BEPS UPDATE:
key issues for financial services

The financial services sector should tread carefully with regard to the OECD’s Base Erosion Profit Split initiative

The Organisation for Economic Cooperation and Development (OECD) has been pursuing measures to address the perceived use of mismatch and arbitrage opportunities between national tax systems designed to transfer profits to low(er) tax jurisdictions. Such action is argued to erode domestic tax bases (base erosion) and moves reported profits (profit-shifting) to locations where there may be little or no related economic activity. Although such planning may be allowable under tax law, there is an increasing perception that it is unfair and undermines the integrity of tax systems globally.

Traditionally, profits recorded by a non-resident company are only taxable in a particular jurisdiction if the economic activities giving rise to those profits are undertaken through a local permanent establishment (PE). A number of factors can contribute to the judgement that a PE exists, such as the existence of an office with staff, retail premises or manufacturing base. A company that operates locally through an agent authorised to conclude contracts on its behalf may also be found to have established PE status. In recent years, there has been increasing concern that globalisation and the digital economy have significantly increased the scope to avoid PE status by supplying goods and services from remote geographical locations. Particular concern attaches to the major global e-commerce businesses. Financial services companies may also in principle offer services without establishing a permanent physical presence in a particular country.

The OECD measures are contained in the Base Erosion Profit Split (BEPS) Action Plan and are intended to enable tax authorities to tax profits where economic activities generating those profits are performed and where value is created. However, while this principle presents challenges when applied to manufacturing or trading activities, it may be even less straightforward in the case of financial services. For some, the financial sector is the epitome of globalised business. The buying and selling of risk is core to these businesses, and capital is the bricks and mortar. The financial services industry is highly regulated with specific capital and other requirements and one must ensure that any transfer pricing guidance appropriately recognises and addresses these features.

There is also a specific focus on insurers, who can write significant amounts of business in a country without having a PE in that location, in particular through arrangements with exclusive agents. One option under consideration is to establish a bespoke framework for insurers to address this concern. A less burdensome regime would apply the general PE rules to insurers, but in a manner that recognises the particular nature of risk transfer in the industry; the economic reality of cross-border insurance and reinsurance; and the regulatory framework in which the industry operates.

The threshold of activity or presence for determining the existence of a PE has historically been quite high. However, Action 7 of the BEPS Action Plan is directed at preventing the artificial avoidance of PE status such as through cleverly worded contracts and risk allocation in contracts. Scheduled for introduction in September 2015, the new rules could limit substantially the scope for arguing that a PE has not been established. In particular, these new rules are expected to tackle the practice of fragmenting group activity between separate legal entities in separate jurisdictions and to restrict the scope for use of “independent” agents or commissionaires.

More generally, in light of these impending new rules, financial institutions need to carefully review their current business models and PE status as some reorganisation of structures and operations may be necessary.

The BEPS project, though still developing, reflects widespread changes in perceptions around corporate tax practices, and is likely to have far-reaching ramifications. The financial services sector has particular characteristics that make a number of the BEPS initiatives challenging; hence the industry should carefully consider its involvement with the OECD’s BEPS initiative.

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