



PRESENTATION
BASE EROSION
PROFIT SHIFTING:
CHANGING MINDSETS AND
MANAGING CHANGE



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TAX HAS BEEN FRONT PAGE HEADLINE NEWS FOR MOST OF THE PAST 5 YEARS; AND A FOCUS OF PUBLIC ATTENTION AND POLITICAL ACTION...

UK Parliament Public Accounts Committee Report 3 December 2012 [Chaired by Margaret Hodge]

- “[W]e were not convinced that their [Amazon, Google and Starbucks] actions, in using the letter of tax laws both nationally and internationally to immorally minimise their tax obligations, are defensible.”

Google, Amazon, Starbucks: The rise of ‘tax shaming’ [BBC News Magazine 21 May 2013]

- “Everything these companies are doing is legal. It's avoidance and not evasion. But the tide of public opinion is visibly turning. Even 10 years ago news of a company minimising its corporation tax would have been more likely to be inside the business pages than on the front page.”





TAX HAS BEEN FRONT PAGE HEADLINE NEWS FOR MOST OF THE PAST 5 YEARS; AND A FOCUS OF PUBLIC ATTENTION AND POLITICAL ACTION...

Pressure grows to tighten global tax rules [BBC News 31 October 2014]

- "We should all pay out fair share."
- "The idea of the two-year BEPS project is to phase in a series of changes in national and international tax law to close loopholes, clarify financial reporting, and tighten rules on the taxation of certain activities"



The end of international tax planning? [The Star Online 30 January 2017 - Tan Hooi Beng]

- "BEPS is coming to town."



BEPS has the potential to significantly impact captives



POSSIBLE BEPS CONSEQUENCES FOR CAPTIVES

- **Increased risk of double taxation**
- **Increased documentation and reporting**
- **Possible increased tax scrutiny**



TOPICS FOR DISCUSSION

- Introduction to BEPS (including an overview of the 15 Action Items)
- BEPS status in Malaysia
- The impact of BEPS on captives
- Key Action Items : Actions 8 – 10 (Ensuring transfer pricing is aligned to value creation)
- Managing BEPS considerations / risks



BEPS IN A NUTSHELL

- Domestic tax Base Erosion and Profit Shifting (BEPS) arises due to MNEs exploiting gaps and mismatches between different countries' tax systems. BEPS results in a loss of revenue for governments, conservatively estimated between 4% and 10% of global corporate income tax (Source: OECD, 2015)
- Developing countries' higher reliance on corporate income tax means they are viewed to suffer from BEPS disproportionately
- Working together in the OECD/G20 BEPS Project, over 60 countries jointly delivered 15 Actions to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment



BEPS IN A NUTSHELL (CONT.)

- The BEPS measures are designed to protect the domestic tax base. The expectation is that profits will be reported where the economic activities that generate them are carried out and where value is created
- G20 Finance Ministers, G20 Leaders and other political leaders have strongly urged the timely implementation of the BEPS package
- More than 85 countries and jurisdictions have joined the Inclusive Framework on BEPS which was established to formalise the enhanced cooperation between countries
- Members of the Inclusive Framework on BEPS commit to implementing the BEPS package and the four minimum standards (e.g., the Action 13 standard on Country-by-Country Reporting)



BEPS: 15 ACTION ITEMS

Action 1: Address the tax challenges of the digital economy			
“Gaps”	“Frictions” (Substance)		“Transparency”
i. Establishing international coherence of corporate income taxation	ii. Restoring the full effects and benefits of international standards		iii. Ensuring transparency while promoting increased certainty and predictability
Action 2: Neutralise the effects of hybrid mismatch arrangements	Action 6: Prevent treaty abuse		Action 11: Establish methodologies to collect and analyse data on BEPS and the actions to address it
Action 3: Strengthen controlled foreign company (CFC) rules	Action 7: Prevent the artificial avoidance of PE status		Action 12: Require taxpayers to disclose their aggressive tax planning arrangements
Action 4: Limit base erosion via interest deductions and other financial payments	Assure that transfer pricing outcomes are in line with value creation	Action 8: Intangibles	Action 13: Re-examine transfer pricing documentation
Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance		Action 9: Risk and capital	
		Action 10: Other high-risk transactions	Action 14: Make dispute resolution mechanisms more effective
Action 15: Develop a multilateral instrument			



BEPS: IMPLEMENTATION

Domestic law change	Transfer Pricing	Treaties	Monitoring
<p>Recommendations for national law, regulations, or administrative practice</p>	<p>Changes to the OECD's Transfer Pricing Guidelines</p>	<p>Signing of multilateral instrument, and changes to the OECD Model Treaty & Commentary</p>	<p>Monitoring/reporting by OECD/Global Forum</p>
<p>Action 1: Digital Economy</p> <p>Action 2: Hybrid mismatches</p> <p>Action 3: CFCs</p> <p>Action 4: Limiting interest deductions</p> <p>Action 13: Transfer Pricing documentation (incl. CbCR)</p>	<p>Actions 8-10: Intangibles Risks & Capital High-Risk Transactions (i.e., assure that transfer pricing outcomes are in line with value creation)</p>	<p>Action 2: Hybrid mismatches</p> <p>Action 6: Treaty abuse</p> <p>Action 7: Permanent establishments</p> <p>Action 14: Dispute resolution</p> <p>Action 15: Multilateral instrument</p>	<p>Action 5: Harmful tax practices</p> <p>Action 11: BEPS information</p> <p>Action 13: Transfer Pricing documentation (incl. CbCR)</p> <p>Action 14: Dispute resolution</p>



BEPS STATUS IN MALAYSIA

- **Income Tax (Country-By-Country Reporting) Rules 2016 introduced in December 2016 - Action 13**
- **Transfer Pricing Guidelines 2012 updated in July 2017**
 - i. Chapter II - The Arm's Length Principle
 - ii. Chapter VIII – Intangibles
 - iii. Chapter XI – Documentation
- **New Chapter X : Commodity Transactions**
- **Amendments to Transfer Pricing Guidelines 2012 reflect Actions 8 to 10**



BEPS: RELEVANT ACTIONS FOR CAPTIVES

- **BEPS focus on captives:** Throughout the final BEPS reports, there are references to captives in a negative context; it is clear that the OECD regards captives as a potential source of profit shifting.
- **Enhanced CFC rules:** Action 3 definition of CFC income: Reference to insurance income which derives from contracts or policies with a related party (receiving a deduction for premium paid).
- **Interest deduction limitations:** Action 4 sets a benchmarked “fixed ratio corridor” of 10% to 30%, meaning that interest deductions would be limited to between 10% and 30% of an entity's or group's EBITDA. Captives are excluded from specific rules on interest deductions that will be developed for banking and insurance groups.



BEPS: RELEVANT ACTIONS FOR CAPTIVES (CONT.)

- **Increased risk of creating a PE:** Action 7 widens the definition of permanent establishment (or “PE”) considerably. Definition of an independent agent narrowed.
- **Increased focus on control and risk:** Actions 8 – 10 seek to ensure that transfer pricing outcomes better align with value creation. Emphasis on demonstrating control and financial capacity in the entity taking on risk. Also a re-characterisation of profit allocations from transactions which are not “commercially rational”. Example given of “commercially irrational” intra-group insurance transaction (i.e. no third party market).



BEPS: RELEVANT ACTIONS FOR CAPTIVES (CONT.)

- **Enhanced tax reporting:** Action 13, which countries are implementing, requires large MNEs have to file a CbC Report for each jurisdiction in which they do business (including number of employees, profit, capital and retained earnings). Information will be used as a risk assessment tool by tax authorities.



KEY BEPS ACTIONS FOR CAPTIVE INSURERS ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION (ACTIONS 8-10)

- **Actions 8–10 is intended to ensure that a transfer pricing analysis is based on an accurate delineation of what the associated enterprises actually contribute in the transaction, including risks actually assumed and the functions undertaken.**
- **There can be a non-recognition of transactions which are "commercially irrational". The test is:**
 - Does the actual transaction possesses the commercial rationale of arrangements that would be agreed between unrelated parties under comparable economic circumstances; not whether the same transaction can be observed between independent parties.



KEY BEPS ACTIONS FOR CAPTIVE INSURERS (CONT.) ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION (ACTIONS 8-10)

• **Example:**

- A manufacturing company located in an area prone to flooding takes out insurance from an associated company in respect of inventory and plant and machinery risk, in exchange for a premium of 80% of the value of the inventory, property and contents. Given the substantial likelihood of claims, there is no active third party market for the insurance of properties in the area.
- The Action 8 – 10 report states that the captive insurance arrangement is “commercially irrational” as there is no market for insurance given the likelihood of significant claims. As such, the transaction should not be and the insurance premium would not be tax deductible for the manufacturing company.



KEY BEPS ACTIONS FOR CAPTIVE INSURERS (CONT.) ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION (ACTIONS 8-10)

- **Another key aspect of Actions 8 – 10 is the increased emphasis on demonstrating control over risk in the entity taking on risk**
 - There must be within the entity competent and experienced decision-makers who have access to information relevant to the decision to take on or lay off a risk. Where an entity cannot demonstrate control over a risk, the return from that risk will be allocated to the group entity that does in fact control the risk and the return to the first entity will be limited to a risk-free return.

Note: the Action 8 – 10 report notes that the mere formalizing of the outcome of decision-making, e.g., with a board meeting or signing of documents, would not qualify as “the exercise of a decision-making function sufficient to demonstrate control over risk.”



IMPLICATIONS FOR CAPTIVES SOME QUESTIONS TO CONSIDER...

- Is the captive performing substantive activities locally?
- Would the captive's transactions have been agreed between unrelated parties under comparable economic circumstances?
- Is there actual decision-making in the right location at the right time?
- Is the captive effectively controlling the risks of the transaction?
- Is the risk transfer pricing arm's length?
- Is there supporting documentation?



IMPLICATIONS FOR CAPTIVES MITIGATING BEPS RISK

- Review operating models and guidelines
- Review transfer pricing and update/revise where appropriate. Revisit functional analysis
- Document commercial rationale for the captive as well as its substance
- Test transactions to ensure that they are rational
- Ensure that there is control over the risks being taken by the captive



IMPLICATIONS FOR CAPTIVES (CONT.) MITIGATING BEPS RISK

- **Engage with local tax authorities and respond to proposals to implement new rules which target captive arrangements:**
 - The Federation of European Risk Management Associations (FERMA) has published a report on captive re/insurance arrangements :
<http://www.ferma.eu/app/uploads/2017/06/2017.06-FERMA-Information-Paper-on-Captive-reInsurance-Guidelines.pdf>
 - The report covers (amongst others): commercial rationale for captives; substance and governance and transfer pricing



IMPLICATIONS FOR CAPTIVES (CONT.) MITIGATING BEPS RISK

- **Key points in the report include:**
 - i. Captive insurance enables European businesses to increase their capacity to take risk
 - ii. The parent company gets a tailor-made risk coverage and pricing, and it can target risk reduction more effectively thanks to better loss information
 - iii. Captive insurance contracts are genuine risk transfer transactions with pricing based on the same approaches as commercial insurers
 - iv. European captives are regulated as other insurance entities under Solvency II
 - v. Many aspects of captive operations, such as the payment of insurance premium tax in source countries, demonstrate their genuine, non-tax functions



THANK YOU

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