

## BEPS: A Spent Force or Radical Change?

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# FEATURED PERSPECTIVE

## BEPS: A Spent Force or Radical Change?

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After two years of efforts, the initial phase of the OECD's G-20-mandated crusade against base erosion and profit shifting concluded on October 5. Following four prior commentaries by these authors on this topic, this article examines from an overall and a Canadian perspective whether the BEPS initiative has turned out to be a spent force or if, instead, it will spawn radical change.

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On October 5, the OECD presented its final package of measures attacking base erosion and profit shifting.<sup>1</sup> Undertaken at the request of the G-20 leaders, the efforts to address BEPS are based on the G-20 and OECD's BEPS action plan from July 2013, which

<sup>1</sup>See OECD and G-20, "BEPS 2015 Final Reports," available at <http://www.oecd.org/tax/beps-2015-final-reports.htm>. The final package contains a report for each of the 15 action items, together with Executive Summaries, available at <http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf>; Explanatory Statement, available at <http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>; and various other incidental documents.

identified 15 actions to end what is perceived by the OECD as unacceptable international tax planning.

On four prior occasions since the advent of the BEPS project in February 2013, we have offered both a general and a Canadian perspective on various aspects of this unprecedented attack on international tax management (including strategic planning and structuring) by multinational enterprises.<sup>2</sup> The release of the final reports gives occasion to revisit our prior views and offer new commentary on the BEPS initiative.

### Background and Retrospective

Simply put, the BEPS project aims to provide governments with tools to increase income taxation of multinationals, despite the OECD's view that corporate taxation is the most harmful form of taxation for economic growth.<sup>3</sup>

The BEPS project is unique in that it reflects a massive, concerted effort by G-20 and OECD nations against cross-border corporate tax planning; it has arisen out of the confluence of several factors:

- decreasing tax receipts of G-20 and OECD state treasuries, driven by economic stagnation after the 2008 global economic crisis;
- rising costs of the welfare state in many developed nations, driven by aging populations putting pressure on healthcare systems and state-sponsored defined benefit pension systems;

<sup>2</sup>See Nathan Boidman and Michael Kandev, "BEPS: The OECD Discovers America?" *Tax Notes Int'l*, Dec. 16, 2013, p. 1017; Boidman and Kandev, "BEPS Action Plan on Hybrid Mismatches: A Canadian Perspective," *Tax Notes Int'l*, June 30, 2014, p. 1233; Boidman and Kandev, "The BEPS Deliverables: A Macro Critique," *Tax Notes Int'l*, Nov. 17, 2014, p. 611; and Boidman and Kandev, "BEPS and Acquisitions of Canadian Targets," *Tax Notes Int'l*, Aug. 3, 2015, p. 431.

<sup>3</sup>See OECD, "Tax Policy Reform and Economic Growth," 2010, at 3.

- a citizenry exposed to more (though not necessarily better) information from the media and public interest groups on the taxation and finances of multinationals; and
- politicians searching for new, expedient sources of government funding without causing a backlash at the polls.<sup>4</sup>

These elements appear to have led governments and the citizenry of G-20 and OECD countries to conclude that multinationals are both the source of and the solution to their financial woes; hence, the BEPS project.

What is not unique about the BEPS project, however, is the substance of its proposals, which have been criticized as being based on the “same old paradigm.”<sup>5</sup> It was not without reason that we titled our first commentary on this subject “BEPS: The OECD Discovers America,”<sup>6</sup> demonstrating our view that there are few anti-international tax planning rules and principles that had not already been implemented by countries involved in the BEPS project. This view was based on our review of the action plan in light of historical elements, most notably:

- the formation of transfer pricing principles in the 1920s and 1930s<sup>7</sup> and their crystallization in the 1960s and 1970s;<sup>8</sup>
- the 1962 adoption of controlled foreign corporation rules in the U.S. and their adoption in Canada in 1972 (effective 1976);
- the 1972 adoption of mechanical debt-to-equity thin capitalization rules in Canada<sup>9</sup> and the 1986 adoption of an anti-earnings-stripping rule (based on a percentage of earnings before interest, tax, depreciation, and amortization) in the U.S.;<sup>10</sup>
- the 1997 enactment in the U.S. of the world’s first anti-hybrid rule;<sup>11</sup>

<sup>4</sup>Politically speaking, foreign multinationals are likely the weakest constituency. But they can certainly vote with their feet, so to speak.

<sup>5</sup>See “Corporate Taxation: New Rules, Same Old Paradigm,” *The Economist*, Oct. 10, 2015.

<sup>6</sup>For a recent similar sentiment, see David Ernick, “OECD BEPS Project: Nothing New Under the Sun?” *Tax Notes Int’l*, Aug. 10, 2015, p. 511.

<sup>7</sup>In Canada, for example, these principles date back to 1939: Canada’s transfer pricing rule was originally introduced by S.C. 1939, c. 46, section 13 as section 23B of the Income War Tax Act of 1939.

<sup>8</sup>See *Hofert v. MNR*, 62 DTC 50 (TAB), Canada’s first transfer pricing case from 1962, which applied the rule, *supra* note 7. See also IRC section 482 regulations from 1968 and the first OECD transfer pricing guidelines from 1979 (basically modeled on the U.S. regulations).

<sup>9</sup>Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), section 18(4).

<sup>10</sup>Internal Revenue Code, 26 U.S.C. (1986), section 163(j).

<sup>11</sup>IRC section 894(c).

- the 1990 adoption of mandatory transfer pricing contemporaneous documentation and penalty rules in the U.S.; and
- successful anti-treaty-shopping attacks based on beneficial ownership, as seen in the U.S. decision in *Aiken Industries v. Commissioner*<sup>12</sup> from 1971 and the Canadian decision in *McMillan Bloedel Ltd. v. MNR*,<sup>13</sup> as well as the U.S. policy of incorporating elaborate limitation on benefits provisions in its treaties since 1993.

Aside from the relative novelty of action 15 (proposing a multilateral instrument with the promise of quick and broad-based implementation of agreed tax treaty changes), we doubted that the project could offer any anti-BEPS solutions that countries could not have already adopted on the basis of preexisting principles and rules.

Notwithstanding this, the BEPS initiative is unique in its context involving a G-20 mandate to the OECD to develop the action plan, and in the OECD’s highly charged accompanying rhetoric that countries are under a moral and political obligation to implement the BEPS project outcomes. The OECD’s rhetoric raised the prospect of a tsunami of harmonized tax reform across the globe that would effectively end international tax planning.

### What Will Happen?

What has transpired or will transpire as a result of the final BEPS package? The answer to this question fundamentally depends on the level of support that G-20 and OECD nations give to the individual measures in the final package. Paragraph 11 of the explanatory statement accompanying the final package is most revealing:

A comprehensive package of measures has been agreed upon. Countries are committed to this comprehensive package and to its consistent implementation. These measures range from new minimum standards to revision of existing standards, common approaches which will facilitate the convergence of national practices and guidance drawing on best practices. Minimum standards were agreed in particular to tackle issues in cases where no action by some countries would have created negative spill overs (including adverse impacts of competitiveness) on other countries. Recognising the need to level the playing field, all OECD and G-20 countries commit to consistent implementation in the areas of preventing treaty shopping, Country-by-Country Reporting, fighting harmful tax practices and improving dispute resolution. Existing standards

<sup>12</sup>56 T.C. 925 (1971).

<sup>13</sup>79 D.T.C. 297 (TAB).

have been updated and will be implemented, noting however that not all BEPS participants have endorsed the underlying standards on tax treaties or transfer pricing. In other areas, such as recommendations on hybrid mismatch arrangements and best practices on interest deductibility, countries have agreed a general tax policy direction. In these areas, they are expected to converge over time through the implementation of the agreed common approaches, thus enabling further consideration of whether such measures should become minimum standards in the future. Guidance based on best practices will also support countries intending to act in the areas of mandatory disclosure initiatives or controlled foreign company legislation. There is agreement for countries to be subject to targeted monitoring, in particular for the implementation of the minimum standards. Moreover, it is expected that countries beyond the OECD and G-20 will join them to protect their own tax bases and level the playing field.<sup>14</sup>

The above statement distinguishes between:

- new minimum standards;
- revised existing standards;
- common approaches that will facilitate the convergence of national practices; and
- guidance drawing on best practices.

Importantly, only “new minimum standards” are backed by a commitment of all OECD and G-20 countries to consistent implementation. We next examine the action items that fall under each of the above four categories.

### New Minimum Standards

According to the explanatory statement, minimum standards have been agreed upon in four areas:

- treaty shopping;
- country-by-country (CbC) reporting;
- fighting harmful tax practices; and
- improving dispute resolution.

#### *Treaty Shopping*

First, the action 6 report recommends three possible changes to tax treaties to address treaty shopping.<sup>15</sup> One change would see the inclusion of a clear, yet fairly innocuous, statement that the countries entering into the treaty intend to avoid creating opportunities for nontaxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements. A second possible change, to be included in the OECD model tax treaty, would be the

inclusion of a U.S.-style LOB rule that restricts the availability of treaty benefits to entities that meet specified conditions.<sup>16</sup> Finally, another possible modification is the inclusion in the OECD model tax treaty of a general antiabuse rule based on the principal purposes of transactions or arrangements (the PPT rule) to address other forms of treaty abuse, including treaty-shopping situations not covered by an LOB rule.<sup>17</sup>

Significantly, the minimum standard agreed upon between all G-20 and OECD countries is to be implemented by countries *both* including the general anti-shopping statement of intention in their tax treaties and, *at their option*, including in their treaties *either*:

- the combined approach of an LOB and PPT rule;
- the PPT rule alone; or
- the LOB rule supplemented by a mechanism to deal with conduit financing arrangements not already addressed in tax treaties.

In other words, the OECD’s formulation of the minimum standard avoids setting a single common standard for combating treaty shopping. This could give rise to problematic situations: aside from the possible contents of the action 15 multilateral instrument and which countries might sign on to it, the touted agreement on minimum standards to counter treaty shopping will only be achieved when two countries agree on their choice of the foregoing options.

In any event, treaty shopping should be an increasingly small problem in light of the proliferation of tax treaties<sup>18</sup> that are largely harmonized on the basis of the OECD model. Nonetheless, the most significant issue in this area is how anti-treaty-shopping rules apply to collective investment vehicles and other fund structures. This requires further analysis.

#### *Transfer Pricing Documentation*

Second, the action 13 report requires the adoption of a standardized approach to transfer pricing documentation.<sup>19</sup> Multinationals will be required to provide:

- high-level information on their global business operations and transfer pricing policies in a “master file” to be made available to all relevant tax administrations; and

<sup>16</sup>These conditions, which are based on the entity’s legal nature, ownership, and general activities, seek to ensure that there is a sufficient link between the entity and its state of residence. Such LOB provisions are currently found in treaties concluded by a few countries, most notably the U.S.

<sup>17</sup>Under that rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.

<sup>18</sup>There are more than 3,500 bilateral tax treaties in place worldwide.

<sup>19</sup>See Executive Summaries, *supra* note 1 at pp. 37-39.

<sup>14</sup>See Explanatory Statement, *supra* note 1 at para. 11.

<sup>15</sup>See Executive Summaries, *supra* note 1 at pp. 21-22. Significantly, these changes are not proposed to be included in domestic anti-treaty-shopping legislation.

- detailed transactional transfer pricing documentation in a “local file” specific to each country, identifying material related-party transactions, the amounts involved in those transactions, and the company’s analysis of the transfer pricing determinations they have made regarding those transactions.

Large MNEs will be required to file an annual CbC report detailing the amount of revenue, profit before income tax, and income tax paid and accrued for each tax jurisdiction in which they do business. MNEs must also report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, the minimum standard requires MNEs to identify each entity within the group that does business in a particular tax jurisdiction and to provide an indication of the business activities that each entity engages in. The new CbC reporting requirements are to be implemented for fiscal years beginning on or after January 1, 2016, and, subject to a 2020 review, would apply to MNEs with annual consolidated group revenue equal to or exceeding €750 million.

The CbC reporting minimum standard is largely a nonsubstantive compliance matter consistent with the general trend of governments requiring taxpayers to report ever-increasing amounts of information. The CbC aspect of the BEPS project already has significant backing, since several countries have adopted it in their national legislations or are in the process of doing so.<sup>20</sup> Of course, the information in CbC reports will only be as useful as the quality and quantity of professionals that tax administrations hire to examine them. If governments do not invest massively in well-trained international tax auditors and the software to back them up, CbC reports will only add to the rampant data overload.

Despite its procedural nature, the importance of the CbC minimum standard should not be understated. CbC reporting will likely have a psychological dissuasive effect on multinationals, which may be less likely to engage in aggressive tax planning if they are aware that governments *may* learn about it from the CbC reports. We previously labeled this phenomenon the “fiscal Panopticon.”<sup>21</sup> CbC reporting may also be viewed as the first, information-gathering stage in a transition from a transfer pricing paradigm based on the arm’s-length principle to one based on formulary apportion-

ment. Ultimately, CbC reporting may be the greatest legacy of the BEPS project.<sup>22</sup>

#### *Harmful Tax Competition*

Third, the minimum standard regarding harmful tax competition set out in the action 5 report will require:

- substantial activity for preferential regimes;
- improving transparency; and
- peer review of preferential regimes.<sup>23</sup>

This standard was developed mainly in the context of intellectual property regimes. The main achievement of the action 5 report is the adoption of the “nexus approach,” which essentially means that taxpayers may benefit from an IP regime only to the extent that the taxpayer has incurred qualifying research and development expenditures that gave rise to the IP income. The nexus approach uses expenditure as a proxy for activity and builds on the principle that because IP regimes should be designed to encourage R&D activities and to foster growth and employment, a substantial activity requirement should ensure that taxpayers benefiting from these regimes did engage in such activities and did incur related expenditures. In this context, the minimum standard also requires a peer review of regimes. Finally, G-20 and OECD countries have agreed to mandatory spontaneous exchange of various types of taxpayer-specific rulings.<sup>24</sup>

The harmful tax practices minimum standard comes as no surprise, after a related joint proposal was tabled by Germany and the U.K. in February 2015. Since then, states have started to eliminate old IP box regimes<sup>25</sup> in order to implement new IP regimes compliant with nexus approach.<sup>26</sup>

<sup>22</sup>See Kevin A. Bell and Rick Mitchell, “Country-by-Country Plan May Be Project’s Greatest Legacy,” *Daily Tax Report*, Oct. 6, 2015.

<sup>23</sup>See Executive Summaries, *supra* note 1 at pp. 19-20.

<sup>24</sup>The framework covers six categories of rulings:

- rulings related to preferential regimes;
- cross-border unilateral advance pricing arrangements or other unilateral transfer pricing rulings;
- rulings giving a downward adjustment to profits;
- PE rulings;
- conduit rulings; and
- any other type of ruling in which the Forum on Harmful Tax Practices agrees in the future that the absence of exchange would give rise to BEPS concerns.

<sup>25</sup>See, e.g., regarding Luxembourg: Loyens & Loeff N.V., “Tax Flash: Luxembourg to Abolish Its IP Regime and to Amend Its Net Wealth Tax,” Oct. 15, 2015.

<sup>26</sup>On the implementation of the BEPS proposals in Ireland, see Finet, *supra* note 20. For specific analysis of the Irish 6.25 percent knowledge development box as the first OECD-modified nexus intellectual property box, see Mason Hayes & Curran, “Tax Update: Irish 6.25% Knowledge Development Box,” Oct. 27, 2015.

<sup>20</sup>See, e.g., regarding implementation in Ireland: J.P. Finet, “IP Box, Country-by-Country Reporting Featured in Irish Budget,” *Tax Notes Int’l*, Oct. 19, 2015, p. 221. Regarding implementation in the U.K., see H.M. Revenue & Customs, “Country-by-country Reporting,” available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/385100/COUNTRY\\_BY\\_COUNTRY\\_REPORTING.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/385100/COUNTRY_BY_COUNTRY_REPORTING.pdf).

<sup>21</sup>See Boidman and Kande, “BEPS: The OECD Discovers America?” *supra* note 2 at p. 1034.

*Dispute Resolution*

Fourth, the action 14 work on dispute resolution identifies the following elements of a minimum standard to ensure timely, effective, and efficient resolution of treaty-related disputes:

- full implementation in good faith of treaty obligations related to mutual agreement procedure (MAP) and timely resolution of MAP cases;
- establishment of administrative processes promoting the prevention and timely resolution of tax treaty-related disputes; and
- establishment of access to MAP by taxpayers (in parallel, a large group of countries has committed to move quickly toward mandatory and binding arbitration).<sup>27</sup>

This minimum standard is also procedural in nature, and its wide backing is unsurprising. It is safe to say that taxpayers and tax administrations want efficient and effective tools for dispute resolution, at least in principle. Action 14 therefore appears to state the obvious.

**Revised Existing Standards**

According to the explanatory statement, existing standards relating to tax treaties and transfer pricing have been updated, but significantly, not all BEPS participants have endorsed the revisions.

First, regarding tax treaties, the permanent establishment definition has been changed to tackle the avoidance of PE nexus through the use of *commissionnaire* arrangements and the fragmentation of business activities.<sup>28</sup> As suggested by the OECD, changes to the PE definition are unlikely to garner unanimous support because they cannot reconcile the interests of traditional head office and branch countries. Although adoption of the revised PE definition may be achieved case-by-case through individual negotiations between treaty partners, it is in our view unlikely to occur as part of the action 15 multilateral treaty. Interestingly, the U.K.'s diverted profits tax and Australia's multinational antiavoidance law are barely veiled attacks on the avoidance of PE status that do not directly change the PE definition in these countries' tax treaties.

<sup>27</sup>Albania, Argentina, Australia, Austria, Azerbaijan, Bangladesh, Belgium, Brazil, Canada, Chile, Colombia, Costa Rica, the People's Republic of China, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Georgia, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kenya, Korea, Latvia, Lithuania, Luxembourg, Malaysia, Mexico, Morocco, the Netherlands, New Zealand, Nigeria, Norway, Peru, the Philippines, Poland, Portugal, the Russian Federation, Saudi Arabia, Senegal, Singapore, the Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Tunisia, Turkey, the United Kingdom, the United States, and Vietnam.

<sup>28</sup>See Executive Summaries, *supra* note 1 at pp. 23-25.

Second, the proposed updates to the OECD guidelines on transfer pricing are likely to be the most controversial aspect of the final package. The stated purpose of the action 8-10 report is to align transfer pricing outcomes with value creation while retaining and working within the confines of the arm's-length principle.<sup>29</sup>

Most significantly, the OECD states that the proposed changes to the transfer pricing guidelines (alongside other changes) will reduce the incentive for MNEs to shift income to so-called cash boxes, a new pejorative term used by the OECD to refer to "shell companies with few if any employees and little or no economic activity, which seek to take advantage of low or no-tax jurisdictions."<sup>30</sup> Specifically, the revised transfer pricing guidelines are targeted at situations in which a capital-rich member of a group simply provides assets, such as funding for use by an operating company, but performs only limited activities.<sup>31</sup> The explanatory statement details that "[i]f the capital-rich member does not in fact control the financial risks associated with its funding, then it will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on nonrecognition applies."<sup>32</sup> Updates to the transfer pricing guidelines have also been proposed in relation to intangibles. In this context, the OECD's statements are equally brazen: "[l]egal ownership of intangibles by an associated enterprise alone does not determine entitlement to returns from the exploitation of intangibles."<sup>33</sup>

The above statements by the OECD suggest that economic returns in excess of a risk-free return are (or should be) attributable to labor rather than capital, and that excess economic returns can only be captured by entities if they have their own employees performing the functions related to the economic activity, rather than having outsourced functions to other group entities or external providers. These statements can hardly

<sup>29</sup>See OECD, "OECD/G-20 BEPS Project: Aligning Transfer Pricing Outcomes With Value Creation — Actions 8-10: 2015 Final Reports," Executive Summary. See also Executive Summaries, *supra* note 1 at pp. 27-30.

<sup>30</sup>See Explanatory Statement, *supra* note 15 at para. 16.

<sup>31</sup>But doesn't any loan, once made and absent default, require only "limited activities"?

<sup>32</sup>See Action 8-10: 2015 Final Reports, *supra* note 29, at p. 13. See also proposed D.2. of Section D of Chapter I of the Transfer Pricing Guidelines — Recognition of the Accurately Delineated Transaction, starting on p. 38.

<sup>33</sup>See Action 8-10: 2015 Final Reports, *supra* note 29, at p. 64-65: "If the associated enterprise providing funding does not exercise control over the financial risks associated with the funding, then it is entitled to no more than a risk-free return."

be supported on the basis of the arm's-length principle; they are contradicted by economic theory and practice.<sup>34</sup>

To give an exaggerated example, assume John Jr. has just outright inherited a very large sum of money from his late father, John Sr., a successful businessman and billionaire. John Jr. is a visual artist with no aptitude or interest in business and finances, but knows he must rely on good and loyal advisers to manage his estate. Thus, John Jr. engages well-paid top-notch financial advisers, asset managers, lawyers, accountants, brokers, and so forth. With their advice, his inheritance is invested in carefully picked high-risk stocks of start-up companies. The strategy pays off impressively and John Jr. doubles his fortune within five years. Now, according to the OECD, John Jr. should only keep a "risk-free return" and his army of advisers should share the rest. The standard "2 and 20" arrangements for compensating private equity fund managers clearly belie this.<sup>35</sup>

The fundamental concern with the OECD's proposed changes to the transfer pricing guidelines is that they attempt to gut out the arm's-length principle from its substance by creating exceptions — such as those for cash boxes — that are inconsistent with the fundamental notion of the underlying principle and business realities. In fact, the OECD's focus on labor is an implicit adoption of formulary apportionment based on salaries and wages. Accordingly, it is unsurprising that at a recent tax conference, Judge Frank J. Pizzitelli of the Tax Court of Canada described the OECD's final BEPS package as a step toward formulary profit attribution principles and predicted that this trend will likely continue in the future.<sup>36</sup>

Considering that the action 8-10 report is a thinly veiled attack on the arm's-length principle, it is unsurprising that not all BEPS participants have endorsed it.

<sup>34</sup>See "Labour Pains," *The Economist*, Nov. 2, 2013, available at <http://www.economist.com/news/finance-and-economics/21588900-all-around-world-labour-losing-out-capital-labour-pains>. For an incisive and insightful critique of the OECD's action 8-10 report, see A. Nikolakakis, "Aligning Transfer Pricing Outcomes With Value Creation" (forthcoming).

<sup>35</sup>Most private equity firms are compensated by a 2 and 20 fee structure. The 2 represents the 2 percent annual management fee on capital deployed, and the 20 represents the 20 percent "carry" over a specific return threshold (typically, no carry is payable if the returns to the limited partners are 8 percent per annum or lower; if the returns are higher, the GP receives carry amounting to the full catch-up between 8 and 10 percent, and thereafter receives 20 percent of the excess above 10 percent). Management fees have come under pressure in recent years, with many fund managers reducing them to around 1.5 percent for large investors.

<sup>36</sup>See Ryan Finley, "Judge Sees Trend Toward Formulary Approaches," *Tax Notes Int'l*, Oct. 26, 2015, p. 307.

## Common Approaches to Facilitate Convergence

According to the explanatory statement, countries participating in the BEPS project have agreed on a general tax policy direction in some areas, such as hybrid mismatch arrangements and interest deductibility. The OECD expects the legislative practices of these countries to converge over time as the agreed common approaches are implemented, enabling further consideration of whether these measures should become minimum standards in the future.

The action 2 final report on hybrid arrangements has two parts.<sup>37</sup> Part I sets out recommendations for domestic rules on payments made to or by a hybrid entity or under hybrid financial instruments. Part I also addresses imported hybrid mismatch arrangements and recommends linking rules that align the tax treatment of instruments or entities with their tax treatment in counterparty jurisdictions. The rules would apply automatically, and there is a rule order in the form of a primary rule and a secondary, or defensive, rule. The recommended primary rule is that countries deny deductions for payments that are excluded from the recipient's taxable income in the counterparty jurisdiction, or if the payment is also deductible there. If the primary rule is not applied, the counterparty jurisdiction can generally apply a defensive rule to require the deductible payment to be included in income or to deny the duplicate deduction, depending on the nature of the mismatch. In the imported hybrid context (for example, a three-country arrangement in which a country 1 corporation funds country 2 corporation via a hybrid instrument that makes a straight loan to a country 3 corporation), a third rule could apply so that if neither the first nor the second country complies with the primary or defensive rules, the third country should deny a deduction for the straight interest payment.

Part II of the report proposes tax treaty changes to ensure that hybrid instruments and entities, as well as dual resident entities, are not used to unduly obtain the benefits of tax treaties and that tax treaties do not prevent the application of the changes to domestic law recommended in Part I.

We have previously commented extensively on the action 2 proposals and have stated that, in our view, coordinated action against hybrid mismatch arrangements is unlikely, though some countries will likely adopt such rules:

The fundamental weakness of the action 2 proposals is that they expect that countries would engage in irrational legislative behavior (for example, hurt resident MNEs without a hope of increased tax revenue or take action to effectively protect the tax base of other countries). However,

<sup>37</sup>See Executive Summaries, *supra* note 1 at pp. 9-11.

as noted, the fatal flaw of this project is the insurmountable difficulties relating to imported mismatches in multilateral situations. In this regard, the OECD's wish to see every country adopt anti-hybrid rules is plainly utopic and, although some countries may enact certain rules, it is unlikely that action 2 would produce massive coordinated changes throughout the OECD/G-20 membership and worldwide.<sup>38</sup>

Our prediction is clearly supported by this action item being labeled merely as a "general tax policy direction," a "recommendation," or a "common approach." Arguably, this demonstrates the lack of effective support behind these proposals.

Further, the action 4 report on interest deductibility recommends an approach based on a fixed ratio rule that limits entities' net deductions for interest (and payments economically equivalent to interest) to a percentage of their EBITDA.<sup>39</sup> The OECD recommends the use of a ratio in the 10 to 30 percent bracket. According to the report, the approach can be supplemented by a relieving worldwide group ratio rule that allows entities to exceed this limit in some circumstances. The proposals also provide for various other relieving provisions, such as:

- a de minimis threshold that carves out entities that have a low level of net interest expense;
- an exclusion for interest paid to third-party lenders on loans used to fund public-benefit projects; and
- the carryforward of disallowed interest expense or unused interest capacity (when an entity's actual net interest deductions are below the maximum permitted) for use in future years.

The final action 4 report has clearly scaled back on prior proposals from the discussion draft released on December 18, 2014.<sup>40</sup> Ultimately, the final proposals reflect our view that the OECD can hardly teach anything to tax policymakers in individual countries, since interest stripping is likely the oldest and most basic tool at the disposal of tax planners. The action 4 recommendation reflects one of the long-standing and well-understood approaches to preventing excessive interest deductions (as perceived by each country). The U.S. adopted this approach in 1986, and many European countries, including Germany, Italy, and Spain, have now done so as well.

<sup>38</sup> See "BEPS on Hybrids: A Canadian Perspective," *supra* note 2 at p. 1244.

<sup>39</sup> See Executive Summaries, *supra* note 1 at pp. 15-17.

<sup>40</sup> See OECD, "Public Discussion Draft — BEPS Action 4: Interest Deductions and Other Financial Payments," Dec. 18, 2014 — Feb. 6, 2015.

## Guidance Drawing on Best Practices

According to the Explanatory Statement, guidance based on best practices will support countries that intend to act on mandatory disclosure initiatives and CFC legislation. Unsurprisingly, these items have been labeled merely as guidance. Both subjects are generally well understood, and there is already broad-based adoption in developed countries. CFC rules, for example, have been around since the early 1960s, and many countries now have them in place.

## What Might Canada Do?

### Political Context

The OECD asserted on October 5, 2015, that the G-20, of which Canada is a member, has "committed" to the BEPS project and to at least implement the minimum standards in the final package.

Three days later, on October 8, the finance ministers of the G-20 countries met in Lima, Peru, to approve the final package. The related press release<sup>41</sup> begins by stating that "G-20 finance ministers endorsed the final package of measures" but then uses weaker language to state that "ministers expressed strong support" (emphasis added) for the measures. The press release then announces that the ministers "renewed a commitment for rapid, widespread and consistent implementation . . . and reiterated the need for the OECD to prepare an inclusive monitoring framework" (emphasis added), and that they "agreed to forward the BEPS measures for discussion and action by G-20 heads of state during their summit on 15-16 November in Antalya, Turkey." The release goes on to say that the final package "includes new minimum standards on: country-by-country reporting . . . treaty shopping . . . curbing harmful tax practices . . . and effective mutual agreement procedures." The release separately refers to other subjects in the final package. In our view, the statements are understandably open-ended and imprecise in terms of what the ministers have committed to do.

Before October 19, 2015, Canada's involvement in the BEPS project took place under a right-of-center majority Conservative government. On that date, however, the left-of-center Liberals were elected to power with an unexpected and strong majority, on a platform that included substantial tax increases on the "rich." Canada's new cabinet was sworn in on November 4, with successful businessman Bill Morneau being appointed as the new minister of finance. It is yet unknown what the new government's specific stance is on the BEPS project.

<sup>41</sup> Available at <http://www.oecd.org/tax/g20-finance-ministers-endorse-reforms-to-the-international-tax-system-for-curbing-avoidance-by-multinational-enterprises.htm>.



Regardless of the inherent political uncertainty surrounding the implementation of the BEPS recommendations in Canadian law, we set out below our views on what seems likely to occur.

### New Minimum Standards

The only minimum standard in the final package that is likely to get attention in Canada is that concerning treaty shopping. Canada has already focused on implementing a new BEPS-inspired anti-treaty-shopping measure. The process began in earnest when the government announced in its 2013 budget that it would consult on an anti-treaty-shopping rule. Later that year, a consultation paper was issued, and, despite substantial concerns from the Canadian tax community, the Ministry of Finance proposed in its 2014 budget the adoption of a PPT-type domestic anti-shopping treaty override.<sup>42</sup> But in August 2014 the government announced that it would not proceed further until the BEPS proposals were complete. Now that the final package has been released, short-listing treaty shopping among the four minimum standards, the Canadian government is expected to restart its anti-treaty-shopping initiative.

It is unclear what approach Canada will choose in light of the final package, however, because there are substantial concerns with the prior proposal in the 2014 budget. One concern is that the action 6 minimum standard requires treaty changes, whereas Canada's approach involves a domestic treaty override.

Further, if Canada pursues anti-treaty-shopping on the basis of a PPT rule, this would raise substantial concerns in respect of its main trading partner, the U.S. The U.S. is the inventor and the proponent of the LOB approach to treaty shopping. Canada, on the other hand, historically considered its domestic general anti-avoidance rule as a sufficient anti-shopping protection. Hence, before 2008, the Canada-U.S. treaty had a one-way-street LOB in favor of the U.S. and a clause protecting Canada's right to apply its GAAR.<sup>43</sup> The fifth protocol to the Canada-U.S. treaty brought in a bilateral LOB, while retaining the rule in Article XXIX-A(7). So what happens now, in light of the OECD's minimum standards? The U.S. is unlikely to give up on its LOB approach, and both the U.S. and Canada are unlikely to agree to the addition of a PPT rule in their treaty, since the U.S. is understood to oppose this approach. Were Canada to adopt a PPT rule as a domestic treaty override in addition to its GAAR, there would be a dangerous and unpredictable combination

of a two-way treaty LOB, a domestic treaty override PPT rule not authorized by the treaty, and a GAAR permitted by the treaty.

A final concern is that Canada's 2014 budget proposal fails to adequately address cases of foreign direct investment by private equity and other funds.

Ultimately, regarding treaty shopping, an LOB approach would be preferable over a PPT rule to ensure certainty and predictability for taxpayers and tax administrators. The LOB should still be subject to appropriate and well-thought-out carveouts, but unfortunately at this stage there are no indications that a full range of carveouts will materialize.

It is unlikely that the other three minimum standards would give rise to substantial changes in Canada. First, regarding CbC, Canada already has well-developed foreign reporting rules. The provisions in section 233.4 of the Income Tax Act (Canada) and the corresponding Form T1134 require extensive information regarding controlled and other foreign affiliates<sup>44</sup> of a Canadian taxpayer. The extent of the required details was substantially expanded for the 2011 and following tax years. The reporting already covers items dear to the OECD's heart, such as number of employees for each foreign affiliate. Further, the rules in section 233.1 and the corresponding Form T106 require information relating to transactions with related non-residents thereby exposing all transactions that are subject to transfer pricing scrutiny. Therefore, Canada's expected adoption of CbC reporting should be an incremental change to its existing foreign reporting rules.

Second, although Canada is presumably supportive of the initiative on harmful tax practices, its own law would be unaffected by it. Canada has no IP-box-type output incentive system for R&D, and so far there have been no indications that one is under consideration. Instead, Canada has historically favored input credit-type tax subsidies in this field.<sup>45</sup> Significantly, Canada has no specific anti-offshoring rule in the ITA, and royalties earned by a foreign affiliate of a Canadian parent that are deductible against active business income of another foreign affiliate are not covered by Canadian CFC rules.<sup>46</sup> Accordingly, Canada may be glad to see the disappearance of IP boxes that are inconsistent with the nexus approach. In light of the final package and the possible proliferation of IP boxes compliant with the nexus approach, however, Canada may be encouraged to adopt its own IP box.

<sup>44</sup>Defined at section 95(1), essentially, as 10 percent foreign subsidiaries.

<sup>45</sup>The incentive system was scaled back substantially starting in 2014.

<sup>46</sup>Also, a foreign affiliate of a Canadian taxpayer that derives arm's-length royalties as part of a business would not be subject to Canada's CFC regime if specific criteria are met (most notably the requirement for more than five full-time employees).

<sup>42</sup>See Michael Kandev, "Canada Intent on Stoppin' the Shoppin' and More," *Tax Notes Int'l*, Mar. 31, 2014, p. 1201. See also Nathan Boidman, "One of the Main Purposes' Test," *22 Canadian Tax Highlights* 9 (May 2014).

<sup>43</sup>Article XXIX-A(7) of the Canada-U.S. tax treaty.

Third, regarding dispute resolution, Canada is among the countries that support mandatory binding arbitration. A provision to this effect was adopted in Canada's treaty with the U.S. (itself the strongest proponent of arbitration), and it is expected that Canada would generally favor the inclusion of similar provisions in its other treaties.

### Revised Existing Standards

Canada's stance on the notion of PE has been contradictory. In relation to the U.S., Canada somewhat understandably appears to consider itself a source country, as demonstrated by the controversial inclusion of a service PE rule (Article V(9)) in the 2008 revision of the Canada-U.S. treaty. In relation to other countries, Canada predominantly considers itself a residence country that would resist an expansion in the scope of PE. Hence, Canada's approach on this issue will likely be decided case-by-case.

Regarding the controversial updates to the transfer pricing guidelines, the Supreme Court of Canada held in *Canada v. GlaxoSmithKline*, Canada's seminal transfer pricing case, that the guidelines "are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to [Canada's transfer pricing legislation] rather than any particular methodology or commentary set out in the Guidelines."<sup>47</sup> Since the arm's-length principle is in the ITA at section 247(2),<sup>48</sup> any OECD pronouncements that are inconsistent with it, even if adopted by the Canadian government as administrative practice, would most likely fail before a Canadian court.

### Common Approaches to Facilitate Convergence

Hybrid instruments and entities, including imported mismatch arrangements, are commonly used in the context of U.S.-Canadian transactions. Canada has no domestic anti-hybrid rules, but the Canada-U.S. tax treaty was amended effective 2010 to deny treaty benefits in some situations involving hybrid entities, but not hybrid instruments.<sup>49</sup> Canada has not yet adopted an overt position on BEPS action 2, but it is doubtful that the hybrid mismatch proposals will come to fruition in Canada either for inbound or outbound arrangements.

Regarding interest deductibility, Canada has had a mechanical debt-to-equity thin capitalization rule in

place since 1972. Under the rule, interest deductions are denied when the average monthly outstanding debt to specified nonresidents<sup>50</sup> exceeds 1.5 times the total of:

- the corporation's retained earnings at the beginning of the year;
- the average of the corporation's contributed surplus at the beginning of a calendar month ending in the tax year; and
- the average of the corporation's paid-up capital.

In response to rising BEPS concerns, Canada's thin capitalization rules have been significantly updated and upgraded on three successive occasions since the 2012 federal budget by:

- reducing the debt-to-equity ratio from 2 to 1, to 1.5 to 1;
- expanding the scope of the rule to trusts, partnerships, and some nonresidents; and
- curtailing possible back-to-back arrangements.

The BEPS action 4 proposals differ from the existing Canadian thin capitalization rules, which are based on debt level; BEPS action 4 recommends an anti-stripping measure based on EBITDA. Could Canada abandon its existing regime and replace it with one in line with the recommendations of the final package?

At the International Tax Seminar of the Canadian Branch of IFA on May 28, 2015, Phil Halvorson, who was seconded from EY Canada to Canada's Department of Finance until May 1, 2015, indicated in a nonrepresentative capacity that of the various BEPS action items, the Canadian tax community ought to pay greatest attention to the report on interest deductibility. The Canadian government apparently has a "keen" interest in addressing the scope of the Canadian thin cap rules and, accordingly, is very interested in where the BEPS deliberations land.

At a later conference on October 14, however, Halvorson reportedly expressed doubt that the Canadian government would make implementation of the BEPS recommendations a priority, although in his view, the action 4 report on limiting interest deductions may affect the largest number of Canadian companies.<sup>51</sup>

Considering the substantial work that has been done to Canada's thin capitalization rules in recent years, it appears unlikely that the Canadian government will scrap an "old, tested, and true" system to draft a new one from scratch.

<sup>50</sup>Essentially, nonresidents who own 25 percent of votes or value of the Canadian borrower.

<sup>51</sup>For prior coverage, see "BEPS Interest Restrictions Not a Priority for Canada," *Tax Notes Int'l*, Oct. 19, 2015, p. 217.

<sup>47</sup>*Canada v. GlaxoSmithKline Inc.*, [2012] 3 S.C.R. 3 para. 20.

<sup>48</sup>The predecessor of Canada's current transfer pricing rule, section 69(3) (now repealed), dates back to the late 1930s. The provision was originally introduced by S.C. 1939, c. 46, section 13 as section 23B of the Income War Tax Act of 1939. The rule was revised in the R.S.C. 1952, c. 148, section 17(3) and amended by S.C. 1952, c. 29, section 5. Upon the 1972 tax reform, the rule was added to the new Income Tax Act, S.C. 1970-71-72 c. 63, as subsection 69(3).

<sup>49</sup>Article IV(7) of the Canada-U.S. tax treaty.

### Guidance Drawing on Best Practices

Canada does not need to take action in areas in which the OECD's recommendations are only treated as guidance, since Canada already has the relevant rules in place.

Effective 2011, Canada adopted section 237.3 requiring mandatory reporting of “avoidance transaction[s]”<sup>52</sup> that have at least two of the following three hallmark characteristics:

- a promoter or adviser is entitled to fees that are contingent on the results of the transaction, the number of participants in the transaction, and so forth;
- a promoter or adviser obtains confidential protection by prohibiting disclosure of the details or structure of the transaction or series under which the tax benefit results; and
- the person obtaining the tax benefit (or a promoter or adviser in respect of the transaction) has contractual protection through any form of insurance (other than professional liability insurance) or other protection, such as an indemnity, compensation, or guarantee that protects a person against failure of the transaction, or pays for or reimburses any expense, fee, tax, interest, penalty, or similar amount that may be incurred by a person in the course of a dispute in respect of a tax benefit from the transaction.

Further, as previously noted, Canada was the second country to have adopted CFC rules back in the 1970s and has one of the most developed and sophisticated CFC systems.

### Action 15 and the Multilateral Instrument

The foregoing shows that if the OECD had its way, a host of tax treaty changes and additions — mainly those related to treaty shopping — would be adopted by all concerned. There are more than 3,500 bilateral tax treaties in place worldwide, however. To avoid the virtually impossible task of quickly renegotiating so many treaties, action 15 recommends the development of a multilateral instrument containing the recommendations that many countries would agree to and adopt as part of all of their treaties. This is a work in progress, and while it remains to be seen whether Canada would sign on to the instrument, the loss of bargaining chips for the sake of overall design and balance of bilateral tax treaties will be a concern in Canada's assessment of whether to do so. Further, since tax treaties affect government revenue and thus must be adopted by Canada's Parliament, the instrument would presum-

<sup>52</sup>As defined for purposes of Canada's GAAR at section 245(3).

ably require parliamentary enactment. It remains to be seen whether that would raise further issues.

### Conclusion

We have noted more than once in our prior commentaries that advocates of the BEPS project promote it as a crusade against nefarious multinationals and their tax planners, who devise and implement tax avoidance strategies that immorally deprive governments of their fair share (the bigger the better<sup>53</sup>) of profits. But we have questioned the necessity and viability (as well as the propriety) of this crusade on the basis that most, if not all, of the G-20 and OECD countries already had decades of experience dealing with taxpayers' tax planning strategies, and had the tools to take action when activity overstepped acceptable tax planning to become unacceptable tax avoidance.<sup>54</sup>

Although the substantive product of the BEPS project has been meager, it was difficult to anticipate the massive effort (and paper output) as well as the impassioned discourse from the OECD that ensued. That dynamic will inevitably have effects on multinationals and (fortunately or unfortunately, depending on the point of view) modify both their tax management expectations and their behavior. Ultimately, this may be all that the OECD sought to achieve. And in that context, having regard to the foregoing, it may be fair to say that the BEPS project is neither a spent force nor one that will lead to radical change.

### Postscript

Subsequent to the completion of this commentary, the heads of state of the G-20 (which includes Canada) met in Turkey and endorsed the October 5 BEPS reports. Further, on November 24 the Canadian Department of Finance's general director of tax policy and legislation, Brian Ernewein, said at the Canadian Tax Foundation's annual conference in Montreal that Canada is expected to implement the reports' minimum standards although even that is subject to the political will of the newly elected Liberal government. In the substantive law area, that would entail adopting, through bilateral and (possibly) multilateral agreement, the action 6 anti-treaty-shopping initiatives. However, because Canada has already been moving toward adopting anti-treaty-shopping measures, this undertaking cannot be said to really be anything unexpected. ♦

<sup>53</sup>For example, it has been noted that China is arguing that profit-split formulas should recognize the alleged role the Chinese government plays in the earning of corporate profits. For prior analysis, see Mindy Herzfeld, “Splitting Profits With Communists,” *Tax Notes Int'l*, Aug. 10, 2015, p. 467.

<sup>54</sup>That certainly characterizes the situation in countries such as Canada and the U.S.