

BEPS 1.0 and 2.0 – Key Transfer Pricing Implications for MNEs

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Background

Sahil specializes in the field of Transfer Pricing and has around 16+ years of rich experience spanning across 2 Big 4 firms in India and most recently, with a reputed mid-tier firm in Singapore. His expertise is spread across various domains like compliance, advisory and litigation with a significant length, breadth, and depth covering all kinds of Transfer Pricing assignments and projects.

He is a commerce and a law graduate with a post-graduate diploma in management (finance and marketing).

Sahil has been assisting various clients in developing appropriate inter-company Transfer Pricing policies, undertaking detailed diagnostic reviews of existing transactions and business models, highlighting the potential red flags and suggesting the appropriate arm's length prices while conducting robust economic analyses for intercompany services, manufacturing, distribution, loan benchmarks, royalty fee, license fee, trademark fee etc.

He has also assisted clients in terms of Transfer Pricing compliance (documentation and planning assignments) and advisory assignments in accordance with the 3-tiered documentation rules as per OECD's BEPS Action Plan 13 and other Action Plans as well. He has also assisted many clients on Transfer Pricing aspects related to Advance Pricing Agreements, Permanent Establishment attribution issues etc.

Sahil has significant Transfer Pricing experience across various industries namely, Information Technology, Telecommunications, Automobiles, Consumer Business, EPC, Real Estate, online professional services, Pharmaceuticals/Healthcare, Banking etc.

He has also been actively involved in various Transfer Pricing webinars and seminars as one of the contributing speakers and has also drafted various technical articles on different topics related to Transfer Pricing. He was recently featured in one of the leading Global magazines as a top Transfer Pricing expert.

Agenda

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OECD's BEPS 1.0 program – Background

Definition - BEPS stands for Base Erosion and Profit Shifting. Generally, these are tax planning strategies adopted by Multi-National Enterprises (MNEs) that exploit gaps and mismatches in tax rules to artificially shift profits to locations with no/low tax rates and no/little economic activity or to erode tax bases through deductible payments such as interest or royalties.

Objective of the program - To address potential tax avoidance or tax leakage strategies adopted by MNEs

How it works – BEPS program assists governments with rules and guidelines, helping them to ensure that profits are taxed where economic activities are taking place and where value is created

OECD's BEPS 1.0 program – How it all began

Why was BEPS 1.0 needed

- When designing domestic tax rules, every country may not consider the effect of other countries' rules
- Gaps in the interaction of different tax systems can lead to income from cross-border activities may go untaxed or be lowly taxed*
- Spread of the digital economy also posed challenge for international taxation

What was required

- A concrete action plan to address BEPS issues in a coordinated and comprehensive manner
- New international taxation standards must be designed to ensure the coherence of corporate income taxation at the international level

What finally came

- 15 Action Plans introduced by the OECD in 2013
- Objective – To tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment

**Key statistics - OECD's 2013 work on potential impact of BEPS indicated that Global CIT revenue losses could be between USD 100 to 240 billion annually*

OECD's BEPS 1.0 program – Action Plans 1 to 2

- **Action 1 – Tax Challenges Arising from Digitalisation** – Deals with large range of tax challenges arising from the digitalization of the economy to develop a consensus-based solution
- **Key issues covered –**
 - Identification of broader tax challenges posed by digital business models, such as those involving user data, remote services, and intangible assets
 - Evaluating probable options for taxing digital activities more effectively, like having in place, nexus rules based on significant digital presence and exploring the potential application of profit allocation methods that reflect value creation in digital environments
 - Potential withholding tax implications for digital transactions and exploring other issues like VAT/GST collection on cross-border digital services
- **Action 2 – Neutralizing the effects of hybrid mismatch arrangements** – Deals with the prevention of use of hybrid mismatch arrangements and at the same time, trying to minimize impact on cross-border trade and investment
- **Key issues covered –**
 - Recommending specific improvements to achieve a better alignment between domestic laws and their intended tax policy outcomes and the introduction of linking rules that neutralise the mismatch in tax outcomes under a hybrid mismatch arrangement without disturbing any of the other tax, commercial or regulatory consequences
 - Suggesting measures at ensuring that hybrid instruments and entities (including dual resident entities), are not being used to obtain unduly benefits of tax treaties

OECD's BEPS 1.0 program – Action Plans 3 to 5

- **Action 3 – Controlled Foreign Company** – Deals with rules/measures for reducing the incentive of taxpayers to shift income from host or high tax jurisdictions into low tax jurisdictions
- **Key issues covered –**
 - Setting out recommendations in the form of 6 building blocks to ensure that jurisdictions implementing them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries

- **Action 4 – Limitation on interest deductions** – Establishing rules that link an entity's net interest deductions to its level of economic activity within the jurisdiction
- **Key issues covered –**
 - Recommending approaches primarily based on certain ratio rules to limit an entity's net deductions for interest and payments economically equivalent to a percentage of its EBITDA and similar other rules

- **Action 5 – Harmful tax practices** - Countering harmful tax practices with a focus on improving transparency
- **Key issues covered –**
 - Recommending a “nexus” approach in order to realign taxation of profits with the substantial activities that generate them

OECD's BEPS 1.0 program – Action Plans 6 to 10

- **Action 6 – Prevention of tax treaty abuse** – Developing model tax treaty provisions and recommendations to prevent treaty abuse
- **Key issues covered** –
 - Recommending strategies that provide safeguards against the abuse of treaty provisions or avoid treaty shopping

- **Action 7 – Permanent Establishment Status** – Preventing artificial avoidance of Permanent Establishment (PE) status in tax treaties through commissionaire structures and more
- **Key issues covered** –
 - Recommending strategies for purported avoidance of PE status through putting in place, commissionaire arrangements or through the specific exceptions of the modified article 5(4) to ensure that each of the exceptions is restricted to activities that are otherwise of a “preparatory or auxiliary” character or other strategies

- **Action 8 to 10 – Aligning Transfer Pricing Outcomes with Value Creation**
- **Key issues covered** –
 - Detailed guidance on the application of arm's length principle along with additional guidance on commodity transactions, profit split method, intangibles etc

OECD's BEPS 1.0 program – Action Plans 11 to 13

- **Action 11 – BEPS data analysis** – Collecting and analyzing data on the economic and fiscal effects of tax avoidance behaviors and on the impact of measures proposed under the BEPS project
- **Key issues covered –**
 - Assessment of existing data sources relevant for BEPS analysis, highlighting the indicators of BEPS, guidance on measuring the scale and economic impact of BEPS and countermeasures etc.
- **Action 12 – Mandatory Disclosure Rules** – Requiring taxpayers and advisors to disclose aggressive tax planning arrangements to tax authorities
- **Key issues covered –**
 - Suggesting the design principles and key objectives of a mandatory disclosure regime or rule, what are the options for such a rule, guidance on international tax schemes and information sharing etc
- **Action 13 – Transfer Pricing Documentation and Country-by-Country Reporting**
- **Key issues covered –**
 - Detailed guidance on the 3-tiered approach to Transfer Pricing Documentation, the relevant provisions, the objectives of preparing and maintaining the same and what are the potential advantages

OECD's BEPS 1.0 program – Action Plans 14 to 15

- **Action 14 – Mutual Agreement Procedure (“MAP”)** – Making dispute resolution between jurisdictions more timely, effective and efficient
- **Key issues covered –**
 - Sharing of best practices and procedures on MAP for making such dispute resolution mechanisms more effective
- **Action 15 – Multilateral Instrument (“MLI”)** – Implementing the tax treaty-related BEPS recommendations to address vulnerabilities in existing tax treaties
- **Key issues covered –**
 - Explaining the concept of MLI, the potential benefits of developing the same and how the same will assist in the swift implementation of BEPS measures

In a nutshell, these 15 Action Plans are primarily guiding tools/instruments for member countries to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. Such Action Plans can also assist member countries to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment.

OECD's BEPS 1.0 program – Potential implications, achievements and key takeaways for MNEs

Potential implications

- Tightening of screws and loopholes under the local tax and transfer pricing rules by tax authorities to ensure enhanced and greater compliance obligations and reporting disclosures
- Increased focus on preparation and maintenance/submission of correct transfer pricing compliance documents by companies to identify inconsistencies within the Group, identify any potential red flags like consistent loss makers, inappropriate policies or business models/structures etc
- Great scrutiny and investigations of related party transactions (cross-border and domestic), specifically, financial transactions/arrangements, management fees/intra-group services and transfer of intangibles
- Emphasis on accurate delineation of each group entity's business activities and related party transactions to ensure consistency in terms of policies and associated remunerations and above all, to identify incorrect business models
- Significant amendments and updation of existing tax policies and frameworks by OECD member countries and especially, developing countries to address key issues like **hybrid mismatch arrangements**, **permanent establishment**, **interest deductions** and most importantly, **transfer pricing provisions and guidelines** with a focus on “substance over form”

OECD's BEPS 1.0 program – Potential implications, achievements and key takeaways for MNEs

Major achievements

- All OECD and G20 countries committed themselves to consistent implementation in the areas of preventing treaty shopping, Country-by-Country Reporting, fighting harmful tax practices and improving dispute resolution by updating and amending their respective tax and TP laws wherein, focus was again on “substance over form”
- Many countries accepted OECD's approach pertaining to either denial of deductions or the recognition of income to tackle the issues pertaining to hybrid mismatch arrangements which was a key achievement
- Limitations on interest deductibility also helped in curbing profit shifting and reducing debt-equity bias to a certain limited extent
- Action 5 was also useful in striving to achieve transparency in the tax framework for many jurisdictions by leading to a detailed review and overhaul of preferential tax regimes, again to a certain extent
- Moreover, Actions 8 to 10 and 13 helped in ensuring that taxpayers are meeting the 3-tiered transfer pricing (TP) compliance requirements within the prescribed framework as per their local laws to the maximum extent, to avoid statutory penalties and potential audits and litigation

OECD's BEPS 1.0 program – Potential implications, achievements and key takeaways for MNEs

Key takeaways

- **Value Chain Analysis (VCA)** - Companies, irrespective of their sizes, volumes or nature of business operations, must firstly undertake a VCA to accurately delineate each entity's activities/functions and map them properly in the Group value chain for a proper and consistent characterization/classification of similar Group entities (like, limited risk distributor, contract manufacturer, captive service provider etc)
- **Group level tax and TP policy document** – Secondly, companies must also prepare a Group level document capturing details of each entity's activities, VCA results, tax and TP framework rules and regulations applicable in each jurisdiction and summary of DTAs/Tax Treaties for each jurisdiction in which the Group operates into. This will immensely help in identifying any incorrect or inappropriate tax arrangements, low or nil tax jurisdictions, potential PEs and any harmful tax practices
- **Local entity level TP compliance documents** – Based on the above 2 key analyses, each local entity must ensure prepare the necessary TP compliance documents like TP documentation, TP disclosure forms, TP notification forms and finally, TP intercompany agreements
- **Operational Tax and TP** – Lastly, companies must also strive to implement Operational tax and TP in their MIS or data infrastructures. This is the effective and efficient management of information, data and processes using technology to ensure the consistency and efficiency of tax and TP policies across the entire Group while ensuring cost efficacy and savings, effective risk management and better process control mechanisms

OECD's BEPS 2.0 program – How it all began

Why was BEPS 2.0 needed

- BEPS 1.0 program did assist in changing the international tax landscape and improving the fairness of tax systems
- However, there were some key outstanding BEPS issues (like addressing the tax challenges arising from the digitalisation of the economy) that remained unresolved.
- This primarily led to the emergence of BEPS 2.0

What was required

- An additional comprehensive international tax program to address unresolved issues pertaining to:
 - ✓ Reallocation of a portion of the profits of large MNEs;
 - ✓ Preventing the proliferation of Digital Service Taxes (DSTs) and related measures;
 - ✓ Avoiding double taxation and excessive compliance burdens, enhance stability and certainty; and
 - ✓ Ensuring that MNEs pay a minimum level of tax in each operating jurisdiction

What finally came

- In 2021, the OECD/G20 Inclusive Framework Two-Pillar Solution was issued and thereafter, detailed rules followed up especially for Pillar Two

OECD's BEPS 2.0 program – Pillar One

- **Pillar One** aims to ensure a fairer distribution of profits and taxing rights among countries. Its key elements include Amount A and Amount B.

- ✓ **Amount A** - The scope of the taxing right under Pillar One would apply to MNE Groups with consolidated Group revenues of EUR 20 billion or more and profitability above 10% and applies to 25% of the profit in excess of 10% of revenues.

The revenue threshold will be lowered to EUR 10 billion after 7 years, conditional on the successful implementation of Amount A. Targeted exclusions apply to enterprises in the extractives, regulated financial services and defence sectors.

- ✓ **Amount B** - Amount B provides for a simplified and streamlined approach to the application of the arm's length principle to in-country baseline marketing and distribution activities (subject to meeting the prescribed conditions), with a particular focus on the needs of low-capacity countries, as they lack appropriate local market comparables. It is expected to reduce disputes, enhance tax certainty, and promote more efficient utilisation of resources for both taxpayers and tax administrations

OECD's BEPS 2.0 program – Pillar Two

- **Pillar Two** seeks to introduce a minimum Effective Corporate Tax Rate of 15% for affected MNE Groups via the Global Anti-Base Erosion (GloBE) Model Rules
 - ✓ Primarily, MNE Groups with annual revenue of EUR 750 million or more in the consolidated financial statements of the ultimate parent entity in at least two out of the four preceding FYs (also known as in-scope MNE groups) will fall under the ambit of Pillar Two
 - ✓ Pillar Two comprises two components – Global Anti-Base Erosion (GloBE) Rules and Subject To Tax (“STTR”) Rule
 - ✓ GloBE Rules comprises the **Income Inclusion Rule (“IIR”)** – Imposition of a top-up tax on a relevant parent entity of an MNE group and the **Undertaxed Profits Rule (“UTPR”)** - Where a top-up tax would be collected in the jurisdictions which the MNE group operates and where UTPR has been adopted, if no top-up tax is collected from the parent entity under the IIR
 - ✓ **Subject To Tax (“STTR”) Rule** - Designed to protect source countries (especially developing economies) by allowing them to impose a top-up withholding tax on certain intra-group payments (e.g., interest, royalties, and service fees) that are taxed below a minimum rate (typically 9%) in the recipient jurisdiction

OECD's BEPS 2.0 program – Potential challenges and Key takeaways for MNEs

Potential challenges

- For both the Pillars, detailed jurisdictional data is required to undertake complex calculations per jurisdiction and to ensure statutory compliances. However, for in scope MNE Groups, this information may not currently be tracked for each jurisdiction
- Specifically for Pillar One Amount A, detailed functional and revenue analysis of each Group entity is required to identify the key markets of the Group, what is the value being created and in which jurisdiction, which jurisdiction has the significant customer base, what are the contributions being made by each entity etc
- For Pillar One Amount B, detailed and accurate description of the activities of each qualifying entity is required to assess whether the provisions of Amount B will apply
- For Pillar Two, filing of Globe Information Return requires analysis and reporting of extensive and granular data, with more than 100 data points (estimated) that might be required from each entity within the Group
- Certain financial data for both the Pillars would also be required from outside the ERP system, while involving multiple aspects including local tax compliances and ultimate parent entity tax reporting, audit provisions and accounting disclosures considering both local GAAP provisions and ultimate parent entity reporting standards/disclosures etc
- Robust technical infrastructure, processes and systems will be required to be in place by the MNE Group that closely interacts with the ERP system to ensure appropriate data capturing, consistency, analysis and reporting

OECD's BEPS 2.0 program – Potential challenges and Key takeaways for MNEs

Key takeaways

Impact Assessment

- Firstly, a thorough evaluation of the Group's exposure to Two Pillar solution is required. Thereafter, identification of high-risk jurisdictions and model top-up tax liabilities needs to be conducted. Review of the Country-by-Country Report (CbCR) safe harbours and their potential application is also needed to be undertaken

Operational Readiness

- Detailed assessment of data readiness, identification of any gaps and red flags is also required. Thereafter, a feasible compliance model and the key responsibilities of internal group functions must be done while involving audit and accounting teams as well
- VCA and Operational tax and TP will still be the key for addressing BEPS 2.0 compliance requirements and underlying issues

Compliances

- Effective Tax Rate calculations for each jurisdiction must be undertaken along with preparation of required compliance returns, Globe Information Return notifications, etc for each entity also needs to be complied with

Q&A

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