BEPS Impact on the FS industry in Ireland

6 October 2015

In brief

The Financial Services ("FS") industry in Ireland will no doubt be considering the various aspects of the BEPS action papers following the release of the BEPS reports. While all 15 actions will have some impact on the sector depending on ownership structures, financing arrangements etc., there are some which are likely to be more significant

Of particular note to the FS industry are Action 7 – Permanent Establishment ("PE"); Action 6 – Treaty Benefits: Action 4 Interest Deductions; Action 13 Country by Country Reporting and Actions 8 – 10 – Transfer Pricing.

The industry will need to ensure that its position is robust to protect the longevity of the international FS sector here. This will be largely centred on substance requirements in Ireland which will be an important defence to any PE, transfer pricing and treaty abuse challenges.

These, together with the most relevant BEPS actions for the FS Industry here, are discussed in more detail below.

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In detail

Action 7 - *Permanent Establishment*

The report states that the "current definition of permanent establishment must be changed in order to address BEPS strategies". The BEPS Action Plan also recognises that in the changing international tax environment, a number of countries have expressed concern about how international standards on which bilateral tax treaties are based allocate taxing rights between source and residence States.

The report makes a number of changes to the PE Article (Article 5) of the OECD's model treaty and these changes will serve to lower the PE threshold. This will mean more taxable profits being allocated from source states to residence states with consequent increases in effective tax rates and compliance costs.

One scenario targeted involves "situations where contracts which are substantially negotiated in a State are not concluded in that State because they are finalised or authorised abroad, or where the person that habitually exercises an authority to conclude contracts constitutes and "independent agent" to which the exception of Article 5 applies even though it us closely related to the foreign enterprise on behalf of which it is acting".

To address this, the change proposed under Action 7 is the "dependant agent" clause, Article 5(5). It is amended so that an enterprise is deemed to have a taxable presence in another jurisdiction if a person acting on behalf of that enterprise:

> *"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****, and these contracts are*
>
> *a) in the name of the enterprise, or*
>
> *b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or*
>
> *c) for the provision of services by that enterprise."*

The commentary changes included, to address the above, notes that the use of the term "permanent establishment" in this context presupposes, of course, that the conclusion of contracts by that person, or as a direct result of the actions of that person, takes place repeatedly and not merely in isolated cases.

However, the above changes to Article 5 will not apply to a situation where a person in an independent agent's capacity as outlined in Article 6.

The changes are aimed at situations where the conclusion of a contract directly results from the actions that the person performs in a Contracting State on behalf of the enterprise even though, under the relevant law, the contract is not concluded by that person in that State. The commentary goes on to state that the changes are not aimed at persons merely promoting and marketing goods or services of an enterprise in a way that does not directly result in the conclusion of contracts.

The determination of the profits attributable to a permanent establishment resulting from the application of paragraph 5 will be governed by the rules of Article 7. However the work in relation to profit attribution will not be completed until 2016.

The changes are particularly targeted at commissionaire structures; however, it is likely that its implications will be much broader. This view is further bolstered when the commentary states that, *"The principal role leading to the conclusion of the contract will therefore typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise."* It should be noted, however, that the commentary does specifically state that certain "low risk distributors" should not be caught by this provision.

Article 5(6), the independent agent clause, is also changed such that if a party acts "exclusively or almost exclusively" for related parties it cannot be deemed to be an independent agent. Hence, related group companies will find it more difficult to use this exception.

The report also proposes a restriction of the specific activity exemptions, to include only activities that are of a "preparatory or auxiliary" character, to prevent businesses relying on these exemptions when the activities may be a core activity for their business. For example, large warehouses used for the storage and delivery of goods for an online business, which previously may not have created a PE, would, under the proposed changes, be likely to fail the "preparatory or auxiliary" test and create a PE. An anti-fragmentation rule has also been included to prevent the artificial fragmentation of business activities in an attempt to benefit from the specific activity exemptions.

Observation

It should be noted that the changes outlined above, and indeed in Action 6 on Treaty Benefits, will be heavily reliant on agreement to the multilateral instrument (expected in late 2016). The multilateral instrument is designed to adopt these changes into all bilateral tax treaties at the same time, rather than waiting until those same treaties adopt the proposed provisions upon renegotiation (which would inevitably take a significant amount of time). However it is quite possible that certain countries will unilaterally begin to apply these approaches before formal OECD implementation.

The lowering of the PE threshold together with the proposed changes to tax treaties will be a key focus for FS Groups to ensure structures that are in place are robust and have a degree of continuity. The changes are prospective therefore should only affect structures and business operations going forward. There is a requirement for FS Groups to review existing operations to ensure safeguards are adopted to protect against the application of these new rules and provide longevity to business structures.

Action 6 - *Treaty Benefits*

Action 6 identifies treaty abuse, and in particular treaty shopping as one of the most important sources of BEPS concerns.

The report suggests that the following three pronged approach be taken to tackle treaty abuse:

1) First, a clear statement in tax treaties that the Contracting States, when entering into a treaty, wish to prevent tax avoidance and, in particular, intend to avoid creating opportunities for treaty shopping.

2) Second, a specific anti-abuse rule based on the limitation-on-benefits provisions (the "LOB rule") included in treaties concluded by the United States and a few other countries will be included in the OECD Model. Such a specific rule will address a large number of treaty shopping situations based on the legal nature, ownership in, and general activities of, residents of a Contracting State.

3) Third, in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule described in the preceding bullet point (such as certain conduit financing arrangements), a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or "PPT" rule) will be included in the OECD Model.

That rule will incorporate the principles already reflected in paragraphs 9.5, 22, 22.1 and 22.2 of the Commentary on Article 1, according to which the benefits of a tax treaty should not be available where one of the principal purposes of arrangements or transactions is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax treaty.

Provided the adopted approach meets the following minimum standard then the parties to the bilateral treaty are free to structure it as they wish:

1) PPT; or

2) LoB + anti-conduit rules; or

3) PPT & "light touch" LoB.

All discussion of the LoB is draft largely on account of the US consultation regarding its own model treaty and as such a large portion of the work in relation to treaty abuse will roll over into 2016. The LoB provisions are to be included in both a detailed and simplified format in the commentary.

Observations

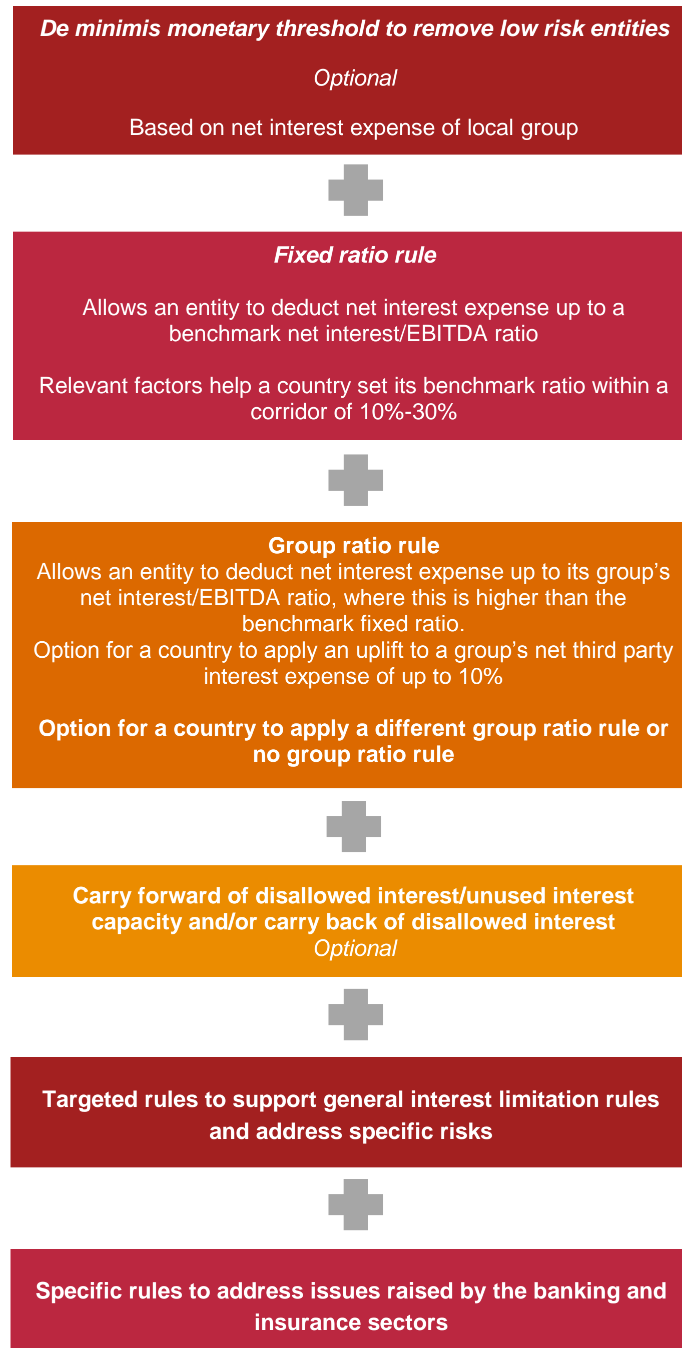
Smaller countries like Ireland are attractive to the international FS sector for many valid commercial reasons and companies should meet the PPT requirements provided they can demonstrate that they are not located there merely to artificially avail of the treaty network. However the PPT is still framed as "one of the main benefits" and as such in analysing the test, there is likely to be a large level of subjectivity involved by the FS Group in applying that test.

Consequently, while the PPT commentary is final, the examples do not sufficiently clear up the uncertainty and FS Groups are likely to face ambiguity and challenges in certain locations. Given the FS Industry's reliance on Ireland's treaty network to carry out its business there are substantial implications for the FS sector that remain to be determined.

Action 4 - Interest Deductions

Action 4 on interest deductions suggests that countries should adopt an interest to EBITDA ratio that is in a corridor from 10%-30%. Under domestic Irish law, the test in determining whether a tax deduction is available in respect of trading interest generally is whether the interest has been incurred "wholly and exclusively" for trading purposes. Therefore the proposed rules under Action4, relating to interest deductions would be new for all Irish entities.

The paper leaves a lot of discretion for individual countries around the mechanics of this rule and in relation to where in the corridor to place the cap. The OECD suggests a number additional rules or add-ons that countries may apply, such as a group ratio rule, a de minimis threshold and carry forwards/backs of disallowed interest/interest capacity. The OECD also suggests that countries may wish to use targeted interest rules to address specific risks. The framework proposed by the OECD is set out in the diagram below.



Observations

It will clearly be very important for FS groups to monitor activity in this space in all jurisdictions in which they have interest deductions. From an implementation perspective, it will be critical that any changes are made with all of the current interest rules in mind. For example, the report suggests that the rule could be applied at either an entity level or a group level within each country. In Ireland, it is likely that an entity test would not be appropriate as the current rules effectively force the separation, within country, of borrower and profit maker in certain situations. Another issue that may be experienced by Irish headquartered groups is that, for commercial reasons, they will often draw down most of their group borrowings in Ireland, whereas the related EBITDA may be located in a different jurisdiction.

Furthermore, it will be necessary for FS groups to consider which of the optional extras listed above they would like to see accompanying the interest ratio rule, bearing in mind that the report suggests that the more options availed of, the lower in the corridor of rates that country is likely to be.

In this regard, the report suggests that there will be a significant amount of flexibility for countries on implementation; hence it will be extremely important for FS groups to ensure that their voice is heard prior to any implementation decisions being taken by the Department of Finance. Financing, and in particular inter-group financing, is one of the oldest and most well-known techniques that have been used by some FS groups to manage their tax liabilities and Irish FS groups will want to protect this position.

Action 13 - *Country by Country Reporting*

It is anticipated that Ireland will introduce Country by Country Reporting requirements and that it will be announced in this year's budget and implemented by way of the Finance Bill.

It was agreed by all OECD members that the first reporting year would be for accounting periods beginning on or after 1 January 2016 with the reports to be filed a year after the end of that accounting period (i.e. 31 December 2017 for periods ending 31 December 2016) Any Irish headquartered FS Group with global revenues in excess of €750m will be required to file a country by country report (CbCR) with the Irish Revenue.

This report requires a number of different data points to be set out for each country in which the group has operations. The items which must be reported are; tax jurisdiction; revenues (split between related and unrelated parties); profit before tax; income tax paid; income tax accrued; stated capital; accumulated earnings; number of employees; & tangible assets.

Observations

While at first look, from a reporting perspective, this appears relatively straight forward our experience from talking to clients is that there are many definitional complications and difficulties in accessing the information from the relevant accounting system. The guidance from the OECD in relation to the application of the CbCR is light and as such key decisions will need to be made by every group. One of the key questions will be how to validate and reconcile the information and build in consistency year on year.

Furthermore, it will be very important that the "story" told by the CbCR can be both substantiated and defended by the TP master file. As the CbCR only provides certain data, the master file must give the full picture as to the transfer pricing policy of the group. It should also be noted that the new transfer pricing documentation requirements will also put a spotlight on the substance of Irish FS entities. In particular, the CbCR template will contain for each country (including Ireland) a breakdown of certain items including; revenue, profit, tax, capital and employees. From this limited information, tax authorities will make their own judgements of the FS Group's commercial, operational and financial profile and whether the allocation of risk and the related profit to the Irish FS group is appropriate.

Due to the complexities involved in both identifying the required data and pulling it from the relevant system we would recommend that groups perform a "dry run", even if only on a sample set of data, so that they are aware of any difficulties they are likely to face on data extraction and also so that they can ensure that all areas of TP documentation are in line and can withstand any likely challenge.

FS groups should be prepared for CbCR as a natural precursor to requests for even greater granularity from tax authorities worldwide. The ability to comply with such detailed data requests, combined with the sensitivity of the information to be provided, makes this development a significant issue for management.

Actions 8 - 10 – Transfer Pricing

Transfer pricing rules which are used for tax purposes are concerned with determining the conditions, including the price, for transactions within an MNE group resulting in the allocation of profits to group companies in different countries.

The impact of these rules has become more significant for business and tax administrations with the growth in the volume and the value of intra-group international trade.

BEPS Actions 8-10 aims to ensure that transfer pricing outcomes are aligned with value creation.

The actions focus on the following three areas:

i) Transfer pricing issues relating to transactions involving intangibles (Action 8);

   The guidance clarifies that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. For the FS industry here, a review of intangibles held, in particular, intangibles which are hard to value may need some consideration.

ii) Contractual allocation of risks and the level of returns to funding provided by capital-rich MNEs(Action 9).

   The action aims to ensure capital-rich entities without any other relevant economic activities will not be entitled to any excess profits.

iii) Other high risk areas (Action 10)

Observations

The impact of this paper on the FS industry is that transfer pricing queries going forward will likely have a more focused spotlight on the substance and the activities performed by the risk-bearing entity and the commercial rationale for the transaction. The more experienced tax authorities are already focusing their transfer pricing queries on these areas and such queries/challenges regarding Irish FS entities are set to increase going forward.

FS Groups will need to consider to what extent these new rules will impact upon their business models. As can be seen above the rules are generally targeting substance over form and as such it will be important to ensure that structures have sufficient substance to withstand tax authority scrutiny.

The single best way for an FS group to pre-empt these challenges is through compelling operational documentation, providing clear evidence of the substance and activities in Ireland. In addition, evidencing that the board has the appropriate skill and experience in the FS industry to undertake their role will be critical.

Conclusion

So all in all a lot of changes proposed which could impact the FS sector here. The proposed changes stemming from the PE paper could lead to an increased level of tax authority activity in this space. The lowering of the threshold may see Irish groups needing to manage their PE position in jurisdictions more closely. It could also lead to the recognition of taxable presences in a number of jurisdictions where they had not done so in the past leading to inevitable questions in relation to attribution (which were not addressed by the OECD in the report on PE).

Action 6 on treaty benefit will also bring further uncertainty to this area of taxation for the FS industry here and therefore groups should perform risk reviews to ensure that they can identify and mitigate any risks.

Action 4 on interest deductibility and the potential adoption of an interest to EBITDA ratio, which is put forward as a best practice recommendation, could have a significant impact on the financing structures of FS groups here. The implementation options chosen both in Ireland and abroad will be critical and it will be important that any proposed rules would be introduced in the context of the targeted rules that are already in place.

From a ***transparency*** perspective, the OECD has brought in a number of measures, which will provide tax authorities with a clearer picture of the overall activities of groups, in all jurisdictions, in which they operate and not just its own. The requirement for large multinationals to submit country by country reports and the proposed automatic exchange of rulings information could also lead to further scrutiny from tax authorities in relation to the cross border affairs of Irish groups.

The results of the transfer pricing actions will mean that it is more important than ever to align ***substance*** with value creation. The updated guidelines on the interpretation of the arm's length principle will also mean that mere contractual allocation of risk without appropriate capacity to manage or mitigate those risks will not be considered to drive value.

Finally, while we are likely to see the adoption of Country by Country reporting in Ireland through the Finance Bill in mid-October, there are a number of rules changes which may be made down the line on the recommendations of these reports. These could be adopted by Ireland in the next number of years, or indeed could come by way of some form of EU directive. The most significant of these, for FS groups, is the move towards more stringent interest deductibility rules and it will be important for them to voice any concerns they may have on Ireland's adoption of the recommendations of this action, or indeed any of the other actions, at an early stage to ensure that the options chosen by the Department of Finance do not lead to any unintended consequences for FS groups operating in Ireland.

Let's talk

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