The impact of the BEPS Action Plan and the value-added based distribution of profits

I. Principle

The OECD (Organisation for Economic Cooperation and Development, founded on 30 September 1961 in Paris) achieved that all economically important countries, in particular all European countries as well as Japan, South Korea, Australia, the USA and China (as one of the 129 members of the OECD forum *Inclusive Framework on Base Erosion and Profit Shifting*) committed to adhere to its principles. BEPS (Base Erosion and Profit Shifting) is the OECD's most important measure aimed at achieving a balanced and correct distribution of taxation among all countries.

The underlying idea is simple:

Where economic activities take place and value is created, taxation should take place - regardless of the legal structure and regardless of the place of residence. The taxation must be distributed among the countries in consideration of the value added that is created in the respective country.

II. Legal Implementation of the BEPS Principles

The international taxation regime has been mainly linked to the residence of the taxpayer rather than the location where value was actually created. This will change fundamentally in the future due to the rapid implementation of the **BEPS principles**, both in double taxation treaties (DTAs) and in national laws. These principles are based on the idea that in the age of globalisation, it is particularly important to grant every state where value added is created the right of taxation of such added value.

On 7 June 2017, the finance ministers of 68 countries signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in Paris. The so-called MLI ("Multilateral Instrument", in force since 1 July 2018) and the draft revision of the OECD Model Tax Convention to Avoid Double Taxation (OECD-MA) presented on 11 July 2017 serve as the cornerstones for establishing uniform and appropriate taxation within the OECD states and all countries applying OECD rules (e.g. China, Hong Kong, Thailand etc.).

1. MLI

The MLI is a multilateral treaty under international law, whereby the BEPS minimum standard is to be implemented quickly and in all DTAs, without the individual bilateral treaties having to be renegotiated again. This means that the respective DTAs are automatically adapted without a new treaty having to be signed and ratified.

The MLI contains a model text for the adaptation of existing DTAs and provides for the **mandatory** implementation of the BEPS minimum standard in addition to options for selection of optional and alternative regulations (options and reservations). A modification of the individual bilateral DTAs is only possible in those points in which the reservations and notifications of both DTA countries with regard to one MLI provision correlate.

The application of the various DTAs is thus becoming more complex and complicated, as the MLI influences around 1,100 DTAs worldwide in one go. As a consequence, not only the text of the respective DTA is now authoritative - rather it must be checked whether a clause of the MLI is applicable, provided that both states agree to the respective amendment by the MLI and there are no reservations. For example, Art. 10 para. 2 and Art. 13 para. 4 DTA China-Germany are modified by the provisions of Art. 8 and 9 MLI and are therefore no longer applicable with the original wording of the DTA China-Germany 2017. Thus, after only two years since its entry into force, the DTA China-Germany is no longer up to date in these two clauses.

Keeping track of the various notifications and reservations of the different states in the 1,100 DTAs concerned is not easy and will require precise analysis in the future.

2. The new OECD Model Convention 2017

The idea of taxation at the place where value added is created is also incorporated in the **new** OECD-MA. For example, the previous version of Art. 5 para. 4 classified logistics centres and warehouses only as auxiliary and preparatory activities, which are not sufficient to establish a permanent establishment and thus to assign a taxation right.

However, the new version of this article is intended to focus on the actual value creation structure of the company so that the use of warehouses can also be subject to taxation in the country which the warehouse is located in.

3. National Legislation

The principles governing the distribution of operating profits (see the Ordinance on the Distribution of Operating Profits in Germany, "BsGaV", of 13 October 2014) regulate the delimitation of income between the parent company and the various operating subsidiaries in different locations worldwide and thus reflect the distribution of value added between the participating states. According to the **Authorised OECD Approach** (AOA), the permanent establishment is to be regarded as an independent and autonomous enterprise for the purpose of profit allocation.

In order to be able to adequately allocate value creation and thus taxation to the various value-adding steps in a supply chain of an international operating company, a minimum of measurable presence at a location is required. With regard to permanent establishments, the OECD is linking up to the so-called **significant people functions (SPF**) for this purpose. This principle is enshrined in German law in §1 (5) sentence 3 no. 1 *Außensteuergesetz* (AStG) of 13 September 1972 (last amended on 5 July 2017). The distribution of the individual value-added contributions between the parent company and the permanent establishment(s) is carried out depending on the "active decision-making power and management function of decision-makers" (*significant people*).

The personnel function thus serves as a starting point for the allocation of value-added activity and the associated operating income.

III. Practical implementation and Risks

Companies must therefore examine their business model carefully and assume that in the future taxes will have to be paid where **economic activities take place and value is created**, e.g. where decision-makers discuss, negotiate or implement agreements. For production companies, it has to be asked where the actual value creation takes place in the value chain, e.g. in development, marketing or production. This is not always easy. If, for example, research and development (R&D) services are provided in one country, the tax authorities of that country may assume that all profits arising from this activity are completely taxable in that country, since without the development activity the product would never have been produced. On the other hand, the country in which production actually takes place can also assume that the majority of the profits are taxable in that country. The exact **allocation** of the individual steps of the supply chain to the different countries can be highly complicated and requires precise analysis and documentation of the entire supply and value chain.

The cost-plus method is only one of many, but by no means always the right method (an overview of the different methods can be found in the **official OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017,** see [https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multi-national-enterprises-and-tax-administrations-2017_tpg-2017-en#page138)](https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-en#page138).

It cannot be correct if 80% of the value added in a multi-national group is generated by the subsidiary in country A, but the value added is merely recognised by a contractual cost-plus arrangement of 6% and payments from the headquarters from country B. In the next two to three years, companies will have to prepare for intensive discussions with the authorities, especially in countries like China, Thailand and Vietnam.

In case of doubt, an estimate will be made by the tax authorities of the respective countries, which has to be challenged in court, should a company be unable to find an acceptable compromise with the respective authorities. In a worst case, such dispute may even lead to a situation where the management may not be allowed to leave the country or goods are no longer allowed to be exported.

We believe that it is advisable to be proactive, to analyze and, if necessary, adjust the tax base in the countries involved in the value creation rather than to wait for the problem to emerge, since it is very difficult to react afterwards. In particular, you need to review and potentially revise the legal structures within your group of companies such as

- Transfer prices for goods,
- License agreements,
- Service agreements,
- Distribution keys and cost allocation for general group functions,
- Employee secondment contracts,
- etc.

Please let us know if you need further information.

Such changes cannot be implemented at short notice. You should first analyze your business model taking into consideration the new regulations. After you optimised your business model, we should explore together how to allocate profits properly based on the above principles and how to legally implement such profit allocation by revising the existing intercompany agreement framework.

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