BBD ENTERPRISES

BEPS as an Opportunity

November 2014 Issue

Not everybody is a musician who walks with a violin. Imagine you go on stage with a shiny Stradivarius and cannot even correctly hold it in your hands. Surely not the best moment of your life. Many can find themselves in a similarly unpleasant situation when their respective tax authorities start asking questions about the complex corporate structures or offshore vehicles they hold, which look good on paper but hardly accomplish what they are supposed to. As advocated by the associates of BBD for many years already, these instruments prove to be useless unless operated according to the latest standards. Recent developments of the BEPS project give some hints as to how.

Background – The BEPS Project

Since the crises put more pressure on governments to raise tax revenues, addressing base erosion and profit shifting ('BEPS') is a key priority of governments around the globe. In 2013, OECD and the G20, the club of 20 major economies, adopted a 15-point Action Plan to address BEPS. The initiative got further momentum by the public perception of an outcry against multinationals making use of complicated tax planning techniques to lower their tax bills. The Action Plan, possibly the biggest ever global tax initiative, aims to ensure that profits are taxed where economic activities generating the profits are performed and where value is created.[1] As an interim result, the first set of seven deliverables of the Action Plan has recently been published.

Many fear the scene will never be the same in the post-BEPS world, even though the BEPS Action Plan is not expected to turn upside down the prevailing consensus-based principles of international taxation, just modernize them. They are correct. However, besides apparent threats the BEPS project may convey for abusive and non-compliant corporate structures, certain tax practices, tax regimes and jurisdictions, it may on the other hand bring significant benefits for those ready to run, attract or facilitate businesses that comply with new rules and new interpretations of old rules under the Action Plan.

In our newsletter we do not intend to provide a technical analysis of the merits of the first seven deliverables, instead aim to draw the main conclusions one may have, foreseeable trends and the opportunities the BEPS project can provide to some.

1 As stated in the foreword of the Action Plan point deliverables published.

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What to expect?

Realigning the location of profits with the location of value creation and economic substance is the ethos of the BEPS project. Below we picked a non-exhaustive selection of key points of the Action Plan points released, all of which to be read and understood in the context of the main objective of the BEPS project.

Action Plan item 6 focuses on preventing tax treaty abuse, endorsing both the so-called limitation of benefits clause ('LOB') approach applied in US tax treaties and the application of general anti-abuse rules, including the main purpose test. While the first applies a set of tests to qualify for tax treaty benefits, most notably the active trade or business test, the second is of a more general nature aimed at preventing the (mis-)use of double tax treaties **where one of the main drivers of a corporate structure or transaction is achieving tax benefits through tax treaty protection**. Even though it is unclear if and to what extent will the OECD rely on the US interpretation of what constitutes an active trade or business, and even if the main purpose test inevitably leaves some sort of uncertainty when weighing tax benefits against other commercial reasons, one may conclude that more **business substance** will in the future be required in corporate structures to qualify for tax treaty benefits under either approach above. Especially for passive investments, holding, financing and licensing companies. Creation of more solid economic substance in international corporate structures will become of utmost importance in the future. **Single function entities with limited resources and activities are ever more likely to fail the tests and hence being denied treaty protection**. There is no guidance available at the moment as to how much substance is required and sufficient; hence, this must be reviewed on a case-by-case basis.

Action Plan item 5 deals with harmful tax practices and revamps the 1998 OECD report on harmful tax competition. When judging whether preferential tax regimes, such as **R&D tax incentives or so-called patent or finance box regimes** are harmful, priority will be given to two aspects of the regime under review. One of them is that **preferential tax regimes shall require substantial business activities in order to avoid being labeled harmful**.

Action Plan item 13 covers the proposed transfer pricing documentation and Country-by-Country-Reporting ('CbCR') requirements for multinational enterprises. CbCR will, inter alia, require disclosing certain indicators of economic activity in each location, such as revenues, tangible assets, number of employees, pre-tax profits and taxes in a pre-set format. **CbCR will enable tax authorities understand what kind of economic activities take place in locations where profits are crystallized**, and therefore will be in a better position to assess whether profits and economic activities are aligned within a group of companies.

The points above well illustrate and support the main message of the BEPS project: shifting away profits from jurisdictions where the activities creating those profits take place to no or low tax jurisdictions, where no substantial economic activities take place, will soon become the practice of the past.

The main means to achieve that is introducing / enhancing substance requirements in various areas of international taxation, such as transfer pricing and tax treaties.

We would like to emphasize that **no or low taxation is not per se a cause of concern**, only when it is associated with practices that artificially segregate taxable profits from the activities that generate them.[2]

Even though more stringent rules will soon apply to shifting solely profits, operating in and hence enjoying the tax benefits of low or no tax jurisdictions will still be an option in the future, actually the only option to lower those tax bills. **Instead of shifting profits the way forward is shifting businesses to low or no tax jurisdictions**. This does of course have its limits.

Winners and losers

Shell companies and sparsely staffed affiliates in exotic tax havens will not do the job. The proverbial 'one man and a dog on a sandy beach'[3] implies it is unlikely that real value is created in these locations, and it is likely not feasible establishing real operations there that could create value and hence attract profits.

There are, however, no or low tax jurisdictions that can indeed facilitate setting up various kinds of value creating business operations as they offer a good mix along the factors investors take into account when setting up overseas businesses, like educated and skilled workforce, good infrastructure, stable legal system and the rule of law, investor friendly business environment and a good double tax treaty network. These locations are often referred to as 'mid-shore centers'.

The UAE and Bahrain are good examples in the GCC region. Even though very tax friendly environments; they are not considered traditional offshore jurisdictions as the tax benefits they offer to foreign investors are not ring-fenced from their domestic economies. These locations can indeed facilitate operations currently run in high tax jurisdictions, which would then generate profits in a no tax environment – without the risk of being caught by BEPS Action Plan measures.

Evidently, the more mobile a service line or department of a group of companies is the easier to relocate it, and any change in operations shall fit into the overall business strategy of an enterprise. Flattening corporate structures and combining passive and active businesses is also expected as a result of the BEPS project, which will also help overcome the seemingly contradictory requirement of more active management of passive investments, such as holdings, intellectual property holding or finance companies. Multifunction entities will be more often heard of.

2 As stated by Ajay Gupta in a presentation at the International Bar Association ('IBA') annual conference in Tokyo on 20 October 2014, cited by Tax Analysts.

3 Cited from the same IBA presentation as above.

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After all, double tax treaties and the principles of international taxation reflected therein are supposed to foster international trade and cross-border investment, and we have good reasons to believe that this will not change even in the post-BEPS world. The BEPS project will show its teeth when profits are artificially segregated from value creating economic activities. Those running real businesses shouldn't be afraid.

We update our clients and business partners on a regular basis about tax, legal, regulatory and other developments in the Middle East and Asia.

We are an independent advisory firm with the focus on helping clients to "de-offshorize" their international structures and to implement substance in various jurisdictions around the globe where we provide significant know-how when it comes to the implementation of onshore solutions.

We are proud to say that the background of our associates is very diverse, ranging from legal, tax, banking, economists and to even medical which allows us to cover various industries. Hence, we are comfortable to say that we can work with our clients in a number of different industries, ensuring that not only the tax and legal structure is put in place in compliance with the rapidly changing regulatory environment but also the various industry specific functions are carried out appropriately.

Furthermore, through our presence in the Middle East (Bahrain) and Asia (Hong Kong) we gained significant insight in the current developments in these striving markets. We also serve as an intermediary for investors from both parts of the world to establish them and also identify investment opportunities.

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