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In this article, the authors discuss the continued push for tax transparency and the anti-tax-avoidance rules that present new tax risks for multinationals as the BEPS project continues to take hold.

Since the release of the OECD's action plan on base erosion and profit shifting, and with governments looking for increased tax revenues, there has been a notable increase in interest in combatting tax evasion and avoidance. Beyond raising tax revenues, governments are feeling public pressure to act aggressively after incidents like LuxLeaks and the release of the Panama Papers.

With BEPS measures being implemented in various countries and with increased transparency measures being developed and adopted, the time for multinationals to act is now. As detailed in our previous article,[1] the country-by-country report was designed to help tax authorities identify risk areas and serves as a useful tool for taxpayers. In this article, we focus on recent legislative developments and identify new tax risk areas for multinationals.

BEPS Developments

In 2013 the OECD issued its action plan on BEPS, providing 15 action points centered on three conceptual pillars: coherence (controlled foreign corporation and interest deduction rules), substance (rules on transfer pricing and avoidance of permanent establishment status), and transparency and certainty (transfer pricing documentation and disclosure rules).

The final reports were issued in October 2015. Most of the reports are not self-executing and require changes to domestic (or regional) tax law and international tax agreements to become legally effective. One exception is that the revisions of the OECD transfer pricing guidelines (proposed in the BEPS actions 8-10 reports) do not require future domestic law or treaty changes to become effective.[2]

The BEPS reports provide either for minimum standards (such as for treaty-shopping abuse and CbC reporting) or for common approaches and best practices (such as for hybrid mismatches and interest deductibility). This will undoubtedly lead to a variation in local implementation that, in turn, will increase compliance costs and the risk of tax disputes. This is why progress on the dispute resolution mechanism is crucial, both at the OECD level (BEPS action 14) and at the EU level.

At the EU level, a proposal for a council directive on double taxation dispute resolution was agreed to on May 23. This proposal sets out a new system for resolving double taxation disputes in which dispute resolution mechanisms are mandatory and binding, with clear time limits and an obligation to reach results. Further, the

[1] Astrid Pieron, Lewis Greenwald, and Lucas Giardelli, "Performing a BEPS Diagnostic — The CbC Report as a Tool for Taxpayers," *Tax Notes Int'l*, Feb. 20, 2017, p. 749.

[2] Jason Osborn, Brian Kittle, and Kenneth Klein, "Are the Final BEPS Reports on Actions 8-10 Effective Now?" *Tax Notes Int'l*, Aug. 22, 2016, p. 709.

proposal seeks to create a tax environment that keeps compliance costs for businesses to a minimum.[3]

To facilitate implementation of the BEPS reports, the OECD has also developed a multilateral instrument that contains provisions executing the BEPS tax-treaty-related measures. The new multilateral instrument will transpose the BEPS directives into more than 2,000 tax treaties. More than 100 countries have concluded negotiations on the multilateral instrument. Of these, 70 jurisdictions have signed the instrument, 68 of them during a ceremony on June 7, 2017.[4] It is worth noting that the United States has not as yet signed the multilateral instrument.

At the regional level, the EU has taken steps to implement some of the BEPS recommendations. In Council Directive (EU) 2016/1164 on rules against tax avoidance practices (ATAD), the EU implemented legislative measures in the following areas:

- interest limitation rules;
- exit taxation;
- general antiabuse rule;
- CFC legislation; and
- hybrid mismatch arrangements.

The attack on hybrid mismatches should be further strengthened by Council Directive (EU) 2017/952, regarding hybrid mismatches with third countries (ATAD II). Although the exit tax provision and the GAAR are not directly associated with the BEPS reports, they are part of the broader aims of the OECD's program.[5] Most provisions of the EU ATAD must be incorporated into the domestic tax law of the EU member states by December 31, 2018. On the other hand, most of the provisions of the ATAD II should be incorporated by December 31, 2019, with an entry into force on January 1, 2020.

[3]Council of the EU, "Double Taxation: Council Agrees its Position on Dispute Resolution Procedures," Release 287/17 (May 23, 2017); European Parliament legislative resolution of July 6, 2017, on the proposal for a Council directive on Double Taxation Dispute Resolution Mechanisms in the European Union, COM(2016)0686, C8-0035/2017, 2016/0338 (CNS).

[4]OECD, "Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures and to Prevent Base Erosion and Profit Shifting" (status as of July 11, 2017).

[5]For details, see Sandy Bhogal, "The EU Anti-Tax-Avoidance Directive," *Tax Notes Int'l*, Sept. 5, 2016, p. 881.

Increasing Transparency

In the context of risk assessments, transparency laws have a direct impact on the likelihood of an audit. Several measures have been taken at a multilateral level to increase transparency in tax matters. For example, 112 jurisdictions currently participate in the Multilateral Convention on Mutual Administration Assistance in Tax Matters, and the Standard for Automatic Exchange of Financial Account Information in Tax Matters provides for a common reporting standard (CRS) that contains due diligence rules for financial institutions regarding collecting and reporting information to the competent authorities.

The CRS Multilateral Competent Authority Agreement implements the automatic exchange of information under the CRS based on article 6 of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. This agreement now has 93 signatories and is open for others to sign.

Inspired by those efforts, the Multilateral Competent Authority Agreement on the Exchange of CbC Reports has been developed to facilitate the implementation of the CbC reporting standard (BEPS action 13). This agreement, which has 64 signatories, is also based on article 6 of the Multilateral Convention.

Specific efforts have also been conducted at the regional level (in particular, by the EU) in the area of tax transparency.

As of January, member states are exchanging information on the tax rulings. With Council Directive (EU) 2015/2376 and Council Directive (EU) 2016/881, the EU has amended the preexisting directive on administrative cooperation in taxation[6] by introducing the mandatory, automatic exchange of advance cross-border tax rulings, advance pricing agreements, and the mandatory automatic exchange of CbC reports.

The EU has gone a step further than the OECD with its draft directive implementing public CbC

[6]Council Directive 2011/16/EU of Feb. 15, 2011, on administrative cooperation in taxation.

reporting.[7] It is worth noting that the text of the draft directive (recently approved by the European Parliament) provides for a safety clause to protect commercially sensitive information and to ensure fair competition. According to the draft, member states may allow the temporary omission of specific items when their disclosure would be seriously prejudicial to the commercial position of the multinational group to which it relates.[8]

The EU has also issued transparency measures in other arenas that could have an impact on tax matters. In 2015 the EU published the 4th Anti-Money-Laundering Directive (2015/849), imposing an obligation on member states to prepare beneficial ownership registers. On July 5, 2016, the European Commission adopted a proposal to further amend that directive to develop a common global standard that would lead to the linking of beneficial ownership registers to facilitate cooperation between member states and would make specified beneficial ownership information public.[9]

On November 8, 2016, the EU Council agreed on a proposal granting access by tax authorities to information held by other authorities responsible for the prevention of money laundering. This directive will require member states to provide access to information on the beneficial ownership of companies. It will apply from January 1, 2018.

Based on these initiatives to increase tax transparency, a proactive and coordinated approach by multinationals is needed now more than ever. Multinationals must closely monitor further developments in this area, as these changes will significantly affect tax strategies.

Risk Areas for Taxpayers

Many countries have already started to incorporate BEPS and transparency measures into their domestic tax law. International tax planning consequently will be affected by these new laws.

A non-exhaustive list of risk areas (and the types of laws that may affect them) includes:

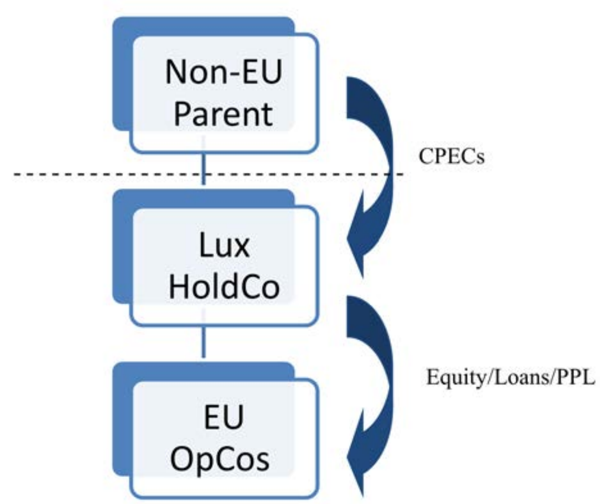
- commissionnaire/commercial agent structures — GAAR and transfer pricing;
- limited-risk distributors — GAAR and transfer pricing;
- intermediate/holding companies — GAAR substance/motive test;
- reorganization/change of business models — taxation of profit potential (exit taxation);
- intragroup financing/use of a group finance company or hybrid financial instruments — transfer pricing, limitations on interest deductibility rules, and hybrid mismatch rules; and
- tax rulings — CbC reporting and the automatic exchange of tax rulings.

We illustrate two of these risks.

Use of Hybrid Financial Instruments

Assume, as shown in Figure 1, that a non-EU parent company holds a Luxembourg holding company (Lux HoldCo), which in turn holds operating companies in the EU (EU OpCos).

Figure 1. Hybrid Example



Lux HoldCo issues convertible preferred equity certificates (CPECs) to its non-EU parent.

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[7] Proposal for a directive of the European Parliament and of the Council amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches, COM(2016) 198 final (Apr. 4, 2016).

[8] Amendments adopted by the European Parliament July 4, 2017, on the proposal for a directive of the European Parliament and of the Council amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches (COM(2016)0198, C8-0146/2016, 2016/0107 (COD)).

[9] European Commission, "Commission Strengthens Transparency Rules to Tackle Terrorism Financing, Tax Avoidance and Money Laundering" (July 5, 2016); and Proposal for a directive of the European Parliament and of the Council amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing and amending Directive 2009/101/EC, COM(2016) 450 final, 2016/0208 (COD).

Lux HoldCo also issues a profit participating loan (PPL) to one of its EU OpCos.

Both the CPECs and PPLs are classic hybrid financial instruments that allow a deduction without inclusion — that is, they provide a tax deduction in one state and a tax exemption of the income or tax deferral in the other state. Regarding the CPECs, Lux HoldCo should be able to deduct interest in Luxembourg since the CPECs should be considered debt in Luxembourg. Conversely, the CPECs could be considered equity in the non-EU parent's state, and, thus, the "interest" should not be immediately taxable in that state. The same tax treatment should apply with respect to the PPL.

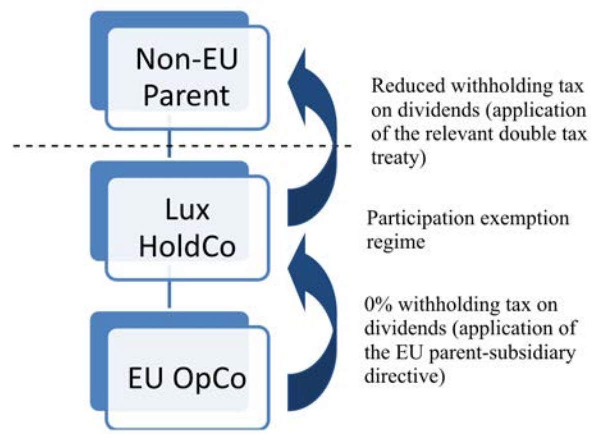
This classic structure should implicate the new measures based on BEPS action 2 as well as the EU ATAD. The PPL described above, being between two EU member states, will be caught by the first EU ATAD (in force as of January 1, 2019), as it results in a deduction without a corresponding income inclusion. Under those rules, the tax deduction of the PPL's interest should be denied in the state where that EU OpCo is located.

Also, the EU ATAD II extends the rules developed on hybrid mismatches to third countries beyond the EU. If a hybrid mismatch involves a third country and the payment has its source in a member state, that member state must deny the deduction. Otherwise, according to article 9 of the EU ATAD II, the member state must require that the taxpayer include the payment in the taxable base unless the third country has already denied the deduction. Thus, under that directive, Luxembourg should deny the deduction of the interest on the CPECs since the source of the payment is in Luxembourg, even though the recipient company is outside of the EU.

Intermediate Holding Companies

Assume, as illustrated in Figure 2, that a non-EU parent company holds a Luxembourg holding company (Lux HoldCo), which in turn holds an EU OpCo. The state in which the non-EU parent company is located does not have a double tax treaty with the state in which the EU OpCo is located (or a less beneficial one) but does have a double tax treaty with Luxembourg (or a more beneficial one). For this purpose, assume that, as between Lux HoldCo and EU OpCo, no withholding tax applies because the conditions of the EU parent-subsidiary directive are met. A reduced withholding tax rate on dividends should also apply between Lux HoldCo and the non-EU parent company based on the applicable double tax treaty. Assume further that the participation exemption regime on dividends (100 percent exemption) applies to the Luxembourg company.

Figure 2. Intermediate Holding Companies Example



Before the report on BEPS action 6 and the EU ATAD, the risk that this structure might be seen as tax avoidance could be mitigated by ensuring that there was sufficient substance in Luxembourg — for example, renting office space, having personnel, holding board meetings in Luxembourg, and so forth.

After the BEPS report on action 6 and the EU ATAD, this structure must be reevaluated. According to article 6 of the EU ATAD, an arrangement (or a series of arrangements) that has been put into place for the main purpose (or for one of the main purposes) of obtaining a tax advantage, and not for valid commercial reasons that reflect economic reality, will be ignored.

The provisions of the EU ATAD require more than was mandated by the previous substance requirements. Evidence is required that Lux HoldCo was interposed into the arrangement for valid business reasons. This condition is in addition to the requirement that Lux HoldCo have adequate substance. If valid commercial reasons do not exist, the interposition of Lux HoldCo will be disregarded.

Conclusion

A broad range of multinationals will be affected by the implementation of the BEPS provisions. Likewise, multinationals should be aware of increasing tax transparency measures that are likely to increase compliance costs and may also lead to the disclosure of sensitive tax information. Monitoring developments in the countries where the group operates and conducting an ongoing evaluation of the tax structures must now, more than ever, be an integral part of the multinational group's international tax planning. ■