

Foundation for International Taxation 20th Jubilee Conference

AN OVERVIEW OF BASE EROSION AND PROFIT SHIFTING PROJECT (BEPS) Background and 15 Action Points

Presentation by :

Uday Ved

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Background & Context

- **Key features of BEPS Project**
 - **Fast Space**
 - **Inclusive**
 - **Transparent**
- **Draft Report containing 15 Action Points (announced on October 5, 2015).**
- **OECD & G20 countries working together on equal footing.**
- **Indian Tax authorities significant contributor to BEPS Project.**

Nature of BEPS outputs

- **Minimum Standards**
- **Commitment to consistent implementation in :**
 - **Areas of Preventing Treaty Shopping**
 - **CbC – Transfer Pricing**
 - **Fighting harmful tax practices**
 - **Improving dispute resolution mechanism**
- **Common approaches and Best Practices for domestic law measures**
- **Detail Report on 15 Action Points**
 - **Are BEPS outputs legally binding ?**
 - **India : Changes in Finance Bill, 2016 ?**

15 Actions around 3 Main Pillars

Coherence

Hybrid Mismatch Arrangements (2)

CFC Rules (3)

Interest Deductions (4)

Harmful Tax Practices (5)

Substance

Preventing Tax Treaty Abuse (6)

Avoidance of PE Status (7)

TP Aspects of Intangibles (8)

TP/Risk and Capital (9)

TP/High Risk Transactions (10)

Transparency and Certainty

Measuring BEPS (11)

Disclosure Rules (12)

TP Documentation (13)

Dispute Resolution (14)

Digital Economy (1)

Multilateral Instrument (15)

Source : OECD Live Webcast (October 5, 2015)

Action 1 – Address the tax challenges of the Digital Economy

- **Digital Economy**
 - Result of the widespread & transformative process brought on by Information & Communication Technology (ICT)
- **Tax challenges & issues of Digital Economy**
 - No unique BEPS issues of Digital Economy
 - Action work on PE definition, Transfer Pricing and CFC rules cover these challenges
 - VAT challenge – to be paid in the country of consumption
- **Virtual PE Concept**
 - Significant economic presence test
 - Report not recommending adoption of this approach
 - Leaves it to a country to decide on this approach

Action 2 – Hybrid Mismatch Arrangements (Coherence)

- **Hybrid Mismatch**
 - Instrument or arrangement which achieves ‘double non-taxation’ or long term deferral not intended by either country.
 - Instrument : Treated as debt in one country and equity in another country.
- **How do BEPS address these mismatches ?**
 - Action point covers general and specific recommendation for domestic hybrid mismatch rules and model treaty provisions.
 - No multiple deduction to a single expense.
 - No deduction in one country without taxation in other country.
 - No multiple foreign tax credit.

GAAR regulations in India address these issues

Action 3 – Strengthen Controlled Foreign Companies (CFC) Rules

- Designing effective CFC rules to combat BEPS and long-term deferral
- *Not a minimum standard* but sets out building blocks for effective CFC rules :
 - Definition of a CFC
 - CFC exemptions and threshold requirements
 - Definition of CFC income
 - Rules for computing income
 - Rules for attributing income
 - Rules to prevent or eliminate double tax
- Co-ordination with other relevant actions including digital economy, hybrids, interest and transfer pricing

Is India ready for CFC

- Will it adversely impact outbound investments ?

Action 4 – Deductibility of Interest Payments (Coherence)

- **Extent of problem – Intra-group lending and financing**
 - **Location of third party interest in high tax country**
 - **Intra-group deductions greater than group's actual third party interest expense**
 - **Use of debt fund tax-exempt income**
- **Key elements of the recommended approach**
 - **Fixed Ratio Rules**
 - **Net interest deduction allowed upto a fixed net interest/tax EBIDTA ratio**
 - **Applies to interest paid to third parties and intra-group financing**
 - **Fixed Ratio : Within a corridor of 10% - 30%**
 - **Optional group ratio rule**
 - **Allows an entity to deduct net interest expense upto group's net interest/EBIDTA ratio**

Action 4 – Deductibility Contd

- Will countries be obligated to introduce these limitations on interest deductibility ?
 - Common approach agreed which may become minimum standards in future
 - Banking & Insurance – specific features and more work required
 - Treatment of excess interest expense – carry forward or carry backward may be permitted

**Indian Context : Section 14A, Section 40A(2), Section 92
(Transfer Pricing) and GAAR provisions**

Action 5 – Countering Harmful Tax Practices (Coherence)

- **Priority and renewed focus on requiring substantial activity for any preferential regime – IP and non-IP**
- **Review of 43 regimes in OECD and G20 countries – focus on 16 IP regimes**
- **IP Regime**
 - **Nexus approach recommended**
 - **Substantial activity – R&D expense**
 - **Value creation is key to taxation**
- **Non-IP Regime**
 - **Holding company structures to be examined**
 - **Treaty abuse – to be addressed**

43 Regimes cover India – No Harmful Tax Practice found currently.

Action 6 – Preventing Treaty abuse (Substance)

- **Treaty abuse is one of the most important sources of BEPS concerns**
- **Three-pronged approach to deal with Treaty Shopping.**
 - **A statement that Treaties intend to avoid tax evasion / avoidance / Treaty Shopping (minimum standard); and**
 - **Inclusion of LOB rule in Treaties; and / or**
 - **Inclusion of general anti-abuse rule (PPT rule) in Treaties**
- **Rules to address other forms of Treaty abuse**
 - **Dividend transfer transactions**
 - **Companies deriving value primarily from immovable property**
 - **Dual resident entities**
 - **Transfer of right / property to PEs in third states**
 - **Ensuring that Treaties do not prevent application of domestic anti-abuse rules**

Treaty Shopping – an India perspective

- Natwest [1996] 220 ITR 377 (AAR)
- AIG [1997] 224 ITR 473 (AAR)
- Azadi Bachao Andolan [2003] 263 ITR 706 (SC)
- E Trade Mauritius Ltd. [2010] 324 ITR1 (AAR)
- KSPG Netherlands Holding B.V. [2010] 322 ITR 696 (AAR)
- Ardex Investments Mauritius Ltd. [2012] 340 ITR 272 (AAR)
- Vodafone International Holdings B.V. [2012] 341 ITR 1 (SC)
- Sanofi Pasteur Holding SA [2013] 354 ITR 316 (AP)
- Serco BPO (P) Ltd. [2015] 60 Taxmann.com 433 (P&H)

Treaty Shopping blessed by Courts in India in past

1. Treaty benefits to be denied to a non-qualified person

2. Qualified person would include :

- **an individual**
- **a Contracting State**
- **publicly listed entities & their affiliates**
- **certain charities and pension funds**
- **other entities that meet certain ownership requirements**
- **collective investment vehicles**

Who are residents of the State

3&4. Treaty benefits to be available to non-qualified person if :

- person engaged in active conduct of business in its State, and
- income is derived in connection with or is incidental to the business

OR

- More than agreed proportion of the entity is owned by certain persons entitled to equivalent benefits

5. Power to Competent Authority to grant Treaty benefits

6. Definitions

Detailed versions of LOB Clause provided for States that do not wish to include the PPT rule

- **Treaty benefit shall not be granted if one of the principal purposes of the transaction / arrangement is to obtain treaty benefit**
 - **Exception – establishing that granting Treaty benefit would be in accordance with object and purpose of the Treaty**
- **Scope wide enough to include direct as well as indirect benefits**
- **PPT Rule to override all other provisions of the Treaty**

Will Multilateral Instrument (Action 15) be a solution to re-negotiate Bilateral Tax Treaties to address Treaty Abuse ?

Action 7 - Artificial avoidance of PE

- **BEPS concerns arising from :**
 - **Commissionaire arrangements**
 - **Substantial negotiation of contracts (but avoiding conclusion thereof)**
 - **Independent agent closely related to foreign enterprise**
 - **Specific activity exemption under A.5 (4)**
 - **Fragmentation of activities between related parties**
 - **Splitting up of contracts**

Revised Article 5(5) and 5(6)

Para 5

- **PE of an enterprise deemed to be in a source State**
 - **Where a person is acting on behalf of an enterprise (i.e. agent) and**
 - **he habitually concludes contracts, or**
 - ***habitually plays the principal role leading to conclusion of contracts without material modification by the enterprise, and***
 - **These contracts are :**
 - **In the name of the enterprise, or**
 - ***for transfer of ownership or granting right to use property of the enterprise, or***
 - ***for provision of services by the enterprise***

Para 6

- **Para 5 shall not apply where the agent is an independent agent acting in the ordinary course of that business.**
- ***However, if the agent acts exclusively / almost exclusively for closely related enterprise(s), he shall not be considered to be an independent agent.***
 - ***Close relation to be determined based on control test or beneficial interest test***

Para 6 brought in consonance with Indian Tax Treaties

Specific activity exemptions

- **A.5(4) – PE shall not be deemed to include :**
 - **Use of facilities for storage, display or delivery of goods**
 - **Maintenance of stock of goods for storage, display or delivery**
 - **Maintenance of stock of goods for processing by another enterprise**
 - **Purchasing goods or collecting information'**
 - **Any other activity**
 - **Combination of the above activities**

Provided the overall activity is of preparatory or auxiliary character

Making all sub-paras of A.5(4) subject to preparatory or auxiliary conditions

Specific activity exemptions

- **Applicability of A.5(4) to following situations :**
 - **Maintenance of warehouse by enterprise making online sales**
 - **Delivery of spare parts to customer to whom machinery sold**
 - **Cables or pipelines that cross territory of a country**
 - **Purchase of goods for the enterprise**
- **Nike Inc. [2014] 264 CTR 508 (Karnataka)**
- **Columbia sportswear Company [2015] 62 taxmann.com 240 (Karnataka)**

Actions 8 – 10 - Revised TP Guidance (Substance)

- **Arm's length principle useful to evaluate transfer pricing.**
- **Perceived emphasis on contractual allocation of FAR and the existing guidance on the application of the principle proven vulnerable to manipulation.**
- **Report reiterates that “arm's length principle” effective and efficient to deal with transfer pricing – other approaches like “formulatory apportionment” would not be immune from manipulation.**
- **Intra-group Contracts : Contractual arrangements to be reviewed against actual conduct.**
- **Allocation of profits to the enterprises that conduct the corresponding business activities.**

Actions 8 – 10 Contd

- **Intangibles : Legal ownership alone does not generate right to profits – Profits linked to value creation.**
- **Special contractual arrangements such as cost contribution arrangement will no longer be possible to inappropriately allocate profits.**
- **Approach on “Hard-to-Value” intangibles – Information asymmetry and lack of transparency are addressed.**
- **Tax administrations can consider ex post outcomes as a presumptive evidence about the appropriateness of ex ante pricing arrangements under arm’s length principle.**
- **Profits of “cash-boxes”, i.e., only funding without exercising control over investment and other risks not entitled to premium returns.**
- **Entitled only to no more than a risk-free financial return.**

Actions 8 – 10 Contd

- **Corporate synergies and location savings :** Benefits from corporate synergies to be allocated to the group members who have contributed to these synergies and not to low-tax jurisdiction. For locational advantages, it needs to be seen that it exists and compare with independent parties allocation.
- **Further guidance required for application of transactional profit splits as most appropriate method.**

Indian Context :

No intangibles created in Back Office operations ?

- Profit allocation based on value creation

Action 12 - Mandatory Disclosure Regime (Transparency & Certainty)

- Regime requires promoters and / or tax-payers to upfront disclose use of schemes presenting certain features or hallmarks.
- Will assist tax administrations in advance of aggressive or abusive tax planning schemes.
- Early counter action possible
- Disclosures may be required even before returns are filed.
- Disclosures required for transactions (NOT ALL) that fall within the descriptions or hallmarks set out in the regime.
- Hallmarks can be generic or specific.
- General Hallmark – target features that are common to a promoted scheme.
- Specific Hallmark – target particular areas of concern such as use of losses.

- **Tax administrations can use the collected information to change behaviour and to counteract tax avoidance schemes through :**
 - **Legislative change**
 - **Risk assessment and audit**
 - **Communication strategies**
- **Not compulsory for countries to introduce these regimes – Not a minimum standard**

Good transparency measure but may enhance compliance burden and could increase litigation if not implemented properly.

Action 13 - TP Documentation (Transparency & Certainty)

- **Country-by-country (CbC) Reporting – Tool to allow tax administrations to perform high level TP risk assessment or to evaluate other BEPS-related risks.**
- **Reporting on “Master File” and “Local File”.**
- **Will cover global allocation of income and taxes with location of activity, etc.**
- **Master File – Will cover high level global information regarding global business operations and TP policies of MNE .**
- **Local File – Will cover in each country identifying related party transactions, amounts involved and the company’s analysis of TP determinations (This requirement already exists in Indian TP regulations).**
- **Master File & Local File to be delivered by MNE directly to local tax administrations.**

- **CbC Report to be filed in the jurisdiction of tax residence of the ultimate parent entity.**
- **CbC Report – to be shared between jurisdictions through automatic exchange of information pursuant to Government-to-Government mechanisms such as Multilateral Convention on Mutual Administrative Assistance in Tax Matters, Bilateral Tax Treaties or Tax Information Exchange Information Agreements.**
- **Developing countries entitled to obtain this information.**
- **CbC Report – Not a substitute for a detailed TP analysis. Also information in CbC Report not a conclusive evidence that transfer prices are or are not appropriate.**

Action 13 Contd

- **CbC Report – Effective implementation to start on January 01, 2016 but could take longer for few countries. Domestic law adjustment necessary to implement this.**
- **Outcome of this monitoring will be reviewed, planned for 2020.**

CbC Reporting may increase compliance burden and associated costs.

Action 14 - Dispute Resolution (Transparency & Certainty)

- **Agree Minimum Standard and number of Best Practices in relation to dispute resolution.**
- **Minimum Standard – Will ensure that MAPs are fully implemented in good faith and administrative processes promote the prevention and timely resolution of treaty-related disputes.**
- **Time frame for dispute resolution – 24 months**
- **Mandatory binding MAP arbitration provision for those countries who agree.**

India has reservation on Mandatory binding MAP arbitration

Action 15 – Develop a Multilateral Instrument

- **A solution to modify Bilateral tax treaties but respecting sovereign autonomy in tax matters.**
- **Precedents not in international tax field but there are several precedents in various other areas of public international law.**
- **Three advantages :**
 - **Highly targeted instrument**
 - **All Bilateral treaties to be modified in a synchronised way for more than 3000+ Treaties**
 - **Political imperative to drive BEPS project.**
- **Governments can achieve the objective without violating Bilateral Tax Treaties.**
- **Work on other areas like Action 5 – Harmful tax practices and Action 6 – Treaty Abuse, Action 4 – Hybrid Mismatches, Action 7 – PE and Action 14 – MAP can be swiftly implemented.**
- **Instrument will be open to signature by December 31, 2016.**

Next Steps

- **New and Revised Rules**
- **Legal certainty and dispute Resolution**
- **Monitoring**
- **Transparency**
- **Develop an inclusive framework**

**India - BEPS-related changes in Finance Bill, 2016 ?
- GAAR – reality by 2017 ?**

Thank you

Presentation by Uday Ved



Further Information

**For further information or if you have any question
Please Contact :**

Uday Ved

Email : udayved30@gmail.com

Mobile : +91 9820058327