TED: Blow Tax Risks, Blow

Guard against tax risks in the BEPS era

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Annual global revenue losses from base erosion and profit shifting (BEPS) were estimated by the Organisation for Economic Co-operation and Development (OECD) to reach a staggering US$240 billion. To address this, the OECD put together a 15-point BEPS Action Plan and the final reports were last released in October 2015.

As governments around the world deliberate on the specific actions to be taken in response to the BEPS recommendations by the OECD, an unprecedented level of uncertainty and tax risks looms over global businesses.

Against this backdrop, Accredited Tax Advisor (Income Tax) Mak Oi Leng, Asia Pacific Global Compliance Management Services Regional Leader and Head of Tax Risk & Disputes Management, KPMG in Singapore, alerted participants to the challenges ahead and shared useful tips for managing tax risks in the BEPS era at a recent *Tax Excellence Decoded* session organised by the Singapore Institute of Accredited Tax Professionals (SIATP).

Key Implications and Risks

Essentially, the OECD's BEPS Action Plan seeks to tackle issues relating to BEPS by recommending enhancement of coherence of cross-border tax rules, tightening of substance requirements and improvement in transparency. In view thereof, companies should review their tax strategies based on these three core principles of coherence, substance and transparency.

Coherence

The OECD recognises that the international tax system contains considerable gaps in its current state and as a result, businesses could exploit such gaps for undue tax advantages. Various recommendations aimed at closing these gaps were proposed.

In its efforts to tackle hybrid mismatch arrangements and eliminate double-dip structures, the OECD advocates the introduction of domestic hybrid mismatch rules to neutralise the effects of adopting such arrangements.

Using a classic example to illustrate this, a hybrid mismatch arrangement may comprise two related parties taking advantage of a hybrid instrument (which qualifies as debt in the source country but as equity in the resident country) to claim tax deduction on the interest expenses incurred in the source country and at the same time, enjoy tax exemption on the dividend income received in the resident country.

A domestic hybrid mismatch rule may be introduced by the resident country to deny the tax exemption on the dividend income if the corresponding amount qualifies for tax deduction as interest expense in the source country. The "double-dipping" effects arising from the arrangement would hence be neutralised. Accordingly, organisations with existing intragroup arrangements which involve hybrid mismatches should monitor legislative developments in the relevant tax jurisdictions to assess and manage potential tax impacts as they arise.

Another area of focus is the effective implementation of controlled foreign corporation (CFC) rules, which are primarily designed to limit artificial deferral of tax by using offshore entities. While Singapore does not currently have CFC rules, groups with international presence should continue to monitor the introduction of, or changes to, CFC rules in the jurisdictions they operate in and be prepared to revise their group structures where necessary in order to mitigate any adverse tax implications.

To address the issue of usage of debts to obtain "excessive" interest deductions, the OECD has suggested the use of a fixed ratio rule (FRR) to limit the net interest deduction within a range of 10% to 30% of earnings before interest, taxes, depreciation and amortisation (EBITDA). As an alternative, the OECD suggests the use of a group ratio rule (GRR) which is based on the group's worldwide ratio. With these in mind, companies with intergroup financing arrangements should assess the impact from the application of FRR or GRR.

SUBSTANCE

The push to tighten substance requirements mainly stems from the desire to align taxing rights with the relevant value-adding activities. The OECD has thus proposed major changes to the Transfer Pricing (TP) Guidelines. Mere legal ownership of the intellectual property (IP) does not in itself provide a right to all (or even any) of the returns from exploitation. In other words, value-creation activities must be aligned with the allocation of profits. This gives rise to the need to review existing IP structures and make appropriate revisions where necessary in response to specific rules to be introduced.

To counter treaty shopping, a minimum standard consisting of a principle purpose test and/or a limitation on benefits rule has been proposed. With the inclusion of a minimum standard, companies should be prepared to face increased scrutiny from tax authorities when applying for treaty benefits.

Companies should also note the OECD's recommendation to lower permanent establishment (PE) threshold and widen the dependent agent definition. Continual reviews and revisions of transaction arrangements should be carried out in order to manage the risks and uncertainties for the businesses.

In addition, the anti-fragmentation rule would apply where complementary functions that are part of a cohesive business operation are carried out by the same or a closely-related enterprise. Companies should thus review and be ready to provide justification to tax authorities, when asked, of the commercial rationale for structuring their own and related entity's activities in relation to the business operation as a whole.

It is imperative that companies keep themselves updated on the developments in this regard, and review existing structures to manage consequences of new PE rules and application.

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TRANSPARENCY

The OECD seeks to improve transparency by pushing for significant additional disclosures by taxpayers and automatic exchange of information among tax authorities. One of the key initiatives of the BEPS Action Plan is the introduction of the new Chapter V of the OECD TP Guidelines. This covers the preparation of Master and Local Files, and Country-by-Country (CbC) reporting which requires companies with annual consolidated revenue of over €750 million to file an annual report on a specified set of business information for each tax jurisdiction in which they do business. The BEPS Action Plan also advocates adoption of mandatory disclosure rules, which include disclosure targeting features of aggressive transactions, specific domestic risk areas, and cross-border BEPS outcomes of concern.

To meet the disclosure requirements, companies should strategise and adopt targeted implementation to balance the collection of relevant information with the reduction of unnecessary disclosures. It is important for subsidiaries to coordinate reporting efforts and details with the holding company.

Holding companies, which have overall control and visibility of the business organisations, play a crucial role in ensuring consistent disclosure of information in the master file, the local files and the CbC report.

Digital Economy

The OECD has recognised the phenomenal growth of the digital economy in the past decade and the need for tax rules to catch up with the digital economy. However, the BEPS Action Plan does not propose any specific digital tax or PE rule for e-commerce, but advocates the shift to collection of indirect tax. The OECD also proposes to address tax challenges arising from the digital economy jointly with the other BEPS action items.

The OECD e-commerce recommendations will translate into greater compliance burden and higher business costs on vendors in the global digital economy. Continual monitoring of country developments and review of supply chain structures are key for e-commerce businesses. As countries are expected to implement their own set of rules to address the digital economy, companies will need to keep up with the various changes in the different countries and react appropriately when the time comes. One thing for sure is that companies will face a greater compliance burden as each country seeks to address their tax concerns in a slightly different way.

Due to the wide and deep impact on businesses consequent to the introduction of the OECD's BEPS Action Plan, it is important to have C-suite's attention and buy-in to implement an appropriate tax strategy to avoid any undesired or unforeseen tax consequences in this BEPS era. Early awareness and buy-in from senior management are essential to provide the mandate for executives to act appropriately. This includes the mapping and evaluation of tax risks consequential to BEPS developments, as well as the formulation of action plans to assess, manage and make relevant changes. Given the rapidly changing regulatory and business environment coupled with stakeholders' expectation for tax/finance functions to do more with less to bring more value to the businesses, organisations should also focus on how to leverage on technology to better manage compliance challenges and tax risks.

Tax risks and uncertainties are the new normal in this BEPS era. There are two ways to deal with it – either hide under a rock or embrace the changes by actively managing them. The choice is obvious.

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