Jyri Hirvinen

The Impact of the OECD BEPS Action Plan on Finnish Multinational Companies – Case Study

Helsinki Metropolia University of Applied Sciences

Bachelor of Business Administration

European Management

Bachelor’s Thesis

7.11.2017

Author(s) Title Number of Pages Date	Jyri Hirvinen The Impact of the OECD BEPS Action Plan on Finnish Multinational Companies – Case Study 30 pages + 1 appendices 7 November 2017
Degree	Bachelor of Business Administration
Degree Programme	European Management
Specialisation option	
Instructor(s)	Robin Lowbridge, Senior Lecturer, University of Wolverhampton

This research attempts to evaluate the effects that the new OECD BEPS action plan might cause to the companies, main focus being in Finnish multinational companies and in the company being researched in the case study part of the research. The author understands the limitations of the one company case study model in the research but believes that useful information can be gained on the effects of the OECD BEPS action plan by examining the changes that the case study company has to go through in order to adapt to the new guidelines set in the action plan.

Keywords	BEPS action plan, OECD, transfer pricing, taxation

Contents

1 Introduction

In principle, the amount of taxes should be straightforwardly paid by the legal framework and tax regulations in certain country whether the company is a multinational enterprise or domestic company. Nevertheless, this seems to not be the case in the modern global business environment. Multinational enterprises have found ways to benefit from their tax optimisation plans and transfer pricing policies so that they gain great increase in profits by avoiding high corporate taxes in certain areas. This can be done in various ways. One way of gaining benefits by tax optimisation is the appropriate transfer pricing plan among the multinational company. Transfer pricing basically means selling the goods within the multinational company. Transfer pricing is a legal and acceptable way of conducting business when done right but there are guidelines which has to be followed in order to act legally. These guidelines are introduced by the Organisation for Economic Cooperation and Development (OECD). OECD estimates that almost 70% of all international trade is made internally in multinational companies (Tax Justice Network, 2015). This makes transfer pricing one of the most important topics when discussing multinational companies avoiding tax burden. Tax havens are also one of the largest problems when discussing base erosion and profit shifting. It is estimated that there is £21 to £32 trillion mostly untaxed financial assets located in the tax havens around the world (Tax Justice Network, 2016). To put this number to the scale, the real national debt of the United Kingdom is estimated to be around £4.8 trillion, around 15 to 23 percent of the amount that is sitting in the offshore tax havens (Nationaldebtclock.co.uk, 2016).

Because of the developing world economy structures and inability of OECD to prevent the unfair tax evasion, OECD started to develop a new set of recommendations and guidelines. The new action plan against Base Erosion and Profit Shifting (BEPS) consists of 15 actions which aim to prevent different aspects of base erosion and profit shifting by clearing the guidelines to make them more easily adaptable and by focusing on issues that have not been addressed earlier, such as issues in the taxation in digital economy. The action plan was put into operation by OECD and G20 countries in the beginning of the year 2016. The objective of the action plan is to cooperate with the current OECD guidelines of the transfer pricing policies and trying to prevent intentional tax optimization and guiding the tax incomes more fairly to the locations where the value is created. The BEPS action plan was created in order to more effectively gather information of the misconducts in the international taxation in the multinational enterprises (MNEs) and to increase the transparency in the international taxation. The misconducts could not be decreased sufficiently with the existing guidelines so new guidelines and recommendations were needed

This research is aiming to see if the new 15 step Base Erosion and Profit Shifting action plan by OECD will have impact in Finnish multinational companies and evaluate the nature of those effects. The relevant literature used in the research will be introduced and critically analysed in literature review section of the research.

2 Literature review

In following sections of the literature review, a quick overview of the current state and historical development of the Finnish economy will be provided in order to better understand the forces that lead to possible changes that BEPS action plan may bring. In addition to that, different views from relevant literature will be introduced and their relevance to the research subject will be evaluated. Also as the OECD BEPS guidelines will serve as a basis in the research, some of the most relevant actions to be most likely to affect Finnish companies will be reviewed more in depth.

A part of the research consists of examining already existing researches and reports of the topic. The problem with such approach is that as the OECD BEPS action plan is only recently being taken into action, there is no comprehensive amount of research about the actual effects that BEPS action plan might have in the Finnish companies. Nevertheless, there are numerous researches on the potential effects that the action plan might bring for the companies and the economy in general. Because the actual data of the effects does not exist yet, these have to be considered as sophisticated predictions instead of actual facts. This research is aiming to use those predictions and reflect them on the case study Company. One major part of the research is also examining the OECD reports and guidelines on the different aspects of Base Erosion and Profit Shifting and trying to see how the Finnish case study company has been able to adapt to them.

The literature reviewed in the research can be roughly divided into two different groups of texts; guidelines and recommendations mostly provided by OECD and then researches from various authors trying to predict the initial consequences that the OECD BEPS action plan might bring. Guidelines and reports from OECD serve as a basis for the legal matters and recommendations on different BEPS related topics. OECD offers guidelines for transfer pricing in their publication *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (*Oecd.org, (2015). *Transfer pricing - OECD).* This publication offers guidance for following so called arm’s length principle. This is done in order to ensure that taxable profits are not artificially being shifted out of governments’ jurisdiction. In addition to the old guidelines, OECD has also published the 15 step action plan which aims to reduce the misconducts in the BEPS related matters. The final OECD BEPS report consists of the following 15 actions:

“Action 1: Addressing the Tax Challenges of the Digital Economy

Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements

Action 3: Designing Effective Controlled Foreign Company Rules

Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status

Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation

Action 11: Measuring and Monitoring BEPS

Action 12: Mandatory Disclosure Rules

Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting

Action 14: Making Dispute Resolution Mechanisms More Effective

Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties”

(OECD, Final Reports, 2015)

In following chapters of the literature review, a short independent description will be given of every action of the OECD BEPS action plan. After the presentation of the outline of the 15 action in the action plan, the possible effects in most important actions for Finnish multinational companies will be introduced based on texts from different Finnish and foreign analysts.

Action 1: Addressing the Tax Challenges of the Digital Economy

The first action in the OECD BEPS action plan aims toward addressing the issues in the taxation of the digital economy. The OECD states that digital economy should not in theory differ from any other form of taxation but it might be difficult to treat digital economy similarly because of the different nature of the digital economy compared to more traditional forms of operations within companies. OECD has identified the issues and difficulties within the taxation in digital economy and attempts to approach these issues by offering the different approaches in order to tackle the difficulties in the digital economy taxation with the existing guidelines on international taxation. The guidelines aim to consider both direct and indirect taxation.

The digital economy has not been a major concern or an issue point in international taxation until very recently as information and communication technology have developed making technologies cheaper and more easily accessible. This has led to vast increase in the use of intellectual technology operations in businesses. The problem for OECD has become the fact that because the digital economy has basically became and economy itself, it is hard trying to isolate it as a different kind of economy from the rest of the economic areas for tax purposes. The digital economy operations such as online sales, application stores, cloud services and high speed trading platforms have further accelerated the growth and importance of digital economy and also made it more difficult to evaluate how and where the tax income should be directed.

The changes that OECD made in the guidelines in the new BEPS model in digital economy, consists of changes in the legal framework of permanent establishments and the location of the value creation. The changes in permanent establishment (PE) framework have an effect to companies that are operating large scale online sales business and have large warehouses from which the deliveries are made. Also the taxation structure of ownership of the intellectual property (IP) has been modified in order to ensure the rightful amount of tax income in the locations where the intellectual property is created (OECD, Executive summaries, 2015).

Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements

The action 2 of the OECD BEPS action plan focuses on addressing the negative effects on competition, efficiency, transparency and fairness that the erosion caused by the hybrid mismatch arrangements are currently causing. The hybrid mismatch arrangements aim to exploit the difference in legal tax framework in different countries in order to achieve double non-taxation situation.

The action 2 aims to neutralize the effects of the hybrid mismatch arrangements by providing the recommendations in the BEPS action plan to national governments to change the domestic laws to meet the demands set in the action plan. Second part of the recommended actions concerns the need to synchronize the implementations of the domestic law as a part of broader unilateral taxation framework. By synchronizing the legal framework, the OECD BEPS project should be able to prevent the base erosion and profits shifting with using the mismatch arrangements as a tool (OECD, Executive summaries, 2015).

Action 3: Designing Effective Controlled Foreign Company Rules

The action 3 of the OECD BEPS action plan aims to create recommendations which should decrease the possibilities for tax avoidance in form of creating affiliate non-resident taxpayers and directing the profit incomes of the resident multinational enterprise through the non-resident affiliate in order to minimize or avoid the taxes on that particular income. This part of the action plan was created because the existing rules on Controlled Foreign Companies (CFC) were not able to follow the pace of development and changes in the global environment. Therefore the old guidelines were not able to effectively tackle the base erosion and profit shifting challenges that occur in the modern international business structure. One of the main themes in this action from the OECD is that the countries should cooperate more and unilateral legal framework would significantly decrease the risk of CFC related issues.

The action 3 issues six major points from which this part of the BEPS action plan is constructed. First of which states that generally the controlled foreign company rules should apply to foreign companies that are controlled by shareholders in the parent jurisdiction. The second point states that CFC rules should only apply to the controlled foreign companies that are operating with significantly lower tax rates than ones applied under the legal framework in the parent country. Third part of the six is saying that even though according to old guidelines all the income can be considered as controlled foreign company income, the new guidelines aim to set the rules which state what income should be considered as controlled foreign company income. The parts four and five are concerned with computing the income and losses of CFC and the jurisdiction in which they should be handled under. The sixth part addresses the issues concerning the possibilities of double taxation and ways to prevent and eliminate the double taxation from happening in the international taxation (OECD, Executive summaries, 2015).

Action 4: Limiting Base Erosion Involving Investment Deduction and Other Financial Payments

The action number four aims in decreasing the amount of base erosion and profit shifting by trying to limit the possibilities of exploiting the system by using interest deductions and other financial payments. The problem is that companies may use financial payments that are economically equivalent to debt but follow different jurisdictional framework and therefore are able to avoid the legal guidelines on deductibility of debt. There are certain basic scenarios where the threat of base erosion and profit shifting may occur in this area. First is companies directing higher amount of third party debt to the countries with higher tax rates. One way for companies is also to generate interest benefits by using intragroup loans. To prevent such practices OECD uses so called fixed ratio rule in the BEPS action plan action 4 as a recommendation (OECD, Executive summaries, 2015).

Action 5: Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance

The action 5 will quite straightforwardly aim to tackle the negative effects of the harmful tax practices taking into account transparency and substance. One of the aims in this action is to make a plan to expand the recommendations that could also cover the non-OECD countries. Most likely the most influential part of the action 5 of the OECD BEPS action plan is the goal to increase the transparency. The transparency is closely linked to the other aim with the action which is to reach consensus on the approach in which preferential tax regimes are approached. The consensus approach should enable the taxpayer only to benefit from the intellectual property regime if the taxpayer incurred to the research and development which has created the value occurred by the intellectual property (OECD, Executive summaries, 2015).

Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

The action 6 in the OECD BEPS action plan is aiming towards preventing benefits from exploiting current treaties in inappropriate circumstances. The action plan identifies treaty abuse as one of the most important base erosion and profit shifting issues. The action 6 can be roughly split in three different sections of aim. First of which is to create treaty provisions and domestic jurisdiction in order to minimize the possibility to gain treaty benefits in inappropriate circumstances. Second aim is the clarification on the jurisdiction so that the tax treaties could not be used as a tool for gaining double non-taxation. Third are the guidelines for countries to be considered about identification of the tax treaties prior to implementing tax treaties with other countries (Ernst & Young, 2015). The action also states that countries should commit to minimizing the possibilities of treaty abuse and ensure that the common intention among the committed parties is to avoid enabling double taxation without creating possibilities for double non-taxation (OECD, Executive summaries, 2015).

Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status

The action 7 aims to review the current definition of the permanent establishment. In the current guidelines, the rules on permanent establishment jurisdiction state that the profits of a foreign company should only be taxed in the state where the company has permanent establishment. That makes it important to define the guidelines of defining rules of permanent establishment in order to more effectively guide the business profits of the foreign enterprise to more rightful direction. The action 7 also aims in cooperating with the changes recommended in the action 6 and to make both of these actions synchronized in order to more effectively prevent the base erosion and profit shifting threat happening by using these jurisdictions (OECD, Executive summaries, 2015).

Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation

Actions 8 to 10 of the OECD BEPS action plan concern the different aspects of transfer pricing outcomes and the value creation. These actions are likely to be among the most significant changes that whole OECD BEPS action plan is providing. Actions 8 to 10 are also likely to cause the most disputes in the international markets because of the possible interpretation and implementation differences in different countries as each national government is likely to implement the new guidelines in the way that is most beneficial for the economic structure in the country. Main change in these actions compared to the former OECD guidelines is that the tax income is supposed to be more effectively directed to the locations where the economic value creation leading to the profit is created. This is significant change to the former OECD guidelines which allowed implementing transfer pricing practices in such manner that it was possible to book profits in the locations where the economic activity creating the value did not actually occur. The actions 8 to 10 in the BEPS action plan concern the transfer pricing policies in the sales of both tangible and intangible goods (OECD, Executive summaries, 2015).

Action 11: Measuring and Monitoring BEPS

The action 11 of the OECD BEPS action plan describes the recommended guidelines for measuring and monitoring the potential base erosion and profit shifting related activities. More detailed methods to research the indicators of the BEPS related actions and the scale of base erosion and profit shifting in the international economy were needed because under the previous guidelines the real scale of the BEPS related actions was left unclear. It was important to discover new methods on measuring and monitoring BEPS as the negative effects of the BEPS activities are significant to the world economy. As the result for trying to solve these issues, the OECD published indicators that can be used to examine possible BEPS actions. The indicators state that possible BEPS related activity can be assumed on the occasions where the subsidiaries of the multinational companies located in low-tax countries are gaining remarkably higher profit margins than company’s average profit rate. Other indicator was the concentration of the foreign direct investment in certain locations. One important indicator is also the concentration of the debt to the locations with higher tax rates The profit rates of MNE affiliates located in lower-tax countries are higher than their group’s average worldwide profit rate (OECD, Executive summaries, 2015).

Action 12: Mandatory Disclosure Rules

The aims of the action 12 are somewhat similar to the ones described in the section discussing the action 11. The action 12 of the BEPS action plan aims to increase the transparency and reporting by multinationals in order to more effectively examine and discover the potential BEPS related actions. This action aims to provide the recommendations on the mandatory disclosure rules. This is done in order to easier supervise the abusive and aggressive transactions, arrangements or structures. The OECD states that the mandatory disclosure rules should be easily understandable and be able to balance the compliance costs with benefits obtained by the tax administration (OECD, Executive summaries, 2015).

Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting

The action 13 of the OECD BEPS action plan is aiming to increase the level of transparency in the taxation and the transfer pricing operations in the multinational companies. The action 13 states that multinational companies should increase their amount of reporting and the level of detail in the reports. From beginning of the year 2016, the multinationals should apply the country-by-country reporting as a part of their annual responsibility. The reporting should follow commonly shared template and include the local allocation of the income, economic activity and the share of the taxes paid individually in each of the country that multinationals are operating in. The report is done individually for the tax authorities in each country that the company have valid operations. It is still uncertain on what scale the multinational company should operate globally (turnover, profits, number of subsidiaries etc.). Most likely the smaller multinational companies will not be affected by this (OECD, Executive summaries, 2015).

Action 14: Making Dispute Resolution Mechanisms More Effective

It is predicted that such large scale changes in the taxation and transfer pricing that OECD BEPS action plan is likely to cause, the disputes between companies and also national governments are inevitable. The action 14 of the action plan concentrates on recommendations and guidelines in order to make dispute resolution mechanisms more effective. The action is aiming to remove the obstacles that might prevent national governments to solve the treaty disputes under the Mutual Agreement Procedure (MAP) (OECD, Executive summaries, 2015).

Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

The action 15 of the action plan aims to provide governments with current bilateral treaties the possibility to amend the bilateral treaties and to implement the measures that have been developed in order to aim towards multilateral instrument that could be able to work as a common jurisdictional framework making it easier for local governments to implement the guidelines in similar manner (OECD, Executive summaries, 2015).

2.1 The reflection on the Finnish economy – the past and the future

There are various reliable sources to research the situation and development of the Finnish economy. In this research main sources used in researching such issues are the official data from the Bank of Finland as well as Verohallinto (official Finnish tax authorities). The Bank of Finland will provide the up to date data of the current situation of the Finnish economy and the recent changes that it has overcame. Verohallinto is providing comprehensive amount of data on the taxation in Finland as well as their plans and expectations for the future concerning the new OECD BEPS project. Valtion-varainministerio (Ministry of Finance) is also discussing the same matters from the governments point of view, offering the reader the possibility to see what is being discussed in the parliament of the Finland at the moment concerning the finance related matters. Based on these sources and various articles from different Finnish economists predicting the possible outcomes of the BEPS project, the research should be able to reflect the ongoing change in the guidelines to the Finnish companies and the case study company in particular.

Traditionally the manufacturing industry has been the leading force for the Finnish economy. From the beginning of the time that Finland has been independent to the mid 1990's majority share of the economic growth was gained through manufacturing. Throughout the history the main areas in the manufacturing industry have been wood and paper industry and machinery industry. Between the 1925 and 2006 the Finnish manufacturing industry has been growing with the average rate of five percent annually. Regardless of Finland going through two recessions and the Second World War during that timeline, the average growth has been significantly higher than the global average. The Second World War may even have slightly increased the Finnish economy growth rate compared to majority of European countries as many of the central European countries were more involved in to the war than Finland and because of the existing strong wood industry, Finland was quickly able to start recovering its economy because large amounts of wood was needed throughout the Europe in order to start reconstruction after the war. Finnish economy has been usually able to recover from the various crisis situations more efficiently than the global average because of the existing strong manufacturing industry and strong export relationships to both the Europe and the Soviet Union as well as later on with Russia. Finland also had its own currency before joining the European Union and adapting the Euro as the currency.

Finland has devalued the currency at least once in a decade historically, usually leading to the increasing rate of recovery during the times of financial crisis or war.

During the 1990s there was a clear shift in the industry structure in Finland which has continued with increasing rate all the way until this day. The electronics and high technology manufacturing started to take place in the Finnish economy structure from the more traditional forms of manufacturing and the development still keeps shifting towards the more high technology manufacturing and intellectual property related industries such as product and program development. During the 21st century, the manufacturing industry growth rate has been decreasing because of the tendency of the Finnish economy to rely heavily in the exporting. Because of the high export rate, the changes in the world economy are able to radically impact on the Finnish economy as well. After joining the Euro zone Finland has had to come up with alternative ways to deal with decreasing growth rate and the effects which changes in the world economy are likely to bring because for example devaluing the currency cannot be used as a tool for increasing the growth rate anymore. Because of the reduced ways to cope with the economic shifts it is important that Finland would be able to more effectively secure the tax income from industries such as product development and program development in order to balance the possible shifts in the local economy. The OECD BEPS project is aiming towards more fair distribution of the taxes in the digital economy as well as trying to guide the tax income to the locations in where the value is created. The BEPS project is potentially able to bring substantial benefits to the economy which has similar industry structure with Finland. This research is aiming to see what kind of benefits or problems the BEPS action plan will bring to the Finnish companies and the case study company and will the results reflect the anticipated benefits that should in theory appear if the BEPS action plan would be executed correctly throughout the OECD countries as well as G20 countries (Stat.fi, 2007).

2.2 The most important BEPS actions – analyst predictions

In the following sections, some of the actions that analysts feel most influential for the Finnish economy will be discussed more in depth. Sources for this section consist mostly of the analyses from Finnish economic publications concentrating on the effects to Finland but also some from foreign publications that are concentrating more on the global scale effects of the action plan.

2.2.1 The digital economy and double taxation

Looking at the direction in which the Finnish economy has headed towards makes the Action 1 of the BEPS report highly relevant. Finnish economy traditionally has been heavily based upon manufacturing, agriculture and forest industry. These industries continued to dominate Finnish economy from the times when Finland gained the independence in the 1917. Nevertheless, now all of these industries are decreasing in the Finland with constantly increasing pace and from roughly mid 1990's on, the high technology and intellectual property related industries are more and more replacing the more traditional industries. As the Action 1 in the OECD BEPS action plan is addressing the problems with the taxation in digital economy, it will also greatly affect in Finnish economy as the industry structure has shifted towards that direction. The issues with the taxation of the digital economy have not been thoroughly discussed in the earlier guidelines provided by the OECD as the challenges relating to the digital economy taxation have only fairly recently been acknowledged and no real solutions to solve the problems have been available. The situation of the industry shifting more towards high technology and digital economy is similar in many developed countries and because of that the effects that possible untaxed or double taxed incomes might bring are fairly high to the world economy in general (Addressing the Tax Challenges of the Digital Economy, 2014).

The analyses and predictions from Finnish economists in the articles and researches used for the research seem to be quite negative towards the successful implementation of the OECD BEPS action plan. Vast majority of the articles from Finnish analysts state that they understand the potential benefits that the BEPS action plan is aiming towards but also say that it is most likely to cause numbers of disputes as well as potential harmful effects on Finnish economy. The articles state that Finnish companies should stay aware of the possible threats that might come along with the new action plan (Herrala, 2016).

One of the main threats for Finnish companies that authors recognize in numerous articles and researches is the threat of double taxation, which would be lethal for many companies if not solved appropriately in time. Authors believe that different governments inevitably will interpret the OECD BEPS action plan differently depending on the industrial and economical structure in the country. Disputes are likely to occur for example in situations where manufacturing is done in a country where the labour and production costs are lower but the product development and R&d is done in different country. The BEPS action plan states that the profits should be taxable wherever the value is created. In situation explained in the example countries may have very different views on how much value of the overall profit is created in which country. The country where the manufacturing is done with low production costs might feel that most of the value is created there because the low production costs enable the company to earn larger profits. The country with the R&D and product development on the other hand is most likely to state that these operations are the ones that create the vast majority of the profits and therefore taxation should be directed there. This kind of situation might lead to double taxation, meaning that the same overall profit is taxed in two different countries. The attitudes of the governments and their interpretations of the BEPS action plan might even lead to a situation where it is no more feasible for certain companies to operate in certain countries because of the disputes in taxation of the profits. In the worst situation this might lead to geographic structure relocation, which would be large expense for a company, or if that is not possible for a company, the possible double taxation would eventually drain the overall profit margins too low and cause bankruptcy (Herrala, 2016).

Other threats that authors recognize are the issues in digital economy. Before the OECD BEPS action plan was taken into action, the profits from online sales were taxed in the country where the company was based. Now that BEPS action plan has been taken into action, there is a threat that the situation might change on the digital economy and profits might be taxed, at least partially, in countries where the company might not even have operations. As Finland is heavily export driven relatively small economy, the financial consequences in the form of lost tax revenues might be considerable. On the other hand again, the foreign companies might have to pay taxes of their online sales in Finland, which would balance the financial tax related issues a little but as said, Finland is export driven economy and incomes in that way would not be sufficient to cover for the taxation losses caused by the new direction that OECD BEPS project is taking taxation in digital economy. After the breakthrough that Angry Birds managed to make in the global markets, Finnish gaming industry has started blooming. The majority of Finnish gaming industry sales is done through online sales and large portion of the sales are going to the markets abroad. It is still uncertain whether the Finnish game development companies have to pay the share of their taxes to the countries where their content is downloaded. The Finnish gaming companies naturally claim that majority of value is created in Finland because R&D and product development operations are located in Finland. Even though this sounds like a valid argument, the companies might have to adapt to the new guidelines and pay a share of their taxes abroad if it is interpreted that enough value is created abroad (Pasanen, 2016).

2.2.2 Leaning towards taxation where the value is created

Actions 8 to 10 describe the guidelines on how the taxation should happen in the location where the value is created. This might not have been the case when the previous guidelines were taking place. It is now more effectively described which kind of actions are value creating actions for a company and which measures should a company take in order to shift their transfer pricing policies more towards the guidelines set in the actions 8 to 10 in the OECD BEPS action plan. If supervised correctly OECD is hoping that these guidelines should be able to address the aggressive tax planning done by multinational enterprises and help to increase the amount of taxation on the profit where the value is actually created instead of cycling the profits through more tax favourable locations. It is estimated in the OECD report that 4-7% of all taxable profit is lost annually as the situation stands at the moment. The estimates vary greatly depending on the source but it can be said that the effect the phenomenon has in world economy is substantial. That is what makes the actions 8-10 of the OECD BEPS action plan basically a fundamental core and probably the most vital parts of the action plan. In Finland, there is still no sufficient data available on potential loss of the tax income but it is currently being researched. The estimates state that level of the tax income loss in Finland is likely to be slightly below the average in the world but predictions still estimate that the BEPS action plan should in theory increase the aggregate tax income slightly (Aligning transfer pricing outcomes with value creation, actions 8-10, 2015 final reports, 2015).

Especially in Finland, the effects of the BEPS action plan are hard to predict. As Finland is quite heavily innovation and technology driven industry, it is important that those value creating activities should be taxed in Finland. The action plan is aiming towards addressing such situations but as it is not still clear how the guidelines will be effectively interpreted and implemented, real effects on Finnish economy stay still unclear. Finnish tax authorities are currently working in order to make the operations such as product development and other creation of the intellectual property within multinational companies to stay as a taxable profit for the Finnish government. If such situation is achieved, it could potentially create substantial increase in the Finnish aggregate tax income (Sandelin, 2015).

Naturally every national government is willing to drive their own cause and because of that disputes on where the profits should be taxed are unavoidable. The scale of in which the disputes are likely to appear are still mostly only sophisticated guesses as the OECD BEPS action plan was only taken into action from beginning of the year 2016. The experts and analysts throughout the fields of research in economy seem quite certain that disputes on where the value is really created are bound to happen.

2.2.3 Country by country reporting and implementation of transfer pricing documentation – timeline and adaption

In the BEPS action plan, the *Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting* part of the action plan addresses the issues concerning country by country (CbC) reporting and implementation of transfer pricing documentation for the governments and multinational enterprises. The new BEPS action plan requires companies to increase the level of transparency for tax authorities by providing them with the necessary information on the transfer pricing and the country by country tax information. Increased level of transparency should enable the tax authorities to more accurately supervise the companies and hence decrease the risk of potential BEPS related activities. The annual country by country report requires multinational enterprises to give the local tax authorities information on their actions in each of the country that they are operating in separately. The Action 13 of the BEPS action plan also states that the participating countries are required to accept the rules regarding confidentiality and consistent use of the framework and to follow the guidelines provided in the action 13 while incorporating the guidelines according to local laws and requirements. Because of the geographical location and the major markets that Finnish multinationals are operating in makes this action of the action plan potentially problematic for Finnish MNEs (Nissinen, 2016).

The first CbC report from MNEs is expected after the beginning of the first fiscal year starting from 1. January 2016 as that is the date when the BEPS action plan is officially taken into action. The beginning of the fiscal year may vary from company to company so it is going to take time until the first CbC reports are collected from all the companies. All the companies should have their reports filed during the year 2018 at the latest. The first report should contain information of that same fiscal year and it has been agreed by the countries participating to the BEPS project that no historical data is required in the first report.

The Action 13 is one of the parts in the new OECD BEPS action plan that could potentially bring the most significant changes to the operations of the multinational companies in Finland. The guidelines defined in the Action 13 require the level of transparency that has not be needed from companies previously. This brings potentially two kinds of changes to the companies. Firstly, the companies that feel that they should not have anything to hide have to adapt to the new requirements and increase their level of reporting and transparency. Increasing those aspects might be difficult in a sense that different amount of measures may be required according to the level of requirements of local tax authorities as it may vary from country to county depending on interpretation of the guidelines in each country. There are also locations where the companies might feel that confidentiality is a problem even though they are reporting to tax authorities as aspects such corruption or even technology might become a problem. In such locations companies might try to make their data look acceptable to meet the requirements specified in the action plan but still make them done in a way that vital statistics are not easily interpreted even if the data were to end up in wrong hands. This is considered as a potential problem for Finnish MNEs as the corruption in Russia is still high and Russia is one of the most important markets for Finnish companies (Nissinen, 2016). Secondly, the companies that might currently be involved in BEPS related activities have to come up with the ways to make their data appear so that it seems like company is following the guidelines stated in the action plan. To avoid such activities, the effective interpretation of the data is needed as well as cooperation between countries. The increased burden in more detailed reporting also adds to companies' costs as it takes more time (Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report, 2015).

3 Methodology

The research is a qualitative research conducted in the form of case study. The methods used in the research consist of case study of a Finnish technology and manufacturing company and its collaboration with its UK subsidiary, as well as researching the current hypotheses and researches available on the subject and trying to reflect those in results gained from the case study. The case study company has international sales in tangible and intangible goods, meaning that both of the categories can be comprehensively studied in said company. The data for the case study is collected by interviewing the case study company. Interviews are done from the point of view of the Finnish parent company and interviewees consist of the top management of the company. The data of the case study company consists also of their strategic meetings with Ernst and Young and the information gathered from those meetings. The data gathered from the case study company is highly confidential by the nature. Because of that, the case study company is kept anonymous, as the strategic plans that company is implementing should not be identifiable. Anonymity of the case study company ensures reliable research data as there is no threat of competitors gaining unfair advantage by seeing confidential information on the transfer pricing policies of the company and the actions it has taken after the introduction of the BEPS action plan. Even though the UK subsidiary is the only location mentioned by name, the operations between the parent company and other subsidiaries as well are largely similar, with some exceptions that have been mentioned individually. Because of that the results of the case study company can be generalized to also be true on the majority of the other subsidiaries that the case study company has.

To maximize the reliability of the data, an optional situation would be to conduct a case study of all the Finnish multinational companies but naturally that is not possible because of the time and practical reasons. This specific company is chosen for the case study purposes because the company has operations across the Europe and Asia and the goods they are producing consist of tangible goods and intellectual property. The case study company is also accessible for author because of connections to the company management. The problem with the one company case study approach in the research arises from the fact that the results of the research cannot necessarily be generalised to reflect the situation the situation in the industry as a whole. In this type of research generalisation is not even considered as desirable. The results only represent the company being researched in the case study but as this kind of research is not comprehensively conducted earlier, the results serve as guidelines to use as a basis in order to form more educated hypotheses of the other companies and the field as a whole. The results got from the Finnish case study company are then reflected to researches from various sources on the predicted effects in the economy in general and specially in Finnish companies. The research is aiming to see whether the researches trying to predict the effects of the BEPS action plan reflect the actual situation in the case study company.

4 Presentation and discussion of findings

In this section, the case study company will be briefly described. Also the actual impact that the OECD BEPS action plan has had on the case study company will be discussed and the changes that it has gone through because of the BEPS action plan will be described.

The case study company is a Finnish medium sized multinational company with the revenue of approximately 20 million euros. The company is operating in the field of manufacturing and electrical engineering. It has several subsidiaries across the Europe and Asia but in order to secure the anonymity of the case study company, the examples described in this research concentrate only in transfer pricing and other issues between the UK subsidiary and Finnish parent company. The portion of the revenue that is collected annually through transfer pricing payments is approximately 4 to 5 million euros. In the following part, the transfer pricing model that the case study company had earlier will be described and then the changes that it had to implement as a result of the OECD BEPS action plan will be shown.

4.1 The situation before the OECD BEPS action plan

The description of the situation before the BEPS action plan shows how the company conducted business with the UK subsidiary. The description states how the relationship between the 3rd party manufacturer of the goods and the both parent company and UK subsidiary is set. It also shows how the rights of the intellectual property are handled and states the transfer pricing policy of the company.

The case study company has developed and maintained the supply chain of the business including framework contracts with the suppliers and 3rd party contract manufacturers. The case study company has also designed the products, being in charge of the Research & Development. Majority of the R&D is currently focused on software (“SW”) in connection to the products.

3rd party manufacturer manufactures the hardware (“HW”) part of the products, based on instructions of the parent company. The parent company provides the manufacturer also with the SW programs that it has developed, so that at the end of the HW production the manufacturer may install the SW to the end product (i.e. software is embedded to the product). The software is provided to the manufacturers via email and the personnel of the manufacturer install the software. There are no transactions between the parent company and the manufacturer regarding the SW; the ownership of the SW does not shift to the 3rd party manufacturer. The manufacturer is merely installing the SW to the products on behalf of the parent company. The products are then either sold directly to subsidiaries or to the parent company who then sells them onwards to the local subsidiaries.

In the current transfer pricing model the parent company has not charged the UK subsidiary regarding the SW that is embedded to the products. The UK subsidiary has only been charged the direct HW production costs. Nevertheless, the SW is essential for the products and represents a significant part of their total value to the end customers. Because of that, the purchase price (cost of goods sold) of the products has been low for the UK subsidiary, but they have invoiced the end customers the total price of the products (attributable to both HW and SW). This has resulted in high gross margins in the UK subsidiary, which has been involved in buy/sell distribution and limited risk local services as franchisee.

Taking into account the functional profile of the UK subsidiary, they should be considered as limited risk distributors / franchisees, whose profitability levels have been analysed with Transactional Net Margin Method (TNMM) resulting in modest but stable operating margin. So far there has not been any intercompany fees in relation to the SW, so the high gross margins realized by the UK subsidiary has been leading also to need for significant franchise fees.

4.2 The situation after the OECD BEPS action plan and the changes in the company operations

In the current model, the parent company provides the 3rd party manufacturers with software programs, so that at the end of the hardware production, the manufacturers may install the software to the end product. The software is provided to the manufacturers via email and the personnel of the manufacturer install the software. However, the ownership of the software does not shift to the manufacturers. The manufacturers merely install the software to the products on behalf of the parent company. The products are then either sold directly to subsidiaries or to the parent company who then sells them onwards to the local subsidiaries. The subsidiaries are only charged for the direct hardware production costs.

In the new model, the parent company will separately invoice the local subsidiaries for the software installed to the products. From VAT point of view, the B2B supplies of software by the parent company would be regarded as supplies falling under the general place of supply rule of Article 44 of the VAT Directive (see appendix 1)**.** According to the general place of supply rule, the software is subject to VAT in the country where the purchaser is established or has a fixed establishment for VAT purposes, if the services are provided to a fixed establishment of the purchaser.

The local subsidiaries do not have fixed establishments for VAT purposes in other countries, according to the general rule; the place of supply is the country where the local subsidiaries are established. Consequently, from the parent company's point of view, reverse charge is applicable to the software charges and the parent company should issue the invoices to the local subsidiaries without VAT. The subsidiaries should account for reverse charge VAT in their own countries. In some cases it may be open to interpretations to whom the software is rendered. However, in this case, the manufacturer is merely installing the software to the products on behalf of the parent company; therefore the software would be rendered to the local subsidiaries and not to the manufacturer.

In the new model, the operating margin of the local subsidiaries shall not change, but the transfer pricing mechanism would include the intercompany SW charge, which would be treated as business income, in addition to the franchise fee, which would be treated as a royalty. In addition, in the case where the parent company sells also the hardware to its affiliates, the intercompany product price shall include both hardware and software items.

4.3 Impact on the case study company

When the BEPS action plan took place, the contracts needed to be re-evaluated. The transfer pricing policies needed to be changed according to new BEPS action plan guidelines even though the UK subsidiary was making high profit. The BEPS action plan states that the profits should be taxed in the location where the value is created. Because of these changes in the BEPS guidelines, the contract was renewed so that subsidiary has to pay for software and licensing as well. These kinds of adjustments lead to the decreasing amount of royalty payments received by the parent company. In current form the contract should better suit the BEPS action plan and more efficiently guide the profits to where the value is created.

The changes in the contract do not bring remarkable change to the operations and taxation in the UK subsidiary, but the case study company has also subsidiaries in other locations and some of these subsidiaries have operations that create remarkable value in the location they are operating. The profit percentages in the contracts with such locations have had to be adjusted accordingly with the amount of the value enhancing operations they have in order to meet the requirements of the BEPS action plan. The amounts that subsidiaries are set to make profit by the contracts are increased in the locations where there are great amount of value increasing operations.

The case study company in this research seems to be very little effected by the new OECD BEPS guidelines as they are relatively small multinational in the global scale with the revenue of around 20 million euros. Most significant changes in the operations of the case study company seem to be in the OECD BEPS action plan action that is discussing the taxation in digital economy. Also as seen in the changes that has been described earlier that case study company had to go through, also the guideline on the taxation to be happening in the location where the value is created, seems to have had an impact on the operations of the case study company. The company has had several meetings with experts from Ernst and Young regarding the effects of the BEPS action plan to the company. It currently seems like that the annual country by country reporting is not required from companies that are operating in the scale that the case study company currently is. The company will continue with their current level of reporting and transparency but are prepared to increase the level of transparency if the situation changes because of the vast increase in the revenues or scale of operations or the OECD BEPS guidelines would require also smaller scale multinational enterprises to implement same level of transparency and country by country reporting as larger companies.

Based on the articles that the Finnish analyst had written on the potential impacts of the OECD BEPS action plan on the Finnish companies the results from the case study research were relatively surprising. The BEPS action plan did have an impact on the case study company and it had to slightly change the way that it is operating in terms of transfer pricing. Nevertheless, the impact was significantly smaller than anticipated. The action 1 of the BEPS action plan had the largest impact on the company as it was basically the only one of the actions that forced the company to change the way they were operating. Nevertheless, as stated earlier in the Presentation of the findings part of the research, even action 1 did not create significant changes to the ways company is operating. The company managed to deal with the recommendations regarding the intellectual property sales by changing the contract structure. In the end, the profit margins of the companies did not remarkably change.

Another action that was anticipated to have an impact on the company was actions 8 to 10. This was one of the main concerns regarding to Finnish multinational companies and national government in the articles and texts from the Finnish business analysts. In this research, actions 8 to 10 did not seem to have the effect that would be of the scale anticipated by the different authors. These actions from the BEPS action plan did have an impact on the company's way to assessing the profit margins for the subsidiaries, but not in the scale that the authors expected. Also the impacts related to the actions 8 to 10 did not occur on the UK subsidiary but the other subsidiaries with more value creating operations.

The author of the research expected the action 13 to be applicable to the case study company but as the results are showing, the meetings with taxation consultants from the Ernst & Young confirmed that the case study company is not operating in the scale that would make the requirement for country by country reporting compulsory. Conclusion of what kind of impact action 13 of the OECD BEPS action plan could have in other Finnish multinationals cannot be drawn from this report as it is still case sensitive and unclear on what sized companies the country by country reporting will be applicable.

5 Conclusion

As a basis for the study the author of the research started the work by gathering information of the OECD BEPS related literature, the main focus being on the OECD official BEPS reports. The BEPS reports offer a comprehensive information package on the base erosion and profit shifting related issues and recommendations and guidelines that are directed to prevent such problems. After that the literature review concentrated on the predicted impacts of the BEPS action plan from various academic authors. It was surprisingly difficult to find contradicting views on the potential impacts of the BEPS action plan from the Finnish authors. The common attitude towards the action plan was largely negative. There was much more diverse literature available from foreign authors but that could not necessarily be straightforwardly used to predict the impacts in Finland as the economic situation and structure in any specific will effect on how the BEPS action plan will impact in any particular country.

The case study was conducted by gathering the information through electronic channel interviews and by visiting Finland for a face to face interview with the operational manager of the case study company. The case study company was pleasant to work with and the gathering of the information was effective. The author of the research acknowledges the possibility of certain companies having intentions on not releasing sensitive information to the public being concerned about the competitive advantage that competitors may get if they were to get to that information. The anonymity of the research contributed to the reliability of the information as there is no possibility for competitors to gain any advantage as it cannot be interpreted what company the research is studying.

Overall, the results from the case study were somewhat surprising and were not in line with all the predictions from different Finnish authors. That does not mean that the predictions stated in different academic articles addressing the threats or possibilities that the OECD BEPS action plan might bring to the Finnish multinational enterprises and to the Finnish economy are wrong. The articles are most likely written to address larger Finnish multinationals such as KONE or Stora Enso which have enormously larger impact on the Finnish economy than the case study company has. Nevertheless, some conclusions can be drawn from this research. The impacts of the OECD BEPS action plan are likely to be similar on the similar sized companies. The author of the article does not believe that the industry the company is operating on would change the results considerably different from ones gained in this research as the case study company's operations include sales in both tangible goods and intellectual property, hence this research can be used as a basis to draw conclusions on the possible impacts for the similar sized company than the case study company or as a basis for further research on the subject.

For the further research purposes this research may be used as a part of a case study sample in a broader scale research as the author of the research does not necessarily find it beneficial to conduct similar studies on the subject. The research could also be used in order to monitor the possible changes in how the OECD BEPS action plan is developing and how the impact on similar kind of companies than the case study company is changing.

References

Addressing the Tax Challenges of the Digital Economy. (2014). OECD Publications Centre.

Aligning transfer pricing outcomes with value creation, actions 8-10, 2015 final reports. (2015). Paris: OECD Publishing.

Countering harmful tax practices more effectively, taking into account transparency and substance, action 5-2015 final report. (n.d.). .

Designing effective controlled foreign company rules, action 3, 2015 final report. (2015). Paris: OECD Publishing.

Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report. (2015). .

Eur-lex.europa.eu. (2016). *EUR-Lex - 32006L0112 - EN - EUR-Lex*. [online] Available at: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32006L0112 [Accessed 1 Jun. 2016].

Ey.com. (2016). *OECD issues implementation guidelines for country-by-country reporting under BEPS Action 13*. [online] Available at: http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--OECD-issues-implementation-guidelines-for-country-by-country-reporting-under-BEPS-Action-13 [Accessed 1 May 2016].

Herrala, O. (2016). [online] Kauppalehti.fi. Available at: http://www.kauppalehti.fi/uutiset/beps-projekti-paisuttaa-raportointia-ja-karjistaa-riitoja/d4PnYFJ9 [Accessed 9 April 2016].

Limiting base erosion involving interest deductions and other financial payments, action 4, 2015 final report. (2015). Paris: OECD Publishing.

Making Dispute Resolution Mechanisms More Effective, Action 14 - 2015 Final Report. (2015). .

Mandatory disclosure rules, action 12, 2015 final report. (2015). Paris: OECD Publishing.

Measuring and monitoring BEPS, action 11, 2015 final reports. (2015). Paris: OECD Publishing.

Nationaldebtclock.co.uk. (2016). *The United Kingdom National Debt Clock 2016 Counter >> nationaldebtclock.co.uk*. [online] Available at: http://Nationaldebtclock.co.uk [Accessed 1 April 2016].

Neutralising the effects of hybrid mismatch arrangements, action 2-2015 final report. (n.d.). .

Nissinen, M. (2016). *BEPS | OIKEUTTA KOHTUUDELLA – THE BLOG OF UEF LAW SCHOOL*. [online] Blogs.uef.fi. Available at: https://blogs.uef.fi/oikeuttakohtuudella/tag/beps/ [Accessed 19 April 2016].

OECD, Executive summaries, (2015). 1st ed. [ebook] OECD Publishing. Available at: https://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf [Accessed 12 April 2016].

OECD, Final Reports, (2016). *BEPS 2015 Final Reports - OECD*. [online] Oecd.org. Available at: http://www.oecd.org/ctp/beps-2015-final-reports.htm [Accessed 12 April 2016].

Oecd.org. (2016). *Convention on Mutual Administrative Assistance in Tax Matters - OECD*. [online] Available at: https://www.oecd.org/ctp/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm [Accessed 1 May 2016].

Oecd.org. (2016). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations - OECD*. [online] Available at: http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm [Accessed 1 May 2016].

Pasanen, V. (2016). *Virpi Pasanen bloggaa: Onko BEPS-hanke vaara Suomen verotuotoille? - Elinkeinoelämän keskusliitto*. [online] Elinkeinoelämän keskusliitto. Available at: http://ek.fi/ajankohtaista/uutiset/2015/10/07/virpi-pasanen-bloggaa-onko-beps-hanke-vaara-suomen-verotuotoille/ [Accessed 19 April 2016].

Preventing the artificial avoidance of permanent establishment status, action 7, 2015 final report. (2015). Paris: OECD Publishing.

Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. (n.d.). Paris: Organization for Economic Cooperation & Development.

Sandelin, E. (2015). *BEPS – häntä alkaa heiluttaa koiraa*. [online] Suunta kasvuun ja kannattavuuteen. Available at: https://suuntakasvuun.kpmg.fi/2015/10/28/beps-hanta-alkaa-heiluttaa-koiraa/ [Accessed 9 May 2016].

Shaxson, N. (2011). *Treasure islands*. New York City: Palgrave Macmillan.

Stat.fi. (2016). *Tilastokeskus - Suomen teollisuustuotannon kasvunvuodet*. [online] Available at: http://www.stat.fi/tup/suomi90/toukokuu.html [Accessed 1 May 2016].

Tax Justice Network. (2016). *Transfer Pricing - Tax Justice Network*. [online] Available at: http://www.taxjustice.net/topics/corporate-tax/transfer-pricing/ [Accessed 1 May 2016].

Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report. (2015). OECD.

Appendix

Appendix 1

Supply of services by intermediaries

Article 44

The place of supply of services by an intermediary acting in the name and on behalf of another person, other than those referred to in Articles 50 and 54 and in Article 56(1), shall be the place where the underlying transaction is supplied in accordance with this Directive.

However, where the customer of the services supplied by the intermediary is identified for VAT purposes in a Member State other than that within the territory of which that transaction is carried out, the place of the supply of services by the intermediary shall be deemed to be within the territory of the Member State which issued the customer with the VAT identification number under which the service was rendered to him.

(Eur-lex.europa.eu, 2016)