OECD/G20 International Tax Reform: Potential Impact on Canadian Companies

Earlier today the OECD provided its *Action Plan on Base Erosion and Profit Shifting* to the G20, which contains 15 specific recommendations for international tax reform. The OECD expects the Action Plan to be largely completed within two years and will invite the participation of G20 countries that are not OECD members. If followed, these recommendations will have a broad impact on international business activities around the world, including with respect to hybrid entities and instruments, anti-deferral rules, deductibility of financing expenses, harmful preferential tax practices, tax treaty abuse, taxation of digital commerce, transfer pricing, aggressive tax planning disclosure, and the collection and use of global tax information. This Update summarizes these recommendations and some of the potential impacts they may have on Canadian companies.

**BACKGROUND**

The Action Plan comes in response to growing international concern regarding base erosion and profit shifting (BEPS). BEPS generally refers to tax-planning strategies that exploit differences in domestic tax rules and international standards that shift profits to jurisdictions with favourable tax treatment where there may be little or no economic activity. The OECD initiated the BEPS project in 2012 to examine tax rules that permit taxable profits to be shifted away from locations where business activities take place. The BEPS project has gathered momentum recently in many countries through increased political and media attention to international tax matters. In February 2013, the OECD released its report *Addressing Base Erosion and Profit Shifting* (the BEPS Report), which identified base erosion as “a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike.” The BEPS Report presents data collected on the existence and scale of BEPS opportunities and provides an overview of the key principles underlying the taxation of cross-border activities that create these opportunities.
The BEPS Report identified six “pressure points” requiring further study and analysis:

- Hybrid mismatches (entity and instrument characterization);
- Transfer pricing (particularly shifting risks and intangibles);
- Digital goods and services (including treaty application);
- Effectiveness of anti-avoidance measures (rules respecting general anti-avoidance, controlled foreign companies, thin capitalization, and limitation on benefits);
- Related-party financing transactions (debt, captive insurance); and
- Harmful preferential tax regimes.

The OECD has considered similar international tax issues in the past, and that investigation led to a significant increase in the number of bilateral tax information exchange agreements, a decrease in bank secrecy and overall improvements in transparency through lists of uncooperative tax jurisdictions. For example, in 2011, the OECD published *Tackling Aggressive Tax Planning through Improved Transparency and Disclosure*, which concentrates on better assessment of tax compliance risks. In 2012, the OECD released *Hybrid Mismatch Arrangements, Policy and Compliance Issues*. In addition, the Global Forum on Transparency and Exchange of Information for Tax Purposes has now expanded to 120 members.

Notwithstanding these developments, the BEPS Report suggested that current international tax standards may not have kept pace with changes in global business practices, and create opportunities for taxpayers to take advantage of asymmetries in domestic and international tax rules. The report recommended developing a comprehensive, holistic approach to deal with the BEPS issue, which would deal with, for example, the balance between source and residence taxation, the treatment of intra-group financial transactions, the implementation of anti-abuse provisions, including CFC legislation, as well as transfer pricing rules. The report stressed that coordination among countries will be key to the implementation of any solution, and recommended the development of a comprehensive action plan to address BEPS issues in a comprehensive manner.

At their February, 2013 meeting, the G20 finance ministers expressed strong support for the BEPS Report and urged development of the Action Plan before their July 2013 meeting. On May 29, 2013, the OECD adopted a *Declaration on Base Erosion and Profit Shifting*, which was signed by 39 countries (including several non-OECD members) and the European Union. The signatories declared that there is a pressing need to address BEPS, agreed to collaborate in evaluating the issues and developing potential solutions to address the challenges raised by BEPS, directed the development of the Action Plan and underlined the need to take the Action Plan forward in a timely and inclusive manner.
THE ACTION PLAN

Consistent with expectations, the Action Plan calls for a comprehensive approach to BEPS. The Action Plan recognizes that an effective process requires the participation of non-OECD countries and therefore proposes that the “BEPS Project” will be launched and that interested G20 countries that are not OECD members will be invited to participate on an equal footing with OECD members. This is important since the BRIC countries are not OECD members and would otherwise generally participate in OECD initiatives as non-voting observers.

The Action Plan calls for “fundamental changes to the current mechanisms and the adoption of new consensus-based approaches” to address BEPS. The Action Plan makes 15 specific recommendations on the following topics: (a) the digital economy, (b) international coherence of corporate income tax, (c) international standards (including transfer pricing), (d) transparency, and (e) implementation of the measures.

The Action Plan proposes that the recommendations will largely be implemented within a two-year period, recognizing that some items (where work is already advanced) will be addressed more quickly, while others will take longer.

For a summary of the recommendations made in the Action Plan, as well as the proposed timelines for their implementation, please see the table at the end of this Osler Update.

(a) The Digital Economy

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

The Action Plan acknowledges the particular difficulties posed by the digital economy by singling it out as an area of concern, although recommendations in this area are closely related to, and may overlap with, other action items. It recommends the establishment of a dedicated task force on the digital economy, which will be tasked with identifying the main difficulties arising from new and changing business models and landscapes in the digital economy and coming up with possible measures to address them.

The Action Plan suggests that the task force examine a non-exclusive list of concerns in this area. For example, a company may be able to avoid tax liability in a country where it has a significant digital presence, because the traditional domestic law and treaty regimes – including, especially, permanent establishment (PE) thresholds based on physical presence – are based on “bricks and mortar” business models and are not adapted to dealing with the digital economy. This would be the case where a company is conducting an online retail business earning substantial income from customers in a country, but having nothing more than a storage facility solely for goods to be delivered to the customers located in that country. Currently, such a storage facility (a “stock of merchandise”) is excluded from being regarded as a PE under the OECD Model Tax Convention (the OECD Model). As a result, under most tax treaties, the profits of that online retail business would be exempt from income tax in the source country.
Other issues of concern highlighted in the Action Plan include the following:

- Characterization of income derived from new business models;
- Attribution of value to marketable location-relevant data generated through digital activity;
- Application of related source rules and indirect taxation of digital goods and services.

(b) Establishing Coherence of Corporate Income Taxation

The Action Plan sets out four actions aimed at producing a “fundamentally new set of standards designed to establish international coherence in corporate income taxation.” These actions are focused on neutralizing the effects of hybrid mismatch arrangements, strengthening controlled foreign company (CFC) rules, limiting tax base erosion that results from interest deductions or other financial payments, and countering harmful tax practices more effectively.

**Action Item 2 – Neutralize the effects of hybrid mismatch arrangements.**

Hybrid entities and instruments are those that take advantage of differences between tax systems, resulting in double (or global) non-taxation of income. For example, if a corporation is regarded as fiscally transparent by its parent corporation’s country of residence, but recognized as a taxable corporation by the country in which it earns income, payments by the entity to its parent (such as interest) may be deductible in the source country, without being recognized as income in the parent’s country. Similarly, a hybrid investment in a corporation may be regarded as debt by the source country, giving rise to deductible interest payments, which the parent’s country may treat as non-taxable dividend income.

To combat these and similar arbitrage opportunities arising from hybrid arrangements, Action Item 2 calls for the neutralization of the effects (e.g., double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This will be effected both multilaterally and domestically. On the multilateral front, changes to the OECD Model will be developed. These changes will ensure that hybrid arrangements (or dual resident entities) are not used to obtain undue treaty benefits. These changes will be coordinated with recommendations about domestic tax rules, in particular rules that (a) prevent the non-recognition or exemption of payments that are deductible by the payer, (b) deny deductions for payments that are not taxable in the hands of the recipient (directly or indirectly through CFC rules), and (c) deny deductions for amounts that are also deductible in another jurisdiction. The Action Plan acknowledges that coordination among jurisdictions, such as a tie-breaker rule, will be necessary if more than one country’s rules apply to a particular structure or transaction.

Canada has previously addressed hybrid mismatch arrangements through changes to its bilateral tax treaty with the United States (and in particular Article IV(7) of this treaty), as well as through the recent introduction of “foreign tax credit generator” rules.
**Action Item 3 – Strengthen CFC rules.**

CFC rules are anti-deferral rules aimed at preventing the inappropriate deferral of tax on certain income that is shifted to an entity in a low-tax country, in particular where the income is passive or mobile and the taxpayer has no real economic connection with the low-tax jurisdiction. These rules generally operate to tax the income earned in the low-tax jurisdiction in the home country on a current basis (i.e., in the year it is earned, regardless of whether or not the income is repatriated).

The Action Plan calls for the development of recommendations regarding the design of CFC rules, in order to counter BEPS in a comprehensive manner, and in coordination with other Action Plan items.

Canada has a sophisticated set of CFC rules, most notably the foreign accrual property income (FAPI) rules. These rules strive to strike a balance between preventing inappropriate deferral of tax on certain income while at the same time encouraging – or at least not hindering – the international competitiveness of Canada’s multinationals. This is achieved through excluding active business income from FAPI. In addition, Canada has other anti-deferral provisions applicable to offshore investment fund properties and non-resident trusts.

**Action Item 4 – Limit base erosion via interest deductions and other financial payments.**

Excessive deductions for interest payments (and similar payments, such as guarantee fees, payments under derivative arrangements, and insurance premiums) are identified by the Action Plan as a source of BEPS concerns. From an outbound perspective, excessive related-party payments may provide a deduction in a high-tax source country and be subject to no or low tax in the recipient’s jurisdiction. From an outbound perspective, debt incurred to invest in offshore operations may give rise to an interest deduction in the residence country, while the offshore income may benefit from an exemption or deferral regime.

The Action Plan calls for the development of recommendations for best practices in the design of rules to prevent base erosion through the use of interest expense and other economically equivalent financial payments. The use of related-party debt and the use of third-party debt to obtain “excessive” interest deductions or to finance the earning of exempt or deferred income are identified as examples that will be targeted. The effectiveness of different limitations will be evaluated. Guidance respecting the pricing of related-party financial transactions will also be developed. The work relating to interest deductions and other financial payments will be coordinated with the work on hybrids and CFC rules.

Canada currently has several tools available to combat excessive interest deductions on the inbound side, such as the thin capitalization rules for related-party interest payments (which have recently been amended to reduce the debt-to-equity ratio from 2:1 to 1.5:1.
and to apply to a broader category of taxpayers) and transfer pricing rules. However, recommendations under this item, if implemented, could further tighten these rules and could lead to their application to a broader range of financial transactions. In 2007, Canada proposed limiting the availability of a domestic interest deduction related to foreign affiliate “double dip” transactions, but these proposals were withdrawn before they became effective. The proposals were subsequently replaced with the recently enacted “foreign affiliate dumping” rules, which have both an inbound and an outbound component. These rules discourage Canadian companies from using borrowed money to make certain investments in foreign affiliates that could otherwise result in deductible interest expenses and non-taxable “exempt surplus” dividends.

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

The Action Plan provides for continued and revamped work on harmful tax practices, which may include reduced corporate tax rates on particular types of income, such as “box” regimes applicable to interest or income from intangibles that may facilitate or even encourage BEPS. The focus will be on improving transparency relating to these regimes, including compulsory spontaneous exchange of information on rulings related to preferential regimes and on requiring that substantial activity exist in order to access any preferential regime.

Canada has previously eliminated various preferential tax regimes, such as its prior NRO rules and (in the 2013 federal budget) the international banking centre rules.

**(c) International Standards**

The focus of action items under this heading (the prevention of treaty abuse and amendments to the PE definition) is to adapt current tax treaty rules to avoid BEPS.

**Action Item 6 – Prevent treaty abuse.**

One area of OECD concern is the “interposition” of entities resident in third countries between the country of residence and the source country, which can lead to or facilitate tax reduction in the framework of bilateral tax treaties – for example, where the treaty between the source country and the third country applies. Particular areas identified include the following:

- Low-taxed foreign branches;
- The use of conduit companies;
- Shifting of income through transfer pricing; and
- Intra-group financing.
The Action Plan proposes the development of (a) model treaty provisions and (b) recommendations for the design of domestic rules, in both cases to prevent the granting of treaty benefits in inappropriate situations.

Canada has separately announced its intention to study “treaty shopping” in the 2013 federal budget (discussed in our Budget Briefing 2013). Department of Finance representatives recently commented that the proposed consultations will likely consider what form such measures should take, rather than whether any measures should be taken at all. It is expected that the government will take into account the Action Plan’s recommendations in conducting its treaty shopping consultations.

**Action Item 7 – Develop changes to PE definition to avoid artificial avoidance of PE status.**

The Action Plan identifies the following two issues:

- 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. While “commissionaire arrangements” are specifically identified, similar arrangements would likely also be included.

- 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.

The Action Plan calls for the development of changes to the PE definition to prevent the avoidance of PE status that gives rise to BEPS, including the use of commissionaire arrangements and the use of “specific activity” exemptions. Work on these issues will also address related profit attribution activities.

It is expected that Action Item 1 (the digital economy) will also examine the PE threshold so that the changes to the PE definition emanating from the Action Plan would be broader than those referred to under Action Item 7.

**TRANSFER PRICING**

Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises. Countries that follow the OECD Model in their tax treaty networks agree to tax each enterprise within a multinational group as a separate entity and on the basis of the arm’s-length principle – namely, that the conditions of the cross-border transactions between them conform to those that would have been made between parties dealing at arm’s length. The OECD has established guidelines to assist tax authorities and multinational groups with the interpretation and application of the arm’s-length principle.
The BEPS Report had expressed concern that the transfer pricing guidelines put “too much emphasis on legal structures (as reflected, for example, in contractual risk allocations) rather than on the underlying reality of the economically integrated group,” which may contribute to BEPS. The Action Plan asserts that existing transfer pricing rules can be used by multinationals in some instances “to separate income from the economic activities that produce [it],” allowing for anomalous results. The chief sources of these anomalies are identified as transfers of intangibles and other mobile assets for less than full value, the over-capitalization of entities in low-tax jurisdictions and the contractual allocation of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties. The Action Plan does not recommend any shift away from the arm’s-length principle, preferring to “directly address the flaws in the current system.” The OECD therefore continues to reject the notion of an alternative transfer pricing system such as one based on global formulary apportionment. However, the Action Plan does suggest that “special measures” may be required with respect to intangible assets, risks and over-capitalization.

In these areas, the Action Plan provides general guidance for the development of rules, which may take the form of revisions to the transfer pricing guidelines or possibly the OECD Model. In general, the Action Plan’s transfer pricing recommendations concentrate on aligning profits with “value creation,” and indicate a focus on the appropriate compensation of “people functions” rather than financial contributions and contractual assumption of risk. Three actions items are proposed in this regard.

**Action Item 8 – Develop rules to prevent BEPS from moving intangibles among group members.**

The Action Plan proposes:

- Adopting a “broad and clearly delineated” definition of intangibles;
- Ensuring that the profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than “divorced from”) value creation;
- Developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and
- Updating the guidance on cost-contribution arrangements.

In determining how to allocate the profits associated with intellectual property, there appear to be three general possibilities: (a) where the intellectual property was developed, (b) where the intellectual property is exploited, or (c) where the intellectual property was financed. It appears clear that the OECD is calling for transfer pricing rules to de-emphasize the third alternative.
Action Item 9 – Develop rules to prevent BEPS from transferring risk among, or allocating excessive capital to, group members.

This action item includes adopting rules or measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital and that returns are aligned with value creation. The Action Plan proposes to coordinate work on such measures with the work on financial payments.

Action Item 10 – Develop rules to prevent BEPS from transactions which would very rarely occur between third parties.

This Action Item includes measures to

- clarify the circumstances in which transactions can be recharacterized;
- clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and
- provide protection against common types of base-eroding payments, such as management fees and head office expenses.

Canada’s transfer pricing rules include a “recharacterization rule” directed at transactions that would not occur between arm’s-length parties and that are undertaken for tax avoidance purposes. This rule has not yet been the subject of judicial interpretation, but there are cases currently before the courts in which the Crown has alleged that it applies. The measures that result from the Action Plan, as well as the expected guidance from Canadian courts with respect to the circumstances in which transactions undertaken by multinational groups may be recharacterized for tax purposes, may have a significant impact on global tax planning.

(d) Transparency

The action items under this heading relate to improving data collection on BEPS, requiring taxpayers to disclose more targeted information about their tax-planning strategies and making transfer pricing documentation less burdensome and more targeted, as well as strengthening tax treaty dispute resolution methodologies.

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

The BEPS Report noted that efforts to counter BEPS were hampered in part by the simple lack of reliable, detailed information that would allow tax administrators to identify the occurrence and impact of BEPS.

The Action Plan recommends the development of (a) methodologies to better identify the scale and economic impact of BEPS, and (b) tools to monitor and evaluate the effectiveness and economic impact of actions taken to address BEPS. This would involve
assessing existing data sources and also identifying new types of data to be collected. The Action Plan mentions the possible use of taxpayer-specific information, such as financial statements and tax returns, but notes the need to respect taxpayer confidentiality.

**Action Item 12 – Require taxpayers to disclose aggressive tax planning.**

Tax authorities’ existing efforts to identify emerging BEPS risk areas are hampered by a lack of timely, targeted and comprehensive information regarding cross-border taxpayer strategies. While tax audits provide much relevant information, they are limited as a tool for early detection of “aggressive” international tax-planning techniques.

The Action Plan proposes the development of recommendations regarding mandatory disclosure rules for aggressive or abusive tax planning, drawing on experiences of countries that have such rules. One focus will be international tax schemes and will involve development of enhanced models of sharing information regarding such schemes among tax administrators.

Canada is already far along in implementing these types of measures. The province of Québec and, very recently, the federal government have enacted rules requiring taxpayer disclosure of aggressive tax planning. The Canadian government has noted that its participation in a multilateral group of tax administrators, the Joint International Tax Shelter Information Centre or JITSIC, has led to early detection of some international tax schemes, including so-called foreign tax credit generators, which the government then addressed through legislation.

**Action Item 13 – Re-examine transfer pricing documentation.**

The Action Plan proposes to develop rules that would coordinate transfer pricing documentation with a view to enhancing transparency while taking into account compliance costs, including a requirement that multinationals report to all relevant governments on their global allocation of income, economic activity and taxes paid among countries according to a common template.

**Action Item 14 – Make dispute resolution mechanisms more effective.**

The Action Plan proposes to address obstacles that prevent countries from resolving treaty-related disputes under the mutual agreement procedures (MAP) under the relevant treaty, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in some cases.

In this regard, although a number of Canada’s bilateral tax treaties contemplate the possibility of arbitration, the Fifth Protocol to the Canada-US Tax Treaty made it the first such treaty to include detailed, mandatory arbitration provisions. Under the Fifth Protocol, taxpayers can compel the competent authorities of Canada and the United States to refer unresolved issues relating to potential double taxation to binding arbitration.
Although neither the CRA nor the IRS publishes statistics on the number or outcomes of cases going to arbitration, the number of MAPs reported by the CRA to have been resolved has increased significantly since the Fifth Protocol came into force (see the CRA’s 2011-2012 MAP Program Report), possibly as a result of the prospect of binding arbitration in the case of MAPs with the United States. The Action Plan’s proposal to consider more extensive arbitration provisions in tax treaties could potentially lead to similar efficiencies for Canadian multinationals operating in countries other than the United States.

(e) Implementation

Some of the work on BEPS is likely to result in changes to the OECD Model, including the introduction of anti-treaty abuse provisions and anti-hybrid rules as well as, possibly, changes to the PE definition and transfer pricing provisions. In order for such changes to become binding on parties to an existing bilateral tax treaty, ordinarily the two parties would have to agree and take the required steps to amend their existing treaty. If the BEPS treaty-related measures had to be introduced on a treaty-by-treaty basis, the large number of treaties and slow process for amending treaties would make the effective, international implementation of such changes a very slow process. Action Item 15 is introduced as a possible means to address these concerns.

Action Item 15 – Develop a multilateral instrument.

The Action Plan recommends consideration of a multilateral instrument (i.e., a treaty or convention signed by multiple countries) that would be used to amend bilateral tax treaties. The intent would be that the parties to the multilateral instrument would have their bilateral tax treaties amended each time that a BEPS treaty-related measure were developed and added to the multilateral instrument (or the OECD Model). As this is a fairly innovative proposal, with scant details provided on how it would work, the Action Plan is recommending at this stage only that an analysis be conducted of the tax and public international law issues related to the development of such a multilateral instrument.

The recommendations set out in the Action Plan would represent fundamental changes to the global international tax system. As a result, the implementation of its recommendations could have a significant impact on the manner in which Canadian companies conduct their affairs. It is important for companies to monitor these developments, which could influence Canadian legislation and their global tax burden. The prior BEPS Report had noted that corporate taxes as a percentage of GDP have been generally increasing since 1965. Accordingly, it is hoped that governments will not use the Action Plan as an excuse to further raise corporate tax burdens, particularly since all corporate taxes are ultimately borne by individuals (including pensioners and other investors, customers, and employees). Also, Canada should ensure that its participation in the Action Plan does not adversely impact the competitiveness of Canadian multinationals.
For further information on the Action Plan and Canada’s international tax regime, please contact any member of our Tax Department.

Summary: Recommendations in the OECD’s Action Plan*

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* Parenthetical dates refer to the Action Plan’s proposed implementation deadlines.