OECD action plan on BEPS and recent tax transparency measures: impact for banking and capital market sectors

17 December 2015

In brief

There have been a number of recent Australian developments in response to the Organisation for Economic Cooperation and Development's (OECD) base erosion and profit shifting (BEPS) project and other recent tax transparency measures that could impact the banking and capital markets sector significantly, including:

- On Thursday 3 December 2015, law introducing the Multinational Anti-Avoidance Rules (MAAL) and country-by-country reporting (CBCR) requirements, as developed by the OECD in Action 13 of the BEPS project, and the requirement for significant global entities with operations in Australia to prepare and lodge general purpose financial statements was passed by Parliament.
- On Thursday 3 December 2015, law introducing the OECD's Common Reporting Standard (CRS) for the automatic exchange of financial account information was tabled in a Bill before Parliament. These rules will apply with effect from 1 July 2017.
- On Monday 30 November 2015, law introducing third party transaction reporting requirements for a number of entities including market participants and administrators of payment systems received Royal Asset. These rules will also apply from 1 July 2017.
- On Friday 20 November 2015, the Board of Taxation (the Board) released a consultation paper on the implementation of the anti-hybrid rules as developed by the OECD in Action 2 of the BEPS project.
- On Friday 11 December 2015, the Board released a consultation paper on the voluntary tax transparency code developed to facilitate business information disclosure.
- On Monday 5 October 2015, the OECD published its final papers on all 15 of its actions on BEPS, marking the culmination of two years of work. The OECD also announced plans to monitor the implementation of BEPS recommendations and to develop a framework to include additional countries. Work on some topics will continue over the course of 2016 and 2017 (e.g. the multilateral instrument in 2016).

The BEPS changes may pose real challenges to the banking and capital market sector. The most significant changes may impact the use of hybrid instruments (particularly the frankability/deductibility of interest payments on regulatory capital instruments), increased permanent establishment (PE) risk for most banking activities and increased cost of compliance with greater transparency.

Even for those banking and capital market sector institutions not immediately affected by these changes, managing resources required to meet the additional compliance requirements will be tough. This article summarises the key BEPS actions, the latest Australian tax developments with regard to transparency measures and their impact on the banking and capital markets sector.

In detail

This article focuses on:

- Hybrid mismatch arrangements (Action 2)
- Controlled foreign companies (CFC) (Action 3)
- Interest deductibility (Action 4)
- Prevention of treaty abuse (Action 6)
- Artificial avoidance of PE (Action 7)
- Transfer pricing (Actions 8-10)
- Re-examination of transfer pricing documentation (Action 13)
- Tax transparency measures

The 2015 BEPS package acknowledges that the banking sector, in particular, has special features which must be taken into account and therefore there is a need to develop suitable and specific rules to address BEPS risks in this sector. The package is a significant milestone in the long journey of reforming the international tax rules. The timing and extent of changes across the globe are difficult to predict but change will be constant.

Action 2: Hybrid mismatch arrangements

The final report released by the OECD on 5 October 2015 on Action Item 2 includes recommendations, both at a domestic law level and at a treaty level, that are intended to neutralise hybrid mismatch arrangements. The OECD recommendations are in the form of a primary rule where a mismatch arises (generally denying a deduction) and a secondary rule (generally to tax income) where countries have not implemented the primary rule.

The rules focus on neutralising the hybridity of instruments or entities and are not concerned with mismatches arising due to differences in tax codes. Accordingly, the final report indicates that mismatches arising because an instrument or entity are located in a low tax jurisdiction or territorial tax regime are not intended to be caught by the rules.

For banking and capital market sector institutions, instruments issued for regulatory capital purposes often have characteristics of a hybrid instrument. The OECD final report concludes that countries are free to deal with the tax treatment of hybrid regulatory capital in their own way. That said, if one country chooses not to neutralise mismatches arising in relation to hybrid regulatory capital, it does not prevent another country from choosing to apply their rules to that same arrangement.

The OECD final report included an example of a deductible/frankable instrument issued by a foreign branch to investors that would be caught by the proposed anti-hybrid rules (see example 2.1 in the OECD final report). In this example, a company established in one jurisdiction issues a deductible/frankable instrument through a PE located in another jurisdiction to predominantly unrelated investors on the open market. Returns on the instrument to the investors are grossed up to include an imputation credit.

The OECD concluded that this arrangement falls within the scope of the hybrid financial instruments rule and, accordingly, imputation credits would be denied to the investors (if recommendation 2.1 was adopted in the parent jurisdiction). If recommendation 2.1 was not adopted by the parent jurisdiction and did not apply, an interest deduction in the PE jurisdiction may be denied. This example has relevance for deductible/frankable instruments issued by many of the Australian banks through existing PEs.

As noted above, the Board has released a consultation paper on the implementation of the anti-hybrid rules as developed by the OECD. The consultation paper focuses on issues associated with the implementation of the anti-hybrid rules into Australian domestic law and not whether the rules should be adopted at all. The consultation paper has been developed, based on the terms of reference provided to the Board in July 2015 by the Australian Government, to facilitate public consultation and to inform its report due in early 2016. The commencement date for these rules in Australia has not been made clear by the Government, and it seems likely a start date will be announced in the May 2016 Federal Budget.

Of particular note to the banking sector, the consultation paper raises the question as to whether an exception for intra-group hybrid regulatory capital and regulatory capital issued to third parties by banking and capital market sector institutions is needed. It also poses the question as to whether imputation credits should be captured by the anti-hybrid rules by virtue of being classified as 'equivalent tax relief'.

With this in mind, taxpayers should turn their mind to their structures and consider what the impact of the anti-hybrid rules may be.

Action 3: Controlled foreign companies

The OECD's proposals set out the key principles that should apply to a jurisdiction's CFC regime. In practice, this will typically mean consideration of, amongst other things, whether the CFC has sufficient substance to assume and manage the risks on its own accord and whether the CFC is overcapitalised.

A review of the Australian CFC rules was announced in October 2006 and in May 2009 the then Labor Government announced plans to 'modernise' those rules. In November 2013, the Coalition Government announced a delay of further consultation until July 2014 pending the work of the OECD on BEPS.

The work on Action 3 did not achieve consensus or a minimum standard principally due to tax competition concerns (that, CFC rules may discourage investment by multi-national companies). While the work on Action 3 highlights how complex and uncompetitive the Australian CFC system remains, there are special rules in the Australian CFC provisions for the banking sector to ensure they remain competitive on a global platform. Interestingly, and not unlike the outcomes in other Action items, the OECD final report did not contain any special recommendations relating to the banking sector.

Whilst the Australian CFC rules are broadly compliant with the OECD recommended approach (and therefore unlikely to be changed), it remains to be seen whether other countries will make changes to their existing CFC regimes or introduce new CFC regimes if they do not presently exist.

For the banking and capital markets sector, groups will need to monitor changes made to CFC regimes globally and consider the impact of these changes on existing structures (particularly for subsidiaries located in lower-taxed jurisdictions). Further, given Australian regulatory requirements for holding capital, there will be a need to carefully consider the interaction with any test of overcapitalisation.

Action 4: Interest deductibility

The OECD final report on Action 4 provides detailed recommendations for best practice rules to prevent BEPS through the use of interest expense, although they do not present as a minimum standard.

The report concludes on a recommended approach based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of EBITDA. The

report suggests a range of acceptable fixed ratios between 10 per cent – 30 per cent, with factors identified for countries to determine their appropriate fixed ratio.

Along with this rule, the report identifies optional rules that countries could adopt. For example, an arm's length debt test, use of an asset ratio test as a ceiling for interest deductions, a worldwide gearing ratio allowing interest deductions based on the group's net interest to EBITDA, use of a de minimis threshold and the carry forward of unused capacity or disallowed interest expense. Despite these recommendations being relevant to the general taxpaying community, the OECD in its report notes that the recommended fixed ratio and group ratio rules are unlikely to be effective in addressing the BEPS risks for the banking sector.

In this respect, the OECD suggests that countries consider excluding banking sector entities from the scope of the rules, in which case they should introduce targeted rules addressing BEPS in this sector.

Australia has robust rules in relation to debt deductions (viz, debt/equity, taxation of financial arrangements, thin capitalisation and transfer pricing) that relate to the general and banking and capital market sectors. The Australian thin capitalisation rules were most recently tightened from 1 July 2014, and therefore there may be little need to amend our current rules in these areas. That said, it is acknowledged that there are a number of difficulties in the ADI thin capitalisation provisions that may need clarification particularly in relating to banking and financial services groups.

Finally, Action 4 refers to the development of transfer pricing guidance for related party transactions but this will now be carried out as a separate project to be contemplated by 2017. It also states that further work will be conducted in 2016 to identify best practice rules to deal with BEPS risks posed by the banking sector (though, does not go as far as to identify the risks). The OECD note that it will be crucial that any recommended interest limitation rules do not conflict with or reduce the effectiveness of capital regulation intended to reduce the risk of a future financial crisis.

Action 6: Prevent treaty abuse

The OECD has proposed three alternative approaches that countries could take to curb tax treaty shopping and other treaty abuses – including a:

1. US-style Limitation on Benefit (LOB) rule,
2. Principal Purposes Test, or
3. combination of both.

The proposed rules are detailed and complex. They will have a particularly significant impact on both collective and non-collective investment vehicles. Certain aspects of the model treaty provisions and detailed commentary on the LOB rule along with further examination of the treaty entitlement of investment vehicles will continue throughout 2016.

The treaty reforms are far-reaching. In particular, the potential denial of treaty benefits to certain funds and securitisation vehicles could be significant since these vehicles cannot always determine who the ultimate owner of the return is (given the shared ownership). In addition, any requirement for obtaining treaty clearance may have a negative impact on commercial securitisations and fund investment.

Given the importance of these vehicles, it is unfortunate that groups may have to wait until 2016 for further guidance on their treaty entitlement.

Those operating across multiple foreign jurisdictions should consider their holding and repatriation structures, and whether they remain effective in a post-BEPS world. In fact, consideration should be given as to whether these structures need to be restructured prior to the end of 2016 (when the multilateral instrument is expected to be signed).

Action 7: Artificial avoidance of PE

The BEPS proposals in relation to PEs (Action 7) lower the threshold for a source country to obtain taxation rights. For example, a dependent agent PE can arise where a person in Australia "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification." The independent agent exemption will be narrowed.

Finally, there will be the option for countries to limit the specific activity exemptions to activities that are of a preparatory or auxiliary nature. The impact of this is to widen the definition beyond the traditional conclusion of contracts.

It is proposed that these changes could be included in the multilateral instrument (Action 15). This change is likely to expand the circumstances in which a non-resident establishes a PE in Australia and may also expose Australian institutions to foreign tax liabilities.

It will be necessary to determine the profit attributable to such PEs under the transfer pricing rules. The OECD will provide further guidance on PE profit attribution next year; however, it is important to note that Australia's current approach for attributing profits to PEs is out of step with current OECD guidelines. This has the potential to result in disagreements between the ATO and other tax authorities on how profits should be attributed to a PE that arises as a result of the proposed changes.

For the banking and capital markets sector, these changes are likely to impact origination activities by coverage, customer relationship managers, deal teams and representative offices. It will be necessary for banking and capital market sector institutions to review existing models, particularly in relation to roles of employees who have the authority to conclude contracts or play a pivotal role in this process. The OECD final report seeks to prevent agents that act exclusively for 'closely related' parties from being able to qualify as independent agents (the test now turns on whether there is common control).

The OECD has indicated that they will need to undertake follow up work in 2016 to address any unintended consequences of changes resulting from the report to the global trading of financial products.

Finally, while not directly a BEPS action item, the Government has recently enacted the MAAL. These rules are Australia's version of the UK diverted profits tax which seeks to tax certain non-residents as if they have a PE in Australia where certain conditions are satisfied. Whilst the MAAL was designed to address profit shifting by technology companies, the rules can apply more broadly to other sectors including, particularly, the financial services sector. Banking and capital market sector institutions will need to be mindful of the application of these rules.

Actions 8-10: Aligning transfer pricing outcomes with value creation

The BEPS measures embodied in Actions 8-10 revise guidance within the OECD's Transfer Pricing Guidelines. The changes align the OECD position more closely with Australia's current law and ATO practice.

It is therefore likely the new OECD guidance will be adopted quickly in Australia. It is possible for new guidance materials for interpreting the Australian transfer pricing laws to be incorporated by regulation rather than by law change.

The revised transfer pricing guidelines will be of a particular note to Australian taxpayers in respect of the following:

1. *Non-recognition and recharacterisation* – broadly consistent with current Australian law, non-recognition of transactions will be permitted where the totality of arrangements differ from those which would be adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances.

2. *Intangible property* – the key theme is the shift from legal form to substance and value creation and ensuring there is a suitable return for those substantial functions. In practice, this will help to reinforce the ATO's current interpretative approach.
3. *Substance* –strong focus on preventing the use of so-called 'cash boxes', described as companies with few (if any) employees and little or no economic activity.
4. *Profit splits* – the OECD is yet to complete its work on the revised application of profit splits, which are likely to become more widely used by tax authorities in implementing the transfer pricing recommendations in the future.

The proposed carve out for financial services from the work on risks and capital has not materialised, although the OECD recognises the impact of regulation on the sector. As a consequence the rules will apply to all financial services groups. There is a clear focus on active, people-based substance on both assumption of, and financial capability to, bear risk. The location of where capital is based and risk is formed, relating specifically to the banking and capital market sector, will need to be considered separately.

In respect of other transactions, the OECD has provided guidance on low value adding services, in particular the level of appropriate mark-up for such services and a simplification of the benefits test.

The impact of the transfer pricing reforms on the banking and capital markets sector could be significant if the rules apply as set out, however the unique role of capital in the banking and capital markets sector makes it a more difficult area for the OECD to tackle and will continue to be subject to further discussion. Specific consideration will need to be given to the appropriate treatment of regulatory costs, for example, funding and liquidity charges and where they are appropriately borne.

There is good news in the form of the recommendations on low value-adding services, as many multinational banking and capital markets groups face tax audits on the appropriateness of charges for intragroup services.

Actions 13: Re-examine transfer pricing documentation

The OECD have proposed a three-tier approach to transfer pricing documentation:

1. a master file containing information relevant for all group members,
2. a local file referring to material transactions of the local taxpayer, and
3. a CBCR containing data on the global allocation of income and taxes, and certain other measures of economic activity.

The rules should apply from 1 January 2016 in some territories. The revenue threshold €750m for CBCR reporting and the CBCR template are to be revisited in 2020.

The adoption of the OECD Action 13 CBCR requirements has been given effect in Australia with Parliament passing laws requiring Australian taxpayers with global revenue over A$1 billion be required to maintain and/or provide to the ATO CBCR, master file and local file reports unless the Commissioner grants an exemption. This is scheduled to commence from 1 January 2016 with the first reporting due 12 months after the close of the reporting year.

For the banking and capital markets sector, changes to transfer pricing documentation represent a major compliance challenge for many banking and capital market institutions as the level of information required is substantial. The local file report has been of particular concern as has been the reporting requirements for banking branches.

Tax transparency measures

While not specifically a BEPS Action item, Australia, on a stand-alone basis is likely to be amongst the world's most transparent tax systems in view of the following:

- The ATO published certain tax data on companies with turnover in excess of A$100 million in only December 2015.
- The adoption of the OECD Action 13 CBCR requirements.
- The Board has been asked by the Government to lead the development of a new code on greater public disclosure of tax information by businesses, particularly large multinationals, by May 2016 (noting that a consultation paper was released on 11 December 2015 and the Board is consulting with stakeholders on the voluntary tax transparency code).
- Calls by Senate Economics References Committee on Corporate Tax Avoidance in its interim report in August 2015 for more transparency measures.

The OECD report takes an approach that is found in a number of countries including the US, UK and Canada and advocates that a standardised disclosure regime should be adopted globally. No doubt revenue authorities will share such disclosed information.

Australia does not currently have such a disclosure regime at this time. Since 2006 there has been a civil penalty regime for promoters of tax schemes, deliberately put in place in preference to a disclosure regime as now recommended by the OECD. Whilst such a disclosure regime could co-exist with the promoter penalty rules, it is questionable whether the ATO will learn more than it already does by existing methods. This is because the promoter penalty rules provide a strong incentive to either seek ATO rulings or to not engage in schemes which could be penalised. In addition, there are extensive reporting obligations on certain corporate taxpayers already such as Reportable Tax Position Schedule requirements.

As highlighted previously, the Government has also recently enacted the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015* (the Bill) which proposes to give effect to a package of measures announced in the 2015-16 Federal Budget to combat multinational tax avoidance. The Bill, which applies to 'significant global entities', includes the following measures:

- The new MAAL designed to counter the erosion of the Australian tax base by multinational entities using artificial or contrived arrangements to avoid the attribution of business profits to Australia through a taxable presence in Australia.
- Doubling the penalties imposed on significant global entities that enter into tax avoidance or profit shifting schemes.
- Implementation of Action 13 which concerns transfer pricing documentation and CBCR into Australian domestic law.
- Requirement that significant global entities (defined as having a global revenue of A$1 billion or more) prepare "general purpose" financial statements for their Australian operations - in contrast to only having to produce "special purpose" financial statements (with effect for income years commencing on or after 1 July 2016).

With regard to the latter, this is a significant change which will potentially impact many multinationals with operations in Australia. 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).

As a late amendment to the Bill with no prior public consultation, there is not as much detail available on this change as for the other items in the legislative package. As a result there are many questions about how the law will apply in practice – for example, whether parent accounts that include information relating to an Australian PE could be lodged instead of separately preparing general purpose financial statements. It will be interesting to see how the Government, the ATO, and ASIC address this.

In addition to the transparency measures targeted at corporate tax avoidance, the introduction of various information reporting measures focused on financial accounts and market transactions will have a significant impact for the banking and capital market sector.

While some of these rules do leverage off requirements already in place for US FATCA reporting, by necessity there are differences that will require adaptation of existing processes and procedures, likely increasing compliance costs.

The volume of these changes, short implementation time frames, and the reporting of customer information to domestic and foreign regulators also presents resourcing challenges and reputational risks for the banking and capital market sector.

The banking and capital markets sector will be caught up in the transparency debate and undoubtedly may well need to change current processes to adapt to new disclosure requirements.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Peter Collins, Melbourne
+61 (3) 8603 6247
peter.collins@au.pwc.com

Matt Osmond, Melbourne
+61 (3) 8603 5883
matt.osmond@au.pwc.com

Ashley King, Melbourne
+61 (3) 8603 1363
ashley.king@au.pwc.com

Gavin Marjoram, Sydney
+61 (3) 8266 0576
gavin.marjoram@au.pwc.com

Nick Houseman, Sydney
+61 (2) 8266 4647
nick.p.houseman@au.pwc.com

Grant Harrison, Sydney
+61 (2) 8266 1986
grant.harrisson@au.pwc.com

Michael Bersten, Sydney
+61 (2) 8266 6858
michael.bersten@au.pwc.com

Prashant Bohra, Melbourne
+61 (3) 8603 4087
prashant.bohra@au.pwc.com

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