# FSTP Perspectives

## A publication for financial services industry tax and transfer pricing professionals

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***In this issue:***



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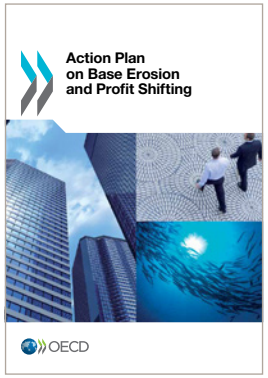
# Foreword




This edition of *Financial Services Transfer Pricing Perspectives* focuses on the release of the Base Erosion and Profit Shifting (BEPS) Action Plan published in July 2013 by the Organisation for Economic Co-operation and Development (OECD). BEPS is a hot topic for multinationals and tax authorities worldwide as it has been designed with a view to addressing perceived flaws in international tax rules.[1]

Through the BEPS Action Plan, the OECD is setting the stage to make it more difficult for multinationals to exploit gaps in international tax rules and to shift profits. BEPS also has implications for the financial services sector, particularly in relation to substance and permanent establishment (PE) issues. Given the importance and attention of BEPS, the OECD expects the first output by September 2014 and the completion of the BEPS Project by the end of 2015. During this process, the OECD will seek input from all stakeholders and consultations directly with businesses, non-governmental organisations, think tanks, and academia. In order to facilitate active involvement of all stakeholders, we understand the OECD will: (i) hold regular briefings, which will be delivered through webcasts and will be accessible for free by all interested parties (scheduled for early 2014); (ii) publish requests for input via the OECD website to inform the work at an early stage; (iii) publish discussion drafts for comments; and (iv) ensure public consultation is organised in order to discuss the comments received. The calendar for planned stakeholders' input in 2014 is available online (*link*).

In this edition, we present four BEPS related articles covering areas we feel will only increase in importance over the coming years.

One of the ways in which tax authorities try to increase their international tax revenues is by challenging the PE status of business operations in their country or the profit attributed to PEs. The first article, *In-transit - travelling bankers and potential permanent establishment implications in a post Base Erosion and Profit Shifting world,* discusses the characteristics to be taken into consideration in determining the possible PE status of travelling bankers.

The second article, *Uncharted territory - The impact of OECD developments on intangibles in the financial services industry,* addresses the increasingly important topic of intangibles in financial services. Recent OECD publications on BEPS and intangibles indicate that financial trading systems and quantitative models are regarded as intangibles. This will potentially open discussions regarding their ownership and allocation of profit.

The third article, *A look at re-characterisation,* we explore the re-characterisation of financial transactions as a means by which governments can challenge activities that the BEPS analysis would regard as avoidance. By looking at the OECD framework and recent legal cases, the author points to criteria that intercompany transactions need to meet in order to avoid the risk of re-characterisation.

1 Explore the latest developments and PwC's global tax specialists' perspectives on each BEPS action point via our dedicated website www.pwc.com/beps

The fourth and final article, *Australia and BEPS*, focuses on BEPS from an Australian viewpoint. It highlights the leading role that Australia wants to take in the global BEPS discussion and examines several recently introduced laws and papers in response to BEPS. In particular, the Australian Tax Office (ATO) has always been at the forefront of transfer pricing discussions.

Finally, we would like to invite you to the upcoming 2014 Financial Services Transfer Pricing Masters Series sessions next spring in Milan and New York and next summer in Tokyo where discussions and presentations on the above mentioned topics as well as other transfer pricing topics will take place. We will announce the dates and other details as soon as they become available.

Please feel free to reach out to your local PwC financial services tax/transfer pricing contact for more information on the Financial Services Transfer Pricing Masters Series sessions, the topics covered in this publication or other transfer pricing matters.

Best regards,

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*Until the work of the OECD is completed, we can expect more frequent and assertive PE challenges, including the international origination arrangements conducted by travelling bankers or representative offices of banks.*

# *In-transit: travelling bankers and potential permanent establishment implications in a post Base Erosion and Profit Shifting world*

*By Wout Moelands and Hamir Khatau*

## *Introduction*

The PE rules provide tax authorities with a means to increase their international tax take by taxing activities undertaken by overseas companies within their borders; either through challenging the PE status of business operations in their country, or, if it has been established that a PE exists, by challenging the profit attribution to that PE. At the same time, tax authority willingness to assert the existence of PEs and to seek to apply PE rules is increasing globally; the Internal Revenue Service (IRS) has been hiring more dedicated personnel to consider PEs; and Her Majesty's Revenue and Customs (HMRC), the ATO and the Inland Revenue Authority (IRA) of Singapore have provided specific guidance on the establishment and treatment of PEs.

Furthermore, it has been a recent focal point for the United Nations and the OECD (i.e., evidenced by *"the OECD Model Tax Convention: Revised Proposals concerning the Interpretation and Application of Article 5"* published in 2012; and as part of the BEPS Action Plan published in July 2013).

One area within the financial services industry that may be specifically prone to challenges on PE status concerns (investment) banks and the origination activities performed by representative offices and travelling bankers. As such, in this article we set out certain considerations that need to be taken into account in analysing the PE status for travelling bankers based on the current OECD Model Tax Convention and the 2012 Commentary. First, however, we address the relevant action points from the OECD BEPS Action Plan in relation to the PE status test.

## *BEPS Action Plan*

The BEPS Action Plan addresses two specific points of interest in relation to the PE test. The first of these points deals with commissionaire structures where there is a de-risking of the local operations (i.e., with the intention of converting the local operations into a commissionaire) and a shift of profit to a central location (i.e., to which the risk is transferred); however, there is no substantive change of functions performed at the local operations. The second point considers those situations where multinational companies may artificially fragment their operations among various group entities to qualify for the exceptions to PE status for preparatory and auxiliary activities.

As provided in the BEPS Action List (Action Point 7), the OECD will pursue further work on the Dependent Agent test in Article 5.5 of the OECD Model Tax Treaty and on the provisions dealing with preparatory and auxiliary activities in Article 5.4 of the Treaty. This work is aimed to be completed within 2 years.

Until the work of the OECD is completed, we can expect more frequent and assertive PE challenges, including the international origination arrangements conducted by travelling bankers or representative offices of banks. Currently, we are already experiencing increased tax authority activity in this respect: PE analyses are being requested as part of advance pricing agreement (APA) applications; there is evidence of transfer pricing arrangements being scrutinised on the grounds of PE; and erratic

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## *In-transit: travelling bankers and potential permanent establishment implications in a post Base Erosion and Profit Shifting world*

application of the rules in some locations is an increasing problem.

Below, we have dealt with certain key characteristics and practical implications that need to be addressed in analysing the PE status of travelling bankers. We will look at these in the order of the relevant paragraphs of Article 5 of the OECD Model Tax Convention. In particular, we will address certain key considerations in relation to the exceptions to PE status for preparatory and auxiliary activities.

### *Travelling bankers – PE test*

*Fixed place of business (Article 5.1-5.4)*

The essential characteristics of a PE per Article 5(1) include a place of business that is fixed and through which the business of the enterprise is carried on.

Considering the day-to-day activities of the bankers (i.e., travel regularly to meet (potential) clients and often using the offices of local affiliates), the first characteristic to be addressed is whether there is a place of business in the countries the bankers are visiting. In this respect, an office is explicitly mentioned in Paragraph 2 of Article 5(1) in relation to what includes a fixed place.

The second characteristic to consider is whether the office would be a 'fixed' place of business. Although the Commentary on Article 5 provides a six month 'cut-off' practical example (rather than a definitive rule) the 2012 Revised Proposal indicates that if the business concerned is conducted in its entirety for a short duration only; or if the activity is performed recurrently for a short duration consistently over a number of years this could cause a PE. Other practical implications in analysing whether a place of business would be fixed, and for which there is no conclusive guidance, includes how the days need to be counted. In considering this, there is currently no clarity on the point at which a PE may arise. (e.g., if more than one banker is in a certain country on one day, should that day be counted as one day or more than one day).

The final characteristic to be considered is whether the 'fixed place' is a 'fixed place of business'. In determining what activities would be considered carrying on the business of the enterprise, Article 5(4) of the OECD Model Tax Convention and the Commentary state that auxiliary and preparatory work would not be considered as 'carrying on a business'. The Commentary to Article 5(4) notes further that even if a fixed place of business exists *"but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question,"* the respective company shall not be deemed to have a PE. As such, where a fixed place of business exists, but only auxiliary and preparatory services are being performed, no PE would be created. On this point, the OECD has inserted some additional wording in the 2012 Revised Proposal indicating that multinationals sending employees to merely visit the offices of a subsidiary would typically not create a PE. However, the activities of travelling bankers would typically exceed merely visiting the office of a subsidiary. Therefore, more clarity on what would be considered as carrying on a business is required and will hopefully be addressed in the work the OECD is anticipating carrying out as part of Action Point 7 of the BEPS Action List.

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*Dependent agents (Article 5.5)*
A dependent agent PE per Article 5(5) is constituted when a person other than an independent agent is acting on behalf of an enterprise and has and habitually exercises an authority to conclude contracts in the name of the enterprise.

In our example, the travelling bankers meet with (potential) clients for customer relationship purposes to promote the bank and to discuss the products and services the bank has to offer. As such, the key test in analysing the dependent agent PE status of the bankers is whether they habitually exercise an authority to conclude contracts in the name of their home office. To aid the interpretation of the meaning of this test, a new sentence was proposed in the 2012 Revised Proposal. This sentence states that in some countries an enterprise could be bound by a contract concluded with a third party by a person acting on behalf of the enterprise, even if the person did not formally disclose that it was acting for the enterprise and the name of the enterprise was not referred to in the contract. However, this proposed interpretation is rather vague and open to a wide range of interpretations.

Specifically, it may be interpreted as lending support to the "economically bound" interpretation of the dependent agent rule, i.e., it is sufficient for the test to operate if the foreign principal is economically bound by the contracts concluded by the person acting for it (assuming the other conditions of Article 5(5) are met).

Also here, the further work of the OECD on the Dependent Agent test in Article 5.5 as part of Action Point 7 of the BEPS Action List will hopefully provide more clarification.

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*Service PEs*

Although not included in Article 5 of the OECD Model Tax Convention, the Commentary and certain double tax treaties (in particular in the tax treaties with certain Asian countries) include the Services PE.

The Commentary provides the following example provision for a services PE to be constituted (by means of a twofold threshold test): *'where an enterprise of a Contracting State performs services in the other Contracting state through an individual who is present in that other State for: (i) a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual; or (ii)'a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services'.* As with the fixed place of business PE, where the services are only of auxiliary and preparatory nature, no services PE is deemed to exist.

For travelling bankers, the second threshold is often the more relevant one as the gross revenues test is typically not met in our experience. However, if it has been agreed by contract to provide services through the employees of a separate enterprise (e.g. an enterprise providing outsourced services), the services performed through these employees will not be taken into account for purposes of the application of the second threshold and this rule applies regardless of whether the separate enterprise is associated to, or independent from, the company that entered into the contract.

### *Summary*

PEs are on the agendas of tax authorities globally to widen their taxable base. One area within the financial services industry that may be specifically prone to challenges on PE status is the origination activities performed by travelling bankers. The analysis is complex and should consider the economic relations, the contractual relations etc.; however, there are still some uncertainties on how the rules need to be interpreted. As such, the additional work of the OECD identified in BEPS Action List may well be required to provide some further clarification in this respect.

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*The trend in terms of ownership and allocation of returns to intangibles is that, although contractual relationships between related parties will continue to serve as a starting point for any transfer pricing analysis, the location where material functions related to the intangible assets are performed is considered to be critical.*

# *Uncharted territory[2] - The impact of OECD developments on intangibles in the financial services industry*

*By Stephanie Pantelidaki and Ryann Thomas*

In July, the OECD released its BEPS Action Plan. Action 8 of the Action Plan outlines the OECD and BEPS views on intangibles. Not surprisingly, the principles outlined in Action 8 are remarkably consistent with the OECD's Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (OECD Revised Draft) issued a few days after the Action Plan in July as well. It is understood that the BEPS process has had a significant influence on the development of the OECD Revised Draft.

Although the entire Action Plan, including Action 8, is applicable across all industries, the implications will differ across industries depending on: (i) the operating and transaction structures adopted in the industry; (ii) the substance of those structures; and (iii) the pricing pressure points arising.

For intangibles used in financial services, the impact of the Action Plan and the OECD Revised Draft will be primarily centred on two topics:
- Identification of intangibles; and
- Ownership of intangibles and allocation of intangibles profits in accordance with value creation.

Historically, the vast majority of intangibles identified in financial services have been market-facing (e.g., trade names, customer relationships). Nevertheless, as the industry continues to expand electronically, trade intangibles[3] (e.g., quantitative or algorithmic models) and hybrid intangibles (e.g., trading platforms) are increasingly being acknowledged as creating value for the enterprise. As the scope of what has been considered an intangible in the financial services industry has been narrower in the past, proper analysis and identification of intangibles will be a critical task for financial institutions in the future.

Once an intangible has been identified, proving where the economic ownership resides, and that the provision of the intangible for exploitation in local jurisdictions is worth paying for, are the next most important issues. This is made worse for financial services due to the globally integrated nature of many business lines and due to the growing use of electronic tools and solutions. There will be similarities in this regard with the difficulties faced by many e-commerce businesses in identifying ownership of intangibles.

Given the lack of focus on intangibles in financial services in the past, this new focus enters uncharted territory for many in the industry. To assist in directing some of this attention, the remainder of this article outlines the basic principles of Action 8, and describe in more detail its likely implications on financial institutions.

More specifically, Action 8 reads as follows: *"Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements".*

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2 This article was originally published in an international transfer pricing journal published by Bloomberg BNA on 20 November 2013.
3 Exhibiting both market-facing and trade-related features.

## *Uncharted territory - The impact of OECD developments on intangibles in the financial services industry*

Action 8 (i) points to the expanded nature of what will constitute an "intangible" in the future. As per the OECD Revised Draft, an intangible is *"something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances"*[4]. The breadth of this definition may be contrasted with that contained in Chapter 6 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines"), which describes a much narrower scope[5].

The OECD Revised Draft does restrict the definition of identified intangibles to exclude purely market conditions or circumstances such as locations savings, local market features, assembled workforce or synergies which, unlike an intangible, are incapable of being owned or controlled by a single enterprise. Nevertheless, the clear intention of Action 8 (i) and the expanded definition of "intangible" in the OECD Revised Draft must translate to increased scrutiny and vigilance from tax authorities on what constitutes an intangible for any enterprise, including financial institutions.

Action 8 (ii) refers to the classic principle of profit allocation being commensurate with value creation as captured through the functions, risk and assets at play in both the "use" and "transfer" of intangibles. The challenge for taxpayers here arises in how to practically apply this principle in cases of, e.g., split economic ownership or the delegation/sub-contracting of non-routine activities or important people functions, both of which are applicable in financial services.

Action 8 (iii) covers "hard-to-value" intangibles, which usually tend to be "hard-to-define" intangibles, for which clearly identifiable cash flow cannot always be identified. This may be applicable to financial services when dealing with hybrid intangibles, such as insurance claims history or access to liquidity, etc.

Updating the guidance on cost contribution arrangements as per Action 8 (iv) will have an impact on financial institutions that use such arrangements for development of systems/platforms across entities. The expected changes under this principle are likely to be around technical issues, such as allocation keys or ensuring an arm's length sharing of costs, rather than on the structure of such arrangements themselves.

### *Identification of financial services intangibles*

As mentioned above, financial services intangibles have traditionally been found in market intangibles, such as trademarks/trade names or customer/distribution lists. However, under the more expansive definition of intangibles contained in Action 8 and the OECD Revised Draft, given the higher profile of intangibles generally as a result of the OECD's work in this area, and within the context of the current knowledge economy, it is expected that there may be an emergence and promotion of a far greater range of intangibles, particularly in the area of trade and hybrid intangibles.

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4 OECD Revised Draft, 40.
5 OECD Guidelines, 6.2.

## *Uncharted territory - The impact of OECD developments on intangibles in the financial services industry*

*Market intangibles*

The most commonly identified intangible in financial services tends to be trade name (group name) and its transfer price is usually expressed as a royalty fee, i.e., a percentage of revenue. Paragraphs 99-103 of the OECD Revised Draft make it clear that there needs to be a "financial benefit" received by the local affiliate through this trade name provision, in order for such a royalty charge to be justified. In practice this translates to demonstrating how the trade name contributes to increasing sales locally (i.e., premium pricing and/or volume increase), and/or possibly reducing costs locally (i.e., cost savings through centrally-carried marketing activities). In any event, it will be necessary to demonstrate that specific benefits received from the use of the trade name lead to increased profit at the local level. However, unlike many consumer facing industries, foreign financial services trade names often compete with strong local trade names, making it difficult to substantiate the value/benefit (i.e., market recognition) of the global name. In addition, any development of local marketing intangibles through efforts in the local jurisdiction to promote the global name needs to be recognised and appropriately taken into account in the royalty charge.

*Trade/hybrid intangibles*

Despite the historic focus on marketing intangibles such as trade name in financial services, the future is far more likely to include a significant weighting on trade and hybrid intangibles. This reflects the growing importance of quantitative and algorithmic models (trade intangibles) in the banking and asset management industries, as well as the increasing focus on information technology, whether that be in trading platforms (hybrid intangibles) or claims processing, capital measurement and regulatory monitoring systems (trade intangibles), etc. As many of these tools have never previously been considered "intangibles", a significant amount of work will be involved for each financial institution to firstly identify all such items, and secondly to confirm if they truly provide added value to local affiliates (as opposed to simply ensuring the enterprise retains its market position). Given the impending finalisation of the OECD Revised Draft, the release of Action 8 and the increasing focus on intangibles globally by tax administrations, it is recommended that – at a minimum –taxpayers in the financial services industry start focusing on the identification of intangibles in their enterprise as soon as possible.

### *Ownership of intangibles and allocation of intangible profits in accordance with value creation*

The trend in terms of ownership and allocation of returns to intangibles is that, although contractual relationships between related parties will continue to serve as a starting point for any transfer pricing analysis, the location where material functions related to the intangible assets are performed is considered to be critical. This focus on functional value creation is formalised in the OECD Revised Draft through the concept of "important functions", which are defined as crucial activities and decisions that have a material effect on the development of the intangible[6].

In practice, this translates to the legal owner being able to outsource certain intangible-related functions, but in order to receive the premium return generated by the intangible, being required to control the functions outsourced and compensate

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6 OECD Revised Draft, 79.

## *Uncharted territory - The impact of OECD developments on intangibles in the financial services industry*

those on an arm's length basis. In situations where all or a substantial part of the important functions are being outsourced to, or are being performed by, one or more members of the group other than the legal owner, it is likely that all or a substantial part of the return attributable to the arising intangible would need to be allocated to the parties actually performing the important functions.

In addition, a mere funding of the intangible-related costs, without the assumptions of any further risks (apart from funding risks), will only entitle the funder to a risk-adjusted funding return and no more[7].

With the above background in mind, taxpayers in the financial services industry are likely to be impacted in some of the following areas:

- Important functions, as carried out by relevant employees, need to be rewarded with part or all (as appropriate) of an intangible's return. In many cases the location where the important functions are carried out is divorced from the location/entity where the intangible's return (of the majority thereof) is received.

  This is likely to be extremely relevant in the creation of quantitative models, which are often prepared in simple excel format by traders in local jurisdictions yet contain significant know how and may – in certain circumstances – be identified as intangibles. There will also be flow on consequences of identifying intangibles associated with particular employees in the financial services industry, where employee mobility tends to be relatively higher than in other industries. That is, if an employee moves from one local jurisdiction to another, is there a transfer of intangible where models used by that employee move with them?

- Many information technologies developed by financial institutions operate globally as a result of the integrated nature of financial services businesses, the focus on global capital maintenance and liquidity management for banks and insurance companies, and the increasing regulatory oversight that requires global transparency (particularly from the US). On the other hand, global systems

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7 OECD Revised Draft, 82-84.

of this kind almost always require some form of localisation, due to differences in regulatory requirements in each local jurisdiction. Difficult questions will arise in determining whether the localisation of such systems by local affiliates entitles those affiliates to an "ownership" share of any intangible return.

- In contrast, difficulties may also arise in the opposite case where material costs have been incurred to develop such global systems in a single jurisdiction (or a few central jurisdictions), but the value added by those systems in the generation of profit in local jurisdictions– which is required to support a royalty charge to local affiliates as described above – is not clear or easy to substantiate. Given the level of regulatory change in the financial services industry, which since the global financial crisis has significantly overshadowed any other industry worldwide, and the increasing pressure on tax authorities in headquarters jurisdictions (such as the US or UK) to push out these costs, this issue is responsible for more than its fair share of concerns raised by tax directors in financial institutions.

## *Conclusion*

The combined impact of BEPS Action 8 and the OECD Revised Draft has been to clarify and strengthen the setting of principles and guidance by which the identification, ownership and valuation of intangibles should be practised by enterprises, including those in financial services. In particular this article has highlighted certain specific areas and topics that are likely to be of most interest to financial institutions.

Based on the summary contained in this article, it should be clear that the key message for tax directors in financial services is that it is never too early to begin work on the identification of, and determination of ownership for, intangibles. Past experience suggests that this is an area that has not been the subject of much focus in the industry, making it likely that more work may need to be done to identify the scope of potential intangibles than is perhaps the case in more traditional manufacturing industries.

With the release of the BEPS Action Plan and the OECD Revised Draft, it is no longer possible to remain complacent on this topic. Intangibles in the financial services industry are unlikely to remain uncharted territory for much longer.

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*Taxpayers must first characterise/define an intercompany arrangement before they can attempt to conduct any meaningful transfer pricing analysis to evaluate the arm's length nature of that intercompany arrangement.*

# A look at re-characterisation

*By Arthur Mendoza*

## Special measures and re-characterisation

The arm's length principle is under attack! As the international community awaits the next phase of OECD's BEPS Action Plan, many people are left pondering what "special measures", beyond the arm's length principle, the OECD will put in place to correct the perceived flaws in the international tax system. While many people fear that this could lead to the formulary apportionment of income among related parties, there are other special measures that the international community share concerns over. Among these top most concerns would be an increased empowerment for tax authorities to re-characterise intercompany transactions.

The character of an intercompany arrangement is the manner in which an intercompany transaction is defined. Taxpayers must first characterise/define an intercompany arrangement before they can attempt to conduct any meaningful transfer pricing analysis (i.e., select a transfer pricing method and find market comparables) to evaluate the arm's length nature of that intercompany arrangement.

Characterisation is a matter of fact, and it is based on the actual functions, risks and assets of related parties under the intercompany arrangement. Because taxpayers have certain discretion over how actual functions, risks and assets are assigned to related parties throughout an organisation, taxpayers have some degree of control over the structure and thus the characterisation/definition of their intercompany transactions.

## Financial transactions – An easy target

Given this level of flexibility, tax authorities are growing ever more sceptical of the manner in which taxpayers have structured and characterised their intercompany transactions. Particularly, attention is paid to transactions which involve functional attributes that are easily assignable to related parties, such as the transfer of intangible property or the transfer of risk from one related party to another. These functional attributes are not only easily assignable but they can also be very valuable, and thus they can significantly affect the amount of tax owed by related parties that perform / own / bear these functional attributes.

For example, a taxpayer may choose to structure an intercompany funding arrangement as an intercompany loan rather than through a contribution of capital. The intercompany loan results in credit risk for the related party lender because the related party borrower could default on its obligations, and thus the related party lender should be compensated with an arm's length interest rate for bearing such credit risks. This characterisation could have obvious tax consequences such as the deductibility of interest payments whereas the distribution of dividends would not be deductible.

The characterisation of financial transactions has been of particular interest by the OECD, so much so that the OECD dedicated two action points on their BEPS agenda to the topic. Action point 2 seeks to neutralise the effects of hybrid mismatches of an intercompany transaction which result in double non-taxation between two taxing jurisdictions. This typically involves financial transactions where an intercompany arrangement can be characterised as debt in one

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jurisdiction and at the same time be characterised as equity in another jurisdiction. Action point 4 seeks to limit base erosion by focusing on interest payments and other similar deductions for financial arrangements. This action item is not limited to intercompany loans, but also includes financial and performance guarantees, derivatives, insurance arrangements, and other intercompany transactions that taxpayers may use in their normal course of business to manage its capital and hedge certain risks for the organisation.

The reason that the OECD dedicates two action points to financial transactions in its BEPS agenda is clear. It's because it was perceived to be relatively easy for taxpayers to structure financial transactions in a way that obtains a specific tax outcome. And if they could do it in such a way to achieve hybrid mismatches by comporting to the local tax rules of both sides of the intercompany transaction, it can have the added benefits of double non-taxation. It used to be that all that tax authorities required of taxpayers to support the characterisation of an intercompany financial transaction was some capital and a contractual agreement.

While it is not clear how much substance is needed under the current landscape, it may be safe to say that tax authorities are demanding greater substance all around.

## *Regulatory framework and interpretation*

The current regulatory framework on re-characterisation can be found under Section D.2 Chapter 1 of the OECD Transfer Pricing Guidelines. This section states that an examination of an intercompany transaction should typically be respected and based on the transaction actually undertaken by the taxpayer as it has been structured by them. However, there are two exceptional circumstances in which it may be appropriate for a tax authority to disregard the characterisation adopted by a taxpayer.

- The first circumstance arises where the economic substance of a transaction differs from its contractual form. The OECD Transfer Pricing Guidelines explicitly uses a financial transaction as an example of this circumstance and implies in their example that certain terms and conditions of an intercompany loan agreement differed from the actual conduct of the related parties. While the OECD does not elaborate on these differences, these inconsistencies could have been the inability of the related party borrower to make timely cash payments, and/or the lack of enforcement of creditor rights for the related party lender. In this example, the OECD said that it might be appropriate for a tax authority to re-characterise the financial transaction in accordance with its economic substance which seemed to be more akin to a subscription of capital.

- The second circumstance arises where the contractual form and economic substance of the transaction are the same, but the arrangements made in relation to the transaction differ from those which would have been adopted by third parties behaving in a commercially rational manner. An example of this would be a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research by the seller.

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> The OECD states that while it may be proper to respect the transaction as a transfer of commercial property, it would be appropriate for a tax authority to conform the terms of that transfer to those that might reasonably have been expected. The OECD implies that it is unlikely that third parties would provide unlimited access to the intellectual property rights arising from future research developments under a lump sum arrangement and therefore re-characterised such terms with an additional services payment.

What does this regulatory framework boil down to? While not explicitly stated, these two re-characterisation examples in the OECD Transfer Pricing Guidelines illustrate the importance of: (i) having rational commercial terms documented in an intercompany arrangement; and (ii) ensuring that those contractual terms are actually followed by the related parties in substance. Intercompany transactions that do not meet such criteria are at risk of re-characterisation.

## *Recent precedent and lessons learned*

Fears about base erosion and profit shifting have given tax authorities the push to act upon the regulatory framework described by the OECD. Just last year in the United States, there were three cases decided by the Tax Court addressing situations in which the IRS challenged the taxpayer's characterisation of financial instruments.

- In PepsiCo Puerto Rico, Inc. et al v Comm'r (TC Memo 2012-269) (PepsiCo), the taxpayer prevailed in its argument that its instrument should be characterised as equity.
- In NA General Partnership, et al v Comm'r (TC Memo 2012-172) (Scottish Power), the taxpayer convinced the Tax Court that its instrument should be characterised as debt.
- In Hewlett-Packard Co. v. Comm'r (TC Memo 2012-135) (HP), the Tax Court disagreed with the taxpayer finding that the instrument actually reflected a debt obligation.

The Tax Court delivered two opinions in favour of the taxpayer on debt versus equity analyses (PepsiCo and Scottish Power). It is quite interesting to note that in both those cases, the intercompany financial transaction involved an acquisition of entities as part of an effort to expand operations across borders, which demonstrated credible business purpose for their respective arrangements. Another important fact in these cases was that the taxpayers closely followed the respective structure of the financial instrument, which supported the economic substance of their arrangements.

In the one case where the Tax Court ruled in favour of the IRS, it was determined that HP's intercompany financial transaction was constructed mainly by an investment bank as a product to market to clients for the purpose of generating foreign tax credits. Also, the Tax Court found that HP had failed to act in a manner that a reasonable equity holder would have acted with respect to a subsidiary. This lack of business purposes and economic substance ultimately resulted in the re-characterisation of HP's financial instrument from equity to debt.

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## Moving forward

These types of challenges are becoming more and more prevalent in the United States. In 2013, another two companies disclosed similar on-going challenges. Ingersoll-Rand disclosed that it may face a tax bill of as much as USD700 million because the IRS is seeking to re-characterise interest income from an intercompany debt as "earned" by Ingersoll-Rand Co., in the United States, resulting in taxable dividends under the re-characterisation. Tyco also disclosed that it is challenging a USD1 billion tax assessment by the IRS based on the latter's view that cash transfers carried out during a series of corporate acquisitions were not debt payments, but rather taxable dividends.

This audit activity reflects a growing assertiveness of tax authorities to re-characterise intercompany transactions under the current market environment. It has also resulted in substantial uncertainty in the international community on how they should operate and how they should structure legitimate intercompany transactions (particularly financial transactions). The hazards of re-characterisation is pointed out under paragraph 1.64 of the OECD Transfer Pricing Guidelines: "Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured."

*While it is not clear how much substance is needed under the current landscape, it may be safe to say that tax authorities are demanding greater substance all around.*

The OECD needs to provide better guidance in addressing this uncertainty in the international community and clarifying the circumstances in which intercompany transactions can be re-characterised.

Clearly defining what constitutes economic substance would be a good start. Putting parameters around commercially rational behaviour would be a step in the right direction as well. These steps would go much farther in addressing the gaps in the international tax system than any "special measure" beyond what the arm's length standard can provide. Further, the OECD needs to provide a more reliable framework to apply the arm's length principle with respect to the characterisation of intercompany transactions. After all, how can tax payers apply the arm's length principle if they don't even know what it is they are pricing?

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*In these times of change, it is important for a multinational taxpayer to review its tax and transfer pricing arrangements with a view to address any risk areas and to be vigilant and continuously monitor the developments in this space.*

# Australia and BEPS

*By Nick Houseman and Prashant Bohra*

The BEPS debate has been active in Australia over the last year. The former Government had openly commented on the need for stronger rules to combat profit shifting and had endorsed the need for global action. The current government has reiterated the need for Australia to be an active participant in the global debate through forums such as the Group of 20 (G20) and the OECD. A number of initiatives have been introduced domestically and the ATO is gearing its administration to address the challenges presented by BEPS.

Notwithstanding the current political climate, many of the themes arising from the BEPS debate have been on the agenda in Australia for a number of years. In fact, it could be argued that through recent reforms in transfer pricing and anti-avoidance legislation, Australia has already implemented many of the legislative tax tools equipped to deal with risks associated with profit shifting.

## 1. Transfer pricing reforms

The rewrite of Australia's transfer pricing rules was initiated in 2011 following the Commissioner's loss in two judicial decisions on the pre-existing transfer pricing regime.

Phase 1 of the reform involved introducing retrospective rules applying to dealings with related parties in tax treaty countries. These rules were enacted in September 2012 and have now been inserted into the Income Tax Assessment Act (ITAA) 1997 as Subdivision 815-A. Despite strong protests from business community and tax advisers, these rules apply retrospectively from 1 July 2004.

Phase 2 involved comprehensively rewriting the Australian transfer pricing rules. These rules have been enacted with effect from 1 July 2013 and will operate on a self-assessment basis with a 7 year statute of limitations for adjustments. The new rules are broader in scope than the existing ones and require detailed consideration of arm's length conditions and also introduce reconstruction powers. There are special considerations for thin capitalisation and pricing related party debt. Documentation will be required to be prepared by the time of lodging tax returns to mitigate penalties.

The intention of the reform was to modernise Australia's transfer pricing rules and more closely align them to OECD's transfer pricing guidance. However, the modernisation is yet to extend to the rules for attribution of profit to PEs that are important to participants in the financial services industry who often operate through PE structures. It is unclear if, and when, Australia will adopt the authorised OECD approach for PE profit attribution. The Board of Taxation (BOT)[8] provided its report on the review of PE attribution rules to the government in April 2013. It is expected, that in line with past practice, BOT's report will be available at the time the Government releases its response to the report. In the meantime, taxpayers (particularly in the financial services industry) have to address significant uncertainties in this area of law which is also receiving

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8 BOT is a non-statutory advisory body charged with contributing a business and broader community perspective to improving the design of taxation laws and their operation.

close attention from the ATO. As an example, the ATO have released a series of Interpretative Decisions (ATO ID2012/90/91/92) regarding the allocation of funding and liquidity costs to a foreign bank's Australian PE. The Interpretative Decisions are not law but a summarised record of a Tax Office decision. The decisions reflect the ATO's view that interest expense to fund general reserve liquid assets and internal estimates of notional funding costs are not deductible under section 8-1 of ITAA 1997 or under the business profits article of a tax treaty. There is disagreement regarding this position, in particular many in industry believe that this decision is not the correct interpretation of the existing rules.

## 2. Increased disclosure and transparency

A number of new disclosure and transparency measures relevant to an Australian taxpayer's transfer pricing arrangements have been introduced in recent times, with further measures also currently being proposed at the OECD level.

*New transparency laws*

New legislative measures intended to improve the transparency of Australia's corporate tax system have recently been enacted. Under the new law, the Commissioner of Taxation is required to publish certain tax information of large corporate taxpayers (on a named basis) including those that have 'total income' equal to or exceeding AUD100 million for an income year, as reported in the entity's tax return. These measures apply broadly from the 2013-14 year and are stated to provide more information to inform public debate about tax policy, enable better public disclosure of aggregated tax revenue collected, and improve information sharing between government agencies. It also has the broader objective of discouraging large corporate entities from engaging in aggressive tax avoidance practices which is part of the government's broader BEPS agenda.

*International dealings schedule*

The ATO has introduced enhanced reporting requirements of taxpayers cross border related party transactions. The new International Dealings Schedule (IDS) has replaced the old Schedule 25A and represents a significant increase in disclosure requirements, particularly for financial services industry where transaction volumes tend to be significantly higher though not necessarily reflective of correspondingly higher risk.

The ATO will use the new schedule as a risk assessment tool to screen for risks and identify areas of concern which the ATO perceives as high risk.

*Reportable tax positions schedule*

The ATO has introduced a reportable tax position (RTP) schedule, which requires certain key taxpayers (based on ATO criteria) to disclose information about reportable tax positions (i.e. uncertain or contestable positions) in an attachment to their annual income tax return.

It is understood that the ATO intends to use the information gathered in the RTP Schedules in its assessment of the tax risk of each taxpayer, which will be considered when selecting cases for reviews or audits. Financial services companies and banks,

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in particular, tend to generally fall in the category of a 'key taxpayer' given their size and hence some taxpayers in the industry may be impacted by these disclosure requirements.

## 3. BEPS specific initiatives

*Treasury paper*

At the time of the OECD's release of its BEPS Action Plan, the Australian government released a paper titled "Risks to the Sustainability of Australia's Corporate Tax Base – Scoping Paper". This paper looks at the broader issues surrounding multinational profit shifting and was developed in consultation with experts from the community sector, academics, business and the tax profession on the taskforce.

The Scoping Paper sets out the Treasury's assessment of the risks facing Australia's corporate tax system as a result of BEPS and makes recommendations on actions Australia should take to address these risks. The recommendations contained in the Scoping Paper are aligned to the OECD's BEPS Action Plan.

*Budget announcements*

As part of the last budget, the former Government announced certain corporate tax changes that interplay with the transfer pricing rules.

These included reduction of the 'safe harbour' debt limit under the thin capitalisation rules to address profit shifting through the artificial loading of debt in Australia. The new Government has now confirmed that it intends to proceed with the proposed reductions of the safe harbour.

The BOT has also been asked to undertake a post-implementation review of debt and equity rules including whether there can be improved arrangements within the Australian tax system to address any inconsistencies between Australia's and other jurisdictions' debt and equity rules that could give rise to arbitrage opportunities. The Board has been asked to report to the Government by March 2015.

However, a couple of other measures to address perceived integrity issues, such as the removal of a tax deduction for interest expenses incurred in deriving certain exempt foreign income and changes to the offshore banking units (OBU) tax regime are proposed to be curtailed by the new Government and replaced by some targeted anti-avoidance provisions.

*ATO Compliance program*

The ATO's 2013–14 Compliance Program has a strong focus on BEPS. Profit shifting has been identified as a significant tax compliance risk for large businesses (turnover of more than AUD250 million) and medium businesses (turnover greater than AUD2 million, but less than AUD250 million).

The ATO has set up a new compliance project team 'International Structuring and Profit Shifting' (ISAPS) to review profit shifting risks as part of specific funding provided to the ATO in the last budget. It is understood that the team will consist of 30 officers experienced in international tax and will act as an "advisory" team to field auditors. Further, it is understood that a significant number of corporate taxpayers have been identified for a risk questionnaire.

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## *4. Conclusion*

Australia will chair the G20 summit in 2014, at which BEPS will be a key agenda for discussion. The recent initiatives of the government reflect Australia's commitment to lead the charge on BEPS. At the ground level, BEPS is influencing the manner in which the ATO is re-organising itself and engaging with taxpayers in risk reviews and audits.

In these times of change, it is important for a multinational taxpayer to review its tax and transfer pricing arrangements with a view to address any risk areas and to be vigilant and continuously monitor the developments in this space.

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