Base Erosion Profit Shifting (BEPS)

BNY MELLON

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The world continues to evolve and nations are becoming increasingly connected. Domestic tax laws have not kept pace with the evolution of global business and, as a result, tax represents a significant business issue impacting an organisation's competitiveness and brand.

The Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) project aims to harmonise domestic tax laws and foster greater integrity to the application of tax globally. BEPS represents the first substantial overhaul of the international tax rules in almost a century.

Upon the implementation of BEPS, Multinational Enterprises (MNEs) and Financial Institutions such as asset managers, pension funds, Collective Investment Vehicles (CIVs), and sovereign wealth funds will need to identify how the proposed requirements under BEPS may impact their organisations.

Endorsed by the G20 leaders, the OECD embarked on a multi-year project aimed at preventing MNEs from reducing their tax burden by exploiting gaps and mismatches in the application of domestic tax laws and double tax treaties.

The intention of the BEPS measures is to realign taxation with economic substance and value creation, while preventing double taxation. To address these intentions, the OECD considered the current tax landscape and identified 15 areas of focus, the 'BEPS Actions'.

The recommendations arising from the BEPS Actions will fundamentally change the current tax landscape. In response to these actions we expect jurisdictions to modify tax treaties and update domestic tax laws. Such changes may result in wide-ranging implications for MNEs.

All MNEs will need to consider the impact of BEPS on their group holding structures, cross-border financing arrangements, transfer pricing arrangements, and permanent establishment status.

Institutional investors, in particular, should consider BEPS-related impacts on their performance. The range of potential impacts on asset managers is extensive from both a strategic and operational perspective. Asset managers may need to contemplate possible changes to investment strategy or potentially shifting the location of core operations.

Firms should consider the potential downsides of non-compliance, which could result in penalties and fines, criminal liability, and reputational issues.

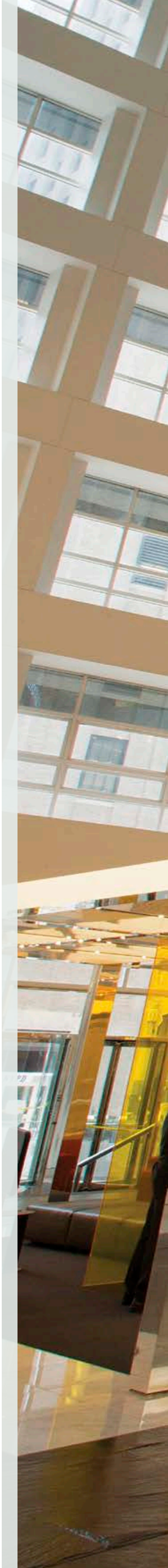
BEPS-related changes could result in increased administrative and compliance requirements, necessitating identification of additional resources, which will require greater oversight.

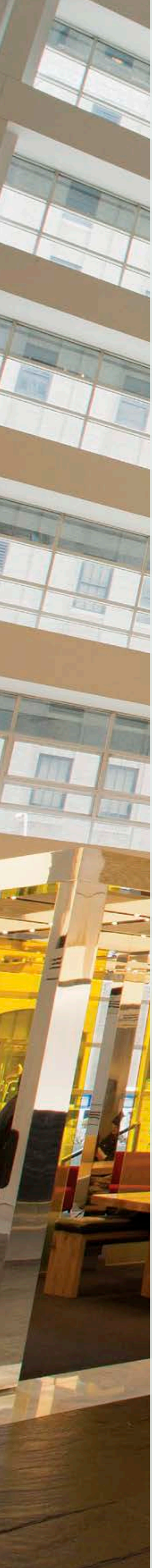
Due to breadth and scope of the BEPS project, firms may find it necessary to undertake a reassessment of the interplay between tax treaties, domestic tax law and local regulatory requirements.

BEPS ACTION PLAN

To implement the BEPS project, with its objective of greater tax integrity, the OECD identified 15 Actions. Action 1 addresses the tax challenges of an increasingly digital economy where products and services can be provided through the internet and Action 15 recommends the development of a multilateral instrument, a model treaty document, reflecting the application of the BEPS recommendations. These two actions provide the overarching framework for the BEPS program which focuses on three fundamental principles:

1. Coherence – Actions 2-5 tackle situations where a country may currently have domestic tax rules that eliminate taxation on an MNE in its home country on any overseas profit or income it may derive. As a result, the MNE may significantly reduce or eliminate its tax liability.





The aim is for countries to come together and agree single standards of domestic law implementation to avoid double non-taxation.

2. Substance – Actions 6-10 intend to align taxation to economic substance and value creation by addressing situations where organisations attempt to obtain the most favourable treaty benefits, by putting in place stronger measures to evaluate where economic substance and value creation occurs. The new provisions will implement rules that require confirmation that a company is real and tax resident in the claimed jurisdiction and the profit generating activity is located in the claimed jurisdiction.

3. Transparency – Actions 11-14 focus on the gathering, sharing, and analysis of information designed to help governments and their tax authorities have greater visibility over their systems and taxpayers. The Actions also intend to make dispute resolution more effective.

BEPS AND THE INCLUSIVE FRAMEWORK

Over 100 countries and jurisdictions are collaborating on the implementation of the BEPS project, extending beyond OECD member countries, of which currently there are 35. The inclusive framework brings in a number of non-OECD countries, many of which do not currently follow the OECD model standard for double taxation agreements and some countries may not currently have a tax system, or such tax system may not be well developed. It is expected that BEPS will be a truly global initiative.

The BEPS Actions aim to provide governments with tools to address the objectives of BEPS, however, the BEPS Actions are not legal instruments and for BEPS to succeed, countries must implement legislation. Given the goals of BEPS and political momentum supporting reforming the international tax system, we can expect to see countries implementing at least some of the BEPS Actions into domestic legislation.

TIMELINE

All OECD members and G20 countries want these actions to be implemented quickly; the aim is for the Actions outlined in the plan to be delivered within the next 18 to 24 months culminating in the development of a multilateral instrument to provide countries with a standard model treaty that would replace or amend existing bilateral tax treaties. It will then be incumbent on participating countries to sign new treaty agreements and or amend their existing tax laws.

THE EUROPEAN UNION AND THE BEPS PROJECT

Similar to the OECD, the European Union (EU) has actively been developing its own action plan to tackle aggressive tax planning. The work of the European Commission is reflected in its Anti-Tax Avoidance Directive (ATAD) which reached political agreement on June 21, 2016 and was formally adopted on July 12, 2016.

Many of the proposals outlined in the ATAD reflect the recommendations arising from the OECD's 15 Actions. However, there are some areas where the rules in the ATAD differ from the corresponding BEPS recommendation.

For example the ATAD includes an exit tax on the unrealised surplus value of assets transferred within an MNE group out of the taxing jurisdiction of a state. This tax is not reflected in the BEPS proposals. Further, the ATAD implies a need for a higher standard of governance around tax matters that is not reflected in the BEPS recommendations.

While the EU's ATAD and the OECD's BEPS proposals largely align, the EU Commission will be required to consider BEPS from an EU single market perspective and must ensure that the BEPS recommendations do not otherwise infringe on existing EU Directives and tax frameworks.

EU Member States must adopt the ATAD into their national legislation by December 31, 2018 for a January 1, 2019 implementation date. However, the proposed implementation date for the exit tax provisions is one year later (January 1, 2020).

BEPS ACTION 6 IMPLICATIONS

As mentioned above, the BEPS Action Plan's primary objective of greater tax integrity targeted MNEs using holding structures and cross-border financial arrangements to exploit gaps and reduce their tax burden. It was, in principle, not designed to restrict tax treaty relief on cross-border portfolio investments by CIVs, non-CIVs, pension funds and potentially sovereign wealth funds, however the current recommendations on preventing tax treaty abuse* may in certain cases restrict such relief.

*Organisation for Economic Co-operation and Development, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 (2015 Final Report) (5 October 2015).

What is Treaty Abuse?

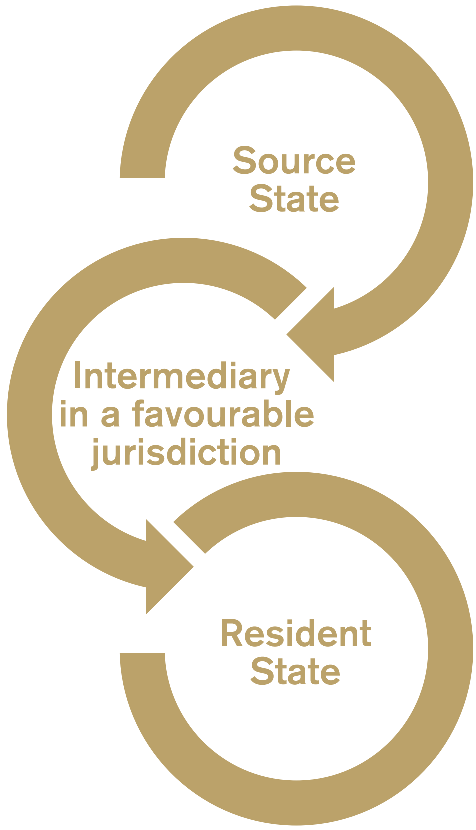
Tax Treaties are typically entered into between two countries to prevent double taxation. Treaty abuse occurs when MNEs exploit the disparities in domestic and international tax rules. 'Treaty shopping' is one of the principal methods MNEs employ to reduce or avoid taxation.

Treaty shopping refers to arrangements where investors who are tax resident in Country A invest in Country B. Country A and Country B either do not have a tax treaty or the tax treaty between Country B and Country C is more favourable than the tax treaty between Countries A and B. The investors will set up a corporate vehicle in Country C to take advantage of the tax treaty between Countries B and C.

Generally, these corporate vehicles are referred to as 'letterboxes', 'shell companies' or 'conduits' because they exist on paper but have little or no economic substance.

Action 6 sets out three proposed methods for preventing treaty shopping. The first method is inclusion of a Limitation of Benefits (LOB) rule supplemented by a mechanism that addresses 'conduit arrangements'. The second method is the inclusion of Principal Purpose Test (PPT). The third method requires a combination of an LOB test and a PPT.

A Typical Example of Treaty Shopping

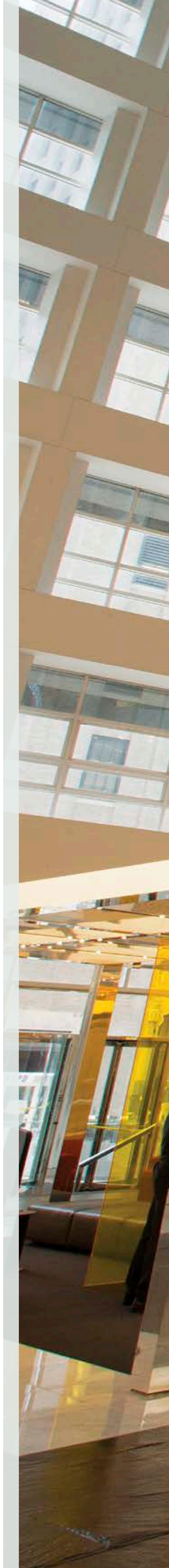


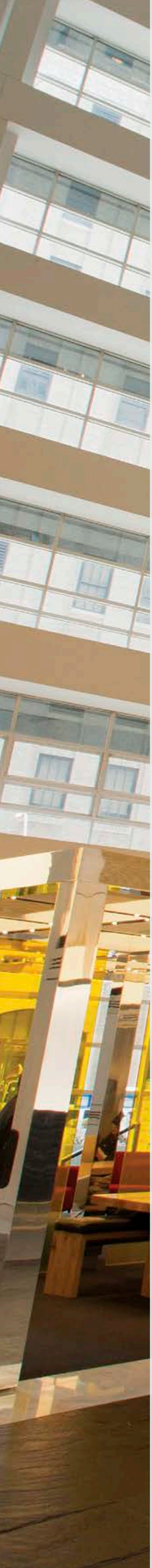
Limitation on Benefits Clauses and Funds

LOB clauses are specific anti-abuse rules that set out a number of prescriptive tests which must be satisfied in order for treaty benefits to apply. The tests include a publicly traded test, an ownership/ base erosion test, active business test, and derivative benefits test. If none of the tests can be satisfied, the treaty claimant can seek discretionary relief from the source country tax authority to apply the treaty.

Many of the current in-force double income tax treaties entered into by the United States contain detailed LOB provisions. The first LOB recommendation outlined in Action 6 is very similar to the US LOB provisions. In its recent Model Treaty, the USA reaffirmed its commitment to applying LOB provisions and most treaties entered into with the US will include an LOB clause.

Where funds invest in jurisdictions that implement an LOB clause, similar to the clauses currently found in many in-force US Treaties to obtain full





treaty benefits, the fund must satisfy one the provisions which it would generally do in the following ways:

- all of the fund's beneficial owners are themselves resident in the same jurisdiction as the fund;
- all of the fund's beneficial owners are themselves resident in jurisdictions which have a double tax treaty with the jurisdiction of the investment (the so-called 'equivalent beneficiaries' test); or
- a certain percentage of the fund's beneficial owners are resident in jurisdictions which have a double tax treaty with the jurisdiction of investment.

Alternatively, the treaty may provide for relief on a pro-rata basis, determined by the percentage of the fund's beneficial owners which are resident in the same jurisdiction as the fund or in any jurisdiction which has a double tax treaty with the jurisdiction of investment.

Principal Purpose Test and Funds

If the PPT is introduced in the double tax treaty concluded between the jurisdiction of the fund and jurisdiction of investment, treaty benefits would be denied where the income arises from transactions or arrangements where one of the principal purposes of the transaction is to obtain tax treaty benefits. The PPT is a subjective test, which looks to all the relevant facts and circumstances. Tax authorities may consider the following facts and circumstances: the purpose of the treaty, the domicile location of the fund, and the length of time the income item was held.

For example, the purchasing of shares on or around ex-date of the dividend payable on the underlying share purchase may be considered by tax authorities as being purchased with the primary objective of obtaining treaty relief and such treaty relief could potentially be denied.

BEPS and cross-border portfolio investors

The implementation of BEPS Action 6 brings unique challenges to pension funds, CIVs, non-CIVs and potentially sovereign wealth funds. The OECD has issued a number of discussion draft consultations on Action 6 as well as proposed changes to the OECD Model Tax Convention and Commentary. These include language that, if adopted, could, in some instances, prevent portfolio investors from accessing treaty relief. Several stakeholders provided responses to these consultations raising concerns about the uncertainty and the potential challenges BEPS Action 6 creates for cross-border portfolio investors.

For example, inconsistencies in establishing country of residence for pension funds could create potential issues in collecting due tax entitlements. The responses to the consultations requested a clear and consistent definition of pension funds, reflecting the diverse range of pension providers in the global market.

It is hoped that the OECD considers the concerns raised and suggestions made in response to these consultations when implementing the changes to the OECD Model Tax Convention and Commentary and in its work on the Multilateral Instrument, as these will have direct impact the ability of pension funds, CIVs, non-CIVs and sovereign wealth funds to access treaty benefits.

BNY MELLON'S SERVICE OFFERING TODAY

For clients subscribed to BNY Mellon's custody tax service, we will endeavor to collect the potential tax benefits stipulated in double income tax treaties or a source country's domestic tax laws as quickly as possible. We do this by following the procedural requirements set out by the source country of income's tax authorities.

Tax treaties set out the qualification criterion, generally found in Article 4 'definition of residence'. In order to claim treaty benefits the person making the claim (the beneficial owner) needs to prove that they are resident for tax purposes in their home country. Typically this is evidenced by provision of a signed and stamped reclaim form with the applicable certificate of tax residence and historically countries administering their tax treaties would honor refund claims on this basis.

Increasingly, however, countries no longer accept this evidence and consistent with the new measures recommended in BEPS Action 6 countries are requiring:

- non-standard ad-hoc documentation;
- provision of proof that income to which the tax claims refers has been paid directly to the beneficial owner for tax purposes;
- proof that no contractual arrangements are in place to pass on the dividend or interest income;
- proof that profit shifting has not occurred;
- proof of the principal purpose of the investment; and/or
- confirmation that an LOB clause is satisfied (if applicable).

BNY MELLON'S RESPONSE TO BEPS

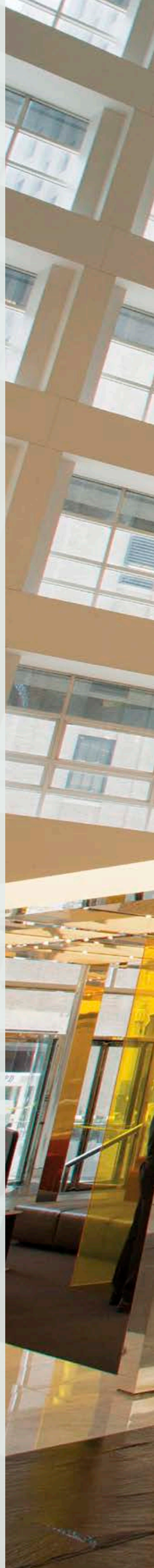
BNY Mellon has instituted a programme across its Investment Services business to ensure BEPS-related changes are incorporated into its products and service offerings. The programme currently anticipates delivery of the following enhancements:

- Capabilities to support Straight Through Processing (STP) of tax data between clients, transfer agents and fund accounting engines (if tax relief at source is to continue);
- Ability to calculate tax withholding, reclaims and income and tax payment amounts based on set of variables;
- Flexible tax table designs for impacted business functions (Fund Accounting and Asset Servicing); and
- Enhanced client and tax reporting.

Most of the enhancements that will be required will be delivered to clients through BNY Mellon's new digital ecosystem, NEXEN.

NEXEN, our secure cloud-based technology platform, provides scalability and agility to deliver BNY Mellon products via an intuitive and powerful platform, rather than the current wide array of systems, applications and electronic-based delivery systems. NEXEN leverages the latest in cutting-edge technologies, and provides our clients with a consistent user experience irrespective of product, region and device.

If you would like to receive more information about BEPS and its implications to BNY Mellon's tax services please contact your Relationship Manager or any member of the Global Tax Services team.



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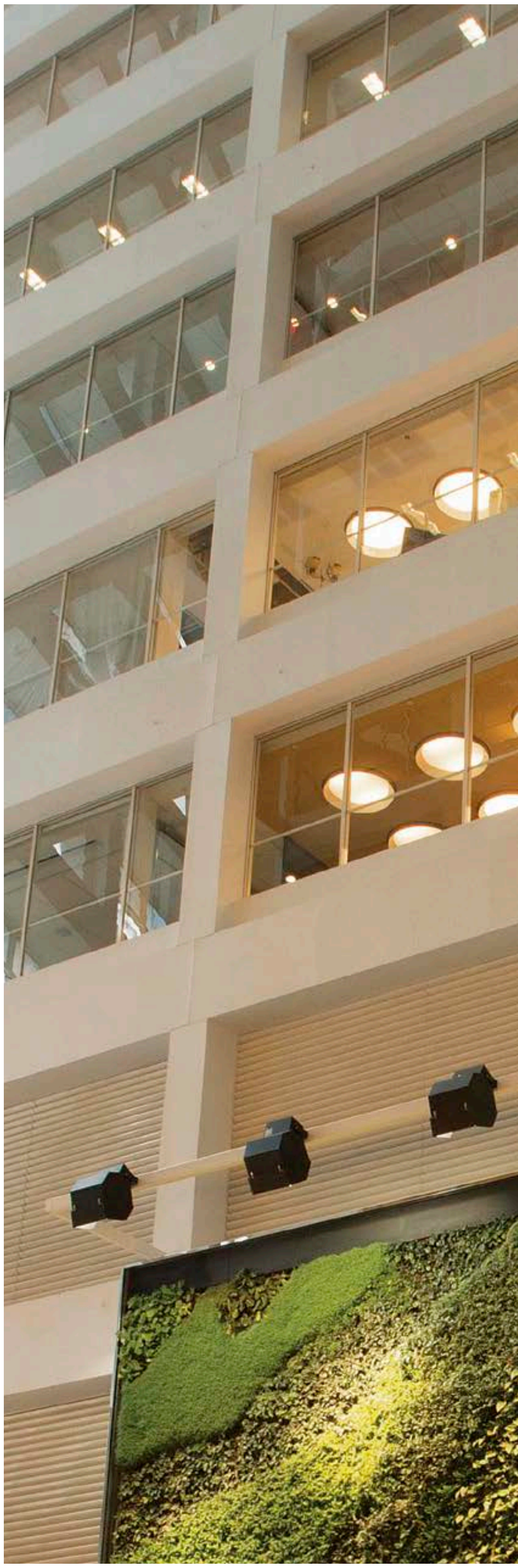

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