OECD action plan on BEPS: the impact for the Asset Management industry from a China / Hong Kong perspective

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In brief
On Monday 5 October 2015, the Organization for Economic Cooperation and Development (OECD) published its final papers on all 15 of its actions on base erosion and profit shifting (BEPS), marking the culmination of two years of work. For the asset management sector, the most significant changes will impact treaty relief for collective and non-collective investment vehicles, the impact of globally mobile marketing and deal sourcing teams on the tax footprint of asset managers, the shift in transfer pricing focus from contracts and risks to value creation and 'significant people functions' and the degree of interaction with tax authorities around the globe. Even for those asset managers not affected by these changes, managing the resource required to meet the additional compliance requirements will be tough. This news flash summarises the key BEPS actions most relevant to the sector and highlights the particular consequences for asset managers in general as well as from the China / Hong Kong perspective.

In detail

Action 2: Hybrid mismatch arrangements

Summary
The OECD is recommending rules to address three types of hybrid mismatch arrangement. The recommendations are to be included in domestic legislation in the form of a primary rule where a mismatch arises (generally denying a deduction) and a secondary / defensive rule (generally to tax income) if the primary rule does not apply.

The report focuses on the importance of co-ordination in the implementation and application of the hybrid mismatch rules to ensure that the rules are effective.

Domestic law changes are proposed to address dual residence avoidance strategies. A new model treaty provision is also recommended.

Asset management takeaway
Globally, hybrids have been a common feature in the asset management industry for a number of years, including instruments such as CPECs (convertible preferred equity certificates) and PECs (preferred equity certificates) as well as entities treated as partnerships in certain countries but corporates in others.

As a result of the OECD proposals, fund managers will likely need to evaluate current hybrid arrangements and in some cases potentially restructure existing arrangements to prevent additional tax leakage within their funds or corporate groups.

Care will also need to be taken where stock lending or repo transactions are undertaken, particularly in intra-group situations, pending further clarity in these areas.

Although the tax authorities in China and Hong Kong are both aware of the possibilities for the use of hybrid instruments or structures in tax planning, they are generally not so concerned about the impact of these instruments and structures on their tax collections in light of their domestic laws and practices.

Action 3: Controlled foreign companies

Summary
The OECD’s proposals set out the 6 key principles that should apply to a jurisdiction’s Controlled Foreign Companies (CFC) regime:

1. Rules for defining a CFC (including definition of control)
2. CFC exemptions and threshold requirements
3. Definition of CFC income
4. Rules for computing income
5. Rules for attributing income
6. Rules to prevent or eliminate double taxation

In practice, this will mean consideration of, amongst other things, whether the CFC has sufficient substance to assume and manage risks on its own account and whether it is overcapitalised.

Asset management takeaway

Asset managers with global corporate structures may need to consider the impact of how the rules are to be interpreted in their head office location, including the impact of treating branches as potential CFCs.

These rules will not impact asset managers headquartered in the Cayman Islands, nor, in the short term at least, Hong Kong given its current tax regime of not taxing offshore profits. As such, it is not expected these jurisdictions to adopt these OECD recommendations.

The BEPS final papers have provided a good reference for China to improve its CFC rules. In particular, China will elaborate the definition of ‘control’ and clarify how to determine the attributable income by making reference to the Action 3 report. These proposed changes have already been reflected in the recently released Discussion Draft of the revised Implementation Measures of Special Tax Adjustment (Guoshuifa [2009] No. 2, Circular 2) (Discussion Draft).

Action 4: Interest deductibility

Summary

The primary rule will be a fixed ratio rule based on a ‘net interest’/EBITDA ratio, with countries free to set the ratio between 10% and 30%. As a minimum, the fixed ratio rule should apply to entities in multinational groups but it may also be applied to domestic groups.

To the extent the primary rule is exceeded, a higher interest deduction can be allowed in certain circumstances if the interest burden is higher at group level (group ratio rule), although further work on how this will be applied in practice is to be undertaken in 2016.

The recommended approach also allows countries to supplement the fixed ratio rule and group ratio rule with other provisions including thin capitalisation/arm’s length principles, de minimis thresholds, exclusions for interest on loans to fund public benefit projects and the carry forward of disallowed interest expense and/or unused interest capacity.

Transitional measures are expected to allow groups to restructure. Further work will take place in 2016 on specific rules to address risks posed by banking and insurance groups.

Asset management takeaway

Private equity and other alternative funds may be impacted by the way in which the group ratio rule is defined and applied, in the likely event that the fixed ratio rule is exceeded in many instances.

Currently, China plans to refer to the Action 4 report to improve its thin capitalisation rule by clarifying the scope of interest expenses, setting out a more reasonable debt/equity ratio and consider the specific features of certain industries, and exploring the possibility to carry forward, or even carry back the non-deductible interest expenses.

The rules for deduction of interest expenses under Hong Kong profits tax are very stringent. They are considered by the Hong Kong Inland Revenue Department (IRD) as effective to safeguard against any possible abusive use of debt financing.

Action 5: Countering Harmful Tax Practices

Summary

The OECD has extended the ‘substantial activity requirement’, previously developed in relation to preferential intellectual property/intangible regimes, to all preferential regimes.

This will require a taxpayer to undertake core income-generating activity and incur expenditure in the entity (or at least the jurisdiction) in order to benefit from the preferential regime.

The OECD has reviewed 43 preferential regimes, including 16 IP regimes, and concluded that none wholly satisfy the new substantial activity requirement, with many not even partially satisfying it.

Asset management takeaway

Asset managers benefitting from preferential tax regimes will be required to adjust their operating model to increase the level of people-based substance and expenditure in those jurisdictions in order to continue to benefit from the regime. Some preferential regimes may be substantially modified or withdrawn as a result of the changes.

China’s New/ High Technology Enterprises (NHTE) regime is one of many regimes noted by the OECD as being inconsistent, in part or in whole, with the OECD recommendations. The China’s State Administration of Taxation (SAT) BEPS task force member explained that although China’s assessment on NHTE was not exactly the same as the recommended ‘nexus approach’, the domestic application requirements are even more stringent than the nexus approach under most circumstances. Therefore, China and other BEPS participating countries do not consider that China’s NHTE incentive to be a harmful tax practice and the report will not lead China to suspend the NHTE incentive.

The Hong Kong government introduced or will introduce policies to strengthen Hong Kong’s competitiveness as location for regional headquarters for multinational group. These include the rules for Islamic finance and the extension of offshore fund exemption regime to private equity funds enacted, as well as the proposed corporate treasury centre regime.

Although these initiatives are viewed by Hong Kong as providing a level playing field with other neighbouring cities, it remains to be seen whether upon review by the OECD they will be considered “harmful tax practices”.

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Action 6: Prevent treaty abuse

Summary

The OECD has proposed three alternative approaches that countries could take to curb tax treaty shopping and other treaty abuses – a combination of limitation on benefits (LOB) rule and principal purpose test (PPT), PPT only, or LOB plus anti-conduit mechanism.

The proposed rules are detailed and complex and will have a particularly significant impact on both collective and non-collective investment vehicles. Further work will continue in 2016 in a number of areas, including entitlement of non-CIV funds to treaty benefits.

Asset management takeaway

The treaty reforms are far-reaching. In particular the potential denial of benefits to non-CIVs could be very significant for the alternative investment management industry, in particular where such funds cannot always identify the ultimate owners of returns.

In fact, some of the issues and recommended solutions in Action 6 report have already been addressed within China’s existing treaties or its own domestic tax legislation on treaty interpretation, e.g., PPT in many treaties signed by China in the last few years, the one year holding period requirement for reduced withholding tax, etc. More recently, two newly signed treaties also contain an “LOB” article. However, the proposed recommendations in the report referred to some more subjective factors, especially in relation to the PPT, which may create uncertainty and unpredictability for taxpayers investing in China.

In practice, the Hong Kong IRD is very much concerned by attempts to use Hong Kong as a location for treaty shopping. Hence although companies incorporated in Hong Kong and overseas-incorporated companies with management and control in Hong Kong are considered as Hong Kong tax residents in most of Hong Kong tax treaties, the IRD will closely examine applications for tax resident certificates with the view to ensuring that the applicants are genuinely entitled the treaty benefits and, inter alia, are not engaging in treaty abuse. It remains to be seen whether the same level of practical scrutiny will be applied to fund vehicles formed under Hong Kong’s proposed open ended fund company regime.

Given the importance of non-CIVs and other SPVs such as securitisation vehicles, it is unfortunate that there will be a further wait until 2016 for more clarity.

Action 7: Artificial avoidance of permanent establishments

Summary

The scope of the dependent agent test is to be expanded to include situations where an agent habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without modification by the enterprise.

The independent agent exemption is to be narrowed such that where a person acts exclusively or almost exclusively on behalf of one or more ‘closely related businesses’, that person shall not be considered to be an independent agent.

Finally, the specific activity exemptions are to be restricted to activities that are of a preparatory or auxiliary nature.

Asset management takeaway

The new rules represent a material change (although possibly less of a material change than the previous draft paper) which has been accompanied by a behavioural change by tax authorities in many countries.

These changes make it more likely that tax authorities will assert permanent establishments (PE) exist as a result of marketing and distribution, capital raising and deal sourcing activities, whether through representative offices or ‘fly-in’ teams.

The SAT believes that China’s domestic treaty interpretation rules in Circular Guoshuifa [2010] No. 75 (Circular 75) has already addressed a lot of issues mentioned in Action 7 report. Besides, the SAT BEPS task force member indicated that the SAT will consider inclusion of the recommendations in Action 7 report during negotiation of double tax treaties in the future. The SAT may even consider revising its interpretation of the PE article in Circular 75 in light of the Action 7 report.

The PE article in the most of the existing Hong Kong treaties follows the current OECD model convention. It is possible that these existing treaties will be modified by means of protocol in the future to reflect the international development.

Actions 8-10: Transfer Pricing

Summary

On transfer pricing, a significant amount of the focus relates to aligning substance with the location of profits with a particular emphasis on the returns associated with risks, capital and intangibles.

The key theme is the shift from legal form to people-based substance and value creation, including:

- Contracts versus conduct – where contracts appear to be inconsistent with conduct of parties the paper authorises non-recognition of non-commercial transactions;
- Funding alone without the control over risks does not entitle the funder to anything above a risk free return. In particular the OECD has gone further than in previous drafts to give specific examples of functions which do not evidence control.
- The updated guidance with respect to intangibles appears to have been brought into alignment with the analysis of risk and capital. However, there is more specific guidance on the definition of control with respect to intangible development and a recognition that assuming the financial risks related to intangible development could attract a risk adjusted return (assuming that the funder has controls over the financial risks).
**Asset management takeaway**

As a result of the new guidance, it will be imperative for asset managers to put a greater emphasis on the functions performed and on evidencing the location in which control of risks and intangibles is exercised using the new definitions. In particular, the form of transactions as outlined in legal agreements may not be respected if they are inconsistent with how the parties operate on a day to day basis.

This will be of particular importance to lead managers or other entities which earn a return for setting group strategy/policies but place a heavy reliance on sub-contractors (e.g. sub-advisors).

Transfer Pricing (TP) is one of the key focuses in China’s adoption of the BEPS final papers. The SAT’s positions on TP have already been fully reflected in the Discussion Draft. Currently there is no TP regulation in Hong Kong and the IRD explains in its departmental interpretation and practice note that it will follow the OECD guideline in practice. Hence any development as elaborated in the OECD final reports on Actions 8 to 10 will likely be followed by the IRD in practice.

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**Action 13: Re-examine transfer pricing documentation**

**Summary**

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

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

The first two apply to all multinationals, the CBCR applies only to groups with a turnover above €750m. The rules will apply from 1 January 2016. Hong Kong currently has no transfer pricing documentation requirements although taxpayers have a general obligation under the domestic law to establish that pricing between related parties is reasonable. The IRD takes an open view on the CBCR requirement and may incorporate this requirement if necessary.

**Asset Management takeaway**

The changes to transfer pricing documentation represent a major compliance challenge for many asset managers as the level of information required is substantial.

Combined with the recent introduction of new transfer pricing documentation requirements in China in the Discussion Draft, asset managers need to take stock of their existing transfer pricing documentation and develop a plan to comply with the new requirements.

Overall, China is among only a few developing countries paying such a high level attention to the BEPS Project. The SAT of China has presented its response to the BEPS final recommendations and its adoption plans in a public forum in Beijing after the release of the BEPS final papers by OECD. On the other hand it is expected that the Hong Kong IRD will keep a close eye on any further developments following the BEPS final papers and take necessary actions to respond by changing the domestic regulations and/or practices.

We can anticipate that the BEPS final papers will drive significant changes, over a reasonable time span, in China’s TP standards, tax treaties, many parts of her domestic tax laws and regulations, and even Chinese tax authorities’ behaviours with an aim to counter tax avoidance as well as reinforcing her taxing rights to get a fairer share of taxation.

**Notes**


China / HK Asset Management Tax New Flash

Let’s talk
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