NEWSLETTER 5/2016

In the following we give you an overview of the latest and most important tax innovations:

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1. Mandatory Transfer Pricing Documentation starting from 2016!

On 6 July 2016 the EU Tax Amendment Act 2016 (EU-Abgabenänderungsgesetz 2016) was passed. The law introduces mandatory standards for Transfer Pricing Documentation in Austria.

Below you will find brief answers to the most frequently asked questions:

1.1. What companies are affected?

Ultimate group parent companies with an annual consolidated group revenue of at least EUR 750 million.

- **Country-by-country Reporting ("Documentation X-Large"):** Country-by-country-Reporting is a standard provided by OECD Base Erosion and Profit Shifting Plan (BEPS Plan) that basically relates to ultimate parent companies of MNE groups with an annual consolidated group revenue of at least EUR 750 million.

In a paper published on 29 June 2016 the OECD provided a couple of clarifications, inter alia, that the Country-by-Country Reporting criteria are based on the consolidation requirements according to accounting standards. This has for example the following implications:

- There is no mandatory Country-by-Country-Reporting for investment funds, as long as there is no consolidation requirement according to the applicable accounting regulations.
- The same is true for partnerships as ultimate group parent companies.

  Under certain circumstances a tax authority may adopt a decision imposing an obligation to submit transfer pricing documentation on another group company, resident of Austria, if an ultimate parent company does not submit the documentation or is not obliged to do so. This is normally the case, where an ultimate parent company is a resident of a third country that has not adopted the mandatory Country-by-country Reporting rules.

(Austrian) business unit with revenue of at least EUR 50 million.

- **"Documentation Large":** Austrian business units with a revenue of at least EUR 50 million in two immediately preceding fiscal years and belonging to a MNE group, that operates in at least two countries, will also become now subject to transfer pricing documentation requirements.

  (Austrian) Group companies are further required to have a Master File in cases where the turnover threshold is not met in Austria, but a foreign group company is obliged to prepare a Master File according to the rules applicable in the jurisdiction of this foreign company. ("Documentation Medium")

- Austrian companies, that do not fall under one or both categories above, remain subject to the general and previously existing Austrian documentation requirements. ("Documentation Small")

1.2. When does the new documentation requirement start?

The new requirement should generally apply to all fiscal years beginning on or after 1 January 2016.

1.3. What is the content of the new documentation?

- **Country-by-country Reporting ("Documentation X-Large"):** Country-by-country-Reporting consists of 3 predefined forms containing information relating to certain financial indicators and the global allocation of the MNE's income and taxes, as well as functions and risks per country, where an MNE group operates.

- **"Documentation Large":** The documentation requirement entails a preparation of a Master File and a Local File for a respective business unit.

  The Master File should provide a general overview of the MNE group business and its overall transfer pricing practices. In comparison to the existing EU Master File standard, the scope of the Master File is extended (in particular analysis of value drivers in business model and value added chains, details regarding the use of intellectual property etc.)

  The Local File supplements the Master File providing for more detailed information (including financial details) with regards to each local business unit.

1.4. What are the Compliance requirements in terms of timing?

- **Country-by-country Reports:** The Country-by-country Reports should be filed with a competent tax authority within 12 months after the end of the respective fiscal year by an ultimate parent entity or another group entity, entitled to represent the ultimate parent entity.

  The competent tax authority shares this information subsequently with all jurisdictions, where business units of an MNE group operate, provided that these jurisdictions have joined the Convention on Mutual Administrative Assistance in Tax Matters.

- **Documentation "X-Large, Large and Medium":** The Master File and Local Files should be finalized by the time the tax return is filed and provided within 30 days upon request of a tax authority.

- **Documentation "Small":** Although no special time frames are provided here, we strongly recommend preparing all documentation relevant for the respective intercompany transactions on time.

1.5. Are there any penalties for non-compliance?

Penalties up to EUR 50,000 are stipulated in regard to Country-by-country Reports, in the event that they are not filed or filed not completely or not correctly.

1.6. What has to be done next?

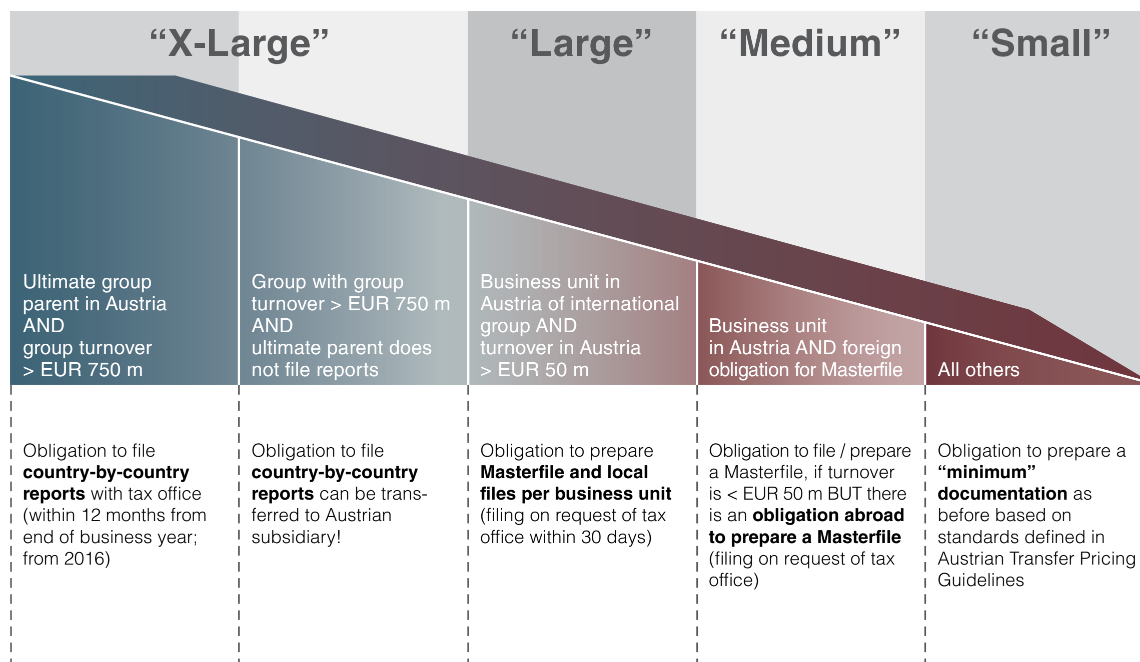
- **Documentation "X-Large":**
  - Austrian ultimate parent companies need to communicate their duty to file the Country-by-country Reports in Austria to the competent tax authorities in Austria as well as to all other group companies. As a result, the determination of the financial indicators for the year 2016 should be organizationally prepared.
  - Austrian group companies should agree whether the documentation requirement exists abroad and/or whether there is a risk that they might become subject to it in Austria. The results should be communicated to the Austrian tax authorities until end of the business year for which the reports need to be filed.

- **Documentation “Large” and “Medium”:** It is in any case advisable to review whether the existing documentation contains all the required information and whether it needs to be expanded. In cases where only the Master File has been prepared, Local Files have to be added for each group entity.

  Documentation “Small”: In cases where there is no need for new documentation, the existing documentation should also be reviewed, as one can expect an increased standard of documentation will now be required.

We are happy to answer any further questions you may have and to support you in preparing the transfer pricing documentation!

The chart below gives a brief overview on the new documentation standards:



2. EU Interest Limitation Rule coming soon!

On July 12, 2016, the European Council adopted a Directive laying down rules against tax avoidance practices used to shift profit among groups of affiliated companies. The Directive comprises the interest limitation rule (so-called “Zinsschranke”) that implies a limited deductibility of borrowing costs, depending on certain performance figures.

2.1. What is the interest limitation rule?

Borrowing costs shall only qualify as tax effective insofar, as the excess of borrowing cost doesn’t exceed 30 percent of the taxpayer’s earnings before interest, tax, depreciation and amortization (EBITDA).

2.2. Which borrowing costs are affected?

The interest limitation rule generally affects all borrowing costs, irrespective of whether the creditor is a third party (e.g. bank) or an affiliate.

2.3. How is the limitation of the deductibility of borrowing costs to be calculated?

The exceeding borrowing costs are defined in Art. 2 of the Directive as the surplus of a taxpayer's tax effective borrowing costs over the tax effective interest revenues the taxpayer receives, whereby the Directive defines the term "borrowing costs" rather comprehensively.

The EBITDA is defined in Art. 4 of the Directive and is to be calculated by adding back to the income subject to CIT the tax-adjusted amounts for exceeding borrowing cost as well as the tax-adjusted amounts for depreciation and amortization.

Simplified calculation scheme:

1. + income subject to CIT
2. + exceeding borrowing costs
3. + tax deductible depreciation

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4. = EBITDA based on EU Directive
5. x 30 %
6. = maximum tax effective interest deduction

2.4. What happens to non-deductible borrowing costs or unused interest capacity?

The Member States can individually decide upon whether the potential carry forwards concerning the interest limitation rule could be recognized as follows:

- The exceeding borrowing costs which cannot be deducted in the current tax period can be carried forward without time limitation;
- Possibly the exceeding borrowing costs, which cannot be deducted in the current tax period, can be carried back for a maximum of three years;
- Unused interest capacity which cannot be deducted in the current tax period can be carried forward for a maximum of five years.

It remains to be seen whether and if so, which of the above simplification rules will be implemented in Austria.

2.5. Are there any derogations from the interest limitation rule?

The Directive gives the Member States the following options for allowing derogations to the interest limitation rule:

- Right to deduct exceeding borrowing costs up to EUR 3 million;
- Right to fully deduct exceeding borrowing costs if the taxpayer is a standalone entity;
- Exception for loans financing long-term public infrastructure projects, and
- Exception for financial undertakings (e.g. banks, insurance undertakings).

The declared objective of the interest limitation rule is to prevent tax base erosion on the internal market and profit shifting abroad. Hence, a deduction of borrowing costs should also be allowed in case the EBITDA rate is not met, but it nonetheless is ensured that borrowing costs are evenly spread within a group. There are two options, which can be assumed by the Member States:

- The full deductibility of borrowing costs should be granted in case the equity ratio of the affiliated entity falls below the equity ratio of the group by only up to two percentage points. Each of the Member States will individually specify how to calculate the equity ratio.
- Additionally, the deduction of borrowing costs shall be possible if the affiliated entity accounts for borrowing cost below the group's ratio of borrowing cost and the debt ratio of group as a whole is higher in relation to the EBITDA than the local entity's ratio.

2.6. When is the interest limitation rule to be adopted?

The Directive is generally to be adopted into national law by individual national legislators until January 1, 2019.

An extended time limit until January 1, 2024 is provided for those Member States which have already implemented adequate regulations on national basis that are as effective as the interest limitation rule.

In Austria the existing restriction on the tax effective deduction of interest payments to group companies residing in low-tax countries according to Sec 12 para 1 no 10 Corporate Income Tax Act might be considered in this context. Should this rule be recognized by the EU committee as equally effective to the interest limitation rule, the adoption of the interest limitation rule in Austria could be postponed until January 1, 2024.

2.7. Does the interest limitation rule apply to already existing loans?

The Directive contains a grandfathering clause which gives the Member States the possibility to exclude loan agreements concluded before June 17, 2016 from the new regulation. However, the exception does not apply to subsequent modifications of loan agreements concluded before June 17, 2016.

The aforementioned provision is optional, thus, it is within the Austrian legislator's discretion to exclude the loan agreements concluded before June 17, 2016 from the interest limitation rule. It remains to be seen whether the Austrian legislator implements such a provision to render the existing loans exempt.

2.8. What should be attended to within a company group with regard to the interest limitation rule?

TPA Tips:

- Borrowing costs of the group should be evenly distributed among individual group members.
- In case the refinancing or amendments of existing loan agreement are considered, it is advisable to examine any possible implications of the interest limitation rule beforehand.
- It should be checked on the level of the individual company whether interest expenses on capital borrowed to finance the construction or production of fixed or current assets (e.g. large-volume real estate projects) incurred. In such cases under certain criteria the interest incurring during the construction period can be capitalized as so-called construction period interest ("Bauzeitzinsen"). The interest limitation rule wouldn't be applicable.
- Any further actions and improvements of interest deductibility (reorganizations, entering into tax groups, possibly application of the exceptions to the interest limitation rule) can be considered once specific information on the implementation of the interest limitation rule in Austria will be available.

CONCLUSION:

In Austria the implementation of the interest limitation rule is equivalent to a paradigm shift. Thus, it can be expected that the adoption of the interest limitation rule will take place rather later than sooner. However, it is not certain yet and it remains to be seen, how the new regulations will be implemented, particularly with regard to the possible exceptions from the interest limitation rule. However, the Directive indicates clearly the direction the European tax policy and, consequently, in the Austrian tax policy will take.

3. BEPS Actions 6 and 7: New tax framework for investment and participation management

BEPS Actions 6 and 7 substantially amend the tax environment for the international investment and participation management. The recommendations of the OECD are not implemented yet. However, the new international tax rules should already be considered in the tax strategy, particularly, if new fund structures are being implemented or if cross-border asset management agreements are concluded.

The OECD and the G20 agreed on fifteen different actions aiming to restrict base erosion and profit shifting (BEPS). The set of measures is to be implemented directly in the domestic laws and/or through amendments to double tax treaties.

In the following, the BEPS Actions 6 (Treaty Abuse) and 7 (Permanent Establishments), which are of great importance for investment and participation management, are explained. Both actions are to be implemented through amendments to double tax treaties or through changed interpretation of the OECD model commentary.

3.1. Action 6 – Risk of higher tax burden on the return

The aim of action 6 is to combat the unjustified claiming of double tax treaties' benefits ("treaty shopping"). For this purpose the OECD proposes the introduction of the following anti-abuse rules:

- **"Limitation of benefits" rule (LOB)**
  The inclusion of the LOB rule should preclude unauthorized subjects from benefiting from treaty entitlements and withholding tax reductions on dividends, interest payments and licenses. While individuals, public entities and publicly traded companies in general meet the criteria of the LOB rule and don't require further verification, non-listed companies need to pass one of four tests:
  1. Ownership test: The entity is entitled to benefit from the treaty if more than 50% of its shares are held directly or indirectly by a person entitled to treaty benefits.
  2. Derivative benefits test: If treaty entitlements for more than 75% of directly invested beneficial owners of the entity are better or at least equally good as treaty benefits achieved via holding the entity's shares, the entity is entitled to benefit from the treaty.
  3. Activity test: Provided the entity is engaged in the active conduct of a business in its state of residence AND the income achieved in other member state is derived from that business, the entity can apply the treaty with regard to that income.
  4. Discretionary relief test: In case the tax subject passes none of the aforementioned three tests, an application for granting the treaty benefits can be filed. It is, however, at the authority's discretion whether the treaty benefits are granted. For instance an entity which is fully controlled by foreign investors and doesn't achieve income from active conduct in its state of residency, would not be entitled to benefit from the treaties benefits.

- **"Principal purpose test" rule (PPT)**
  The PPT rule denies treaty benefits if the main purpose of the transaction or arrangement is to obtain those benefits. Tax authorities may be entitled to assume treaty abuse if one of the main purposes of an arrangement or transaction is of a fiscal nature. The tax payer would have to provide prove that the chosen structure is in accordance with the purpose and objective of the treaty. In Austria this is not a new approach as a number of treaty cases has already been denied by referring to national anti-abuse rules. However, whereas now the tax payer can provide evidence via provision of material, non-fiscal motives, under the application of the PPT rule the burden of proof would increase significantly.

Impact on fund structures:
The introduction of the LOB rule would have a huge impact e.g. on existing fund structures. The main goal of international funds is to enable joint investments for investors from different nations, whereby the investors are commonly not residents of the fund's state of residence.

Thus, the OECD allows derogations, applying for instance to
- Investment funds with a large number of investors and a widely dispersed investment; such investment funds should be able to benefit from treaty entitlements;
- Investors if they were entitled to obtain comparable or better benefits under other applicable treaties (e.g. of their home states).

For funds a PPT rule would be easier to apply. However, the classification of certain fund structures as abusive will depend on the interpretation of the PPT rule by the respective national tax authorities.

TPA Tip:
It is recommended to conduct a tax screening of investors if a new fund is established in order to increase chances of obtaining treaty benefits in the future.

3.2. Action 7 – Risk of permanent establishments in target markets

Under the current double tax treaties, business profits of foreign enterprises are generally taxable in the state, in which the entity has its permanent establishment (PE) to which the profits are attributable. Thus, the tax treaties' definition of PE is crucial when determining whether a non-resident enterprise must pay income tax in another state.

For the participation and investment management the definition of an agency PE is of great importance: An independent agent (e.g. broker, manager or consultant) acting on behalf of the principal in the ordinary course of his business, to date does not create a PE.

BEPS Action 7 provides regulations, according to which an agency PE will be created more easily due to the following amendments:
- A PE for an enterprise will be created if the agent, unless he is independent, acts in the principal role leading to the conclusion of contracts that are routinely concluded without material modification. Thus, in participation and investment management a PE can be created by an asset manager, consultant or other advisor, who in the course of their activity supervises the local asset and negotiates contracts. The PE would be created in addition to the already existing local subsidiary.
- The definition of an independent agent will be restricted significantly. If a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to qualify as independent agent. The term "almost exclusively" is met if the agent achieves more than 90% of its revenue from its activity for enterprises to which it is closely related.

TPA Tip:
Due to the aforementioned restrictions, in the future it will be necessary to ensure that the wording in contracts with consultants (acting almost exclusively for an enterprise or a fund) is distinct. Otherwise discussions with tax authorities will be inevitable.

CONCLUSION – implementation of Action Points 6 and 7 open
The OECD published its report setting out its recommendations in relation to fifteen different BEPS actions. It remains to be seen whether and to what extent the actions are implemented by the Member States. If the OECD does not succeed in concluding a multilateral tax treaty with numerous Member States, the implementation on the bilateral treaty level will be a tedious process. However, in order to be prepared for the amended framework's consequences as well as possible, the potential effects of the amended tax treaties should be considered when setting up new enterprises or funds.

4. IFRS 16 Leases: Overview and impact on long-term lease contracts

On January 13, 2016 the International Accounting Standards Board (IASB) finished its long-standing project on lease accounting and published IFRS 16, Leases, which replaces the current leasing Standard IAS 17 and related interpretations. IFRS 16 is likely to have a significant impact on the financial statements of a number of lessees and also on the long-term lease negotiations.

4.1. Objective

IFRS 16 sets out principles for the recognition, measurement, presentation and disclosure of leases in IFRS financial statements, with the objective of ensuring that lessees and lessors provide relevant information for those transactions. Especially the provision of a single lessee accounting model, requiring lessees to recognise right-of-use-assets and liabilities for virtually all leases, unless the lease term is 12 months or less or the underlying asset has a low value, on the balance sheet, is intended to improve the quality of financial reporting and the comparability of financial statements of lessees.

4.2. Scope

IFRS 16 applies to all leases, including subleases and sale and leaseback-transactions, except for leases related to the exploration of mineral resources, biological assets, service concession arrangements and certain rights within the scope of IFRS 15, Revenue from Contracts with Customers, and IAS 38, Intangible Assets.

4.3. Identifying a lease

At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Control is conveyed where the customer has both the right to direct the identified asset's use and to obtain substantially all the economic benefits from that use.

4.4. Separating components of a contract

For a contract that contains a lease component and additional lease and non-lease components, such as the lease of an asset and the provision of a maintenance service, lessees shall allocate the consideration payable on the basis of the relative stand-alone prices, which shall be estimated if observable prices are not readily available. As a practical expedient, a lessee may elect not to separate non-lease components from lease components and instead account for all components as a lease.

4.5. Effective date and transition

An entity applies IFRS 16 for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted if IFRS 15 has also been applied (prematurely if before 1 January 2018).
As a practical expedient, an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application.
A lessee shall either apply apply IFRS 16 with full retrospective effect or alternatively not restate comparative information but recognise the cumulative effect of initially applying IFRS 16 as an adjustment to opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

4.6. Impact of IFRS 16 on long-term lease contracts

The most significant effect of the new requirements of IFRS 16 will be an increase in lease assets and financial liabilities. In 2014 listed companies using IFRS or US GAAP disclosed almost USD3 trillion of off balance sheet lease commitments. Accordingly, for companies and industries with material off balance sheet leases, and particularly with long-term lease negotiations, such as airlines, retailers, travel and

leisure and transport, there will be a significant change to key financial metrics derived from the company's reported assets and liabilities, for example, leverage (gearing), current ratio, asset turnover (sales/total assets), EBIT, EBITDA. It is expected that the terms and conditions of future debt covenants will change. The IASB does not expect the effect on equity to be significant for most companies – the effect will depend on the company's financial leverage, the terms of its leases and the ratio of lease liabilities to equity. As described above the new accounting model for lesses is expected to increase the operating profit and the finance costs and will result in a higher EBIT and EBITDA.

In particular IFRS 16 is likely to have a significant impact on the long-term lease negotiations since the amount of the lease liabilities depends among others on the amount fixed payments, therefore on the length of the non-cancellable period of a lease under consideration of an extension option, whose exercise is reasonably certain.
However, it should also be noted that the amount of lease liabilities also depends on

- variable lease payments that depend on an index or a rate
- variable lease payments that are not included in the measurement of the lease liability (such as lease payments linked to sales)
- lease incentives receivables
- residual value guarantees oft he lessee
- reasonably certain payments of a purchase option
- reasonably certain payments of penalties for terminating the lease

IFRS 16 might provide incentives to structure transactions to achieve desired accounting outcomes. Examples include reducing the length of lease terms and making lease payments variable, all in an attempt to recognise smaller lease liabilities.

Nonetheless, the IASB acknowledges that the change in accounting might have an effect on the leasing market, if companies decide to buy more assets and, as a consequence, lease fewer assets. However, it can be observed, that a lease typically provides financing of assets without any supplementary guarantees, ongoing renewal of assets based on latest available technologie, services provided with leases (for example, maintenance of assets), a way of sharing risks and profits between a lessee and a lessor (for example, via variable lease payments linked to sales) or the ability to use an asset for only the needed portion of the asset's total economic life.

CONCLUSION:
Lessees as well as lessors should re-examine their leasing activity as a result of applying IFRS 16. This may result in changes to the length of leases or changes in payment terms or in the offer of additional services by the lessor.
Though the effective date seems far away, entities should ensure that they have implemented systems and processes to identify all lease contracts, to capture the information needed to determine the measurement of the right-of-use asset and the lease liability, and to prepare the new disclosures.

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