On 5 October, the Organisation for Economic Co-operation and Development (OECD) released the final reports under its Action Plan on Base Erosion and Profit Shifting (BEPS) launched in July 2013.

The OECD has issued final reports on all 15 focus areas in its two-year long project addressing BEPS. These reports detail the recommendations developed by OECD and G20 countries for significant changes to key elements of international tax systems, including transfer pricing rules, the deductibility of interest expense, hybrids, the permanent establishment concept, and limitations on tax treaty benefits. Also included are new country-by-country reporting requirements and a new two-tier approach to transfer pricing documentation. It is important to note that the OECD’s reports are recommendations only and, for these recommendations to take effect, they must be implemented into domestic legislation and/or included in bilateral treaties through the Multilateral Instrument (Action 15) or via bilateral negotiation.

The BEPS project broadly looks to ensure that profits are taxed where the economic activities generating the profits are performed and where value is created through amendments to double tax treaties, the commentary on the OECD Model Tax Convention, transfer pricing guidelines and domestic law.

At the time of issuing its ‘final’ recommendations, the OECD announced plans for the OECD and G20 countries to work on monitoring the implementation of the BEPS recommendations and to develop a framework for including additional countries in these efforts. Work on some topics such as the multilateral instrument and financial payments will carry on into 2016 and 2017.
Asia-Pacific is reasonably unique in that it is a region made up of OECD members, such as Australia, New Zealand and Korea, key OECD ‘partners’, such as Indonesia and mainland China, and other ‘interested parties’. It is therefore likely that many Asia-Pacific jurisdictions will not implement the complete package of OECD recommendations. OECD members will, such as Australia, but in Singapore, for example, the Ministry of Finance has been following BEPS closely and announced on Tuesday 6 October that it supports the final recommendations while suggesting that its tax code is already broadly BEPS compliant (as regards substance, transfer pricing and treaty abuse in particular).

Even if Asia-Pacific non-OECD members choose not to implement parts of the BEPS proposals, the financing and group structures of Asia-Pacific asset management subgroups of OECD member countries (such as the US or European asset managers) will undoubtedly be impacted by BEPS related domestic law changes filtering through from those headquartered countries that are OECD members.

Consideration has therefore been given to how the different Actions might interact should a country decide to implement one or more of the recommended Actions.

The wide potential for domestic and treaty law change across jurisdictions, coupled with the complexity of the recommendations, makes it really important for asset management groups to review the potential longevity of their own corporate and fund structures.

**Action 6 - Treaty Abuse**

While this report is titled as “final,” there will be further OECD work specific to investment funds in 2016 and amendments should be made during that time.

With regard to collective investment vehicles (CIVs), i.e., widely held regulated funds, the report restates the OECD view that the 2014 Action 6 drafting is suitable for addressing the potential treaty eligibility concerns of CIVs and that it reflects the conclusions of the OECD's 2010 CIV report. In practice, this means that CIVs may continue to struggle to obtain treaty benefits in certain jurisdictions where the CIV is not recognized as a “person” in a tax treaty and / or is not the beneficial owner of its assets. We have seen scenarios where Australian trusts, the Australian CIV vehicle of choice, have struggled to obtain treaty benefits in certain jurisdictions (including OECD member countries).

The OECD’s previous Treaty Relief and Compliance Enhancement (TRACE) implementation package is again referred to as the solution for implementing certain limitations-on-benefits (LOB) tests in practice. As such, the report has not materially changed with regard to CIVs since the last discussion document, and we understand no further work will be performed in this area.

It remains to be seen how these proposals will be implemented across Asia-Pacific. This is particularly important in the context of the development of the Asian Region Funds Passport, ASEAN Funds Passport and mutual recognition of funds between Hong Kong and mainland China, which will see a significant increase in cross border investment by funds into funds in Asia. At the minimum, these proposals will increase the administrative compliance on Asian funds to obtain tax treaty benefits.

For non-CIVs such as private equity, hedge funds or certain types of trusts, the OECD indicates that further work is required in certain areas:

- **Non-CIVs funds in general**
  The OECD reiterates that they recognize the economic importance of these funds and that they should be granted treaty benefits where appropriate. This is supported by the final report on hybrid mismatches (Action 2), which suggests changes to the Model Tax Convention that would clarify the treaty position of transparent vehicles. In the context of the above Australian trust example, this would be a welcome development.

  The report also points towards potential derivative benefits provisions to be introduced in 2016, i.e., provisions that would allow certain entities owned by non-residents to obtain the treaty benefits that these residents would have obtained if they had invested directly.

- **LOB rules**
  The US entered into public consultation on its LOB rules in 2015, and the OECD wants to consider whether any resultant changes, to be published in 2016, should be factored into Action 6.

- **REITs**
  Updating the LOB commentary to include specific provisions for REITs that reflect previous OECD work on treaty issues for REITs.

- **Pension funds**
  Updating the OECD Model Tax Convention to include a definition of “recognized pension fund” that qualifies as treaty resident. The life and pensions industry will be interested to note that the proposed definition includes entities and arrangements that operate exclusively to invest funds for the benefit of recognized pension funds.
**Action 7 - Permanent Establishments**

There were few changes to the wording on permanent establishments (PEs) contained in the earlier discussion drafts; however, this area could have a significant impact on the asset management industry. The OECD has recommended that Article 5(5) of the Model Tax Convention should be amended to say:

“where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise ... that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise ...”

For an asset manager, this revised definition of what constitutes a PE could clearly impact capital raising, sales and due diligence teams undertaking business in multiple jurisdictions.

Although an increase in the number of PEs recognized may not necessarily raise substantially more tax revenue, it will clearly result in an increased administrative burden for these taxpayers.

There are still exceptions to the definition of PE, but amendments, as noted below, have been recommended:

- While activities can still be considered “preparatory and auxiliary,” they must not be part of the core business activities to avoid giving rise to a PE. Article 5(4) has been modified to provide further guidance around what is considered “preparatory and auxiliary.”

- Businesses that seek to claim the independent agent exception may no longer be able to do so if they are considered to be closely related to the foreign enterprise on behalf of which they are acting and the activities are performed exclusively or almost exclusively on behalf of one enterprise or closely related enterprises.

Further analysis will be required to fully understand how the proposed changes could impact the PE risk for a fund itself. Some countries, such as Australia in the form of the “Investment Manager Regime”, offer an investment manager exemption to mitigate this risk (as does the Hong Kong for example) but in other jurisdictions a widening of the definition could cause problems for an actively traded fund.

Finally, if it is determined that an asset manager has a PE, a further exercise will need to be undertaken to determine the profit attributable to that PE using transfer pricing principles. The OECD has stated that follow-up work will be undertaken to provide greater certainty over determining the attribution of profit as a result of changes made in Action 7, with a view to providing the necessary guidance before the end of 2016.

**Actions 8 to 10 - Risk and Recharacterization**

Situations where an actual transaction may be disregarded have been clarified as being those where the “exceptional circumstances of commercial irrationality apply”, such that transactions make no “commercial sense.” This appears to be a greater hurdle than was set out in the previous draft in relation to the discussions on recharacterization.

The new report contains an example clarifying how the concept of control of risk could be applied in an asset management context. The example (provided at paragraph 1.70 of the report) is welcome in making clear that where an investor hires a fund manager to invest on its behalf, this does not equate to transferring control of that risk. The distinction is critical in determining the return that each party should achieve, confirming that a fund manager should receive payment for its fund management activities, with the return on the capital invested being attributed to the investor.

An additional specific asset management example focuses on the situation where a regulatory license is a required precondition for conducting investment management business in a particular country. In some cases, there may be a restriction on the number of foreign-owned firms to which such licenses are granted, and in such cases, the example suggests that value may be attributed to the license holder. Conversely, where such licenses are readily available and do not restrict access to the market, attributing such value may not be appropriate. Consideration should be given to pricing arrangements in places where this fact pattern does not align with existing policy.

**Action 13 - Transfer Pricing Documentation & Country-by-Country Reporting**

The final report from the OECD on transfer pricing documentation and country-by-country reporting (CBCR) introduced no new content.

Many asset managers will be below the threshold for CBCR (€750m). However, as a result of the OECD’s recommendations, all asset management groups will need to ensure the consistency and appropriateness of information included in their transfer pricing documentation and central ownership will be key to achieving this. In particular, the first year of documentation produced in the master file/local file format (in Australia, for example, this would be 1 January 2016 where taxpayers are members of multinational enterprises) will be vital as this will form the basis for, and comparison with, subsequent years. Groups may therefore wish to plan now for the time needed to help ensure the appropriateness of information included in the FY2016 master file and local country files.
Action 5 - Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

Action 5 requires substantial activity for any preferential regime and calls for the development of a framework for compulsory spontaneous exchange of information between tax authorities on rulings with respect to preferential regimes that meet specified criteria.

For the second purpose the OECD has been working on defining categories of rulings as well as a process that will assist in determining which countries should receive the ruling.

The framework covers six categories of rulings: (i) rulings related to preferential regimes, (ii) cross border unilateral advance pricing arrangements (APAs) or other unilateral transfer pricing rulings, (iii) rulings giving a downward adjustment to profits, (iv) permanent establishment (PE) rulings, (v) conduit rulings and (vi) any other type of ruling where there is a view that the absence of exchange would give rise to BEPS. These developments mean that asset management groups should generally consider their approach to seeking rulings going forward, both with regards rulings being sought on behalf of the manager and the funds they manage.

In the Asia-Pacific region this Action is particularly relevant for incentive-based tax regimes, such as the “Financial Services Incentive – Fund Management Scheme”, available to Singapore fund managers and / or tax incentive schemes available to funds managed by Singapore based fund managers, such as the “The Enhanced Tier Fund Tax Exemption Scheme” for example. In the final report, there is no specific mention of the fund itself, perhaps because it is usually a transparent vehicle in most jurisdictions – although in Singapore they are usually established as a Singapore tax resident (and exempt) company with access to treaties. There is a possibility of such fund companies falling under “holding company regimes” and in particular, the second sub-category which is applicable only to companies that hold equity participations and earn only dividends and capital gains. This should become clear in due course.

In this regard, the OECD is not objecting to the use of tax incentives as a tool to attract investments. Under the substantial activity requirement (noted in the section on IP business), the key is the nexus rule which links preferential tax treatment to actual economic activities. The OECD is focused on ensuring there is a nexus between the taxpayer receiving the tax incentive and the core activities contributing to that income. One suggested approach is to use the level of expenditure to gauge substance and activities necessary to earn the income.

So far as Singapore incentives are concerned, the government has traditionally applied a substance based approach (such as minimum spend on Singapore operations, minimum headcount requirements, etc.), such that the tax incentives are in-principle aligned with the proposals by the OECD. Some refinements to the existing tax incentives may be adopted. However, it remains to be seen to what extent the relevant authorities will adopt based on the recommendations as proposed in this report. For example, whereas the Singapore fund management incentive refers directly to advising or managing, the report refers to fund managers making investment decisions.

A broad BEPS point is that it is more important than ever that taxpayers seeking to obtain tax incentives in Singapore will have to ensure that their operations in Singapore are business-driven and they are able to meet the stringent conditions required as part of an incentive. The tax authority is similarly likely to be more watchful than ever about the criteria required to obtain a tax incentive. This is also likely also be the case in other ASEAN jurisdictions that have also recently introduced certain tax incentives.

Action 4 - Interest Deductibility

The key proposal is to establish interest deductibility rules based on a fixed ratio that look to the ratio of an entity’s net interest expense (interest expense less interest income) to its EBITDA or EBIT. The report recommends setting a benchmarked “fixed ratio corridor” of 10% to 30%.

The fixed ratio may be supplemented in some jurisdictions with a group ratio, considering entity-level leverage (subject to an additional uplift in certain circumstances) with respect to the group’s leverage ratio. This may allow for highly leveraged sectors of the economy that might operate outside the “fixed ratio corridor.”

The report recognizes that the banking and insurance industries have unique financing requirements and refers to revised guidance for these industries, to be published by the end of 2016. There is currently no indication that further guidance will be developed for the asset management industry. The proposed rules are intended to be applied to financial activities with no regulatory requirement as well as regulated and unregulated investment vehicles.

While such rules would likely be neutral at the level of the fund, they would likely affect the funding and post-tax returns at the investee level of fund structures.
**Action 15 - Develop a Multilateral Instrument**

This Action provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable countries, that wish to do so, to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.

An ad hoc group has been formed to develop a multilateral instrument and negotiations will be take place until 31 December 2016. The initial conference to negotiate the convention starts on 5 November 2015, under the chairmanship of the UK, supported by vice-chairs from mainland China and the Philippines. Over 90 countries have indicated they will participate in the negotiation. The participating countries have been offered a level of flexibility with regards to the terms of their participation in the multilateral instruments development and implementation.

Most major Asia-Pacific economies, including mainland China, Japan, India, Australia, Singapore and Hong Kong, have been involved in the initial discussion on development of the BEPS multilateral instrument and therefore developments on this Action are relevant to the Asia-Pacific wealth and asset management industry.

Over the past two years, the wealth and asset management industry has made a considerable effort to share information with the relevant OECD working parties about fund structures and common asset management business models. The final reports reflect that effort, but the work is far from finished.

As we move into the next phase of the BEPS project, and as governments begin to implement the OECD’s recommendations, the industry will need to continue its work to help ensure that decision-makers are well-informed before making policy choices that may impact managers, funds and their investors.
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