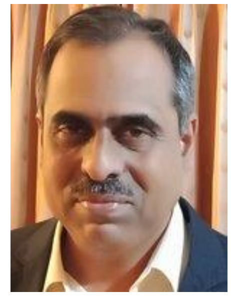
How OECD Transfer Tax Initiative Affects Smaller Businesses

By **Ganesh Ramaswamy** (December 6, 2021)



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The Organization for Economic Cooperation and Development's base erosion and profit shifting initiative, known as BEPS 2.0, aims to ensure a fairer distribution of taxing rights with respect to profits of large multinational enterprises, or MNEs, and to set a global minimum tax rate that countries have to implement. The initiative is expected to have a far-reaching impact on tax-friendly jurisdictions and MNEs.

The BEPS 2.0 package consists of two parts, commonly referred to as Pillar One and Pillar Two. Pillar One is focused on profit allocation and nexus whereas Pillar Two focuses on global minimum tax. The aim of this move is to stabilize the international tax system and bring about tax certainty for taxpayers and tax administrators.

The BEPS 2.0 guidelines are primarily aimed at MNEs and have been designed to minimize the impact on small and midsize multinational enterprises, or SMEs.

The guidelines are unlikely to affect the SMEs or their owners, as the operations generally carried out by SMEs are too small, in comparison with the large enterprises for which the guidelines were designed.

However, for those SMEs that act as contract manufacturers or service providers for large businesses, those with cross-border dealings with large businesses, and those that are subsidiary companies of large businesses, there will certainly be an impact.

The implementation of the BEPS 2.0 guidelines provides both opportunities and challenges for SMEs. On the one hand, SMEs look at the nonapplicability of BEPS 2.0 to them as a great advantage they have over MNEs that could be their competitors. On the other hand, most countries will build the BEPS 2.0 guidelines into their national tax legislation, and it will affect all businesses, both small and big, that are engaged in cross-border activities.

BEPS 2.0, when implemented in jurisdictions where the current rate of effective corporate tax is less than 15%, will force SMEs to evaluate many operational aspects of their current business model, be it supply chain, inventory policies, sales, research and development, or intellectual property.

SMEs will have to evaluate their operational structures and processes from a business and tax perspective. They will have to quickly and effectively redefine their business and tax models, and eliminate current inefficiencies to establish an operating model best suited to the new environment.

SMEs that have cross-border sales and services may need to adjust their sales and service models. Most of the relevant tax jurisdictions have made new rules for permanent establishments in those jurisdictions, which has come out of the modification of the definition of a permanent establishment under OECD BEPS Action 7.

Affecting changes to the permanent establishment definition results in multilateral instruments that incorporate BEPS measures in bilateral treaties, amending the bilateral tax treaties. In some situations, the result has been to make employees, agents or warehousing operations in a particular jurisdiction liable for paying corporate tax. SMEs now have to explore ways of understanding the tax laws of such tax jurisdictions, and ensuring that they do not get into tax entanglements.

Once SMEs are subjected to tax in a particular jurisdiction, they also become responsible for tax compliance and possible payroll tax, value-added tax or goods and services tax outgoings, and social security contributions. Therefore, it is very important that SMEs focus on setting up fully compliant, tax-efficient international-sales policies, as well as supply chain and mobility policies, so that they can optimize their tax and VAT or GST outgoings.

Next, with the implementation of the BEPS 2.0 model, SMEs may have to comply with input reporting requirements and provide tax authorities with enormous data pertaining to their businesses. Apart from the cost involved in providing this data to the regulators, SMEs may also have to publicize confidential information about their businesses and their transactions with related parties.

Lastly, per the newly implemented rules in many tax jurisdictions, there has been a paradigm shift in the methods used to recognize profits from holding IP. In earlier years, the profits from IP were based on formal legal ownership of risk and capital.

Action 8 of the OECD's BEPS initiative provides guidance on valuation of IP by aligning IP ownership with value added services. It suggests that high-value services offered by senior executives to the development of the IP should also be considered for purposes of IP valuation.

With implementation of the BEPS 2.0 model, now is a good time for small and midsize businesses to reflect on their tax-governance frameworks and tax controls, and consider whether their current framework is robust enough for the current climate. SMEs should review whether their existing tax frameworks, to the extent these exist, are integrated with their business strategies.

SMEs may be missing opportunities or creating risks by inadvertently excluding tax considerations from their business strategy and decision-making processes. Small and midsize businesses will therefore have to formulate, establish and document tax policies and deploy them consistently around the world in their global dealings.

They will have to do the same in their tax filings and discussions with tax authorities. This is because tax authorities around the world are sharing a lot of information about taxpayers among themselves. If SMEs enter into settlements or agreements with tax authorities in one jurisdiction, the same becomes known to tax authorities in other jurisdictions.

A tax settlement is an arrangement that is acceptable to the taxing authorities, and that allows a taxpayer to retire an outstanding additional tax debt. Taxation authorities sometimes allow this type of tax settlement when extenuating circumstances exist that would prevent the taxpayer from honoring the full debt. SMEs will have to ensure that they do not get into similar tax liability situations in other jurisdictions, which could be expensive for them.

There is no doubt that BEPS 2.0, when implemented around the world, throws up challenges for SMEs. SMEs will have to focus on establishing synergies between their business functions, developing coordinated tax policies, and converting these challenges into opportunities.

SMEs may look at tax benefits arising from expansion or new product launches that may result in net operating losses, which can be used as a shelter on taxes payable on other profitable businesses. Similarly, investment into capital assets may bring in more depreciation benefits, which will reduce taxes and at the same time increase the value of the business.

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