

International Tax Reform 2015-BEPS Final Reports

OCTOBER 6, 2015 52 MIN READ

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On October 5, 2015, the OECD released its [final reports](#) relating to the OECD/G20 base erosion and profit shifting (BEPS) project (the Final Reports). The BEPS project began in 2013 and has received unprecedented attention from governments and the private sector. The Final Reports outline the OECD's recommendations and the participant countries' consensus for addressing each of the 15 specific actions identified in its [Action Plan on Base Erosion and Profit Shifting](#) (see our Update on the BEPS Action Plan, "[OECD/G20 International Tax Reform: Potential Impact on Canadian Companies](#)," July 19, 2013). The actions included in the Final Reports are:

- Action 1 – Addressing the tax challenges of the digital economy
- Action 2 – Neutralising the effects of hybrid mismatch arrangements
- Action 3 – Designing effective controlled foreign company rules
- Action 4 – Limiting base erosion involving interest deductions and other financial payments
- Action 5 – Countering harmful tax practices more effectively, taking into account transparency and substance
- Action 6 – Preventing the granting of treaty benefits in inappropriate circumstances
- Action 7 – Preventing the artificial avoidance of permanent establishment status
- Actions 8-10 – Aligning transfer pricing outcomes with value creation
- Action 11 – Measuring and monitoring BEPS
- Action 12 – Mandatory disclosure rules
- Action 13 – Guidance on transfer pricing documentation and country-by-country reporting
- Action 14 – Making dispute resolution mechanisms more effective
- Action 15 – Developing a Multilateral Instrument to modify bilateral tax treaties

The Final Reports will be presented to the G20 Finance Ministers for their approval on October 8, at their meeting in Lima, Peru. If approved, the Final Reports will then be presented to the G20 Leaders at their meeting in Antalya, Turkey, on November 15 and 16, 2015.

This Update summarizes the principal aspects of the Final Reports and considers some of the potential impacts they may have on Canadian companies. The Final Reports represent the

consensus views of 44 countries which make up about 90% of the global economy. As a result, if the recommendations in the reports are adopted into tax treaties and domestic law, they could have significant impacts on cross-border trade and investment around the world. Many countries have expressed a willingness to follow the OECD's recommendations. The G20 and OECD countries have agreed to work toward a consistent and coordinated implementation of the BEPS recommendations.

Unfortunately, the recommendations in the Final Reports may lead to a significant increase in international tax disputes and compliance costs in Canada and around the world, and a potential corresponding reduction in productivity. In particular, the consensus nature of the Final Reports results, in many cases, in ambiguous recommendations that may be drafted or interpreted in a manner that serves a particular country's self-interest. By avoiding discussion of difficult issues (such as the allocation of taxing revenue between source and residence countries), the consensus in the Final Reports likely masks significant differences in views between countries with respect to who will collect more tax revenue as a result of the proposals. In Canada's case, the government should remain mindful of the need to ensure that tax treaty provisions and domestic rules protect the competitiveness of Canadian businesses and encourage investment in Canada. In particular, given the significance of the United States to the Canadian economy, Canada should be reluctant to proceed with many of the BEPS recommendations unless and until the United States has enacted comparable amendments.

Background

The BEPS Action Plan was developed at the request of the G20 in response to growing public concern about base erosion and profit shifting. BEPS generally refers to tax-planning strategies that exploit differences in domestic and international tax rules to shift profits to low or no tax jurisdictions where there may be little or no economic activity. The Final Reports represent the culmination of the OECD's multiyear project aimed at improving the coherence, substance and transparency of the international tax system. On September 16, 2014, the OECD released the first seven deliverables promised under the BEPS project (the 2014 BEPS package). In many respects, the Final Reports released October 5 incorporate the recommendations included in the 2014 BEPS package, as well as various other BEPS reports the OECD has released over the past two years. The Final Reports also include recommendations and refinements not found in previous reports, which are summarized below.

The Final Reports

a) The Digital Economy

Action Item 1 – Addressing the tax challenges of the digital economy

Most international tax regimes were designed well before the advent of the digital economy. Action 1 addresses the tax challenges that have emerged as a result of the digitization of commerce and the global economy. In general, Action 1 identifies four main tax policy concerns raised by the digital economy:

- A. a person's nexus to a jurisdiction when that person does not have a physical presence in the jurisdiction;
- B. attributing value to transactions in which data is collected, used or supplied;

- C. characterizing income derived from new digital products and services; and
- D. ensuring the effective collection of value-added tax (VAT) or goods and services tax (GST) on cross-border supplies of digital goods and services

The Final Report on Action 1 focusses primarily on the first and last of these concerns. The Report notes that the digital economy and its business models intensify existing risks of BEPS. Many of the BEPS risks identified in preparing the Final Report therefore informed the recommendations set out in the Final Reports on other Actions, particularly Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status.

Background

The Final Report on Action 1 was prepared by the Task Force on the Digital Economy, a subsidiary of the OECD's Committee on Fiscal Affairs in which non-OECD, G20 and OECD countries participate on an equal footing. The Report builds upon the deliverable released on September 16, 2014 as part of the BEPS 2014 Package (the Digital Economy Report). The Digital Economy Report, in turn, continued the OECD's work published in a Discussion Draft dated March 24, 2014. For more information on either the Digital Economy Report or the Action 1 Discussion Draft, please see our Osler Updates of [September 16, 2014](#) and [March 25, 2014](#) respectively.

The Final Report

The Final Report on Action 1 describes the evolution and characteristics of information and communication technology, identifying content production, data collection and sale and cloud-based processes as key drivers of the digital economy in the recent past. The Report also identifies several important emerging developments, such as the "internet of things" (connected devices), virtual currencies and 3D printing, which will present increasing taxation challenges. Rather than forming a separate sector of the economy, information and communication technology now permeates all sectors, as increasing numbers and types of businesses develop online advertising, cloud computing, online payment services and other electronic business models and services. The digital economy, however, also presents numerous tax issues as a result of the increased mobility of people and systems, reliance on data streams rather than tangible property, the ability to create monopolies and general volatility.

One of the important solutions proposed by the Task Force to address these concerns is modifying the definition of "permanent establishment" in the OECD Model Tax Convention (and eventually through the Multilateral Instrument discussed in Action 15) to ensure that the exceptions are restricted to activities that are truly "preparatory or auxiliary." A new "anti-fragmentation" rule is also recommended to prevent business activities from being overly fragmented among related entities (as discussed under Action 7, below). So, for example, a large local warehouse from which a number of employees fulfill orders placed through an online retailer in another jurisdiction would be considered a permanent establishment under this recommendation.

Other challenges posed by the digital economy will be addressed in other Actions relating to transfer pricing and controlled foreign companies. Transfer pricing measures will be aimed at attributing value from the exploitation of intangibles among members of an affiliated group of companies based on functions, assets and risks. The transfer pricing guidance will also attempt to address "information asymmetries" between tax authorities and taxpayers arising from the transfer of intangibles that are difficult to value or the use of cost contribution arrangements. Similarly, the recommendations relating to controlled foreign company income would seek to tax certain income earned from digital transactions in the

jurisdiction of the ultimate parent company.

The Final Report also considers methods to impose VAT (or GST/HST) on goods, services and intangibles acquired by consumers from sellers in another jurisdiction. This could include modifying the treaty definition of permanent establishment to cause the entity fulfilling orders in the consumer's jurisdiction to be the supplier for VAT/GST purposes (and therefore subject to domestic VAT/GST legislation). The Final Report also recommends that countries apply the OECD's International VAT/GST Guidelines, under which liability for tax is imposed on the consumer but the responsibility for collection is imposed on the non-resident supplier under a simplified reporting and payment system. The Report notes that other options, such as imposing a withholding tax on some digital transactions or a new concept of nexus in the form of a significant economic presence, are not recommended.

b) Hybrid Mismatch Arrangements

Action Item 2 – Neutralizing the effects of hybrid mismatch arrangements

A hybrid mismatch exists where, as a result of different tax treatments in different jurisdictions, the same transaction results in inconsistent tax outcomes. For example, a hybrid mismatch arrangement can arise either from a hybrid instrument (such as one that is viewed as debt in Country A but equity in Country B) or a hybrid entity (such as an entity that is a partnership in Country A but a corporation in Country B). Action 2 is intended to neutralize tax mismatches without disturbing the commercial or regulatory consequences of affected transactions or arrangements.

Background

On March 19, 2014, the OECD released two Discussion Drafts on Action 2, the first making recommendations for changes to domestic laws and the second addressing issues relating to the OECD Model Tax Convention. For more information on these Discussion Drafts, please see our [Osler Update dated March 20, 2014](#).

The OECD also released a deliverable on Action 2 as part of its 2014 BEPS Package (the Hybrid Report). (Please see our [Osler Update of September 16, 2014](#) for more information). The Hybrid Report made a number of recommendations, including linking domestic rules, whereby the treatment of an amount in one jurisdiction would be linked to its treatment in other jurisdictions. This involved both a "primary" response, as well as a defensive measure that would apply if the other jurisdiction did not adopt the primary rule.

The Final Report

The Final Report on hybrid mismatches builds upon the Hybrid Report.

Very generally, the Final Report identifies two principal outcomes that are meant to be prevented and provides detailed recommendations for domestic law provisions to address these outcomes. A hybrid mismatch can take the form of a "deduction/no inclusion" (D/NI) outcome, in which payments are deductible in the payer's jurisdiction and not included in the recipient's income in the recipient's jurisdiction. Such outcomes may arise under a hybrid financial instrument or as a result of a payment made by or to a hybrid entity. A hybrid mismatch may also arise from a "double deduction" outcome, where a single economic expenditure results in deductions in two taxing jurisdictions, for example because of a deductible payment by a hybrid entity or a dual resident.

The Final Report recommends primary and secondary rules that will apply automatically and that are not intended to disturb the commercial outcome of an arrangement or transaction. The primary rule applies to deny a deduction for a payment in the payer's if it is not included in the taxable income of the recipient jurisdiction, or if it is also deductible in the recipient jurisdiction. If the primary rule has not applied, the recipient jurisdiction's secondary rule should apply to include the amount in income or deny the deduction.

The Final Report also proposes adding a new provision to Article 1 of the OECD Model Tax Convention that would specifically address the application of treaties to the income of fiscally transparent entities.

The Final Report acknowledges that a high degree of integration and co-ordination among countries is required to make its recommendations effective. In addition, the number and sometimes staggering complexity of arrangements and transactions that could give rise to a hybrid mismatch – the Final Report is almost 500 pages, including nearly 300 pages of examples and guidance – suggests that the implementation of the recommendations will be a significant undertaking.

This significant complexity, including the need to track and monitor the foreign tax treatment of separate entities, could prove very difficult in practice. Significant additional issues arise on implementation and transition into the proposed rules, particularly if countries adopt different versions of the proposals at different times. As noted above, Canada should be reluctant to adopt these proposals unless and until similar changes are enacted by the United States. In the event that these proposals are introduced into Canadian domestic law, various financing transactions involving Canadian multinationals could be adversely affected (potentially increasing the cost of capital and decreasing the competitiveness of Canadian multinationals).

Action Item 3 – Designing effective controlled foreign company rules

Action 3 identifies CFC rules – otherwise known as “controlled foreign corporation” rules – as key methods of combating BEPS practices. Subpart F in the United States and the “foreign accrual property income” (FAPI) regime in Canada are both examples of existing CFC rules. Action 3 is aimed at assisting countries in designing CFC rules to further reduce opportunities for companies to engage in BEPS practices and avoid or defer taxation by earning certain income in offshore subsidiaries.

Background

The Final Report on Action 3 follows up on a Discussion Draft released on April 3, 2015 (the CFC Draft). For more information on the CFC Draft, please see our [Osler Update dated April 6, 2015](#). Notably, the CFC Draft made it clear that its recommendations did not reflect a consensus view of the OECD member states, but rather were simply preliminary considerations for public discussion.

The Final Report

The Final Report sets out a number of recommendations in the form of “building blocks” for an effective CFC regime: the definition of a CFC, including exemptions and threshold requirements, the definition of CFC income and its computation, the rules for CFC income attribution, and the prevention of double taxation on imputed income. The Final Report provides sufficient flexibility to allow countries to design a CFC regime that targets BEPS in a manner that is consistent with differing tax policy priorities.

Canada has a sophisticated and time-tested CFC regime. However, Canada's regime does not accord with some of the recommendations included in the Final Report. For example, with respect to the threshold requirements, the Final Report recommends that a CFC system include a tax rate exemption that would allow companies that are subject to an effective tax rate above a particular threshold (i.e., a rate that is similar to the parent's domestic rate) to be exempt from CFC taxation. The Final Report suggests that the exemption could be combined with a list of countries that automatically satisfy the exemption. Canada currently has no such exemption (the only threshold is an extremely narrow *de minimis* exception for FAPI of \$5,000 or less). If this recommendation were adopted, with an effective tax rate threshold (or list) that included the United States and Canada's other important trading partners with tax rates similar or higher than Canada's, the compliance burden on Canadian multinationals of the FAPI regime would be significantly reduced, without any increasing BEPS concerns.

Action Item 4 – Limiting base erosion involving interest deductions and other financial payments

According to the OECD, the use of interest (and in particular related party interest) is one of the simplest methods of shifting income available in international tax planning. Since most countries tax debt differently than equity, and many allow a deduction for interest expenses but not for dividend payments, there is a tax-induced bias in favour of debt financing. This bias is compounded in the cross-border context where planning techniques may be used to reduce or eliminate the tax a lender would otherwise bear on the receipt of interest income. As a result, Action 4 was designed to develop a set of best practices to prevent BEPS arising from the use of interest expenses, particularly in the following related party settings where:

- multinational groups place higher levels of third party debt in high tax countries
- intragroup loans are used to generate interest deductions in excess of the group's actual third party interest expenses
- multinational groups use third party, or intragroup financing, to fund the generation of tax-exempt income

Background

The OECD released an Action 4 Discussion Draft on December 18, 2014 (the Interest Draft). The Interest Draft set out a number of alternative approaches that could be employed to limit interest deductions, including:

- A. a kind of formulary apportionment rule which would apply in a group context, limiting a company's net interest expense to a proportion of the group's actual net third party interest expenses.
- B. a fixed ratio rule which would cap a company's interest deductions by using a fixed ratio of interest expenses to its earnings, assets, or equity.
- C. a hybrid approach, employing aspects of both A and B.

The Interest Draft did not specifically recommend one approach as better than another. It did, however, recognize that a group-wide ratio rule could increase compliance costs, given the greater flexibility it gives countries as compared to an allocation rule (increasing the chances that countries would adopt different standards). It also identified various issues with each alternative approach, and noted a lack of consensus in the manner in which countries

currently address interest deductibility.

The Final Report

The Final Report recommends an approach based on a fixed ratio rule, generally limiting an entity's net deduction for interest (and payments economically equivalent to interest) to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA). The Final Report recommends that, at a minimum, the limitation should apply to entities in multinational groups. Recognizing that countries may prefer to use different fixed ratio limits, the Final Report recommends a range of between 10% and 30%.

Other recommended "best practices" include:

- potential to supplement fixed ratio with a worldwide group ratio rule that would allow an entity to exceed the limit in certain circumstances. Specifically, this would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group
- potential to allow an uplift of up to 10% to the group's net third party interest expense to reduce double taxation
- potential use of an "equity escape" rule (similar to a rule used in Germany) which compares an entity's level of equity and assets to those held by its group
- if a group ratio rule is not adopted, it is recommended that countries apply a fixed ratio rule to entities in multinational and domestic groups (and possibly also standalone entities that are not part of a group) without improper discrimination
- potential *de minimis* threshold which carves out entities which have a low level of net interest expense
- potential exclusion for interest paid to third party lenders on loans used to fund certain public-benefit projects
- potential to carry forward disallowed interest expense and/or unused interest capacity (where an entity's actual net interest deductions are below the maximum permitted) for use in future years

The Final Report also recommends targeted rules to prevent avoidance of the general interest limitation rules, and to address other specific risks.

Additional rules are recommended for the banking and insurance sectors, since banks and insurance companies often have significant amounts of interest income (reducing the prospects of a "net interest" limit applying). The OECD contemplates doing additional work in 2016 to identify targeted rules to deal with BEPS risks posed by banks and insurance companies.

The Final Report recognizes that transitioning into the recommended rules could result in a significant cost for some entities, and therefore recommends countries provide a reasonable amount of time to allow restructuring existing financial arrangements (or potentially grandfathering existing debt).

The recommended fixed ratio rule is more similar to the "earnings stripping" rules currently in place in the United States and various other countries than the thin capitalization rules

that Canada has had for several decades. As a result, implementing the recommended fixed ratio approach in Canada could result in a significant amount of disruption to multinational groups, potentially without raising any material additional Canadian tax revenues. While it is helpful that the recommended rule applies to “net interest expense,” rather than gross interest, it remains a blunt instrument that could have a significant adverse effect on many businesses. For example, a multinational group may include companies with significant commercial differences that could influence their desired amounts of debt (and resulting interest expenses). For example, worldwide group members could operate in different industries, may be at different stages of production or development, may have different capital requirements, may have different credit ratings, etc. The Final Report appears to largely ignore such commercial factors, effectively assuming that most decisions regarding corporate debt levels are tax motivated. Most of the proposed measures to reduce the negative impact of the rules are listed as “optional,” without any apparent regard to the potential negative impact of the proposals on capital expenditures, investment decisions and competitiveness of different companies and the countries in which they operate.

c) Harmful Tax Practices

Action Item 5 – Countering harmful tax practices more effectively, taking into account transparency and substance

While most of the BEPS Action Items are aimed at preventing taxpayers from abusing domestic and international tax rules, Action 5 recognizes that some countries are guilty of gaming the international tax system. In particular, Action 5 is aimed at curbing tax competition among countries and avoiding a “race to the bottom” that could result in no taxes on certain sources of income. The Action 5 recommendations are intended to supplement the OECD’s 1998 report on Harmful Tax Competition, and help stymie the use of preferential tax regimes in which no or low effective tax rates apply to income arising from certain geographically mobile activities.

Background

The OECD released a deliverable on Action 5 as part of its 2014 BEPS Package. For more information, please see our [Osler Update of September 16, 2014](#). The OECD’s intention is not to harmonize tax systems or rates, but rather to create a “level playing field.” Various factors are reviewed in determining whether a regime is preferential, including ring-fencing from the domestic economy and lack of transparency. If a regime is identified as being potentially harmful, additional analysis is done to determine whether the regime creates harmful economic effects (such as shifting activity from another country). Where a preferential regime is found to be harmful, the country is given an opportunity to abolish the regime or remove its harmful features. Other countries may take defensive measures to counter the effects of a harmful regime.

The Final Report

The Final Report focuses on (a) requiring substantial activity to access the benefits of preferential regimes (such as reduced tax rates on intangibles), (b) improving transparency through the compulsory exchange of certain tax rulings, and (c) ongoing review and monitoring of member and associate country regimes.

A consensus was reached on using the “nexus approach” to realign the taxation of profits with substantial activities. This approach (developed in the context of IP Regimes) allows taxpayers to benefit from an IP regime only to the extent that the taxpayer itself incurred

qualifying research and development (R&D) expenditures that gave rise to the particular IP income. This approach uses the proportionate amount of expenditures as a proxy for substantial activity. Further recommendations are provided to determine relevant details such as (a) qualifying taxpayers (such as residents, domestic PEs of foreign companies or foreign PEs of domestic companies), (b) applicable IP assets (such as patents and assets that are functionally equivalent), and (c) qualifying expenditures. Outsourcing to unrelated parties (but not to related parties) may be a qualifying expenditure. Acquisition costs are not included as qualifying expenditures. Jurisdictions may permit a 30% “uplift” to qualifying expenditures, to reduce the impact of acquiring IP or outsourcing R&D activities to related parties.

No new entrants are permitted in IP regimes that are not consistent with the nexus approach after June 30, 2016. Jurisdictions are permitted to introduce grandfathering rules that will allow taxpayers benefiting from an existing regime to keep such entitlement until up to June 30, 2021. After that date, no more benefits may be given.

With respect to transparency, the Final Report indicates that a framework has been agreed covering all rulings that could give rise to BEPS concerns in the absence of compulsory spontaneous exchange. Specifically, the framework applies to: (a) rulings related to preferential regimes; (b) cross border unilateral advance pricing arrangements (APAs) or other unilateral transfer pricing rulings; (c) rulings giving a downward adjustment to profits; (d) permanent establishment (PE) rulings; (e) conduit rulings; and (f) other future categories identified by the Forum on Harmful Tax Practices.

For countries that have the necessary legal basis in place, exchange of information under this framework will take place from April 1, 2016 for future rulings, with the exchange of certain past rulings to be completed by December 31, 2016. The Final Report also sets out best practices for cross-border rulings.

The Final Report notes that 43 preferential regimes have been reviewed. Of the 16 IP regimes reviewed, all were considered inconsistent, either in whole or in part, with the recommended nexus approach. The rationale for this is that details of the nexus approach were only finalised during the BEPS project. Countries with such regimes will proceed with a review of possible amendments of their regimes’ relevant features. Review of preferential regimes will continue, with the possibility of reassessing regimes based on the substantial activity requirement.

d) Treaty Abuse

Action Item 6 – Preventing the granting of treaty benefits in inappropriate circumstances

As part of its BEPS project, the OECD indicated that one of the most important sources of BEPS concerns is treaty shopping, which arises from the interposition of an entity resident in a third country with little or no economic rationale other than to benefit from that country’s favourable tax treaty network. Action 6 called for work to be carried out 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; and
- C. identify the tax policy considerations that, in general, countries should consider before

deciding to enter into a tax treaty with another country.

Separate from the OECD initiatives, Canada's 2014 Federal Budget had proposed a domestic anti-treaty shopping rule that would have denied treaty benefits in certain situations. After engaging in consultations, however, Canada agreed to await further work from the OECD/G20 on the BEPS Project.

Background

In the 2014 Report released September 16, 2014, the OECD set out its preliminary recommendations for addressing treaty abuse. Please see [Osler Update of September 16, 2014](#) for further information.

In November 2014, the OECD released another Discussion Draft on Action 6, which followed up on some of the principal outstanding items identified in the 2014 Report (2014 Treaty Draft). See our [Osler Update](#) on the implications of the 2014 Treaty Draft for collective investment vehicles (CIVs) and non-CIV funds.

Finally, on May 25, 2015, the OECD released a third Discussion Draft on Action 6 which clarified some of the recommendations set out in the 2014 Report (2015 Treaty Draft). Please see [Osler Update dated May 25, 2015](#) for more information on the 2015 Treaty Draft.

The Final Report

The Final Report indicates that participating countries have agreed to a minimum standard to protect against treaty abuse, reflecting a common intention that tax treaties are meant to eliminate double taxation without allowing for non-taxation (or reduced taxation) through abuse or evasion, including abusive treaty shopping.

In furtherance of the minimum standard, countries may choose (a) a combined approach using both a limitation-on-benefits (LOB) rule and a "principal purpose test" (PPT) rule; (b) a PPT rule alone; or (c) an LOB rule combined with an anti-conduit rule. The LOB rule, which may apply to limit the availability of treaty benefits to an entity that is otherwise a resident of a contracting state, sets out objective conditions that are meant to ensure that there is a genuine connection or sufficient link between the entity and its residence state. Canada's treaty with the United States is the only Canadian treaty that currently has a comprehensive LOB rule. The PPT rule is a general anti-abuse rule that denies the availability of treaty benefits where one of the principal purposes of a transaction or arrangement is to obtain such benefits, unless the granting of the benefits accords with the object and purpose of the relevant treaty provision.

A principal concern is that the recommended PPT rule would introduce significant uncertainty and reduce investment. In particular, the ambiguous nature of the rule and the interpretive examples could allow tax authorities to seek to deny treaty benefits in almost any situation (as a tax benefit arises in virtually every situation in which a tax treaty applies). This inherent uncertainty appears to be the main reason the United States has rejected the PPT approach. Also, Canada's general anti-avoidance rule already applies to Canada's tax treaties, making a treaty-based PPT rule somewhat duplicative.

The Final Report recommends that the title of the OECD Model Tax Convention be amended to emphasize the role of treaties in preventing tax abuse. The title will now read:

Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance

The preamble and introduction to the Model Convention have similarly been revised in an attempt to ensure that tax treaties are interpreted and applied in a manner that recognizes their role in preventing tax abuse.

The Final Report suggests that no further treaty changes are needed for collective investment vehicles (CIVs), although it notes that implementation of the recommendations in the TRACE project are important for the practical application of treaty benefits to CIV funds. The Report also notes that further work is required with respect to the treaty entitlements of non-CIV funds. Further work will also involve proposed changes to the Model Tax Convention to ensure that a “recognized pension fund” is considered resident in its jurisdiction of formation, regardless of whether it is taxable therein. The combination of proposing broad anti-avoidance rules, and failing to ensure that these rules will not inappropriately deny treaty benefits for non-CIV funds (after several years of study) is a significant failure of the Final Report. Canada should be reluctant to adopt these proposals unless these concerns can be addressed in a manner that encourages investment in Canada, particularly during the current downturn in the resources sector.

The Final Report indicates that its recommendations will be proposed for inclusion in the Multilateral Instrument (as discussed below in Action 15). The Final Report also notes that the United States released an updated draft of its model tax treaty – which included revisions to the U.S. version of the LOB rule – in May 2015. The Final Report indicates that the U.S. provisions, once finalized, will be considered in the context of the Multilateral Instrument negotiations.

Action Item 7 – Preventing the artificial avoidance of permanent establishment status

In line with the OECD’s efforts to curb treaty abuse, Action 7 was developed to change the definition of a permanent establishment (PE) in order to reduce opportunities for businesses to artificially avoid PE status. The Action Plan originally identified two key issues in addressing the avoidance of PE status:

- A. The ability of non-resident companies to sell goods into a source country without having a PE even though employees of a local subsidiary are used to negotiate the contracts. Within this issue, the OECD identified “commissionaire arrangements” as particularly problematic, although similar arrangements were also contemplated.
- B. The fragmentation of business activities among related corporations so as to enable a foreign corporation to qualify for the exemption from PE status for preparatory or ancillary activities.

Background

The OECD previously released a Discussion Draft on Action 7, on May 15, 2015 (2015 PE Draft). Please see [Osler Update dated May 20, 2015](#) for more information.

The Final Report

Under Article 5 of the OECD Model Convention, on which the PE provision in Canada’s bilateral tax treaties is based, an enterprise will generally have a PE in a source state if it has a fixed place of business (Fixed Place PE) therein, or if there is an employee or agent (other than an independent agent acting in the ordinary course of business) in the source state who acts on behalf of the enterprise and has, and habitually exercises, an authority to conclude contracts in the name of the enterprise (Agency PE). Both Fixed Place PEs and Agency PEs are

also subject to a general exemption for preparatory or auxiliary activities that only involve a modest connection to the source state (the Specific Activity Exemptions).

This definition has not changed since the 1963 version of the OECD Model Convention. Due to developments in the way modern business is conducted, however, the OECD expressed concern that advances in technology have made it possible for considerable volumes of trade to be conducted in a country without giving rise to a PE. The Final Report on Action 7 addresses these concerns by proposing the following key changes to the definition of a PE:

- **Agency PE:** According to the Final Report, the activities of an intermediary in a country that are intended to result in the regular conclusion of contracts to be performed by a non-resident should be sufficient to cause that non-resident to have a taxable nexus to the country, unless the intermediary is genuinely independent. As a result, under proposed changes to Article 5(5) and (6), it will no longer be necessary for contracts to be concluded in a country in order to give rise to a PE in that country. A PE will arise if a person acts in the source state on behalf of the non-resident enterprise and habitually plays a “principal role” leading to the conclusion of contracts that are “routinely concluded” without material modification, and the contracts are in the name of the enterprise, are for the transfer of property of the enterprise (or for the right to use property of the enterprise), or are for the provision of services by the enterprise. An exception applies where the person is an independent agent acting in the ordinary course of its business. However, the independent agent test will not be satisfied if the agent acts “exclusively or almost exclusively” on behalf of one or more enterprises to which it is “closely related.”
- **Preparatory or auxiliary exemption:** Changes proposed to Article 5(4) will mean that the “preparatory or auxiliary” exemption from PE status will only apply if the overall activity of the Fixed Place PE is of a preparatory or auxiliary character. In addition, to deal with the potential fragmentation of activities to avoid PE status, a new “anti-fragmentation” rule is proposed to be added to Article 5. Under this rule, the “preparatory or auxiliary” exemption will not be available where the overall activity (assessed in combination) of an enterprise or of closely related enterprises is not of a preparatory or auxiliary character. The business activities must constitute complementary functions that are part of a cohesive business operation.
- **Splitting-up of contracts:** The Final Report proposes measures aimed at abuses of the “twelve month” threshold for a building site or a construction or installation projects. The OECD is concerned that this threshold may be avoided in respect of a single site or project by the splitting-up of contracts. The Final Report proposes to deal with this either under the Commentary to the PPT rule included as part of the Action Item 6 Treaty Abuse measures, or alternatively as a specific rule in the Commentary to the PE definition (for countries that do not adopt the PPT rule or that are specifically concerned about this issue).

The Final Report acknowledges that further work needs to be done with respect to the attribution of profits to a PE, and that necessary guidance will be provided before the end of 2016.

The changes to the PE definition will be proposed for inclusion in the Multilateral Instrument (Action Item 15).

If adopted, the proposals put forward in the Final Report on Action Item 7 could substantially enlarge the number of circumstances in which the business profits on an enterprise would become taxable in foreign jurisdictions, significantly increasing compliance costs. In particular, the change from the bright line “conclusion of contracts” test to the more

subjective “plays a principal role” standard, and the narrowing of the independent agent exception, will lead to greater uncertainty about whether or not a PE exists as a result of contractual negotiations taking place on behalf of a non-resident in a state. Moreover, the Final Report’s failure to simultaneously ensure that profits will be attributed by countries in a consistent manner could lead to a significant increase in international tax disputes.

e) Transfer Pricing

Action Item 8 – Developing rules to prevent BEPS from moving intangibles among group members

Transfer prices are prices at which an enterprise transfers physical goods or intangible property to, or provides services to, an associated enterprise in another country. Many countries, including Canada, follow the OECD Transfer Pricing Guidelines to help determine the appropriate transfer price that must be given to related party cross-border transactions. A key difficulty in applying transfer pricing rules, however, is the mobility of intangible property and the value to be given to such property. Action 8 is designed to address the issues relating to moving intangible property among group members.

Action Item 9 – Developing rules to prevent BEPS from transferring risk among, or allocating excessive capital to, group members

In line with Action 8, Action 9 addresses the adoption of rules and measures to ensure that inappropriate returns do not accrue to an entity solely because it has contractually assumed risks or provided capital when that entity does not play a significant role in value creation.

Action Item 10 – Developing rules to prevent BEPS from transactions that would very rarely occur between third parties

Action 10 recommends measures to clarify the circumstances in which a transaction can be recharacterized, clarify the application of transfer pricing methods, and provide protection against common types of base-eroding payments, such as management fees and head office expenses.

Background

Actions 8-10 have collectively resulted in the greatest number of BEPS publications from the OECD, including the following Discussion Drafts and Deliverables:

- July 30, 2013 Discussion Draft on transfer pricing aspects of intangibles (Action 8)
- September 16, 2014 Deliverables as part of the 2014 BEPS Package, including final and interim revisions to Chapters I, II and VI of the OECD Transfer Pricing Guidelines
- November 3, 2014 Discussion Draft on low-value-adding intra-group services (IGS Draft)
- December 16, 2014 Discussion Draft on cross-border commodity transactions (Commodity Draft)

- December 16, 2014 Discussion Draft on the use of profit splits in a global value chain (Profit Splits Draft)
- December 19, 2014 Discussion Draft on Transfer Pricing (TP Discussion Draft), including discussion of Actions 8-10 and proposed revisions to Chapter I of the OECD Transfer Pricing Guidelines
- April 29, 2015 Discussion Draft on cost contribution arrangements (CCA Draft)
- June 4, 2015 Discussion Draft on hard-to-value intangibles (HTVI Draft)

The Final Report On Actions 8-10

The Final Report on Actions 8-10 includes proposed revisions to Chapters I, II, VI, VII and VIII of the OECD Transfer Pricing Guidelines.

The stated purpose of the Final Report is to align the transfer pricing methods to allocate profits to the most important, value creating economic activities.

In implementing Actions 8, 9 and 10 the proposed revisions establish a new framework for transfer pricing analysis that, if adopted by Canada, may affect both the determination of transfer pricing and the scope of contemporaneous documentation required to establish a defence to Canadian transfer pricing penalties. A key issue will be the extent to which the revised guidelines are administered by Canada retroactively, or only prospectively.

The Final Report indicates there will be additional work done on the transactional profit split method in 2016 and finalized in 2017.

Guidance for Applying the Arm's Length Principle

The Final Report asserts that the existing international standard for transfer pricing rules, the arm's length principle, can be misapplied so that it results in outcomes in which the allocation of profits is not aligned with the economic activity that produced the profits. This potential misapplication is based on the perceived emphasis of the arm's length principle on contractual allocations of functions, assets and risks which could lead to outcomes that do not correspond to the value created through the underlying economic activity carried on by members of a multinational group.

The Final Report revises and finalizes the discussion in the TP Discussion Draft, providing revisions to the OECD Transfer Pricing Guidelines to attempt to ensure that transfer pricing outcomes are aligned with value creation. In addition to abandoning the Potential Special Measures included in the TP Discussion Draft – which were the subject of intense criticism – the Final Report takes a significantly more nuanced approach to the topic of risks.

As noted above, the proposed revised guidelines establish a new framework for conducting a transfer pricing analysis, which we will discuss in greater detail in a future Osler publication. Notably, under the revised OECD Transfer Pricing Guidelines:

- The actual transaction between associated enterprises in a multinational group is determined by supplementing, if necessary, the terms of the contract with evidence of the actual conduct of the parties. Where the contractual arrangements are incomplete or contradict the conduct, the conduct of the parties may replace the contractual arrangements.
- The identification of specific risks and their impact is required to determine which

associated enterprise assumes risk for transfer pricing purposes. To assume a risk, the associated enterprise must both control the risk **and** have the financial capacity to assume the risk.

- The actual contribution made by an associated enterprise that solely provides capital (e.g., a so-called “cash box”) depends on the control exercised by that enterprise. Where the enterprise does not exercise control over the investment risk, the enterprise should only expect a risk-free return.
- Tax administrations should not disregard the actual transaction or substitute other transactions for transfer pricing purposes unless the transaction between associated enterprises in a multinational group lacks commercial rationality. The key question is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances.

The revised OECD Transfer Pricing Guidelines provide some new examples to explain how actual conduct can supplement or replace the contractual arrangements with the “actual transaction”:

- An agency contract between a parent corporation and a subsidiary is silent about marketing and advertising activities and the subsidiary launches a media campaign to increase brand awareness. For transfer pricing purposes, the actual transaction is not limited to the agency contract but is supplemented by the actual conduct of the subsidiary. (¶1.44)
- A parent corporation licenses intellectual property to a subsidiary for a royalty, but performs the negotiations with third party customers, provides technical support, provides staff to enable the subsidiary to fulfill customer contracts and is a joint contracting party with customers. For transfer pricing purposes, the subsidiary may not be capable of providing the contracted services without the parent and the parent corporation controls the business risk despite providing a licence. In such a case, the actual transaction is not defined by the written contract but the conduct of the parties, which includes the actual functions performed, assets used and risks assumed. (¶1.48)
- A company carrying on a manufacturing business owns commercial property that is prone to flooding. The commercial property cannot be insured by third parties due to the uncertainty over the exposure and no active market for insurance being available for similar properties in this area. A related company provides insurance for a high premium. As there is no market for insurance given the likelihood of significant claims, the transaction is commercially irrational and other more attractive or realistic alternatives should be considered. Examples of more attractive alternatives include relocation by the manufacturer or not obtaining insurance. The actual transaction would not be recognised and the profits of the manufacturer are not reduced by the premium payment for transfer pricing purposes. (¶1.126)
- A company conducts research activities to develop intangibles to be used to create new products. The company agrees to transfer unlimited rights to all future intangibles over a period of 20 years to a related company for a lump sum payment. There is no reliable means to determine whether the payment reflects an appropriate valuation. For transfer pricing purposes, the arrangement is commercially irrational because the range of development activities is uncertain and valuing the potential outcomes is speculative. The arrangement, including the form of payment, would be replaced based on the functions performed, assets used and risks assumed. This could include recasting the arrangement

as a financing transaction or the provision of research services or a licence with contingent payment terms. (¶1.128)

Hard-to-Value Intangibles

With respect to the transfer pricing of intangible property, the Final Report states that hard-to-value intangibles cover intangibles or rights in intangibles where no reliable comparables exist and the projections of future cash flows or income from the intangible are highly uncertain at the time of the transfer between associated enterprises.

Where tax administrations find it difficult to establish or verify what events are relevant for the pricing of a transaction involving hard-to-value intangibles, the Final Report states that tax administrations may consider “*ex post*” outcomes as presumptive evidence about the appropriateness of the “*ex ante*” pricing arrangements. Such presumptive evidence may be subject to rebuttal, however, if it can be demonstrated that it does not affect the accurate determination of the arm’s length price.

To ensure that the above approach is applied only in situations where the difference between *ex post* outcomes and *ex ante* projections is significant, and where such a difference is due to developments or events that were, or should have been, foreseeable at the time of the transaction, the Final Report states that this approach will not apply if one of the following four exemptions applies:

- the taxpayer provides details of the *ex ante* projections used at the time of the transfer to determine the pricing arrangements and provides reliable evidence that any significant difference between the financial projects and actual outcomes is due to unforeseeable developments occurring after the determination of the price that could not have been anticipated or the probability of occurrence of foreseeable outcomes were not significantly over or under-estimated;
- the transfer of the hard-to-value intangibles is covered by a bilateral or multilateral advance pricing arrangement between the countries of the transferee and the transferor;
- any significant difference between the financial projections and actual outcomes mentioned does not have the effect of reducing or increasing the compensation for the hard-to-value intangibles by more than 20% of the compensation determined at the time of the transaction; or
- a commercialization period of five years has passed following the year in which the hard-to-value intangibles first generated unrelated party revenues for the transferee and during that commercialization period any significant difference between the financial projections and actual outcomes was not greater than 20% of the projections for that period.

As a result, the Final Report recognizes that where the taxpayer can satisfactorily demonstrate what was foreseeable at the time of the transaction and reflected in the pricing assumptions, and that the developments leading to the difference between projections and outcomes arose from unforeseeable events, tax administrators will not be entitled make adjustments to the *ex-ante* pricing arrangements based on *ex post* outcomes.

The Transactional Profit Split Method

The Final Report appears to pull back on the potentially broader use of the transactional profit split method (TPSM) envisioned in the Profit Splits Draft. It acknowledges that the TPSM may not be straightforward to apply on the part of taxpayers or to evaluate on the part of tax administrators.

The Final Report reiterates that TPSM can be a useful method, particularly in situations where there are no comparable uncontrolled transactions, where the transaction at issue involves intangibles, or where multiple parties exercise control over a risk or share group synergies that result from deliberate concerted group action. However, it acknowledges that, even in such circumstances, the TPSM will not necessarily be the most appropriate method. The Final Report also recognizes that, as a practical matter, the mechanism for conducting the functional analysis needed to quantify each parties' contribution—a critical step in applying the TPSM—is unclear, and may vary in different circumstances.

The Final Report calls for the development of additional guidance. A discussion draft of such guidance will be released during 2016, followed by public consultations in May 2016. The final guidance is scheduled for release in the first half of 2017.

Commodity Transactions

The Final Report provides new guidance in respect of cross-border commodity transactions between associated enterprises in an effort to attain greater consistency in the manner in which tax administrators and taxpayers determine the arm's length price for commodity transactions and to ensure that pricing reflects value creation. As such, the following will be added to the OECD Transfer Pricing Guidelines:

- The comparable uncontrolled price (CUP) method is generally an appropriate transfer pricing method for commodity transactions between associated enterprises. Quoted prices can be used under the CUP method as a reference to determine the arm's length price, as they generally reflect the agreement between independent buyers and sellers in the market on the price for a specified type and amount of commodity, traded under specific conditions at a certain point in time. However, comparability adjustments should be made when required to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable.
- A particularly relevant factor for commodity transactions is the pricing date, which refers to the specific time, date or period selected by the parties to determine the price for commodity transactions. This provision is designed to prevent taxpayers from using pricing dates in contracts that enable the most advantageous quoted price. Where the taxpayer can provide evidence of the pricing date agreed by the associated enterprises at the time the transaction was entered into and that is consistent with the actual conduct of the parties, the tax administrations should determine the price for the commodity transaction by reference to the agreed pricing date. If the pricing date specified in any written agreement is inconsistent with the conduct of the parties, the tax administrators may determine a different pricing date based on what independent enterprises would have agreed in comparable circumstances. Where there is no evidence of an agreed pricing date, the tax administrations may deem the pricing date based on the facts (i.e., the provisions would allow tax authorities to impute the shipment date as the pricing date for the commodity transaction).

Low Value-Adding Intra-Group Services

In response to the Action 10 imperative to provide protection against common types of base eroding payments, such as management fees and head office expenses, the Final Report revises Chapter VII of the OECD Transfer Pricing Guidelines to include an elective, simplified approach to pricing low value-adding intra-group services.

The simplified approach, which is available in respect of certain supportive services that are not part of the core business of the multinational group, applies a profit mark-up of 5% (revised from 2-5% in the IGS Draft) to a pool of costs that is associated with services that benefit multiple group members and allocated among those group members according to a consistent allocation key. This approach is intended to reduce the compliance burden of determining and demonstrating arm's length prices, promote certainty that prices will be accepted by tax authorities, and permit efficient review of documentation by tax administrators.

Multinational groups that wish to avail themselves of the simplified approach are generally expected to apply it on a consistent, group wide basis in all countries in which they operate and that have adopted the simplified approach.

The Final Report says that participating countries have agreed to an implementation plan that contemplates a large group of countries adopting the elective simplified approach before 2018. It also envisages that some countries may include a threshold such that, if the threshold is exceeded, the tax administrator may reject the application of the simplified approach and require a full functional and comparability analysis. The Final Report anticipates that follow-up work on the design of such threshold and implementation issues will be undertaken in 2016.

Cost Contribution Arrangements

The Final Report provides guidance intended to prevent the use of Cost Contribution Arrangements (CCAs) to circumvent the application of the arm's length principle. CCAs are contractual arrangements used by enterprises to share the contributions and risks involved in jointly developing, producing, or obtaining assets or services, with the expectation that the resulting assets or services will be mutually and proportionately exploited by the enterprises (either jointly or separately).

The Final Report clarifies the circumstances under which an enterprise will be considered to be participating in a CCA. It notes that the normal approach to delineating the transaction—including allocating risk—and valuing/pricing any intangibles, applies to CCAs. Furthermore, it requires that contributions to CCAs, particularly intangibles, not be measured at cost when doing so is likely to result in non-arm's length results. The final report softens somewhat the requirement that contributions be measured based on value.

Action Item 13 – Guidance on transfer pricing documentation and country-by-country reporting

Many countries, including Canada, may impose significant transfer pricing penalties when taxpayers fail to properly document cross-border related party transactions. The extent of the documentation required can be quite onerous in some situations, and the compliance costs are only magnified when different countries have different reporting requirements. Action 13 is focused on revising current standards employed by taxing authorities regarding transfer pricing documentation requirements and country-by-country reporting in order to increase transparency while reducing compliance costs (or at least reducing the risk that such costs will increase following the BEPS Final Reports).

Background

Action 13 saw a deliverable released on September 16, 2014 as part of the 2014 BEPS Package (the Documentation Report). For more information on the Documentation Report, please see our [Osler Update of September 16, 2014](#).

Action 13 has been one of the fastest moving BEPS Actions, with a new Chapter V (Documentation) for the Transfer Pricing Guidelines being released with the Documentation Report, and an Implementation Package for country-by-country reporting being published on June 8, 2015.

The Final Report

The Final Report did not contain any new substantive provisions or guidance from the previous September 2014 deliverable. The focus remains on establishing a standardized approach to transfer pricing documentation by requiring multinational groups (and their members) to create and file a “master file,” a “local file” and, for multinational groups with consolidated group revenue of at least EUR 750 million, a “Country-by-Country Report”. See our [Osler Update of September 16, 2014](#) for more detail on the requirements of each.

The Final Report contains new details regarding the implementation of the recommendations. The recommendations are to be implemented through domestic legislation and, in the case of the Country-by-Country Report, model legislation has been created. It is recommended that domestic legislation require the master file and the local file to be filed directly with the local tax administration and that the ultimate parent of a multinational group be required to file the “Country-by-Country Report” in its jurisdiction of residence within one year from the end of the relevant taxation year.

The Final Report recommends that Country-by-Country Reports be required for fiscal years beginning on or after January 1, 2016, meaning the first Country-by-Country Reports would be due on December 31, 2017 for multinational groups with calendar year-ends. Country-by-Country Reports will automatically be shared by the competent authority in the jurisdiction where the report is filed with tax administrations in relevant jurisdictions. The competent authority will have six months to review and forward the Country-by-Country Report for those filed by the end of 2017, with the deadline for sharing future reports reduced to three months after filing. The OECD intends to develop an electronic template and user guide to accommodate the electronic exchange of Country-by-Country Reports.

The implementation of this Action will be monitored by the OECD and will be reviewed in 2020.

f) Transparency

Action Item 11 – Establishing methodologies to collect and analyze data on BEPS

One of the key problems with the OECD’s BEPS Project has been obtaining accurate data on the incidence of BEPS. Action 11 is designed to address these data deficiencies and establish methodologies to collect and analyze the scale and economic impact of BEPS. Action 11 also seeks to develop tools to monitor and evaluate the effectiveness and economic impact of actions taken to address BEPS.

Background

The OECD released a Discussion Draft on Action 11 on April 16, 2015 (Action 11 Draft) focused on improving the analysis of BEPS.

The Final Report

While the Final Report on Action 11 recognizes that the following BEPS indicators confirm that profit shifting is occurring, that it is significant in scale and likely to be increasing, and that it creates adverse economic distortions, the indicators and all analyses of BEPS are severely constrained by the limitations of the currently available data. Nevertheless, the findings of the work performed since 2013 highlight the magnitude of the issue, with global corporate income tax (CIT) revenue losses estimated between 4% and 10% of global CIT revenues (i.e., USD 100 to 240 billion annually). The following indicators of BEPS activity are identified in the Final Report:

- The profit rates of multinational enterprises (MNEs) affiliates located in lower-tax countries are higher than their group's average worldwide profit rate.
- The effective tax rates paid by large MNE entities are estimated to be 4 to 8.5 percentage points lower than similar enterprises with domestic-only operations.
- Foreign direct investment (FDI) is increasingly concentrated.
- The separation of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomenon has grown rapidly.
- Debt from both related and third-parties is more concentrated in MNE affiliates in higher statutory tax-rate countries.

However, the data available is not comprehensive across countries or companies, and often does not include actual taxes paid. In addition, the analyses of profit shifting to date have found it difficult to separate the effects of BEPS from real economic factors and the effects of deliberate government tax policy choices (although the empirical analysis in this Report, along with several academic studies, confirms that strong anti-avoidance rules reduce profit shifting in countries that have implemented them).

Accordingly, the Final Report recommends that the OECD work with governments to report and analyze more corporate tax statistics and to present them in an internationally consistent manner. The focus of the Report's recommendations in this area is on improved access to and enhanced analysis of existing data, and new data proposed to be collected under Action 5 (Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance), Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting) and, where implemented, Action 12 (Mandatory Disclosure Rules) of the BEPS Project. These improvements in the availability of data are expected to ensure that governments and researchers will, in the future, be better able to measure and monitor BEPS and the actions taken to address BEPS.

Action Item 12 – Requiring taxpayers to disclose aggressive tax planning

A number of countries, including Canada, require taxpayers to disclose certain aggressive tax planning. Action 12 is aimed at ensuring other countries adopt similar measures to assist taxing authorities' efforts to identify emerging BEPS risks and quickly detect "aggressive" tax-planning trends.

Background

On March 31, 2015, the OECD released a Discussion Draft on Action 12 focussed on the design and implementation of mandatory disclosure rules.

The Final Report

The Final Report provides a general framework that is mainly aimed at enabling countries which do not already have mandatory disclosure rules to design a regime that adapts to their particular needs and circumstances. The recommendations in the Final Report do not represent a minimum standard and countries remain free to choose whether or not to introduce mandatory disclosure regimes. In fact, many countries, including Canada, have already introduced and enacted such regimes.

The Final Report sets forth the main objectives of mandatory disclosure regimes, which are to:

- (a) increase transparency by providing the tax administration with early information regarding potentially aggressive or abusive tax planning schemes;
- (b) identify the promoters and users of such schemes; and
- (c) deter taxpayers from entering into such schemes.

The Final Report goes on to identify its recommendations as to the key design features of a mandatory disclosure regime, which can be summarized as follows:

- Imposing a disclosure obligation on both the promoter of a tax scheme and the taxpayer participating in the scheme, or imposing a primary obligation to disclose on one or the other. The Final Report recommends that where the promoter has the obligation to disclose, the timeframe for disclosure should be linked to the scheme being made available to taxpayers, and where the taxpayer has the obligation, the timeframe should be linked to the implementation of the scheme.
- Including a combination of generic and specific hallmarks. The existence of a hallmark should trigger a requirement to disclose. Generic hallmarks are generally features which are typical of or common to promoted schemes (e.g. confidentiality requirements or the payment of premium fees). Specific hallmarks target particular areas of concern (e.g. losses). Canada's "reportable transaction" rules already make use of such hallmarks, requiring disclosure of transactions where at least two generic hallmarks are present.
- Establishing a mechanism to track disclosures and identify repeat promoters or participants in tax schemes. For instance, in Canada a promoter of a tax shelter must acquire a tax shelter identification number before promoting the tax shelter, and must provide the CRA with the list of investors or participants. The Final Report recommends similar features to those already in place in Canada.
- Introducing penalties (including non-monetary penalties, such as suspending the legal effectiveness of a scheme where it has not been disclosed). In Canada, such monetary and non-monetary penalties are already provided for as part of its existing mandatory disclosure regime.

The Final Report also provides certain recommendations for mandatory disclosure regimes that are aimed specifically at combatting international tax schemes which may involve multiple parties and tax benefits in different jurisdictions. In particular, the Final Report recommends that:

- (a) countries develop hallmarks that focus on the type of "cross-border outcomes" that cause them concerns; and

(b) taxpayers that enter into intra-group transactions with material tax consequences be required to make reasonable enquiries as to whether a particular transaction forms part of an arrangement that includes a “cross-border outcome” that is specifically identified as reportable under their home jurisdictions’ mandatory disclosure regime.

In addition to the Canadian reporting requirements discussed above, it is worth noting that, somewhat consistent with the concept of a “cross-border outcome”, Canada also requires the disclosure of certain foreign holdings (such as foreign affiliates, controlled foreign affiliates and the ownership of certain other foreign properties exceeding certain thresholds).

Action Item 14 – Making dispute resolution mechanisms more effective

The OECD recognized that actions to prevent BEPS must be complemented with actions that ensure certainty and predictability for businesses. As such, Action 14 recommends changes to mutual agreement procedures (MAP) so that international tax disputes can be resolved more efficiently and provide taxpayers with greater certainty of their tax treatment.

Background

A Discussion Draft on Action 14 was released on December 18, 2014 which, among other matters, discussed the possibility of including arbitration clauses in the OECD Model Tax Convention.

The Final Report

The Final Report recognizes the fundamental importance of MAP to the proper application and interpretation of the OECD Model Tax Convention. It establishes a minimum standard for resolving treaty-related disputes, with related changes to the Model Convention. The minimum standard requires countries to fully implement MAP-related treaty obligations in good faith and ensure access to and timely resolution (averaging 24 months) of MAP cases for eligible taxpayers. The report recommends that cases where the taxpayer disagrees with the application of an anti-abuse rule should be eligible for MAP; if adopted, this change should help reduce the number of cases that qualify for neither MAP nor binding arbitration.

The Final Report commits OECD countries to rapidly and effectively implementing the minimum standard, as ensured by a peer-based monitoring mechanism that will report to the Committee on Fiscal Affairs to the G20. The assessment methodology for the monitoring process will be developed in 2016. The Final Report also includes a set of best practices designed to support the minimum standard.

In addition to the minimum standard, 20 countries, including Canada, the United States, and the United Kingdom, have committed to providing for mandatory binding MAP arbitration in their bilateral tax treaties. The 20 countries account for over 90% of outstanding MAP cases (as of the end of 2013). The mandatory binding MAP arbitration provision will be developed in the course of negotiating the multilateral instrument as set out in Action 15. The Final Report notes that the 20 countries have not agreed on whether all cases will be eligible for MAP arbitration, or only a defined subset of cases.

Despite the recommendations in the Final Report on Action 14, BEPS related international tax disputes will likely rise significantly. In particular, the Final Report combines sufficiently ambiguous rules with broad access to financial data which will undoubtedly result in many countries seeking to raise additional corporate tax revenues. In the absence of specific allocation rules to avoid double tax, or effective swift and binding dispute resolution mechanics, taxpayers may often be caught in the middle. Moving ahead with other BEPS

recommendations before fully implementing effective dispute resolution mechanics is like sending a new car down a hill before testing (or in some cases even installing) the brakes.

g) Implementation

Action Item 15 – Developing a multilateral instrument

In order to address BEPS in a targeted and synchronized manner, Action 15 was introduced to develop a multilateral instrument that could be used as an alternative to separately amending the over 3,500 bilateral tax treaties that may be affected by the BEPS Project.

Background

Action 15 saw a deliverable released on September 16, 2014 as part of the 2014 BEPS Package. For more information on this deliverable, please see our [Osler Update of September 16, 2014](#). That preliminary report concluded that a multilateral instrument is both (a) feasible, based on non-tax precedents; and (b) desirable, to ensure the sustainability of the consensual framework to eliminate double taxation on cross-border trade and investment.

The Final Report

The Final Report notes that the goal of Action 15 is to streamline the implementation of tax treaty-related BEPS measures. A mandate for the formation of an *ad hoc* group (the Group) to develop a multilateral instrument was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers in February 2015. The Group is open to all interested countries on an equal footing. The Group began its work in May 2015 with the aim to conclude its work and open the multilateral instrument for signature by December 31, 2016.

So far, about 90 countries are participating in the work on an equal footing. The United States has been notably absent from the process. U.S. officials have indicated that, unless the multilateral instrument were to include binding arbitration, there may be no benefit to the U.S. to participate, particularly having regard to the extensive time demands that the various other BEPS initiatives have placed on constrained resources.

While not discussed in the Final Report, there appear to be a significant number of unresolved issues with a multinational instrument, including: (a) procedures for revising or updating the multilateral instrument once enacted, (b) differences in ratification procedures in different countries, (c) differences in views between countries on how certain provisions should be drafted/interpreted, (d) different official languages for different treaties, (e) whether there is a need for agreement on any accompanying commentaries, (f) potential to impact on original bilateral negotiation balance in treaties (by changing some provisions but not all), and (g) the extent to which countries may want to selectively “cherry pick” implementation of only certain provisions.

While the OECD has had a Model Tax Convention for many years, virtually no bilateral treaty has simply adopted that model. In addition, developing countries have largely opted to follow a separate approach based on the UN model treaty. Accordingly, it will be interesting to see the extent to which a large number of countries agree to adopt common language in significant tax treaty provisions.

For further information on the BEPS initiative (including the 2015 BEPS Reports) and Canada’s

international tax regime, please contact any member of our Tax Department.