, and tangible assets in each tax jurisdiction. Lastly, MNEs identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities in which each entity engages.

As of February 2018, 81 countries had adopted or expressed their intent to adopt the OECD CbyC report template, while 54 countries had adopted or expressed their intent to adopt the OECD master file and/or local file documentation standard.

The new reporting under Action 13 (master file, local file, and CbyC Report) will make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of shifting substantial amounts of income into tax-advantaged environments and, in the event of an audit, will provide information to help target audit inquiries. The CbyC reporting requirements do not, however, provide sufficient detail to enable tax authorities to distinguish with certainty the aggressive arrangements from those properly structured. As a result, it will become increasingly important for MNEs to have properly documented their global value chains and the economic and operational rationale for their allocation of profit among MNE group entities. Further, the CbyC regime makes it imperative that companies speak with a single voice across jurisdictions and articulate consistent transfer pricing positions. Moreover, the rules themselves pose significant procedural hurdles as governments around the globe institute new filing processes.

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Posing perhaps an equally significant challenge to MNEs’ global tax footprint are BEPS-style rules that have been, or are contemplated to be, unilaterally implemented by various countries. These rules introduce new substantive and procedural uncertainty that are not addressed by the OECD and although quite similar in scope, purpose, and design, are not a part of the BEPS project.

Early examples include the United Kingdom’s Diverted Profits Tax (DPT), which imposes a punitive tax on profits deemed to be moved out of the United Kingdom’s as a result of either an avoided PE or through making payments that lack economic substance (or to a company that lacks economic substance and is located in a low-tax jurisdiction), and Australia’s Multinational Anti-Avoidance Law (MAAL), which applies similar avoided PE rules.\(^9\)

While the OECD has just released its interim report on its ongoing work under BEPS Action 1 (Addressing the Tax Challenges of the Digital Economy), countries such as Italy and India have unilaterally pursued digital economy taxes (with Italy enacting a new tax on digital transactions—a 3 percent levy on gross value of the transaction, and India proposing new virtual PE rules as part of its 2018 budget—effective April 2019 when passed). Similarly, on March 21, 2018, the European Commission made two legislative proposals including a new digital or virtual permanent establishment (the Commission’s preferred long-term solution) and a tax on certain “digital” revenues (which the Commission views as an interim solution only).

\(^9\) Australia has also adopted DPT rules which apply an economic substance analysis.
How to prepare

MNEs that operate in any of the jurisdictions implementing the OECD’s BEPS-related recommendations or that rely on tax treaties to avoid costly double taxation with respect to their cross-border operations may be directly affected by these new rules. In particular, as more countries sign and adopt the MLI, taxpayers will need to quickly assess how treaties affecting them will change, evaluate how and when their operations might be affected, and develop plans to address that impact.

Understanding the impacts of the OECD’s BEPS-related recommendations and the MLI, especially the catalysts for controversy described above, empowers businesses to make informed decisions about their tax controversy risk. If MNEs do not think ahead and proactively seek to review and refine their global narratives and/or restructure to mitigate risk, they may be unprepared for the coming controversy.

Instead of waiting for risk to materialize, MNEs should consider these leading practices to prepare for and mitigate risk by playing both “offense” and “defense.”
Offense

The introduction of the PPT
— Comprehensively review your related-party arrangements and transactions to identify any arrangement which appears to have as one of its principal purposes the obtaining of treaty benefits
— Review treaties affecting your business to determine the objects and purposes of those treaties
— Be prepared to argue that certain treaty benefits resulting from your arrangements are in line with the overall goals of administrative cooperation and double taxation; better yet, consider specific treaty provisions that provide support for the receipt of treaty benefits with respect to your intercompany arrangements

The revised PE standards
— Review your existing global footprint and intercompany distribution agreements to identify exposures under existing PE rules and the revised PE standards adopted as part of the MLI
— Specifically, analyze your supply chain, with a particular focus on any commissionaire or similar dependent agent arrangements, to determine your risk of a tax authority deeming those arrangements a PE
— Consider whether your independent agents will now be considered “dependent” under the new rules
— Prepare for possible changes to PE status in some jurisdictions by revising your tax planning or restructuring your business

Changes to the rules on transfer pricing and allocation of profit with respect to risk and intangibles
— Review your company’s entire value chain to identify the key drivers of value creation in your organisation and the control of risk functions associated with those value creating activities
— Evaluate your intercompany agreements to ensure that parties contractually assuming risks in fact have control over those risks and the financial capacity to take on those risks
— Ensure that value drivers are appropriately compensated at each level, mitigating the risk of DEMPE-related adjustments

CbyC reporting
— Standardize your review processes for information to be shared with tax authorities and consider using a central repository for transfer pricing materials
— Eliminate inconsistencies in messaging; speak with a single voice across jurisdictions
— Review CbyC reporting positions in light of industry peers to identify potential audit risk areas based on outlier data in line with recently released guidance on CbyC reporting and CbyC implementation

Defense

— Prepare documentation supporting your current business model and transfer pricing under the new rules
— Standardize compliance and dispute resolution procedures across your organisation
— Develop standardized review processes for information to be shared with tax authorities and a central repository for transfer pricing materials
— Establish procedures for your local tax teams to follow in local audits and related controversies
— Ensure that local tax teams have the enterprise knowledge to describe global value chains effectively and consistently among jurisdictions
— Anticipate potential tax authority questions and prepare responses which can be leveraged across the company to improve quality and consistency of messaging
— Develop online and social media governance to be shared with employees across the enterprise, especially those involved in R&D activities, to mitigate the risk of affiliates or employees overstating their capabilities or functions online

In light of newly enacted U.S. tax reform, many MNEs may already be reviewing their operations and considering tax and business model restructuring opportunities. This is a unique moment allowing for tax planning synergies as MNEs can simultaneously consider the BEPS and U.S. tax reform consequences of their operations and respond to these changes in a single coordinated effort. To the extent you need support in reviewing or even remediating your business structure and tax planning in preparation for BEPS controversy, KPMG professionals stand ready to assist.
Contact us

If you would like to discuss any of these matters further, please reach out to any of the members of our BEPS Controversy Readiness team.

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