# Base Erosion and Profit Shifting (BEPS) in Asia

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## In brief

The concept of Base Erosion and Profit Shifting (BEPS) has taken on greater meaning and has been subject to much analysis by tax authorities around the world as Governments grapple with a post-GFC world where tax revenues are not recovering to their pre-GFC levels. Ostensibly, the review seeks to identify where double non-taxation outcomes arise from gaps in the international framework of tax agreements and laws, as well as address situations where profits are perceived to be geographically divorced from their activities. Whilst the G20 & OECD have largely sought to coordinate their responses, some countries in the region have already made a start by targeting perceived tax planning abuses.

With the release of the final package of the Base Erosion and Profit Shifting (BEPS) project on 5 October 2015, this special report focuses on the current BEPS-related developments and the impact for Pharma & Life Sciences companies operating in Singapore, Australia, Japan and China.

## In detail

### Singapore BEPS actions

For Singaporean based Pharma companies, there are a number of recent measures that will impact them in the coming years that are BEPS related. Singapore already has adopted the internationally agreed arm's length principle for the determination of prices for transactions between related parties, has tax treaties that incorporate provisions to guard against treaty abuse, and has provided for exchange of information upon request in line with the internationally agreed standards. Nevertheless, Singapore's new BEPS plan includes a number of recent features that are directly relevant to pharmaceutical companies.

#### *i) Maintenance of contemporaneous Transfer Pricing (TP) documentation*

With the second edition of the Singapore TP guidelines issued by IRAS (Inland Revenue Authority of Singapore) on January 6 2015, tax payers must have in place transfer pricing (TP) analyses and contemporaneous TP documentation to establish the arm's length prices. It has therefore become imperative for MNC's across industries to align profit with substance in each location where they have a business presence. If taxpayers are unable to substantiate their transfer prices are at arm's length by maintaining contemporaneous TP documentation, IRAS may not support the taxpayers in mutual agreement procedure (MAP) discussions to resolve the double taxation matters and may not accept advance pricing agreement (APA) applications.

#### *ii) Tax Incentive for R&D, Innovation, and product development activities*

Singapore's Economic Development Board (EDB) provides a number of tax and grant incentive schemes for foreign and domestic investors to attract investments. The government makes strategic use

of tax incentives to draw investments that create economic value and supports the BEPS principle that profits should be taxed where substantive economic activities generating the profits are performed and where value is created. These programs continue to be developed in the BEPS environment, and may be impacted by other country's own BEPS measures.

### *iii) Withholding tax benefits*

Pharmaceutical manufacturers often pay royalties to their head office for the use of rights to manufacture drugs. Royalties received from overseas parties by a Singapore company will generally be subject to foreign withholding tax. In most cases, a tax treaty would help to reduce the withholding tax exposure, given Singapore's extensive treaty network. Under Approved Royalty Incentive (ARI), full or partial exemption of withholding tax on royalties is given to eligible companies, usually subject to the condition that the tax relief does not result in an increase in tax liability in the foreign country. The grant of ARI is given provided it helps in economic spin off for Singapore where the technology or know-how transferred must be more advanced than the prevailing industry average.

### *(iv) Supplemental updates in Singapore in January 2016*

On 4 January 2016, the Inland Revenue Authority of Singapore ('IRAS') published its third edition of Transfer Pricing Guidelines. Some of the highlights of the latest guidelines are as follows:

- *Timelines for APA process*: The IRAS has specified stringent timelines to APA applicants for pre-filing meeting and the submission of requisite pre-filing meeting materials at least 9 months and 10 months respectively, before the first day of the proposed APA covered period.
- *Application of cost plus method*: With a view to ensuring that a correct level of remuneration is earned by group service providers, the IRAS has issued guidance in the application of the cost plus method where it may now deem additional cost to be included in the cost base of the provider of services and/or goods even if such additional costs are not actually incurred and accounted for in the accounts.
- *Obligations arising from MAP or APA process*: The IRAS clarified that it is not precluded from conducting a tax audit on a taxpayer if there is non-compliance with the Singapore tax laws in the event that the IRAS or the foreign competent authority rejects the taxpayer's MAP or APA application.

This guideline was issued barely a year following release of the second edition of Transfer Pricing Guidelines on 6 January 2015, which introduced contemporaneous transfer pricing documentation requirements in Singapore for the first time. This indicates that the IRAS is closely monitoring the evolving international tax developments vis-à-vis transfer pricing compliance level and practices in Singapore and is ready to make changes to further tighten the transfer pricing regime and related aspects in Singapore to address or respond to evolving needs. It is therefore imperative that given the current tax environment, the taxpayers pay adequate attention in ensuring implementation of sound transfer pricing policies and practices supported by robust transfer pricing documentation. This will also help the tax payers to access and support the APA process should they decide to pursue cross-border tax dispute prevention strategies to mitigate their transfer pricing risks.

### ***Australian BEPS actions***

While preferring to act in coordination with the G20 and OECD, Australia has been an early mover in relation to the BEPS project, enacting new 'BEPS inspired' measures to combat perceived weaknesses in its tax system as a result of BEPS-related activities being undertaken by domestic and foreign multinational companies. In a climate that is being fuelled by a Senate Inquiry into Corporate Tax Avoidance that is publicly investigating the tax practices of Multinational Companies, including Global Pharmaceutical companies operating in Australia, there is much to be concerned. While further measures are expected on Transfer Pricing, Country by Country (CbC) Reporting and other BEPS related projects, some new rules have already come into effect in Australia.

### *(i) Multinational Anti Avoidance Law (MAAL)*

As a part of the response to the Digital Economy element of the BEPS program, the Australian Government has recently enacted into law, new rules that seek to overcome tax planning that seeks to avoid the creation of a permanent establishment in Australia and thereby retain offshore (usually in low or nil tax jurisdictions) the profits from sales into the Australian market. While these rules are primarily aimed at technology and licensing companies who have a presence in Australia that are contractually separate from the sales transactions conducted with the offshore entity, and is limited to company groups with global revenues

of over A$1 billion, there is scope for these rules to apply to services provided or goods sold into Australia that are not sold through a local 'buy/sell' distributor subsidiary. These laws have taken effect from 1 January 2016.

*(ii) Tax transparency measures*

Further BEPS-related measures in Australia include new 'Tax Transparency' measures whereby the Commissioner is required to publish an entity's name, Australian Business Number (ABN), total income, taxable income or net income (if any) and income tax payable for certain Australian corporate tax entities with turnover of over AUD 100 million. The information to be published is sourced from taxpayers' tax returns, which is a break from the tradition of the Australian Taxation Office (ATO) of maintaining full confidentiality of such tax information. The first release of information has already been reported by the ATO in December 2015.

In conjunction with the ongoing Senate Inquiry, the publication of this information is likely to put more pressure on Multinational Pharma companies, especially those operating on small margins or generating small tax profits or even losses.

*(iii) Financial reporting*

The new law requiring 'significant global entities' (i.e. entities that are part of a group with global income of more than AUD 1 billion) to prepare general purpose financial statements for their Australian operations is a significant change which will potentially impact many multinationals with operations in Australia. The new financial reporting requirements will apply for years beginning on or after 1 July 2016.

While some Australian subsidiaries and branches of multinationals already prepare general purpose financial statements, others prepare special purpose financial statements (which contain more limited disclosures), and some do not prepare Australian financial statements at all.

The general purpose financial statements will need to be submitted by the taxpayer to the ATO by the time of filing the tax return if they have not previously been filed with the Australian Securities and Investments Commission (ASIC).

The ATO will be required to share the financial statements it receives with ASIC. Documents filed with ASIC are available to the public, so unlike CbC reporting, which only requires information to be provided to tax authorities, this change will increase public transparency over the financial affairs of multinationals' Australian operations. This was the key reason behind the change.

*(iv) Anti-hybrid measures*

On the financing front, the Board of Taxation has recently begun consultation on proposed anti-hybrid rules with the release of a Discussion Paper. The Board has been requested to undertake consultation on the implementation of new tax laws to neutralise hybrid mismatch arrangements, pursuant to the recommendations of the G20 and OECD under Action Item 2 of the BEPS Action Plan and to examine how best to implement anti-hybrid rules in the Australian legal context. The Board is due to deliver its report by March 2016 to allow this issue to be considered as part of the 2016 Australian Federal Budget response. At this stage, we expect an announcement to be made in respect of the anti-hybrid measures in the 2016 Australian Federal Budget.

*(v) Other BEPS-Related Measures*

As part of the BEPS project, the CbC reporting will apply for years beginning on or after 1 January 2016, in line with the OECD's recommendation. All Australian and foreign groups with an Australian presence that have global turnover of more than AUD 1 billion will need to file the master file and local file with the ATO. The CbC report is expected to be filed by the parent company of the group with their home tax authority. As such, Australian multinationals will need to file the CbC report with the ATO.

The General Anti-Avoidance rules have also been amended to increase the penalties for anti-avoidance or transfer pricing related adjustments arising for income years beginning on or after 1 July 2015. The rates will be up to 100% of the tax shortfall from the adjustment.

***Japanese BEPS actions***

As a result of the release of the final package from the OECD/G20's Base Erosion and Profit Shifting ('BEPS') project on October 5, 2015, Japan will make necessary amendments to its legislations and tax treaties in accordance with the guidance given in the final reports.

*(i) Actions that have already been implemented*

The 2015 Japanese Tax reform package amended Japan's domestic legislation with respect to the dividend exclusion rule. Specifically, from the perspective of preventing international double non-taxation, Action 2 of the BEPS Project recommends that countries that have a dividend exclusion rule should deny the dividend exemption for dividends that are deductible in the counterparty jurisdiction. Therefore, based on the OECD guidance, dividends included as deductible expenses are to be excluded from the scope of foreign

dividend exclusion rule in Japan for fiscal years commencing on or after April 1, 2016.

*(ii) Actions expected to be implemented in the FY2016 tax reform*

On 24 December 2015, the Japanese Cabinet approved the 2016 tax reform proposal, which includes revised Japanese transfer pricing (TP) documentation requirements. The revisions are based on recommendations contained in the BEPS Action 13 Final Report. Under the reform, the preparation and filing of a Master File and CbC Report will principally be required of the ultimate parent company of a multinational enterprise ('MNE') with consolidated revenues of over JPY 100 billion. For Master File, submission will also be required for Japanese subsidiaries or branches of foreign headquartered MNEs that meets the threshold test. For CbC Report, Japan will use the exchange of information provisions of its tax treaties in order to obtain CbC Reports for the Japanese subsidiaries or branches. The Master File will be required for taxpayers' fiscal years beginning on or after 1 April 2016, with the submission deadline one year following the close of the ultimate parent company's fiscal year to which the Master File and the CbC Reports relates. Additionally, the new rules will require the contemporaneous preparation of a 'Local File' by all taxpayers having transactions with a related party that exceeded a total transaction amount in the preceding tax year of JPY5 billion or with intangible property transactions with a related party that exceed a total transaction amount in the preceding tax year of JPY300 million. For taxpayers with such transactions, the Local File must be prepared at the time the taxpayer's corporate tax return for the relevant year is filed, effective for taxpayers' fiscal years beginning on or after 1 April 2017.

*(iii) Actions expected to be discussed including the needs for further tax reform*

Further reforms to the Japanese tax system in response to the final BEPS papers are expected by PwC. The existing Controlled Foreign Corporations ('CFC') rules will likely be examined in light of the OECD's guidance since the Japanese CFC rules are outdated. For the transfer pricing ('TP') rules, reform of the current TP rules as well as the enforcement of the rules is expected to be discussed in line with the OECD guidance. And, finally, for the earnings stripping rules, as the OECD guidance advises that the fixed standard ratio of the non-deductible portion of interest should be between 10 percent and 30 percent, and that the thin capitalization rule should be supplemental, Japan's divergence from this may raise a need for further tax reform in order for it to be compliant with the current OECD guidance.

***Chinese BEPS actions***

In the 2nd half of 2015, the Chinese State Administration of Tax (SAT) released discussion draft of *Implementation Measures of Special Tax Adjustment (Discussion Draft) to revise and upgrade the existing Implementation Measures of Special Tax Adjustment (Trial)* (Guoshuifa [2009]No.2,Circular 2). This document, which referenced the OECDs BEPS Action Plans and China's specific issues, included key changes that will see: the introduction of the three-tier TP documentation (TPD) requirement; detailed procedures of special tax adjustments and investigation; additional TP administration rules on equity transfers, intangibles, and intercompany services; and refined controlled foreign corporations (CFC) rules. See here for more information on these developments.

More recently, following the release on 5 October 2015 of the final BEPS Report on all 15 Action Plans, the SAT presented its stance on these measures and plans to 'localise' these actions for implementation in China on an as-needed basis. Speaking as to the principles of this localization, the SAT identified the following principles for implementation.

*Principle 1. Combination of BEPS recommendations and addressing China's specific circumstances*

While some BEPS recommendations will be introduced into the China's domestic tax laws and regulations, not all of them will be copied directly. Instead, China will adapt BEPS recommendations based on its own circumstances on an as-needed basis, and may also develop some tax rules to address China-specific issues.

*Principle 2. Combination of protecting tax interest and boosting economic development*

On one hand, China will improve tax laws and regulations to plug BEPS loopholes, especially by developing rules to prevent profits from being shifted to low or no tax jurisdictions. But on the other hand, China will also protect the interest of cross-border business activities that are full of substance, give enough certainty to MNCs and remove tax barriers in their cross-border businesses.

*Principle 3. Combination of reinforcing tax administration and promoting tax compliance*

China will enhance its international tax administration capacity and capability through strengthening exchange of information, improving its tax administration system, as well as further collaborating with international counterparts. But all in all, the main purpose of a strengthened tax administration is to encourage taxpayers' compliance.

China expects that the new international tax regime will not only allocate tax revenue among different countries in a fairer way, but also protect the interest of MNCs on cross-border businesses.

For more information on these principles, see this link.

*Aligning TP outcomes with value creation*

TP is one of the key focuses in China's localisation of the BEPS Report. Some of the highlights that reflect the SAT's positions on TP include:

- It is necessary to analyze the contributions (i.e. development, enhancement, maintenance, protection and exploitation) made by local Chinese enterprises to intangibles so as to ensure that these contributions are reasonably compensated by foreign related parties, especially where the legal owner of the intangibles resides outside of China.
- Similar to intangibles, location specific advantages also create values, and has been well recognized in comparability analysis, contribution analysis and profit split consideration.

*Actions expected in the near future in relation to the BEPS project*

As reiterated by SAT official, the China action plan would mainly include:

- revision of the domestic tax laws and regulations (e.g. the Tax Collection and Administration Law)
- localisation of the BEPS package (e.g. revision of Circular 2)
- adjustment of the tax authorities' international tax administration divisions
- establishment of the national tax risk monitoring and response system on MNC's on a group basis
- use of information technology to facilitate international tax administration

## The takeaway

The global BEPS agenda being driven by the G20 and OECD is likely to impact all Pharma companies operating in the region. Asia is a vital component of many global pharmaceutical companies' value chains with manufacturing, distribution, research & development and sales & marketing functions spread throughout the region. As such, changes in tax reporting (CbC, tax transparency) and tax rules (anti-avoidance measures, Transfer Pricing) on a local and international level is likely to impact how companies are structured and operate in Asia. Given a number of these measures have already begun applying to Pharma companies such as the CbC reporting and MAAL, Pharma companies should consider the guidance and impact that these new rules are going to have on their operations and start to prepare for the changes as soon as possible.

## Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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