Base Erosion and Profit Shifting (BEPS):

Key considerations for real estate funds

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Foreword

On 5 October 2015 the Organisation for Economic Co-operation and Development (OECD) issued their highly anticipated reports on proposals to tackle what governments perceive as tax-avoidance, using international tax standards (base erosion and profit shifting or BEPS). The development of these proposals was prompted largely by prominent reports in the media of a number of well-known multinationals who were paying very little corporate income tax in countries where they were deriving significant sales revenue. As a result of this press coverage, the drive to revise international tax arrangements gained a political impetus that it had previously lacked, and the proposed revisions to the international standards have been turned around according to a remarkably tight timetable.

This article explores the impact on real estate funds of four of the 15 OECD actions:

- limiting treaty benefit
- restricting interest deductions
- restricting the use of hybrid instruments
- expanding the permanent establishment definition.

The OECD has acknowledged that part of the price for this rapid advance has been that some of the more complex questions have had to be set to one side, and investment funds that are not collective investment vehicles (non-CIVs), which includes most real estate funds, are expressly stated to be one of the areas that will need further work. Some of the proposals as currently drafted for more mainstream businesses could have serious consequences if applied to non-CIVs without some form of compensating relief.

Tax planning in non-CIVs has a different purpose to many other vehicles. Many countries establish preferential tax regimes for things they want to encourage – including pension funds, sovereign wealth funds and other acceptable tax exempt investment entities. At present, such investors are disadvantaged by the tax system if they want to invest cross-border because foreign tax credits have no value to investors who are exempt from tax in their home jurisdiction. Any incremental tax applied overseas is an additional cost, which either reduces the value of the funds or restricts the investments in which it is practical to invest, resulting in greater volatility.

By contrast, US taxable investors into non-CIVs are not affected by the range of intermediate holding companies separating them from the ultimate investment, because they choose to ignore the intermediate entities all for US tax purposes and claim a credit for any overseas tax suffered.

The proposed changes on treaty shopping and interest deductions would have particularly significant impacts for real estate funds. The proposals on treaty shopping would add a so-called "principal purpose test" to income tax treaties. The principal purpose test only requires the use of a tax treaty to be one of the principal purposes in adopting a structure in order for treaty relief to be denied – how many fund managers could refute tax planning being a principal consideration when setting up a fund in Singapore or Luxembourg?

The revised interest deductibility rules suggest limiting interest deductions to no more than 30 percent of EBITDA (with potential carve outs if overall external leverage for the group is higher). This is clearly well below the interest payable on the level of gearing that a typical investor could hope to obtain from a bank when the loan is secured against real estate.

The proposals with respect to treaty abuse and interest deductibility are so far only recommendations, and even if the OECD adopts them later this year, it will be up to individual countries to adopt them into domestic law and renegotiate their treaties to reflect them. Significant differences in the approaches of different states are likely. Australia has already indicated that changes to its rules on interest are unlikely and that capitalization is still a developing concept in many emerging markets.

A number of countries have published consultation documents or taken early indicated action, suggesting that there will be a range of reactions. However, it is clear that the proposals are likely to result in significant changes and challenges for the real estate funds industry and fund managers would be well advised to start considering the impact now.

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Interest deductions and other financial payments

To address base erosion through deductions for interest and payments economically equivalent to interest, the OECD is proposing that jurisdictions limit net interest deductions to 10 percent to 30 percent of an entity's earnings before interest, taxes, depreciation and amortization (EBITDA). Under the proposed approach, a government may also allow taxpayers to deduct a larger amount based on average third party debt across the group. This new approach would represent a significant change in mindset for the real estate industry. Given that many loans use the underlying assets as security, the key traditional measure of loan capacity has been loan to value ratios. However, the OECD test is much more focused on interest as a proportion of earnings. The interest rate, as well as the amount borrowed, will therefore affect the deductibility. The proposals will have a significant impact on real estate investments, as property holding companies (Prop Cos) are generally highly leveraged with both bank and related party loans.

What are the proposals?

Introduction of tests to limit net interest deductions

A main test and a supplementary group test have been introduced. Under the main test, the OECD recommends that tax relief for net interest (including third party) be limited to 10 percent to 30 percent of EBITDA for each entity. It is not clear at this stage quite how EBITDA will be measured; indeed, it is left for individual states to determine their own calculations. This opens up the potential for a confusing array of different methods, some of which may be more reflective of the commercial realities of a real estate fund than others. For example, while real estate funds often have an underlying source of income in their rental streams, many will raise much more significant amounts of their profit from the disposal of properties or the disposal of one or more companies owning the properties – it is not yet clear which of these will be included in the EBITDA calculation in which jurisdictions. However, regardless of the details of the calculation, it is likely that many real estate funds may face a significant disallowance of both intercompany and bank debt under this fixed ratio approach.

There is some potential for relief in as much as the report recommends that governments consider the option to introduce a group test based on the worldwide ratio of third party interest expense to income, with a potential uplift of 10 percent (note, once again, it is generally an income rather than an asset based test, although countries have the option to adopt an asset test if preferred). A group test would be helpful as it at least recognizes that many banks are happy to lend significantly more than the standard EBITDA test would allow, especially when the loan is secured against real property.

A 'group' refers to 'a parent company and all entities which are fully consolidated on a line-by-line basis in the parent's consolidated financial statements'. In a real estate fund, investments are generally held through separate, parallel holding structures and debt funding is typically obtained at the Prop Co level. The maximum bank loan-to-value ratio is often restricted by local banking regulations and varies considerably across countries. For example, the maximum bank loan-to-value ratio for a company acquiring commercial properties in Hong Kong is 40 percent while banks in the UK may provide mortgage loans of up to 90 percent of the market price of UK commercial properties.

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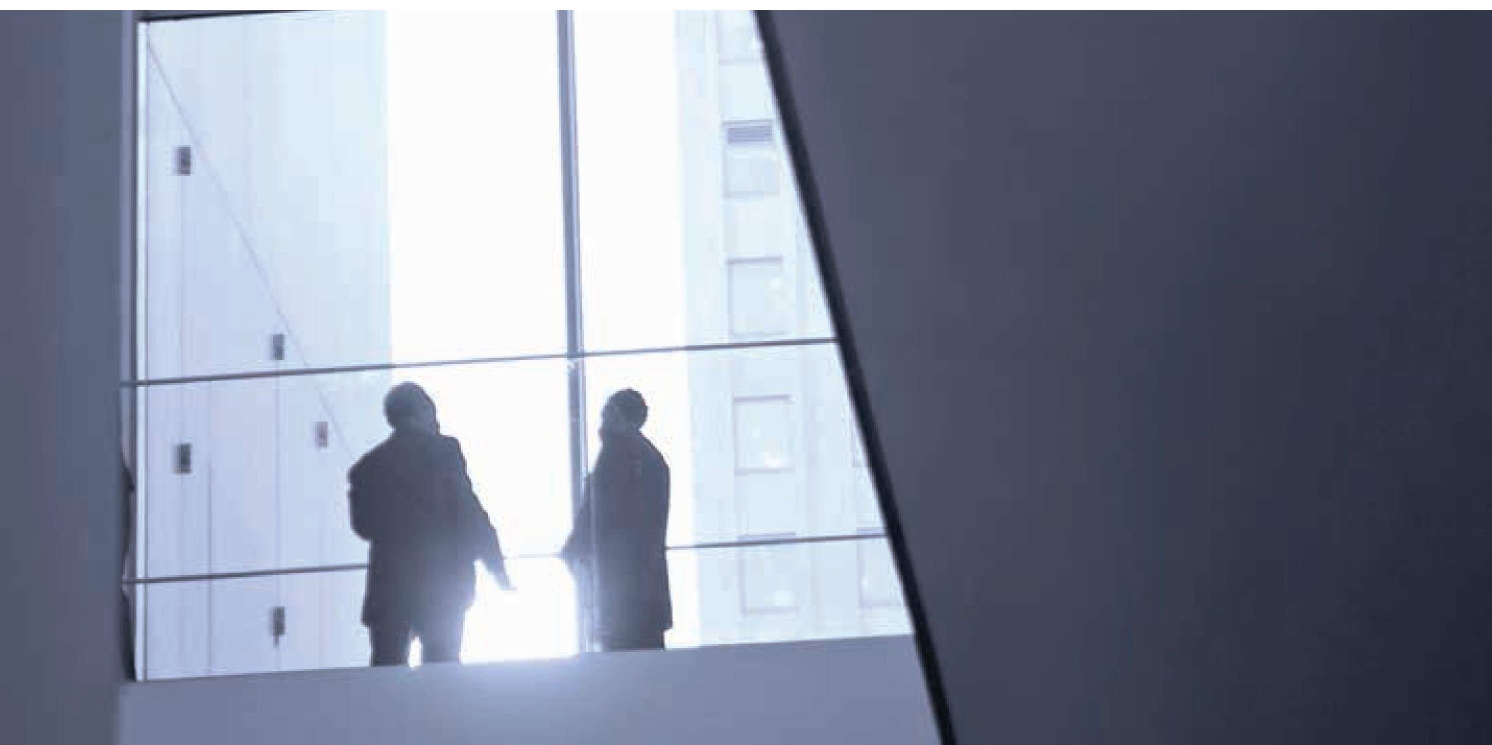

The requirement for a group to be headed by a company may lead to some strange results – if the fund is an unincorporated entity, such as a partnership or a trust, holding each asset in a separate stream of companies then, *prima facie,* it would seem that every asset would be in a separate group subject to its own third party test. Conversely if the fund is a company, or if there is a master holding company under the fund, then all the assets may be in the same group, potentially leading to a restriction of bank debt as well as intercompany debt in the highly leveraged countries.

In light of the above, managers running funds with investments in various jurisdictions should review the existing investment holding structure, determine how the group test could potentially be applied to the fund and whether a potential restructuring is feasible. However, clearly any restructuring strategies will depend on the local implementation of the OECD recommendations and any targeted anti-avoidance rules.

Scoping in the "payments economically equivalent to interest"

The OECD makes it clear that the rules should also apply equally to payments economically equivalent to interest. Payments under profit participating loans (PPLs) have been specifically identified as one of such payments.

PPLs are used extensively by real estate funds, especially those with Luxembourg holding platforms, and are generally considered to be interest bearing deductible debts in Luxembourg. Treating payments under PPLs as interest payments may then result in a significant portion of deductions being disallowed for tax purposes. Real estate fund managers should therefore review their current PPL arrangements to determine the impact if the OECD recommendations are adopted.

Implications

The impact of the new rules on real estate funds will ultimately depend on how and to what extent each individual state adopts the OECD recommendations. In particular, the operation of targeted anti avoidance rules will play an important role in driving the funding structure of real estate investments. While it remains to be seen what exclusions each state will allow, funds heavily leveraged with internal loans will likely be significantly impacted. Funds with external debts will also need to review their arrangements and stress test them against the new rules.

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Hybrid mismatch arrangements

The OECD is recommending that countries adopt new rules to neutralize the effect of hybrid instruments and entities. If adopted, these changes may affect a range of real estate investment structures. Investors will need to adapt their current business models and in some cases the changes are likely to lead to higher levels of tax and lower returns.

What are the proposals?

The introduction of domestic hybrid mismatch rules

The OECD has recommended that countries should introduce domestic hybrid mismatch rules to deny a tax deduction (or force an inclusion of income) for payments made under an arrangement which involves a hybrid instrument or entity where a tax mismatch arises. The rules operate to deny a tax deduction for payments made under such arrangements that are also deductible in another jurisdiction, prevent exemption for payments that are deductible for the payer and deny a deduction for a payment that is not included in ordinary income of the recipient.

The recommended rules contain a primary rule and a defensive rule to avoid double taxation and to ensure that the tax mismatch is eliminated even where not all jurisdictions adopt the rules.

In addition, the OECD has suggested that countries should adapt their domestic provisions to ensure that there is no dividend exemption for payments that are tax deductible for the payer and should introduce measures to prevent hybrid transfers being used to duplicate withholding tax credits.

The OECD has also proposed a change to its model treaty to ensure that hybrid entities are not used to obtain treaty benefits unduly. This provision already exists in a number of US tax treaties.

The OECD has recommended that countries should be free to decide in their policy choices whether to apply the rules to neutralize mismatches in respect of intra-group hybrid regulatory capital.

Who is affected?

The proposed rules are intended to apply only to related parties, parties who are in a group or parties to a structured arrangement. Broadly:

- Parties will be treated as members of a group if they form part of the same consolidated group for accounting purposes;
- Persons are treated as related parties if one person holds a 25 percent investment in the other or the same person holds a 25 percent investment in both;
- A structured arrangement is broadly an arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances of the arrangement indicate that it has been designed to produce a hybrid mismatch. There is no requirement for a tax avoidance motive.

Application to real estate investment structures

Hybrid instruments are used quite widely in the context of real estate funds. This may include both structuring an investor's contribution into a fund and structuring the fund's investment into intermediate holding companies or local property companies.

Where each investor has less than a 25 percent investment in a Fund the new rules may not apply to the investors' contributions into the fund. However, many private real estate fund vehicles are in the nature of club deals where investors often hold more than a 25 percent stake. In addition, hybrid instruments between the fund itself and its subsidiaries are likely to be caught as they will be between group members.

Hybrid instruments are commonly used to finance Luxembourg based real estate investment structures. Instruments

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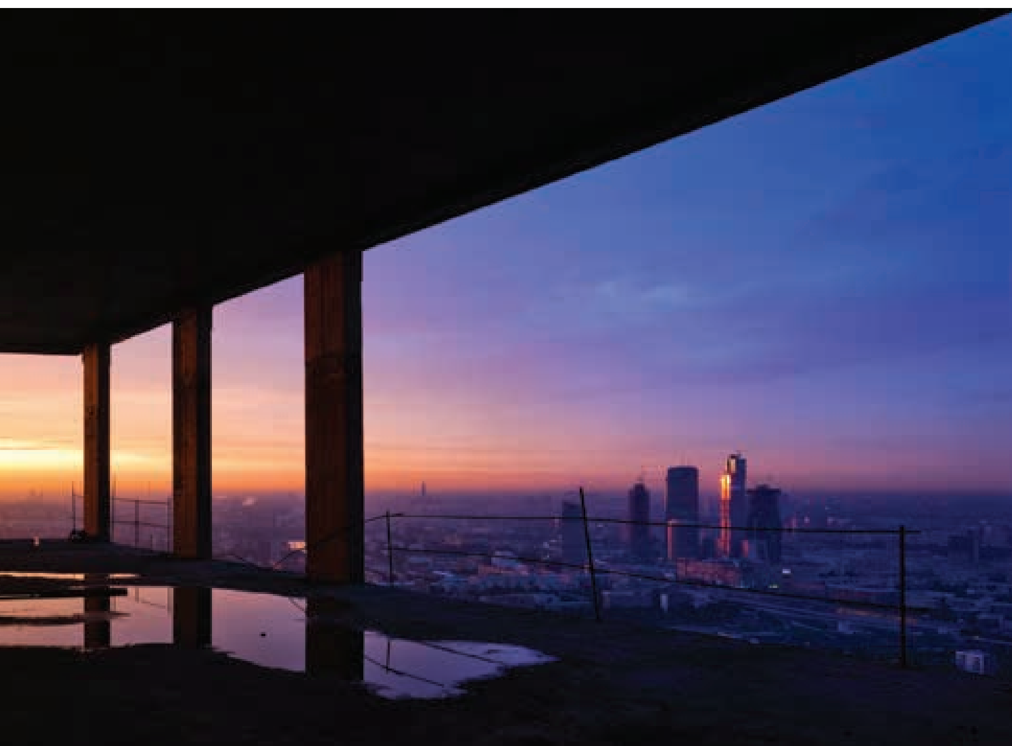

such as Preferred Equity Certificates, Tracking Preferred Equity Certificates or Convertible Preferred Equity Certificates may be treated as debt for Luxembourg tax purposes but could well be equity from the perspective of the investor. Where instruments are used purely to avoid the application of Luxembourg withholding tax and there is no other tax advantage, the proposed hybrid rules may have no effect.

For example, if a Luxembourg holding company, funded by way of a hybrid instrument, receives only dividends and capital gains which are tax exempt in Luxembourg under its participation exemption regime, the hybrid mismatch rules are unlikely to impact a payment under the hybrid to its investor as it will already not be deductible for Luxembourg tax purposes. If, however, the Luxembourg company receives income that is taxable and claims a deduction for the payment under the hybrid, the proposed rules could apply depending on the tax treatment of the investor. It will therefore be necessary to consider the tax characteristics of investors to determine whether or not the proposed rules will give rise to additional taxation. In principle, tax exempt investors should not be affected but taxable investors may need to review their position. Instruments such as tracking loans or profit participating loans generally should not be affected by the proposals since these would normally be treated as debt for both the lender and borrower.

The hybrid rules may also be relevant to certain commonly used real estate vehicles such as Real Estate Investment Trusts (REITs), Japanese Tokutei Mokuteki Kaisha (TMKs), Real Estate Funds (REFs) and similar vehicles which allow a deduction for dividends paid as long as certain conditions are met. The report acknowledges that the use of such vehicles is a matter of government policy designed to encourage investment in real estate rather than aggressive tax avoidance and states that the hybrid rules are not intended to prevent the application of REIT regimes. However, the report does suggest that in the hands of the recipient state, dividends from such entities should not be exempted under a participation regime or similar mechanism. This could have significant impacts for many commonly used investment structures and seems to go against some of the spirit of allowing jurisdictions control over the taxation of their own real estate and the ability to simplify investment in real estate by removing taxation barriers to entry.

Implications

The OECD has no power in itself to implement law, so the exact implementation of these proposals will depend on individual states implementing domestic law and amending treaties (although the latter may be achieved through the proposed multilateral instrument). The timeframe for changes is likely to vary from country to country. The UK has, for example, already announced its intention to give effect to the OECD's recommendations and a number of new provisions are likely to be introduced with effect from 1 January 2017, with no grandfathering of existing arrangements currently contemplated.

Real estate fund managers and investors should review their current structures to identify any hybrid instruments that are currently in place and consider risk areas in the light of these proposals. They should then monitor the implementation of these proposals across all relevant countries.

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Preventing treaty abuse

Tax has a significant impact on the return to investors in real estate funds. Many investors, such as pension funds, and sovereign wealth funds, do not pay tax in their home country so cannot claim a credit for overseas tax paid. Real estate funds have traditionally been able to avail themselves of lower rates of withholding tax on distributions of profit as a result of benefiting from double tax treaties. However, the nature of a real estate fund is that often the fund vehicle itself and its underlying holding entities do not require a great deal of substance to achieve their commercial purpose, while the nature of the fund vehicle and/or the investors often makes it impractical to look through the fund entity to the substantial investors beyond.

The OECD is proposing to make it more difficult to claim treaty relief by restricting the cases in which treaty relief can be claimed. In general, claimants will be asked to demonstrate that they are conducting an active business or to establish that one of the reasons (not necessarily the dominant one) for creating a structure was not to obtain treaty benefits. The OECD has recognized that investment funds are a special case, and has said it will make further proposals over the next year about how the rules will be adapted for them. However, unless any exemptions are widely drawn, it is likely that the tax costs of many real estate funds will rise significantly over the coming years, having a significant impact on returns.

What are the proposals?

The report is a difficult document to read as it contains a large number of alternatives, reflecting a significant amount of disagreement among the contributors. As a result two main tests are proposed. The first is a limitation on benefits (LOB) test (similar to the one in US treaties), which makes treaty benefits available only to certain types of investors, such as governments or certain pension funds, or to active businesses. The second is a principal purpose test, which looks at the reasons for entering into a transaction and will be more familiar to investors in common law jurisdictions. Governments, in their treaties, are free to adopt both tests or just one, so it is possible that this will result in significant variations between different treaties.

Under the LOB test, the definition of an active business seems to require the conduct of substantial managerial and operational activities by officers or employees of a company. This may present challenges for real estate funds, where holding companies generally require little active management and where management is frequently outsourced to agents. The type of income over which the treaty claim is made must also arise from a business that forms part of or is complementary to the business carried on by the recipient. It is not yet clear how this will apply to different categories of real estate investments, or to different types of income (rental, sales, dividend, interest, etc) that may arise from a real estate investment.

Under the LOB test, there may be a limited basis to claim treaty relief if the shareholders of an entity would in any case be entitled, if they held the investment directly, to treaty benefits that are at least as good as those claimed by the holding company. However, the detailed rules require seven or few investors to hold at least 95 percent of the voting rights, at least in the detailed version of the LOB, so its application in real estate funds may be

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limited. Tax authorities may also be able to grant benefits to other entities on a discretionary basis.

The principal purpose test would deny treaty benefits if one of the main reasons for entering into a structure was to obtain treaty benefits – the commentary explicitly states that it does not have to be the dominant purpose. The test is therefore stricter than many similar anti-avoidance laws, and, given the importance of tax efficiency to real estate investments, it may be hard for many funds to meet.

The treatment of regulated collective investment vehicles will be left to treaty partners to determine – it remains to be seen how flexible the rules will be in practice, and there is scope for significant differences between different investment locations. The report notes that there is still further work to be done on investment funds that do not qualify as collective investment vehicles under the OECD definition (non-CIVs). CIVs are defined as vehicles that are widely held, hold a diversified portfolio of securities and are subject to regulation to give protection to investors, and non-CIVs are all other investment funds, including the majority of real estate funds, that are not sufficiently widely held or regulated to fall within the definition of a CIV. The working group is continuing to assess the impact of the proposed changes on these sectors and to draft further proposals on how to deal with investment vehicles without opening the door to what the OECD regards as treaty abuse.

Implications

It is clear that there will be some significant changes to the requirements to claim treat benefits, and once individual countries have decided on their new approach it is unlikely that existing structures will be grandfathered. Fund managers should therefore be examining their fund structures to understand their potential exposures, and what alternatives may be available to mitigate the impact of the changes. It is also clear that the OECD has not yet finalized its view regarding the application of the rules to investment funds, and remains open to hearing industry views - stakeholders in the industry should take this opportunity to make sure that their voices are heard to try to ensure that the final rules are fair and workable for all parties.

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Changes to the rules on permanent establishment (PE)

The OECD is proposing some significant changes to the rules for determining whether a company has a taxable presence in an overseas territory. Although the rules were developed to attack perceived tax avoidance through internet selling or commissionaire arrangements, they are widely drawn and may catch real estate investors as well. In particular, many real estate funds have locally based teams who play a significant role in the acquisition process of investments. However, where key decisions and the signing of documents occur outside the target location, it has been argued that the holding company does not have a taxable presence in the target location. This argument may be more difficult to make under the new rules. In the worst case, this may give the target country the right to tax disposals or apply a higher rate.

What is changing?

A PE can arise even if contracts are not concluded by the agent

In a typical fund, employees of the fund manager and its related sub-advisors will negotiate and execute contracts on behalf of the fund and its subsidiaries. In doing this, it is possible they are acting as agents and under the current rules, where an agent habitually concludes contracts on behalf of a principal in another country, they may create a permanent establishment of the principal there.

In a real estate fund, this may typically arise where the fund is looking to invest in Country X. Typically, the fund management group will have an entity in Country X which will have employees who provide advice to the fund manager. Alternatively, fund management staff may travel to Country X for the purposes of the transaction. Practically, it is difficult to conduct a real estate transaction without visiting the country at all, as it is necessary to inspect the property, to meet the vendors and to conduct due diligence.

However, historically, the undertaking of certain activities in country has not resulted in a PE being created. Typically, key decisions are taken through an investment committee that meets outside the country. The composition of the investment committee is frequently a key selling point for the fund in the investment memorandum, and the committee will be composed of senior people with significant expertise who are the real decision makers on key matters. The involvement of in-country staff in non-determinative negotiations has typically not resulted in a PE.

The new proposals seek to extend the occasions on which a PE will be created to include situations in which an agent "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise."

The commentary states that this phrase "must be interpreted in the light of the objective and purpose of Paragraph 5, which is intended to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, i.e. where that person acts as the sales force of an enterprise."

The revised standard also makes it clear that it remains necessary for the agent to act habitually in order to give rise to a PE – a one off transaction is not enough.

In the context of a real estate fund, this raises a number of points. Clearly, fund managers should review their operating protocols to see how they stand up in the light of the new proposals. It is clear that significant negotiating activities are

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likely to come under greater scrutiny. On the other hand, the OECD has indicated that the agent has to be the principal force behind the agreement and that the outside enterprise would generally not make material modifications – this may mean that provided the ICOMM and other offshore management remain active in the business, there is still scope for significant preparatory activities to be undertaken onshore. It is also worth noting that the OECD is focusing mainly on sales activities in their commentary. While they make it clear (see below) that purchasing can also create a PE, they seem to have a different focus to many real estate funds, who concentrate more heavily on the acquisition decision than the disposal. Real estate funds should make sure they have adequate procedures in place to cover divestments as well as acquisitions.

Funds should also consider the meaning of the word "habitual" in this context. An SPV (Special Purpose Vehicle) typically only enters into two transactions in its life – a purchase and a sale. Over a 5 year period, does this amount to a habit? Will tax authorities look to actions across the fund as a whole, or only on an entity-by-entity basis? The answer may vary according to different local interpretations and the extent to which a fund is focused on a single country or making rare investments as part of a regional or global mandate.

The independent agent test is stricter

The new guidelines make it clear that where "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 be an independent agent". For these purposes, persons are closely related where they are under common control or where one has more than 50 percent of the beneficial interest or voting rights in the other or a third person has a greater than 50 percent beneficial interest or voting right in both. Although most funds don't have a 50 percent interest in the investments, a typical limited partnership or trust arrangement does result in control resting with the investment manager.

Where fund managers have relied on the independent agent exemption in the past they may need to consider whether this is still appropriate.

The exemption for purchasing activities only applies where these are auxiliary or preparatory

Although not widely used in the real estate fund industry, presumably as it was not clear that real estate constituted goods, the old PE rules stated that a PE was not created where a fixed place of business existed "solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise." This has been tightened to make it clear that it only applies where the purchase is ancillary to the main activities of the company.[1]

However, the exemption for ancillary activities remains, and activities such as collating information about a building, understanding the market, possibly even undertaking due diligence, should be seen as auxiliary activities.

Arrangements split over related parties are aggregated

A further change to the PE standard was brought in specifically with real estate construction in mind, and so while it may not directly affect real estate fund managers, it may impact on the level of taxation in underlying development projects in the funds, or impact on the purchase price for developed properties.

Under the existing model convention, a construction project only results in a PE if it lasts for more than 12 months (although individual treaties frequently specify a different time period). This resulted in some developers splitting the construction contract between several different companies, each of which operated for less than the time period set out in the relevant treaty. The OECD is proposing to amend the model convention to make it clear that a series of contracts on the same site carried out by closely related enterprises should be aggregated for the purposes of applying the test. They also encourage treaty states, where possible, to apply domestic anti-avoidance rules in this regard.

Implications

The OECD has no power in itself to implement law, so the exact implementation of these proposals will depend on individual states amending treaties and implementing domestic law. Further, the current proposals are not designed with real estate specifically in mind. The OECD has acknowledged that funds are a special case, and there may be some modification of the proposals in so far as they impact the funds industry.

On the other hand, changes to bilateral treaties could be made under the multilateral instrument that is expected to be developed next year, and some countries are already making announcements regarding the tightening of their permanent establishment tests. Real estate fund managers should review their current operating arrangements and consider which elements might be vulnerable to an attack under the new rules. It does seem clear that the maintenance of a strong and active investment committee with a regular, offshore involvement in the agreement of contracts is likely to be key in ensuring the success of any offshore structure and that extra care will be needed over the activities conducted in onshore locations.

"The maintenance of a strong and active investment committee with a regular, offshore involvement in the agreement of contracts is likely to be key in ensuring the success of any offshore structure."

1. Jurisdictions may retain existing safe harbor rules if they prefer.

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Designed by Evalueserve.
Publication name: Base Erosion and Profit Shifting (BEPS)
Publication number: 132953-G
Publication date: December 2015