

# *The OECD/G20 BEPS Project final package of measures: what does it mean for the Banking industry?*

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## *In brief*

On Monday 5 October 2015, the Organisation for Economic Cooperation and Development (OECD) published its final package of reports on Base Erosion and Profit Shifting (BEPS), which was endorsed by the Finance ministers from the G20 group of countries during their meeting on 8 October 2015 in Lima.

For the Banking sector, the most significant issues arising from the OECD's BEPS Project are those related to transfer pricing, with a shift in focus in pricing from contracts and risks to value creation and "significant people functions", as well as new documentation and reporting requirements; and of more operations being treated as permanent establishments. Products offered by Banks are also likely to be affected - notably with there being less tax treaty relief for certain securities lending operations, and for funds managed in both the traditional and alternatives sectors. Even though these OECD recommendations remain subject to implementation (which may take years), the BEPS Project is already causing "climate change", which the Banking industry needs to monitor and anticipate carefully.

## *Why the Banking industry should care about BEPS*

The Luxembourg Banking industry, whether investment banking, private banking or lending platform activity, is by nature a cross-border activity. As such the measures proposed by the OECD/G20 BEPS Project become relevant both from a product perspective (affecting clients, and after-tax returns), and from a corporate perspective (the way banks themselves operate).

The main consequences of the BEPS Project for the Luxembourg Banking industry are likely to come in the following areas: (a) transfer pricing setting and disclosures; (b) increasing risk of permanent establishments; and (c) the potential for severe restrictions on tax treaty access for clients/products.

Other action points under the BEPS Project could affect the Luxembourg Banking industry, but probably to a lesser extent. The practical impact of BEPS measures for each individual banking group might well be very different, depending on the nature of its products offered (e.g. investment banking or private banking) and its organisation/financing.

Media concern and pressure group activity linked to corporate tax issues is likely to remain notably intense, and, particularly within the Banking industry, reputational concerns linked to the management of taxes and the BEPS agenda will be an important issue for the highest level of management. This will increasingly influence how banking groups do business, and also how they help their clients do business.

## ***BEPS measures in more detail***

### **1. *Transfer pricing and disclosures***

One of the main themes of the BEPS Project has been the need for better alignment of substance with the location of profits. There is a particular emphasis on allocation of the returns associated with risks, capital and intangibles. The key change is the shift from the priority of legal form to that of people-based substance and value creation. For instance, where contracts appear to be inconsistent with the conduct of the parties, the BEPS Project recommendations could lead to the non-recognition of non-commercial transactions. It will be important for banking groups to put a greater emphasis on defining the functions performed, and on evidencing the location in which control of risks and intangibles is exercised, using the new definitions.

Transfer pricing documentation will also be a challenge for the Banking industry. The BEPS Project measures impose a requirement for each taxpayer to have available a “master” file, containing information relevant for all group members, and a “local” file, referring to material transactions of the local taxpayer. Although this approach has been broadly foreseen as part of the new Luxembourg transfer pricing regime that took effect at the beginning of January 2015, these requirements (which are greatly more prescriptive and detailed) should be further analysed in the post-BEPS world to ensure optimum compliance.

Moreover, and subject to meeting certain conditions (e.g. a group having turnover above EUR 750 million), a set of Country-by-Country Reports (CbCRs), containing data on the global allocation of income and taxes, and certain other measures of economic activity, will have to be prepared for each and every country where a group has operations. Unlike other transfer pricing documentation, a full set of CbCRs will have to be submitted to the tax authorities of the country where the group parent is resident. These CbCRs will then be automatically exchanged between the tax authorities of every country where the group has operations. These CbCR BEPS Project measures are expected to be legislated by many countries in the very short term, and (in line with the OECD’s Final Report on this topic) would require reporting of FY2016 data, with CbCRs being submitted before the end of 2017. Banking groups, in common with all other large multinationals, thus face a considerable and imminent challenge to ensure that their internal financial and IT systems will be able to generate the data needed, in a reliable and accurate form.

This type of obligation is not new for the Banking industry, as a similar requirement already exists within the EU at a consolidated level under the Capital Requirements Directive IV (CRD IV). Furthermore (and unlike the BEPS CbCR Project measures), CRD IV reporting results in information becoming publicly available. However, the content, the format and the purpose of these two reporting obligation, although similar, are not fully aligned, so this is likely to imply additional work.

	<b>CRD IV Appendix to FS</b>	<b>BEPS To the Tax Authorities</b>
Name, activities, tax jurisdiction	X	X
Turnover/Revenue	X	X (Split between related & non related)
Employees	X	X
Profit (Loss) before taxes	X	X
Income taxes	X	X (Accrued and paid)
Public subsidies	X	X
Stated Capital		X
Accumulated earnings		X
Tangible assets other than cash & cash equivalents		X

## **2. Permanent establishments**

One of outcomes of the BEPS Project is a set of recommendations for making changes to the definition within the OECD Model tax treaty of the term “permanent establishment”. The aim is to broaden its scope, thus more often creating a tax “footprint” in a country, even in situations where currently there are only functions and activities that are below the permanent establishment threshold.

The measures were primarily aimed at large international groups that distribute physical products, which in many cases have local presences in customer or consumer countries that act as “commissionaire” agents for a central organisation based offshore, and which are currently able to use the tax treaty wording to escape having any of the offshore profits taxed where the customer is based. However, the wording of the new definition makes it much more likely that a local presence, which has a significant involvement in the concluding of any type of contract between a customer and a non-local group company, will not be able to avoid being treated as a taxable presence of the non-local group company. In the Banking sector, this could mean that businesses with an international client base might find that they have permanent establishments in certain countries, just because of senior sales or relationship managers visiting clients.

Also, a local presence that is currently regarded as a representation office may well become a taxable permanent establishment in a post-BEPS world.

The impact could be quite significant, notably for the Private Banking sector, but also for any banking groups with booking models (e.g. lending platforms), as most of the clients are outside Luxembourg and some key aspects of origination/managing the client may also be exercised outside Luxembourg. The Banking industry should analyse whether the detailed pattern of activity within the business could cause one or more permanent establishments to have to be recognised under the new rules. This would probably then also raise additional questions from an allocation of profits perspective. Current banking business models may therefore need to be revisited.

It should also be noted that, although the new measures themselves will require tax treaties to be modified and then ratified before they have full effect, the focus on this aspect throughout the BEPS Project is already causing some tax authorities to be much more aggressive in claiming that permanent establishments are arising under existing tax treaty definitions. Attention to this topic in the near term may thus be prudent.

## **3. Preventing treaty abuse**

The use of structures set up primarily to mitigate the burden of withholding taxes, or the incidence of taxes on capital gains on assets being disposed of by non-residents, or to secure other tax treaty benefits, is perhaps the feature of the international tax landscape that the BEPS Project has most aggressively sought to bring to an end.

To try to bring this about, the BEPS Final Report that covers tax treaty abuse sees the OECD recommending urgent and co-ordinated modification of tax treaties, adding an entire new clause to tackle the issue. The measures set out three alternative approaches that countries could take to curb tax treaty shopping – either a combination of a set of Limitation-On-Benefits (LOB) rules plus a Principal Purpose Test (PPT); a PPT only; or LOB rules plus other “anti-conduit” measures. The impact of such treaty revisions would be particularly significant for many of the products that banks offer to their clients.

Notably, the Banking industry will need to examine carefully whether treaty benefits will remain available for some securitisation structures, and for securities lending transactions (these might also be adversely affected by BEPS Project-driven “anti-hybrid” changes to local laws as well as by the implementation of a general anti-abuse rule in the EU Parent Subsidiary Directive). Indeed, some arrangements involving dividend payments are explicitly described by the BEPS Final Report that covers tax treaty abuse, and are there stated to be an example of where a PPT would operate to deny treaty benefits.

These proposed measures will also have consequences for funds managed by the Banking industry. Potentially, there could be a major impact on “alternative” investment funds such as private equity vehicles, which are not currently regarded by the OECD as Collective Investment Vehicles (**CIVs**), because they are not fully regulated or do not have sufficiently wide ownership. Further work by the OECD is however to continue in 2016 to settle the final scope of entitlement of these non-CIV funds to treaty benefits.

The proposed measures should normally allow CIVs to qualify for treaty benefits, although any treaty that includes LOB rules will need also to deal specifically with the treaty status of CIVs before treaty benefits can be available with any degree of certainty. The BEPS Project has revalidated prior work done by the OECD which both encourages treaty partners to make it clearer that CIVs have treaty access, and outlines options as to how treaty access should be applied in this regard.

### ***How compulsory are the BEPS measures? And when are they to take effect?***

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The final package of BEPS Project reports confirms that all the OECD and G20 countries “are committed to the comprehensive package”. Four different ways for the implementation of BEPS Project measures are however identified, as follows.

- (i) “Minimum standards” to tackle issues – here there is an explicit commitment agreed to by all countries to consistent implementation. The OECD sees this in terms of “levelling the playing field”. The “minimum standards” apply (among other areas) to the anti-treaty shopping measures, and the Country-by-Country Reporting transfer pricing measures.
- (ii) “Updated existing standards” – these being the revised texts of OECD Transfer Pricing Guidelines, and the changes to the parts of the Model treaty Commentary other than those covered by “minimum standards”. Here it is recognised that not all BEPS Project participants have yet fully “endorsed” these standards – which suggests that implementation may be less mandatory.
- (iii) “Agreed general policy directions” – these being the BEPS Project recommendations on hybrid mismatches, and on interest deductibility. The OECD says here that, because a general policy direction has been agreed, countries’ rules are now expected to “converge over time” through the implementation of the “agreed common approach”.
- (iv) “Guidance based on best practices” – at this time, there is no compulsion to introduce these measures.

Work continues on the development of a “**multilateral instrument**”. This important part of the BEPS Project would cause bilateral tax treaties to be modified in a synchronised and efficient way, thus causing the various BEPS Project measures which involve treaty modifications to become effective, consistently, in many countries at once, and over a rapid timescale. The aim is for the multilateral instrument is to be open for signature by the end of 2016. A group (bringing in up to 90 countries) has been set up to draft its text, and had its first substantive meeting on 5-6 November 2015 to progress this work.

The OECD and G20 countries have also agreed to work to monitor the implementation of BEPS Project measures, through an as-yet-undefined “**peer review**” process. Compliance, in particular with the “minimum standards”, would be reviewed, via reports on what individual countries have done to implement the BEPS Project recommendations.

Political support for the BEPS Project is particularly strong in several EU Member States, and the EU Commission not only endorses the BEPS Project, has said that it wishes to build on these reforms. The EU Commission will be active in seeking to secure the implementation of BEPS measures uniformly across the EU, and all EU taxpayers should not underestimate the pressure that will come from this

direction. Conversely, the USA looks to be much more lukewarm in its willingness to support the BEPS Project measures.

Although the BEPS Project reports are now all in final form, it is clear that the “finish line” for the BEPS Project is still a long way away. There is certainly a risk that domestic implementation of measures will occur in a unilateral manner that is not properly consistent with the BEPS Project, and thus that the desired international cohesion of the measures ends up being impaired or absent. Also, countries will continue to seek to provide business with an overall “tax-competitive” environment, in which the proportionality and practicality of the implementation the BEPS Project measures will play a very important role.

The Banking industry will need to consider not only the consequences of how Luxembourg implements the various BEPS Project measures, but also of how (and to what extent) all the other countries where the Luxembourg business operates or transacts with will implement them.

## Let's talk

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