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COMPLYING WITH BEPS LAWS

AUROBINDO PONNIAH, EXECUTIVE DIRECTOR, TAX – TICE ENERGY, PwC TAXATION SERVICES SDN BHD SPOKE ON COMPLYING WITH BEPS LAWS AT MIA'S BASE EROSION AND PROFIT SHIFTING (BEPS) SYMPOSIUM 2017. BELOW ARE SOME HIGHLIGHTS OF HIS PRESENTATION.

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THE final report on BEPS issued by the Organisation for Economic Co-operation and Development (OECD) in October 2015 indicate that the impact of BEPS on developing countries, as a percentage of tax revenues, is higher than BEPS' impacts on developed countries, given developing countries' greater reliance on corporate income tax.

In a globalised economy, governments need to cooperate and refrain from harmful tax practices to address tax avoidance effectively and provide a more stable international environment to attract and sustain investment. Actions 2, 4, 6, 7 and 15 look at the subject matter of complying with BEPS Law.

ACTION 2 – NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

Action 2 refers to arrangements arising from the different tax treatments of an instrument or entity. A hybrid instrument is an instrument that assumes the characteristics of both debt and equity. In a case of a hybrid financial instrument, one party may record the instrument as debt, giving rise to interest whereas the other party treats it as equity which results in dividend. Since the tax treatments for interest and dividend are different in most tax jurisdictions, a hybrid instrument allows an entity to design tax structures that benefits from the different tax jurisdictions.

A simple example of a hybrid entity is a partnership, whereby in some countries the entity or the partnership is taxed, whereas in some other jurisdictions the partners are taxed individually instead. These mismatches in the global tax systems allow taxpayers to reduce their tax liabilities; hence the need for the OECD to address the issues arising from hybrid instruments and entities. These mismatches usually result in double non-taxation, long-term deferrals, multiple deductions for a single expense, deduction without a corresponding taxation and multiple

foreign tax credits.

For hybrid instruments and entities, the OECD proposes the use of linking rules to align the tax treatment in both the party and the counterparty's jurisdictions. For example, a tax deduction is not allowed if it is not included in the counterparty's taxable income or it is also deductible for the counterparty. Alternatively, the counterparty's jurisdiction can require inclusion of the deductible payment as income or deny a duplicate deduction.

Hybrid entities also affect tax treaties. For dual resident entities, the OECD proposes to not change the treaty rules but to review the situation on a case-by-case basis, and there should be changes to the domestic provisions to counter any tax avoidance. The OECD is also proposing new provision or commentary to ensure that benefits from treaties are granted only in appropriate cases as well as addressing issues on the elimination of double taxation.

ACTION 4: LIMITING BASE EROSION INVOLVING INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

In most jurisdictions, interest is tax deductible and the deduction accorded to the interest gives rise to certain risks. In order to reduce the tax payable, MNC groups often load high levels of 3rd party debt in a jurisdiction that has high tax rates. Similarly, intragroup loans are sometimes structured so that the resultant interest payments are higher than the actual 3rd party interest payments. Another common approach is the use of intragroup and 3rd party financing to generate tax-exempt income.

In order to counter these practices, the OECD has come up with some recommendations. The first is a fixed ratio rule to limit an entity's deductions for interest and similar payments to a percentage of EBITDA. However, the OECD also recognises that in some jurisdictions the interest rates are higher. It therefore proposes the use of a supplemental worldwide group ratio which allows an entity to exceed the fixed ratio limit in certain circumstances. Ideally, the fixed ratio and group ratio should work together as there could be non-tax reasons for high 3rd party debts in some instances.

ACTION 6: PREVENTING THE GRANTING OF TREATY BENEFITS IN APPROPRIATE CIRCUMSTANCES

Action 6 primarily focuses on preventing treaty abuse and treaty shopping, and the use of intermediary jurisdiction where treaty benefits are claimed when such benefits were not intended to be granted. A good example is an investment in India through a Singapore or a Mauritius tax resident company. Under the tax treaties between India and these two countries, capital gains arising in India, if not related to properties or land, would only be taxable in the country of residence of the taxpayer. Therefore any capital gains from the disposal of the investment would not be subject to any tax in India but instead in Singapore or Mauritius. Since the capital gains are tax exempt under the latter's respective domestic provisions, effectively the income can be brought out of India tax-free.

Therefore any capital gains from the disposal of the investment would not be subject to any tax in India but instead in Singapore or Mauritius where capital gains are tax-exempt under their respective domestic provisions.

Under most tax treaties, profits of foreign enterprises are only taxable in the country of business if there is a PE and therefore it is possible to avoid paying tax on business profits if creation of PE can be avoided.

The OECD recognises that these tax treaties were signed a long time ago. Since business has evolved over the years, there is a need to amend the treaties. The OECD is recommending that treaties should have a clear statement that there is no intention to create opportunities for non-taxation or reduced taxation. In addition, the OECD is recommending the inclusion of a Limitation of Benefits provision which effectively puts in place conditions that must be met by the taxpayer in order to use the tax treaty. The OECD is also proposing a general anti-abuse clause based on the principal purpose of the transaction or arrangements i.e. Principal Purpose Test; if one of the principal purposes or the transaction arrangement is to obtain treaty benefits, then it should be denied.

ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS

Action 7 addresses businesses' Permanent Establishment (PE) status. As a general tax rule, a PE has to exist in order for business profits to be taxed. Under most tax treaties, profits of foreign enterprises are only taxable in the country of business if there is a PE and therefore it is possible to avoid paying tax on business profits if creation of PE can be avoided.

Common strategies adopted by MNC groups in order to avoid the creation of PE include an arrangement to convert a subsidiary into a commissionaire, the use of independent agents which do not solely rely on that source of income, leveraging on the exceptions given such as setting up a representative office for preparatory and auxiliary services activities, as well as fragmentation of activities and splitting up of contracts.

The definition of PE included in the tax treaties is therefore crucial in determining whether a non-resident entity is liable to income tax in the country of business. The OECD proposes that the rules on PE be tightened up and similarly, the rules on independent agents and fragmentation of activities be narrowed down. Moving forward, we can expect the Malaysian Inland Revenue Board (IRBM) to amend the definition of PE on the tax treaties in line with the recommendation by the OECD.

ACTION 15: DEVELOPING A MULTILATERAL INSTRUMENT TO MODIFY BILATERAL TAX TREATIES

Current tax treaties are meant to eliminate double taxation but due to globalisation, some features of the treaties facilitate BEPS. In order to arrest these BEPS issues, the tax treaties need to be modified but the process can be time consuming. As a way forward, instead of renegotiating thousands of bilateral tax treaties, the OECD is recommending that countries sign up to a multilateral treaty which will amend bilateral treaties when required. Common items such as the amendments to the definition of a PE or the Limitation of Benefits provision can be included in the multilateral instrument, so that the countries that sign up for this multilateral instrument will automatically have their bilateral treaties amended. ■