Global ITS Update

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Dear ITS Network colleagues. The following are just my thoughts as I read the CAP.

We will appoint discussion champions for several of the Action subjects. Hybrids, Debt, CFC, Harmful Regimes are the most likely.

General Comments

1. In one sense the CAP is a little underwhelming, doing little more than restating BEPS concerns and showing that an aggressive timetable is required for anything to happen at all. However it will provide additional support for Revenue Authorities to be more aggressive, for political pressure on local law makers to accelerate domestic law change and for potential EU Directive change, particularly relating to Hybrid outcomes. It also emphasises that the substance of arrangements is a necessary element of all tax planning.

2. The CAP calls for member states to effectively apply globally the domestic tax concept of matching deductible payments with taxable receipts in commerce. This is a bold call that faces enormous challenges as countries use fiscal policy to encourage economic growth, often in competition with other countries.

3. It is a truism that "substance matters". CAP considers it relevant for PE status (for the most part), support for allocation of value to IP and its ongoing exploitation, Treaty residence status, beneficial ownership analysis and GAAR provisions. The CAP continues to emphasise that regulators and if necessary the treaty negotiators should be encouraged to focus on substance wherever possible.

4. At the risk of oversimplification, the CAP displays a determination to protect the current principles of TP in the OECD model and seeks to find largely tactical rather than strategic approaches to protect that position. Hence CAP remains committed to Residence over Source, rejects the formulaic approach and encourages clarification, rather than wholesale amendment to the concept of Permanent Establishment. Several of the TP Actions have been in the pipeline for some time. The specific reference to Commissionaire structures may be concerning to some companies.

5. The call to greater transparency in Action 11 and the call for more widespread reporting of Aggressive Positions in Action 12 are expected to bring greater awareness of how companies arrange their international affairs. This is a major change in policy which, if adopted widely by countries, may well change behaviours in the short term much more quickly than any formal change to domestic laws or tax treaties.

Non TP Comments

6. **Action 1** The digital economy issue clearly has proven a greater challenge to define and even greater challenge to develop solutions. There is a real risk members will act unilaterally if there is any slippage on this. The desired outcomes of this action by Sept 14 are set very low.

7. **Action 2** The non taxation of income arising from transactions for which another party has claimed a deduction or deductions allowed in more than one country for the same expense is the target of Action 2. This has an aggressive deadline of Sept 14, but is stated to require coordination with other Actions with a deadline of a year later, which may create an additional challenge.

8. There are five different or combined responses at the treaty or domestic law level. All of these responses have been adopted by some member states with some resulting abatement of hybrid outcome or double non taxation. Most of such changes (anti-dual resident, dual consolidated loss limits, dividend exemption limitations, subject to tax limits on deductions etc) have been domestic law changes. However each country tends to chose tax laws that balance taxation revenues with the desire to encourage economic growth.

9. Suggestions to amend treaty terms to attack hybrid outcomes seem less effective. Treaties largely only limit the rate of withholding tax at source on deductible payments such as interest and royalties. The treaty generally does not determine the deductibility in the payer country (except for TP) or the taxation in the recipient under local law. An obvious exception will be if the EU seeks to issue a directive that limits exemption for dividends for which a deduction has been claimed, as is the case already in the UK and Germany.

10. **Action 3** The OECD acknowledges it has never needed to examine the role of CFC provisions before. Action 3 will be one of the most challenging. The outcome set for delivery by Sept 15 is simply to develop recommendations regarding design of CFC rules. Many countries have CFC rules developed with deliberate policy objectives in mind which are unlikely to be merely rejected in favour of a generic approach from the OECD. The US and UK both adopt a benign approach to their application, so it seems the progress of this Action 3 will be very slow with limited chance of consensus. In an EU context, it also remains to be seen whether such initiatives are in line with the fundamental freedoms.

11. **Action 4** There are very few members of the G20 that do not have a limitation of deductions for interest by reference to general transfer pricing concepts or a more formulaic approach that may limit compliance costs of annual testing. Action 4 sets a target of Sept 2015 for design of domestic rules which reflect best practice. Many countries already have chosen rules that limit excessive levels of debt being misallocated to their country's tax system; hence it is unlikely there will be a material impact of this Action. The proposed additional guidance on allocation of costs in the financial services industry is welcome. The timing of Dec 2015 seems unfortunate given the ongoing discussion of this matter within the OECD for some time.

12. **Action 5** There is a major concern, ever since the 1998 OECD report, regarding the practice of preferential tax regimes that are not apparent from the tax regime itself, but rather the manner in which it is applied through concessional rulings. That concern has now broadened to apply to specific domestic laws granting favourable tax treatment of financing and IP income. Thus it has been given a high priority of Sept 2014 and the Forum of Harmful Tax Policies "will be refocused". Action 5 has potential of widespread impact if countries adopting such practices are willing to

respond. In the short term such countries may impose additional substance requirements to justify allocation of profit or deemed to a foreign branch. It is unclear what sanctions are proposed to be imposed on such countries if they maintain present practices. There was recent press regarding objections raised by Germany against the UK Patent Box concessions. It is unclear how such provisions will be discussed with any consensus.

13. **Action 6** Treaty abuse clauses are included in most treaties or under domestic law. However CAP Action 6 goes further by recommending that a general principle be adopted between treaty partners that the treaty should not be used to generate double non taxation. While this is seen as an urgent matter due to be delivered in Sept 2014, the terms used are extremely general and may be of limited impact in the short term. However such level of uncertainty for business is a real concern in deciding whether they are entitled to rely upon a treaty.

14. **Action 7** The premise of the OECD is that tax presence may be avoided because of overly narrow concepts of PE in the present business environment particularly as they may relate to the concept of agency PE and concepts of preparatory and ancillary activities normally excluded from being a PE. The challenges of being overly prescriptive were evident at discussions between business and the OECD on this matter. The deadline of Sept 2015 seems a long way off for such an ever present issue for companies.

15. **Action 11** due by 2015, relates to disclosures of taxation attributable to business activity. The most important issue for business is that a common approach is required. This will facilitate ease of compliance for business and the provision of the most informative data for regulators and the public, if such data is disclosed.

16. **Action 12** due by Sept 2015, is the design of a modular approach to disclosure of tax outcomes seen as abusive or aggressive. This is an attempt to create a common general approach from which countries may then chose to depart. Thus where an hybrid outcome or a double deduction is available under the respective laws it is likely new disclosure rules will result in the relevant countries being made aware of such outcomes on a more timely basis and may react to amend law if thought appropriate .

17. **Action 14** is due by Sept 2015 and represents a somewhat wishful approach given the experience of our firm and clients regarding the resolution of Mutual Agreement Processes. The concept of arbitration would be particularly interesting given the reluctance of any nation to succumb to the jurisdiction of another on Taxation matters, as seen in the EU.

18. **Action 15** relates to the concept of effecting treaty changes on an accelerated basis by adopting concepts with a degree of legal novelty. This is thought necessary to ensure the legislative impact of CAP is seen more quickly.

CAPS Early comments by Tony Clemens for immediate distribution to the ITSN after issue of CAP. It does not comment on TP issues.

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