Practitioners Highlight BEPS-Driven Tax Changes in North America and EU

by Stephanie Soong Johnston

At a conference in New York, practitioners from Mexico, Canada, the Netherlands, the United Kingdom, and Ireland examined how the OECD's work to address base erosion and profit shifting has shaped domestic tax policy and the corporate landscape in their jurisdictions.

They spoke May 21 at the seventh annual Worldwide International Tax Update, hosted by Sullivan & Worcester, which focused on tax updates from the United States' biggest trading partners in North America and the European Union.

Mexico and Canada

Mexico is taking a rather aggressive approach in the BEPS context and appears to be getting ahead of itself by immediately imposing measures to address BEPS in its domestic legislation, according to Bernardo Ramírez of Chevez Ruiz Zamarripa.

"Probably no one heard that this was intended to be a set of harmonized rules that will be adopted by all the countries at the same time," he said.

Mexico has undergone a great deal of tax reform, with a complete overhaul of its tax system for 2014 that included the revocation of the business flat tax and the imposition of new limitations on the maquiladora regime. The tax reform measures were included in the Mexican government's 2014 budget and took effect January 1. (Prior coverage.)

In light of the OECD's work on BEPS, Mexico made changes to its domestic tax laws, such as applying more stringent rules to the deductibility of some related-party transactions. Payments made by a Mexican resident entity will be nondeductible when they are also deducted by a Mexican or nonrelated resident party, except when the related party also regards the income as taxable in the same fiscal year or in the following one, Ramírez said.

Payments to related parties will be nondeductible when the Mexican resident payer has control over the recipient; the payments correspond to interest income, royalty income, or technical assistance; and if any of the following fact patterns are true:

- the payee is an entity that is transparent for tax purposes except where its participants are taxed on such income and the payment is at arm's length;
- the payment is considered nonexistent for tax purposes in the recipient's country of residence; and

- the recipient does not consider the payment as taxable income.

Therefore, Ramírez explained, if a Mexican resident entity makes a payment and the payment is considered, for example, by a U.S. company to be a deductible item, the deduction for the Mexican entity would be disallowed unless the U.S. company considers that payment taxable income.

"Obviously the situations where this may happen depend on the legislation of other countries, so the rules to understand how this provision will really work are pretty unclear, and nothing has been issued as guidance as of today," he said. Ramírez anticipates that the rule will create issues during audits by Mexican tax authorities because it will require examining tax legislation in different countries.

Another domestic tax change in line with the OECD's BEPS initiative is a new obligation to file informative returns to apply for treaty benefits. These returns must state such information as the identity of the effective beneficiary of a payment.

In addition, regarding related-party transactions, the Mexican tax authorities may request nonresidents to submit an affidavit that income realized is subject to double juridical taxation in its country of residence.

Therefore, Ramírez said, if the income is not taxed by the nonresident receiving the payment, Mexico would deny the benefits of the treaty to the nonresident. "There is a discussion about whether this goes against the nondiscrimination clauses of the tax treaties," he said. "The view of the Mexican tax authorities is that it doesn't, so we will have to wait and see in court if they succeed or not."

Canada has also had several tax law changes in recent years, but much to its detriment, according to Michael Colborne of Thorsteinssons LLP. "It's been a culmination of the Department of Finance addressing things they found irritating over the last 40 years, things that taxpayers thought was business as usual," he said. "It came together in a whole bunch of different legislative amendments that really screwed up our system."

Regarding BEPS, Canada decided to take action on treaty shopping. In 2013, after losing several treaty shopping cases, "the government went nuts," Colborne said, and although the BEPS project was going on, Canada went ahead with its own proposal for a domestic anti-treaty-shopping rule, he said.

Shortly after Budget 2013 was released on March 21, 2013, the Department of Finance on August 12, 2013, published a consultation paper exploring options to tackle perceived treaty abuse. The paper appeared to indicate a preference for addressing the issue through domestic legislation. (Prior coverage.)

In Budget 2014, released on February 11, the government unveiled a proposed general anti-treaty-shopping provision based on a main purpose test that would be enacted under domestic law. Following are the main components of the proposed anti-treaty-shopping rule:

- Main purpose provision: Treaty benefits will be denied if it is reasonable to conclude that one of the main purposes for undertaking a transaction (or one that is part of a series of transactions or events) was to obtain the treaty benefit.

- Conduit presumption: This rule introduces a rebuttable presumption that the main purpose requirement is met if the relevant income is primarily used to make direct or indirect payments, distributions, or transfers to others who would not have been entitled to equivalent or more favorable treatment had the relevant income been received directly.

- Safe harbor: If the conduit presumption does not apply, a safe harbor rule would introduce a rebuttable presumption that the main purpose provision will not be satisfied if one of the following conditions is met:

  - the relevant person carries on an active business in the state with which Canada has concluded the tax treaty that is substantial compared with the activity carried out in Canada that gives rise to the relevant treaty income; or

  - the person is not controlled, either directly or indirectly, in any manner whatever by another person or persons that would not have been entitled to an equivalent or more favorable treaty benefit if the other person received the relevant treaty income directly; or

  - the person is a publicly traded trust or corporation.

- Relieving provision: If the main purpose provision applies, treaty benefits may still be provided, in whole or in part, subject to a standard of reasonability.

Stakeholder comments on the proposal are due by June 11. (Prior coverage.)

The Netherlands and the EU

BEPS is certainly keeping European practitioners busy in the international taxation realm, said Michiel van Kempen of the New York office of Loyens & Loeff, who called the project "a wind that blows through the whole of Europe."

International tax planning by multinationals has been a hot topic for political debate, not only in the United Kingdom, the United States, and elsewhere, but also in the Netherlands, he said, adding that there is "a lot of interest in the political field in international taxation and the role the Netherlands is playing there."

The Netherlands will actively participate in the OECD BEPS discussions, and its general view is that if actions are taken to address the sources of BEPS, they should be taken multilaterally so that there is a level playing field between all jurisdictions, according to van Kempen.

Therefore, he said, the Netherlands is not making major unilateral changes to its domestic legislation in response to the work on BEPS -- at least, not yet. "We are all waiting for the outcome of these various discussions and reports," he said, referring to the deliverables outlined in the OECD's BEPS action plan.

However, the Netherlands did make slight changes to its tax legislation to address base erosion and profit shifting, van Kempen said.

These changes include new substance requirements for companies engaged in intercompany financing or licensing activities. The rules, set out in a decree that was released in December 2013 and entered into force January 1, codified existing administrative guidance on substance requirements. (Prior coverage.)

Previously, only companies that requested an advance tax ruling or advance pricing agreement for their intercompany financing or licensing activities were required to comply with the requirements, although compliance was considered a best practice for non-ruling companies.

Under the new rules, taxpayers that are mainly (that is, 70 percent or more) engaged in intercompany financing or licensing activities, or activities generating similar income, such as rental or leasing income, that have received or accrued interest or royalty income (or similar income) from foreign group companies, and that claim the benefits of a tax treaty or EU directive, must declare in their annual Dutch corporate income tax return whether they continuously satisfy a specified set of substance requirements throughout the year.

A taxpayer that does not satisfy the substance requirements continuously throughout the year should disclose which requirement is not met and provide information that will enable the Dutch tax authorities to make a proper assessment. Moreover, such a noncompliant taxpayer should provide a summary of the interest, royalty, and similar income received for which treaty benefits are claimed, as well as provide information on the payer of the income. The rules are subject to a penalty provision. If the Dutch tax authorities conclude that the substance requirements are not met, they can spontaneously notify the foreign tax authorities.

Van Kempen also noted that in addition to the OECD's work on neutralizing hybrid mismatch arrangements, the EU is proposing amendments to the EU parent-subsidiary directive (2011/96/EU) to address corporate groups exploiting mismatches between national tax rules to avoid paying taxes on specific types of profits distributed within the group.

The European Commission on November 25, 2013, adopted a proposal to amend the directive that contained a general antiabuse provision to prevent "directive shopping." It also contained a provision related to payments on hybrid instruments that would deny tax benefits to companies using hybrid loan instruments. Under the provision, the member state of the parent company should tax the profits the parent company derives from hybrid loan instruments that have been deducted in the jurisdiction in which the subsidiary is located.

He said that at the Economic and Financial Affairs Council meeting on May 6, an updated proposal to amend the directive was discussed, but it did not include a general antiabuse provision because of diverging views and concerns among member states. The EU presidency prepared the revised proposal in an attempt to enact the amendments as soon as possible and achieve early progress in addressing hybrid financing arrangements.

"The Netherlands was not in favor of such a general antiabuse provision," van Kempen said. "So what we will see is a proposed amendment to the parent-subsidiary directive, purely focusing on these hybrid mismatches," he said. He noted that approval of the amendments to the parent-subsidiary directive has been postponed until the next ECOFIN meeting on June 20. If the proposal is approved, then member states should implement the amendments into their domestic laws by December 31, 2015.

"So you have to keep into account that within the European Union, this amendment will soon be enacted, and that the general antiabuse provision will be further discussed and may or may not be introduced at a later stage," he said.

United Kingdom and Ireland

The U.K. government is committed to tackling tax avoidance and has introduced 34 separate measures since 2010 to address the problem, according to Michael L'Estrange of Watson, Farley & Williams LLP. However, what's particularly complex about tackling tax avoidance in the context of the BEPS initiative is "the perceived need for global tax laws in addition to the more domestic matters, particularly with respect to digital businesses," he said.

One immediate domestic change related to BEPS and the digital economy is that beginning in January 2015, VAT will be charged in the country where goods and services are consumed rather than where the supply is based. The current rules have led some companies to deliberately locate in countries with a much lower tax rate, so moving the place of charge to the country where the goods and services are consumed is estimated to increase U.K. VAT receipts by £300 million each year, L'Estrange said.

Treaty abuse is another interesting BEPS area for the U.K., since it has about 120 bilateral double tax agreements and is looking to prevent treaty shopping. Two ways the U.K. government has tried to address the problem are to include a main purpose test or a limitation on benefits clause in its treaties, he said.

However, according to L'Estrange, "the U.K. view is that the purpose-based approach, which looks at transactions, is more flexible than the limitation on benefits approach, because the purpose-based approach applies to abusive transactions and doesn't deny benefits when nonqualifying persons are engaged in wholly commercial transactions."

In addition, the U.K. recently reformed its controlled foreign company rules in an attempt to move to a more territorial tax system, and it isn't likely that the government will change the rules much more, L'Estrange said.

The U.K. is also working on limiting base erosion through interest deductions and using debt to facilitate the shifting of profits to low- or no-tax jurisdictions.

"Many countries have introduced antiabuse rules or arm's-length tests, and in the U.K. we have both of these," L'Estrange said, noting that the country has thin capitalization rules and structural interest restriction rules that apply to all the debt within a company or group and counter tax-driven creation of intergroup debt.

L'Estrange said that although we must wait and see what the international approach will be to limiting base erosion through interest deductions and other financial payments, he hopes that countries will recognize the importance of interest deductions to corporations. "By restricting the deductibility of interest, this can have a significant impact on many businesses that need those deductions to reduce their tax liabilities when they need to borrow significant amounts of money to enter into projects," he said.

Ireland is well aware of its international tax reputation, and criticism from politicians abroad hasn't fallen on deaf ears, according to Philip McQueston, a senior associate in the tax department of A&L Goodbody in Dublin. The U.S. Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations grilled Apple during a May 2013 public hearing, criticizing the company for exploiting the differences between the Irish method for determining residency, which is based on where management and control is located, and the U.S. method, which is based on the place of incorporation. The subcommittee heard that Apple uses a structure that includes an entity that is incorporated in Ireland but not managed and controlled there. (Prior coverage.)

The Irish government was quick to defend its tax system after U.S. officials accused Ireland of being a tax haven (prior coverage), and shortly after the hearing, in December 2013, Ireland changed its legislation to address the type of tax planning that Apple used and to prevent the use of "stateless" companies to avoid corporate taxes. (Prior coverage.)

"However, the Irish domestic changes did not go so far as to close off the type of structure that it is understood Google uses, where an IP holding company is tax resident somewhere in the world even if resident in a jurisdiction that has low or no taxation," he said.

He noted that during a July 2013 Oireachtas (Parliament) committee hearing on global taxation, Pascal Saint-Amans, director of the OECD Centre for Tax Policy and Administration, said that Ireland is not a tax haven and that the consequences of the double Irish tax structure could not be blamed on countries or on businesses.

"He said there is a need for multilateral action in order to address the deficiencies of international tax rules and [that] there needs to be international consensus," McQueston said of Saint-Amans. Ireland's response to the BEPS action plan, therefore, has been positive, he said.

In October 2013 the government published a paper outlining Ireland's international corporate tax strategy, making clear its commitment to the OECD's work on BEPS. On May 27 it launched a BEPS consultation. (Prior coverage.)

"The key theme of the BEPS project is the alignment of profit with economic substance, so one view is that it will result in endorsement and encouragement of employment in Ireland," McQueston said. He explained that Ireland's 12.5 percent corporate tax rate is linked to the creation of genuine economic activity and employment in Ireland. "If there is a need, for example, to locate activity where intellectual property is held, one view is that may result in an on-shoring of intellectual property," he said. He added that many multinational groups with Irish operations currently hold intellectual property in their Irish operating company.

Because the OECD's work on BEPS is ongoing and in a constant state of development, McQueston is seeing clients take the approach of carrying on without currently changing their tax planning in light of the BEPS project itself. While they are keeping a close eye on BEPS developments, they probably won't review their tax strategies and structures until the OECD introduces concrete proposals or until relevant countries introduce unilateral changes to their domestic law, he said.

Possible benefits for multinationals as a result of the BEPS project include getting clarity on international tax planning in relation to particular types of cross-border international tax arrangements.

"It may be easier for multinationals to defend against criticism," he said. "If, after the BEPS project, changes are introduced and they are simply using structures that have been approved, it makes it more difficult for media or politicians to create a justifiable case against multinationals."