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Tax

Regulation

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What is BEPS?

Base Erosion & Profit Shifting (BEPS) refers to tax planning strategies taken by multinational enterprises to exploit gaps and mismatches in tax rules worldwide, reducing tax payable by shifting their profits to jurisdictions with lower tax rates.

The BEPS project was initiated by the OECD and G20 countries in 2013. In October 2015, a comprehensive 15-point Action Plan was released in response to growing concerns about the inability of the international tax system to keep up with globalisation. The BEPS package sets out 15 actions along the key pillars of (i) improving coherence of corporate income taxation to reduce loopholes in the interaction of countries' domestic tax laws, (ii) establishing substance requirements in international standards, and (iii) ensuring a transparent tax environment as well as certainty. It is expected that once implemented, measures recommended under the BEPS package will result in the taxation of profits where the economic activities that generate them take place and where value is created.

The OECD established the Inclusive Framework (IF) in January 2016 so that countries and jurisdictions can collaborate on the implementation of the BEPS package. On 11 of February 2019 Armenia has joined the OECD's Inclusive Framework on BEPS.

Members of the Inclusive Framework will develop a monitoring process for the four minimum standards as well as put in place the review mechanisms for other elements of the BEPS Package. The monitoring of the four minimum standards will ensure that all members, as well as jurisdictions of relevance, will comply with the standards in order to ensure a level playing field. All countries and jurisdictions joining the framework will participate in this review process, which allows members to review their own tax systems and to identify and remove elements raising BEPS risks.

Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS

Why do we need the Convention and who are the signatories?

In June 2017, Armenia among 68 countries signed the Multilateral Convention (hereinafter referred to as the "Convention" or referred to as the "Multilateral Instrument" or "MLI" in international practice). This Convention is one-of-a-kind (unique) instrument developed by the Organisation for Economic Cooperation and Development (OECD) aimed at prevention of base erosion and profit shifting (BEPS). It will allow swiftly extending (transposing) the principles envisaged under the BEPS Project into sheer number of Double Tax Treaties (DTTs) at a time.

This instrument is deemed to be as quite flexible. It is left on the signatories to decide which of their DTTs will be covered by the Convention and which of its provisions (and what extent thereof) will be applicable.

The MLI covers recommendations from the base erosion and profit shifting project that affect double tax treaties. This applies both to various minimum standards and some additional recommendations. The MLI was developed under Action 15 and encompasses recommendations for:

- Action 2 (hybrid mismatches)
- Action 6 (treaty abuse)
- Action 7 (permanent establishments), and
- Action 14 (dispute resolution).

When will the rules of our DTTs change?

The DTT provisions will change as Armenia and other countries implement the domestic procedures necessary for the ratification of the Convention on their part. As at the beginning of February 2019, 87 signatories have signed the Convention, and 19 of them, for example, Austria, Australia, France, the UK, Ireland, Japan, Singapore, Malta, Poland, Israel, the Isle of Man, Jersey, Lithuania, Malta, Monaco, New Zealand, Serbia, Slovakia, Slovenia, Sweden, have already ratified it into their respective domestic laws.

The MLI establishes a different beginning on the start date for the application of the provisions in respect of withholding tax at source, other taxes and mutual agreement procedures. With respect to withholding taxes at source, the new rules apply to the payments made from 1 January of the year next following of the year of entry into force of the MLI for each of the DTT partners.

Which of our DTTs will change?

Armenia has extended the MLI to 46 DTTs, including DTT with Austria, the UK, Cyprus, Latvia, Luxembourg, the Netherlands, China, France, etc.

What provisions of DDT will change?

The Convention provides for a number of key measures:

- Minimum standard which is mandatory for all MLI signatory countries, including (1) provisions aimed at combating international treaty abuses, and (2) the provisions aimed at improving mutual agreement procedures.
- Optional provisions (the decision remans at the countries' own discretion).

Minimum standard: provisions to combat international treaty abuses

The MLI signatory countries can implement the minimum standard in terms of combating the abuses in one of the 3 options below:

Option 1: Implementing only the principal purpose test (PPT);

Option 2: Implementing the PPT test and the Simplified Limitation on Benefits Provision (S-LOB);

Option 3: Implementing the detailed Limitation on Benefits Provision in combination with the mechanism to address conduit financing structures (beyond the scope of the MLI).

Most DTT partners have chosen to apply Principal Purpose Test.

- Benefits under the DTT shall not be granted if obtaining these benefits was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.
- This is the default option to ensure the minimum standard is met

The Simplified Limitation on Benefits Provision, which Armenia has chosen to apply, has not been opted for by most of the partner countries.

- The following persons shall be entitled to benefits under DTTs: individuals; the contracting jurisdiction itself or political subdivisions thereof; entities, if the principal classes of their shares are traded on recognised stock exchanges; certain non-profit organisations; entities engaged in providing retirement benefits, etc. Tax benefits are available to entities engaged in the active conduct of business if the income is derived from that business. It is noteworthy that if such a rule is introduced, benefits under DTT treaties will not be available to holding companies, corporate administration centres, group financing centres (including cash pooling) and investment business entities (except for professional market participants), as their activities do not fall under the term "active conduct of business", as set forth in the Convention.
- The S-LOB provision will apply only if:
  - Each party to a DTT has chosen to apply it;
  - One party to a DTT has chosen to apply the simplified limitation on benefits provision, while the other party has chosen to apply the primary purpose test, but the other party also either:
    - allows asymmetrical application of the simplified limitation on benefits provision in such situations; or
    - has agreed to mutual application of the simplified limitation on benefits provisions with DTT partners that apply it.
- It should be taken into account that the simplified limitation on benefits provision will not apply to most of Armenia's DTTs (including those with Cyprus, Luxembourg, the Netherlands, the UK and other countries that have chosen to adopt an easier option - the PPT option - and have not provided for the asymmetrical application of the limitation on benefits provision). The list of the countries choosing to apply the limitation on benefits provision may include Russia that wishes to introduce the provision based on bilateral agreement.

The minimum standard: improving mutual agreement procedures

With regard to improving mutual agreement procedures, MLI envisages the improvement of mutual agreement procedure and, at the choice of contracting jurisdictions, the introduction of arbitration procedure. It should be noted that Armenia did not support the provisions regarding the arbitration procedure. This means that the mutual agreement procedure will remain the only way (exclusive remedy) to resolve disputes between Armenian and foreign competent authorities.

Optional provisions

Dividends	The article "Dividends" introduces a new criterion for ownership of the company's assets, i.e. the ownership rules established by a single DTT must be observed within 365-day period prior to the date of payment of the income (dividends). It is noteworthy that the rule is additional and does or replace the existing criteria for the application of reduced tax rates.	
Provisions on capital gains from alienation of shares or interests of entities deriving their value principally from immovable property	The treaties will include the provision that such income shall be taxed where the immoveable property is situated. Concurrently, an additional provision is introduced in accordance with which the test on the volume of immovable property in the assets of the alienated entity must be made each day during the 365-day period preceding the transaction.	
Permanent establishments	Construction site activity: prohibition against splitting up of contracts in a period (or periods) of time.	This provision is aimed at preventing the artificial division (splitting up) of contracts to avoid the formation of a permanent establishment. However, the rule will not apply to the DTT provisions related to exploration and production of mineral resources.
	Narrowing the definition of the term "activities of preparatory or auxiliary character".	Business activity does not result in a permanent establishment only provided that such activity is in the list of exemptions under the DTT and is not of a principal nature. Also, under the new provision it is prohibited to divide business processes into separate activities that may be interpreted as "activities of preparatory or auxiliary character" to avoid the formation of a permanent establishment.
	Tightening the provisions relating to agency agreements (commissionaire arrangements)	Provides for the formation of a permanent establishment in cases where the activity is carried out by an agent who habitually concludes contracts on behalf of the enterprise or habitually plays the principal role leading to the conclusion thereof.
	Anti-abuse rule for permanent establishments situated in third jurisdictions	Provides for the right of a contracting jurisdiction where the income is derived to tax the income of a permanent establishment if it is exempt from income tax in the jurisdiction of residence of its headquarters and is taxed at reduced rates in the jurisdiction where such permanent establishment is situated.

Provisions relating to hybrid mismatches: entities or transactions that are treated differently under the domestic tax laws of contracting jurisdictions	Fiscally transparent entities	Income should be subject to mandatory taxation in one of the contracting jurisdictions. A DTT partner-country (a contracting jurisdiction) may refuse in using an exemption or deduction (credit) if the income tax has not been actually paid in the other contracting jurisdiction.
	Dual resident entities	The issue of dual residence of legal entities should be resolved by the competent authorities in the framework of the mutual agreement procedure, while the possibility of applying the benefits under the DTT will be denied if the tax authorities could not agree on the residence of the entity. Armenia has chosen the option under which, if an entity is recognized as a tax resident of both contracting jurisdictions for the purposes of Article 4 of the DTT "Residents", instead of "place of effective management", the determination of the tax residence status of such entity will be determined only within the framework of mutual agreement procedure.
Methods for elimination of double taxation	Armenia will continue to apply a tax deduction method.	

What does this mean for you?

For the application of international tax treaties, it will be necessary to further analyse whether and how exactly the MLI has affected it. The final version of the changes in each of the ratified DTT depends on the position of both partners in the DTT. Positions can be asymmetrical. Since the majority of the countries have already expressed their respective positions, and large-scale ratification of the Convention by other countries is expected in 2019, we recommend assessing now which of your transactions/structures will be affected by these changes.

On the front foot

As your business comes up against a growing wave of tax changes and pressure to increase tax transparency, you will need to review and possibly revise your approach to tax planning, tax risk management and tax disclosure.

The business is looking to you to take the lead. As a board, seeing the big picture, setting a clear tax risk appetite, and ensuring these are enforced throughout the organisation and communicating it effectively with all stakeholders is going to essential in embedding tax management into successful and sustainable strategic management.

If you would like to discuss any of the areas raised in this article, please contact your own Grant Thornton adviser or one of the contacts listed.

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