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FINAL PACKAGE OF MEASURES UNDER THE BASE EROSION AND PROFIT SHIFTING ('BEPS') PROJECT

An Indian Perspective

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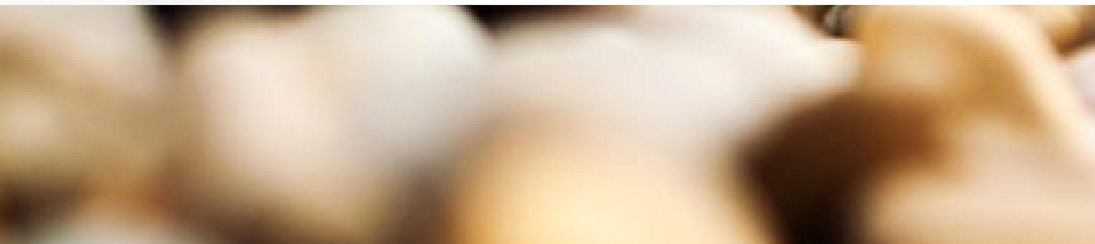

Background

Objective

The BEPS project represents the single most important multilateral initiative in the field of international tax in recent memory. The objective of this project is to revise prevailing international tax rules so as to eliminate gaps and mismatches that enabled the shifting of profits to no or low-tax jurisdictions. It was widely felt that in addition to loss of revenue for governments, BEPS also undermined the integrity of the overall tax system.

The Action Plan on BEPS released by the OECD in 2013 identified 15 actions based on three fundamental pillars:

- Introducing coherence in domestic tax rules that affect cross-border activities
- Reinforcing substance requirements in the existing international standards
- Improving transparency as well as certainty for businesses and governments

Seven preliminary reports were issued in September 2014, which were endorsed by the G20 leadership. The final output released in October 2015 consolidates the work on all of the 15 actions in the form of a comprehensive BEPS Package. This package has been endorsed by the G-20 Finance Ministers as well as the G-20 leaders.

India's role / concerns

In addition to OECD members-countries, members of the G-20 (including India) were also actively involved in the BEPS project on an equal footing. Other developing countries were also engaged extensively in the project through various consultation mechanisms.

BEPS is acknowledged as having a detrimental effect on the Indian economy due to its negative impact on tax revenues. It has been noted that the problems associated with BEPS are exacerbated in an Indian context due to India's heavy reliance on revenues from corporations (including multinationals), which are dependent upon international tax rules. Among the various aspects addressed by BEPS, India has identified challenges posed by the digital economy, artificial avoidance of PE status, treaty abuse and transfer pricing as being particularly relevant in the Indian context.

Source v. Residence- Does BEPS have a role?

While India has long been a strong proponent of source based taxation, it is pertinent to note that BEPS actions are not directly aimed at changing the existing international standards on allocation of taxing rights between source and residence taxation. However, it is expected that actions under the BEPS project will help in restoring both source and residence taxation in a number of cases involving cross-border transactions. This may help mitigate some of the concerns expressed by developing countries such as India.

Action 1:
Addressing the tax challenges of the digital economy

Highlights of the BEPS Report

This action was aimed at identifying issues raised by the digital economy and for developing detailed options to address them. The Final Report contains a detailed overview of the digital economy, its business models and its key features, identifies the various BEPS challenges that arise in the context of the digital economy and provides recommendations on how to address them.

The Report notes that with the rapid penetration of digitisation across virtually all sectors of the economy, it will not be possible to ring-fence the digital economy from the rest of the economy for tax purposes. It notes that this would require the drawing of arbitrary lines between what is digital and what is not, and accordingly recommends that tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by identifying key features of the digital economy and determining which of such features exacerbate tax challenges or BEPS concerns. The Report also calls for a close monitoring of the rapid developments in the digital economy (including the Internet of Things, Virtual Currencies such as bitcoins, advanced robotics and 3D printing, peer-to-peer sharing of goods and services etc.) as they may generate additional challenges to tax policy makers in the near future.

The Report discusses several tax and legal structures that are relevant in the context of the digital economy and the means by which they exacerbate BEPS risks both in the country of residence as well as in the country of source (i.e. the market). For instance, the importance of intangibles in the context of the digital economy coupled with their mobility for tax purposes under the existing regime could generate substantial opportunities for minimising taxes in the country of residence. Likewise, the ability to centralise infrastructure in a remote location and conduct substantial sales and services into a market jurisdiction combined with the ability to conduct substantial activity with minimal use of personnel can be exploited to eliminate or reduce the tax burdens in the market / source state.

The BEPS risks associated with the digital economy are expected to be addressed by the various measures developed in the context of other actions in both the state of residence as well as the market/source state. This is set out in the table below:

Addressing BEPS Issues in:	Proposed Measures in other Actions that aim to address BEPS in the digital economy
Market / Source jurisdiction	Work undertaken as part of Action 7 (Artificial Avoidance of PE Status) will ensure that core activities in the digital economy cannot inappropriately benefit from the exception from PE status and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status.
Residence jurisdiction	Work undertaken as part of Action 3 (Controlled Foreign Company or CFCs) could be leveraged to ensure that CFC provisions capture the types of revenue that are typically generated in digital economy transactions such as license fees and income from sales of digital goods and services. Such an approach could limit the use of offshore structures used to defer income from tax in the residence jurisdiction
Both Market and Residence Jurisdiction	Work in respect of Actions 8-10 (Transfer Pricing) can help address BEPS challenges in the context of the digital economy by de-emphasising the legal ownership of intangibles and by instead focusing on ensuring an appropriate return for companies performing the important functions, contributing important assets and controlling economically significant risks.

A few other measures in this regard (e.g. a new nexus in the form of a significant digital presence test, a withholding tax on certain kinds of digital transactions and an equalisation levy) were considered, but not recommended. This is based on an expectation that the measures developed as part of the BEPS project will mitigate some of the tax challenges posed by the digital economy and that consumption taxes will be effectively levied in the market country.

An Indian perspective

Challenges from a digital economy perspective are stated to be a matter of significant concern for India. India's position has been that a rigid application of residence-based taxation rules has led to several digital companies paying virtually no taxes in India despite India being a huge market for the digital economy. It is also reported that India advocated the introduction of a withholding tax on digital transactions (a position that was not ultimately accepted in the final report).

India has taken several unilateral measures aimed at countering these challenges. These include:

- **Enactment of "Equalisation Levy":** In line with the recommendations of Action 1, a new Chapter on "Equalisation Levy" has been introduced in the Finance Act, 2016. Equalisation levy @ 6% is leviable on the amount of consideration for any "specified service" received or receivable by a non-resident from, inter-alia, a person resident in India carrying on business or profession.

  Further, the term "specified service" is defined to mean the following:

  - online advertisement
  - any provision for digital advertising space
  - any other facility or service for the purpose of online advertisement; and
  - any other service as may be notified by the Central Government in this behalf.

  As can be seen, the scope of term "specified service" is very wide especially when it states that it also includes any other any other facility or service for the purpose of online advertisement.

  Also, given that Equalisation Levy is not a part of domestic tax laws of India, a non-resident may not be able to seek treaty protection and hence availability of credit of this levy in his/her home country could also pose challenges.. To this extent, the Equalisation Levy regime marks a departure from the recommendations of OECD in Action Plan 1 which stated that existing treaty obligations ought to be respected to ensure consistency with existing international legal commitments.

- **Treating a website as a PE:** There are several instances of the Indian tax authorities seeking to treat websites as a PE of a foreign enterprise in India. It is relevant to note that India, in its reservations to the OECD Model Commentary has expressly stated its view that a website may constitute a PE under certain circumstances. While this position has not found favour with Courts so far (see for instance ITO v. Right Florists Pvt. Ltd. (2013) 25 ITR(T) 639 (Kolkata - Trib.)), the issue is yet to be considered by the higher judiciary.

- **Expanded scope of Royalty/FTS:** India has also sought to bring several transactions in the digital world within the scope of royalties or fees for technical services (for e.g. subscriptions to online databases, payments for online advertisements etc.). This has been done through an expansive reading of treaty provisions as well as by amendments to the domestic law definition of royalties. This has led to increased assertions of withholding tax on Indian payers making such payments to foreign enterprises

The interplay between India's unilateral measures as above and the BEPS recommendations is not yet clear. For instance, it remains to be seen whether India will continue to assert the existence of a PE through websites, notwithstanding the fact that the BEPS recommendations have expressly not accepted the nexus test based on significant digital presence. Likewise, a question may arise whether an expanded reading of the royalty definition and the consequent assertion of withholding taxes is compatible with the BEPS rejection of a comprehensive withholding tax on digital transactions. If left unaddressed, these could potentially undermine the BEPS objective of providing certainty to businesses.

Action 2:
Neutralising the effects of hybrid mismatch arrangements

Highlights of the BEPS Report

This Report is addressed towards arrangements that exploit differences in the tax treatment of entities and instruments in multiple jurisdictions to obtain tax benefits such as double non-taxation or long-term deferral. The recommendations are set out in two parts – Part I contains recommendations for changes to domestic law and Part II sets out recommended changes to the OECD Model Convention.

Part I of the recommendations seeks to neutralise hybrid mismatches, by putting an end to outcomes such as multiple deductions for a single expense, deductions without corresponding taxation or the generation of multiple foreign tax credits for one amount of foreign tax paid.

Part II is aimed at ensuring that hybrid instruments and entities, as well as dual resident entities, are not used to obtain unduly the benefits of tax treaties and that tax treaties do not prevent the application of the changes to domestic law recommended in Part I. Part II first examines the issue of dual resident entities, i.e. entities that are residents of two States for tax purposes. It provides that that cases of dual residence under a tax treaty would be solved on a case-by-case basis by means of an agreement of the competent authorities rather than on the basis of the current rule-based on the place of effective management of entities. Part II also deals with application of tax treaties to hybrid entities. It recommends that benefits of tax treaties are granted in appropriate cases to the income of these entities but also that these benefits are not granted where neither State treats, under its domestic law, the income of such an entity as the income of one of its residents.

An Indian perspective

There are no specific rules under Indian domestic law that are designed to neutralise the effects of hybrid arrangements. However, structures involving hybrid arrangements may potentially be hit under the GAAR stated to come into force in 2017.

Given the range of situations identified and addressed as part of the BEPS project, there are several structured arrangements or intra-group transactions involving Indian companies that could potentially be hit under an anti-hybrid rule introduced based on the BEPS proposals. For instance, interest payments on convertible debt (e.g. Compulsorily Convertible Debentures) could be disallowed in India if such payments are characterised as dividends eligible for a participation exemption in the country of the debenture holder (if such country characterises such a debenture as equity under its local law). Similarly, transactions involving disparate characterisation of Indian entities (e.g. Limited Liability Partnerships) under Indian law and foreign law could also trigger the applicability of such provisions. Transactions between an enterprise and its permanent establishment may also trigger measures designed to neutralise any potential tax benefits that may arise as a result of a mismatch in characterisation of such transactions.

In summary, the rules proposed as part of this Action are extremely detailed and wide-ranging in their scope as such, and could potentially have the ability to affect a very large variety of cross-border transactions.

Action 3:
Designing Effective Controlled Foreign Company (CFC) Rules

Highlights of the BEPS Report

The Report on Action 3 sets out recommendations which are designed to ensure that jurisdictions that choose to adopt CFC rules can effectively prevent taxpayers from shifting income to foreign subsidiaries. The Report also highlights that existing CFC rules in many countries have often not kept pace with changes in the international business environment and hence do not tackle BEPS effectively.

Given the above, this report sets out recommendations in the form of 'building blocks'. These recommendations are not minimum standards, but they are designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries. The Report sets out the following six building blocks for the design of effective CFC rules:

- **Definition of CFC:** CFC rules generally apply to foreign companies that are controlled by shareholders in the parent jurisdiction. The Report sets out recommendations on how to determine when shareholders have sufficient influence over a foreign company for that company to be a CFC. It also provides recommendations on how non-corporate entities and their income should be brought within CFC rules.

- **CFC exemptions and threshold requirements:** The report recommends that CFC rules should apply only to controlled foreign companies that are subject to effective tax rates that are meaningfully lower than those applied in the parent jurisdiction.

- **Definition of income:** The Report recommends that CFC rules should include a definition of CFC income which would be attributed to the shareholders in the parent jurisdiction.

- **Computation of income:** The Report recommends that CFC rules use the rules of the parent jurisdiction to compute the CFC income to be attributed to shareholders. It also recommends that CFC losses should only be offset against the profits of the same CFC or other CFCs in the same jurisdiction.

- **Attribution of income:** The Report recommends that, when possible, the attribution threshold should be tied to the control threshold and that the amount of income to be attributed should be calculated by reference to the proportionate ownership or influence.

- **Prevention of double taxation:** The Report emphasises that countries adopting CFC Rules should allow a credit for payment of foreign taxes. It also recommends that countries should consider relief from double taxation on dividends and on gains arising from the disposal of CFC shares where the income of the CFC has previously been subject to taxation under a CFC regime.

An Indian perspective

While there are no CFC provisions currently under the domestic tax law of India, the same were proposed as part of Direct Taxes Code, 2013 (DTC) (now scrapped) to prevent deferral of taxes by Indian MNC's. As per the DTC provisions, once a company satisfies the definition of a CFC, all income of that CFC (active as well as passive) would be attributed to the Indian shareholder. Unlike the BEPS recommendations, there were no specific provisions in the DTC allowing underlying tax credit and the provisions also provided for a treaty override in the context of CFC. Also, as per the DTC provisions, only "foreign companies" were covered within the ambit of CFC provisions (unlike the recommendations in this Report to cover non-corporate entities as well). The introduction of the Place of Effective Management (POEM) test of corporate residency also suggests that the introduction of the CFC rules may no longer be a policy priority for the Government. This is because, the POEM rules, can to some extent, address the same abuses as a CFC regime by bringing to tax incomes earned by subsidiaries abroad.

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Action 4:
Limiting Base Erosion involving interest deductions and other financial payments

Highlights of the BEPS Report

It is increasingly recognized that base erosion can occur as a result of significant interest deductions and other financial payments. Typically, this may arise in three scenarios:

- Groups placing higher levels of third party debt in high tax countries
- Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense.
- Groups using third party or intragroup financing to fund the generation of tax exempt income.

In this regard, this Action seeks to design rules that would prevent base erosion through use of interest deductions. The recommended approach in this regard involves fixed ratio rule, which allows an entity to deduct net interest expense up to a benchmark net interest to EBITDA ratio within a range of 10% to 30%. Factors to be considered in arriving at the benchmark ratio within this range are also provided for in the Report.

This is coupled with an optional group ratio which allows an entity to deduct net interest expense up to its group's net interest to EBITDA ratio (where this is higher than the benchmark fixed ratio).

A discussion draft on 'Group Ratio Rule' was released by the OECD in July 2016 and public comments thereon were released in August 2016. The discussion draft included a detailed outline of the key elements of design and operation of this rule. It also highlighted the various approaches viz. (i) to calculate a group's net third party interest expense, (ii) to define group-EBITDA, and (iii) to address the impact of losses on the operation of the group ratio rule.

The report also acknowledges that in view of the specific requirements of the banking and insurance sectors, further work will need to be undertaken to address these sectors. A discussion draft and public comments on BEPS concerns posed by banking and insurance sectors were released by OECD in September 2016.

An Indian perspective

There are no formal thin capitalisation norms under Indian law. However, there are limited general provisions (i.e. section 14A of the Income-tax Act, 1961), which limit the deductibility of expenses (including interest payments) incurred in relation to exempt income. It is expected that thin capitalisation norms could be indirectly made applicable through a potential recharacterisation of debt into equity, once GAAR comes into force.

It is also relevant to note that in the absence of capital convertibility, debt inflows into India are typically subject to a stringent regulatory framework, which inter alia involves a minimum debt-equity ratio (4:1 under the automatic route and 7:1 under the approval route) in respect of borrowings from foreign shareholders owning more than 25% of equity. In addition to tax considerations, these requirements too will have to be kept in mind while determining funding structures for Indian investments.

The norms recommended under this Action could also have a bearing on outbound investments from India, where debt (both intra-group debt as well as external debt) is used as the primary means for funding acquisitions and investments.

Action 5: Countering harmful tax practices

Highlights of the BEPS Report

This Action is intended to deal with preferential regimes that risk being used for artificial profit shifting and a lack of transparency with regard to rulings. In this regard, the focus of the Action was to require a substantial activity test for preferential regimes and provide for a framework for effective exchange of information in relation to preferential regimes.

The key recommendations in this regard are as under:

- **Substantial Activity for preferential regimes:** It was agreed that the substantial activity requirement for assessing preferential regimes would be strengthened to ensure that the taxation of profits is aligned with the substantial activities that generate them. In this regard, the 'nexus approach' was identified as the preferred approach. This would use expenditure as a proxy for activity and require that taxpayers benefiting from a preferential regime are in fact engaged in the relevant activities and incurred actual expenditure on such activities. For e.g. in the context of IP regimes, such a test would allow a taxpayer to benefit from a preferential regime only to the extent that the taxpayer himself has incurred substantial expenditure in relation to the research and development.

- **Improving transparency:** A framework for exchanging information covering all rulings that could potentially give rise to BEPS concerns has been agreed upon. In respect of countries that have the necessary legal basis in place, it is expected that such an exchange of information will commence from 1 April 2016 (with information on past rulings to be exchanged by 31 December 2016)

An Indian perspective

The Finance Act, 2016 introduced a 'Patent Box' regime to incentivize indigenous R&D. As per this regime, a concessional tax rate of 10% (plus surcharge and cess) was made applicable to 'eligible' royalty income earned by 'eligible' assessees on a gross basis. The Patent Box Regime is intended to be in compliance with the recommendations in Action 5 of the BEPS Project, albeit with some key differences. The highlights are discussed below:

- The Patent Box Regime applies to a patent developed in India. The term 'developed' has been defined, inter-alia, to mean expenditure incurred by the taxpayer for any invention in respect of which a patent is granted. By linking the reduced tax rate on IP income to the expenditure incurred on development, the regime appears to be in line with the 'nexus approach' recommended by Action 5.

- The Action 5 report indicates that expenditure on IP acquisition or related-party outsourcing should be excluded in measuring qualifying expenditure for the nexus approach, subject to an 'up lift' not exceeding 30% of the qualifying expenditure. This aspect is not dealt with by the Patent Box regime.

- Also, expanding the coverage of qualifying IP income to IP income embedded in the sale of manufactured products would also need to be considered.

Apart from the above, with India pledging to remove tax incentive regimes in sync with a reduction in the corporate tax rate, this action may have little direct relevance vis-à-vis preferential regimes offered by India. However, to the extent that Indian groups seek to take advantage of preferential regimes (typically relating to intellectual property, financing structures, holding companies etc.) in overseas jurisdictions the substantial activity test based on expenditure incurred in that jurisdiction could prove relevant.

Action 6:
Preventing the granting of treaty benefits in inappropriate circumstances

Highlights of the BEPS Report

Addressing treaty abuse and treaty shopping is widely seen as one of the most important areas dealt with as part of the BEPS project. Particularly, this assumes relevance in the Indian context, mindful of the Indian Government's long stated concerns on the subject.

The Report recommends the following three-pronged approach to counter treaty abuse/shopping strategies:

- **Minimum Standard:** Inclusion in tax treaties of a clear statement/ preamble that treaties are entered to avoid creating opportunities for non-taxation or reduced taxation through evasion or avoidance including treaty shopping arrangements. Countries have committed to ensure this as a minimum level of protection against treaty shopping ("the minimum standard").
- **Comprehensive Limitation on Benefits Article:** A specific anti-abuse rule in the form of a comprehensive Limitation on Benefits ('LOB') Article to be included in the OECD Model convention, which will comprise of various conditions based on factors such as legal nature, ownership, general activities etc.
- **Principal Purpose Test:** In order to address other forms of treaty abuse that would not be covered within the LOB clause, a more general anti-abuse rule based on a 'Principal Purpose Test' or a PPT rule to be included in the OECD Model Convention. Under this rule, if one of the principal purposes of the transaction or arrangements is to obtain treaty benefits, the benefits would be denied unless it is established that the granting of such benefits would be in accordance with the object and purpose of the treaty.

In addition to the above, the Report lists down certain tax policy considerations that are relevant in order to decide whether to enter into a tax treaty or to amend or terminate existing treaties. These considerations include:

- The extent to which a risk of actual double taxation exists
- Risk of excessive taxation that may result from high withholding taxes in Source State
- Benefits for cross-border trade and investment that result from (i) Protection from discriminatory tax treatment (ii) Greater certainty of tax treatment (iii) Mechanism for bilateral resolution of disputes
- Benefits from provisions on administrative assistance (For instance, ability to exchange information, assistance in tax collections, etc.)
- Risk of double non-taxation or low taxation

An Indian perspective

Treaty abuse has long been one of India's foremost concerns in relation to cross-border taxation. Accordingly, various measures have been adopted by it, both at a unilateral as well as bilateral levels to help curb its incidence. These include:

- **Preamble clause in tax treaties:** It is pertinent to note that preamble to many of India's tax treaties already contains "prevention of fiscal evasion" as one of the objectives for which the treaty has been entered into (For instance, India's treaties with the US, Singapore, UK, Brazil, China, Netherlands, etc.).
- **Amendments in domestic law:** Several provisions have been introduced in the Indian domestic tax law to ensure that object and spirit of tax treaties is not undermined. Such provisions include the requirement to furnish a tax residency certificate, requirement to obtain a Permanent Account Number, self-declarations containing prescribed information as well as a compulsory application to be made to the tax officer to determine the appropriate withholding tax in certain cases (not yet specified) [Section 195(7) of the Income-tax Act, 1961] etc. In addition, India has also adopted a toolkit of measures (which include limiting deductions, requiring withholding of taxes at a higher rate) in respect of payments made to countries which do not effectively exchange information with India (Cyprus has been notified under this provision). However, it is stated that the Indian tax authorities will proceed to retrospectively rescind the classification of Cyprus as a 'Notified Jurisdictional Area' once the amended India-Cyprus tax treaty is in force.
- **LOB clauses:** Many tax treaties which have recently been negotiated by India (over 30) include a LOB clause. Most of these LOB clauses contain the subjective test of the "main purpose" rule (similar to proposed PPT rule) for treaty entitlement (For instance, India's treaties with UAE, UK etc). Some of India's treaties also have a comprehensive LOB clause akin to the US standard. It is also reported that India is actively seeking to renegotiate its tax treaty with Mauritius to curb treaty abuse.
- **Treaty override when GAAR applies:** The GAAR provisions which will be effective from FY 2017-18 include a clause to override tax treaties in cases where provisions of GAAR are triggered.

The multilateral consensus aimed at curbing treaty abuse under the aegis of the BEPS project is likely to provide a fillip to India's efforts in this direction. In an Indian context, a comprehensive LOB article containing clear and objective tests for treaty eligibility will prove preferable to a more subjective principal purpose test, in order to provide certainty to investors and ensure consistency in application.

The Government has also modified the India-Mauritius tax treaty to remove the capital gains exemption on a prospective basis. Similar changes are said to be on the anvil in respect of other treaties that also provide for a capital gains exemption in India (such as Singapore, Cyprus and the Netherlands). These changes, will, to a large extent address India's concerns over treaty abuse.

Action 7:
Preventing the artificial avoidance of PE Status

Highlights of the BEPS Report

This Action, together with Action 6, aims to restore taxation in cases where cross-border income goes untaxed or is taxed at very low rates due to the applicability of treaty provisions. Tax treaties typically provide that business profits of a foreign enterprise are taxable in a State in which such foreign enterprise has a PE.

This Action identifies the following key areas which are perceived as providing a leeway to Multinational Enterprises to circumvent the PE definition and makes suitable recommendations in respect thereof:

- **Selling of goods in another State through 'Commissionaire' arrangements or similar strategies:** In such cases, foreign enterprises typically do not fall within the PE definition as the contracts which are concluded by the Commissionaire are not binding on the foreign enterprise as they are not concluded in the name of the foreign enterprise as required by Article 5(5) of the OECD Model Convention. Similarly, other strategies that seek to avoid the application of Article 5(5) involve situations where contracts substantially negotiated in a State are not concluded in that State because they are finalized or authorized abroad.

  To address this, it is proposed that, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered as having a sufficient taxable nexus in that country, unless that intermediary is performing those activities in course of an independent business.

  Specifically, situations where a substantial part of negotiations of a contract happens in a Source State and the mere formal conclusion or sign-off takes place in the Resident State should also be regarded as one which triggers PE of the foreign enterprise in the source country.

- **Artificially avoiding the PE status through specific activity exemptions:** The Report notes that when the exceptions to the definition of PE were first introduced in Article 5(4) of the OECD Model Convention, the activities covered were generally considered to be of a "preparatory" or "auxiliary" nature and hence outside the purview of PE definition. However, given the dramatic way in which businesses are now conducted, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities.

  Thus, in order to ensure that profits derived from such core activities (which may be hitherto considered preparatory or auxiliary) are taxed in the Source State, the Report recommends modifications to Article 5(4) to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character.

- **Fragmentation of activities between closely related parties:** Given the ease with which Multinational Enterprises alter their structures to obtain tax advantages, the Report recommends changes to the PE definition to ensure that a PE status cannot be avoided by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities so as to fall within the exception in Article 5(4).

- **Splitting-up of contracts amongst group entities to avoid a PE:** The Report also recommends that a PE status cannot be avoided merely by splitting up of contracts between closely related enterprises in a manner such that duration of each contract is below the threshold limit for constitution of PE as may be provided in respective tax treaties (for e.g. in the context of construction contracts etc.)

The Report acknowledges that changes that will be made to Article 5 of the OECD Model Convention and the Commentary thereon to give effect to these recommendations will be prospective and should not affect the interpretation of the former provisions of the OECD Model Convention. A discussion draft pertaining to attribution of profits to a PE under BEPS Action Plan 7 was released by OECD in July 2016.

An Indian perspective

Commissionaire structures are not common under India's legal system which is based on English law. It is however, relevant to note that many of India's treaties have a wider definition of Agency PE in that an agent is considered to constitute a PE if he habitually secures orders wholly or almost wholly for the enterprise. While there is some litigation in India as to whether mere canvassing for orders (which may be ultimately accepted or rejected by the principal) would constitute a PE, the recommendation in the BEPS report will undoubtedly reinforce and support the Indian tax authorities' position on this issue.

Similarly, limiting the scope of the exclusions in Article 5(4) to only those activities that are preparatory and auxiliary in scope could see existing business models become liable to tax in India under the new standard. Fragmentation of activities and splitting up of contracts have in some Indian cases been targeted under judicial anti-abuse principles. Until such time as the necessary changes to treaties take effect based on the BEPS recommendations, one may potentially expect a closer scrutiny of structures to ensure that there is no artificial fragmentation or splitting up of contracts to reduce tax burdens. This may also be exacerbated once the Indian GAAR regime comes into force.

Actions 8 to 10:
Aligning Transfer Pricing Outcomes with Value Creation

Highlights of the BEPS Report

The objective of this report is to address the present anomalies in the TP guidance wherein emphasis was more on contractual allocation of Functions, Assets and Risks rather than the value creation through the economic activity.

This report has carried out changes to the OECD TP Guidelines of 2010 in 5 chapters i.e. Chapter I, II, VI to VIII, out of the total 9 chapters.

Chapter I: Arm's Length Principle

In this chapter, section D speaks about the guidance for applying the arm's length principle. It is stated that for arriving at the comparability analysis, various factors like Contractual terms of the transaction, Functional analysis, Characteristics of the property or services, Economic circumstances and Business strategies have to be considered.

This report has widened the scope of each of the comparability factors stated above and provides guidance on how to understand these factors.

It is provided that **'Contractual Terms'** should not only be considered but the actual conduct of the parties has to be seen along with the other comparability factors.

Further, as regards **'Functional Analysis'**, this Report has provided detailed guidance regarding the analysis of the risk in commercial or financial relations. It has elaborated the different risks such as strategic risk, operational risk, transactional risk, financial risk and hazard risk. It is also stated that the conduct of the parties (assuming these risk) has to be seen having regard to the contractual arrangement entered with the associated enterprise.

It is also stated that, the Functional analysis has to be in relation to the risk assumed by the parties. It has also provided guidance on the allocation of the risks between the parties based on the exercise of control over the risk.

The Report lays down various situations wherein the comparability adjustments can be made for Location Savings, Other local market features, Assembled workforce and Group Synergies.

Chapter II: Transfer Pricing Methods

- **Guidance in respect of 'Commodity Transactions'**: It is provided that Comparable Uncontrolled Price (CUP) method is an appropriate TP method for transfer of commodity, and quoted prices can be used as reference to determine the ALP.
- **Scope of work for Guidance on the Transactional Profit Split Method (PSM):** The scope of revision will be to clarify and provide guidance on the application of PSM on the transactions involving Highly Integrated business operations; Unique & valuable contributions; Synergistic benefits, profit splitting factors. It is also proposed to evaluate whether a Transactional PSM can be used to support the results under a TNMM, or to determine royalty rates, or in other ways.
- The Report will form the basis for draft guidance to be developed by OECD working party during 2016 and expected to be finalised in the first half of 2017.

Chapter III: Special Considerations for Intangible properties

The report provides that the legal ownership of intangibles by an Associated Enterprise (AE) is not only responsible for the returns from the intangibles. The economic ownership also has to be evaluated.

- AEs performing important value-creating functions related to the development, maintenance, enhancement, protection and exploitation of the intangibles should also be compensated appropriately in consonance with their contributions to the value creation.
- If an AE provides funding and assumes related financial risks, but does not perform any functions relating to the intangible, then AE should be compensated only for a risk-adjusted return on its funding.
- If an AE provides funding, but does not exercise or undertake financial risks associated with such funding, then it is entitled only to a risk-free return.
- An AE assuming risk in relation to the development, maintenance, enhancement, protection and exploitation of the intangibles, must exercise control over such risks and have the financial capacity to assume the risks.

The report provides that Intangibles have to viewed not from the accounting perspective, but from TP perspective. The report provides guidance on identification of intangibles and the different categories, Ownership of intangible and development and maintenance of the same. It also provides guidance on transfer of intangibles or rights in intangibles and transactions involving use of intangibles in connection with the sale of goods or the provision of services.

Further, the Report also provides guidance for determining the arm's length conditions in cases involving intangibles on the following aspects:

- General principles applicable in transactions involving intangibles.
- Supplemental guidance regarding transfers of intangibles or rights in Intangibles.
- ALP of transactions involving intangibles for which valuation is highly uncertain at the time of the transaction.
- Hard-to-value intangibles.
- Supplemental guidance for transactions involving the use of intangibles in connection with the sale of goods or the provision of services.

Chapter IV: Intra Group Services

The guidance provided in this Report addresses two issues arising in the analysis of transfer pricing for the intra-group services i.e., whether intra-group services have in fact been provided, and what charge for such intra-group services can be said to meet the arm's length principle.

The report now provides guidance regarding 'low value-adding intra-group services':

- Low value-adding intra-group services have been defined to mean accounting, auditing, human resource activities, public relations support, in-house legal services, information technology services not forming part of principal activity of the group, etc.
- The ALP for the low value-adding intra-group services, passing the benefit test is cost (which can be direct or allocated) plus 5% mark up. This ALP will apply only when the MNE has elected the simplified approach.

The Report further provides that the tax administrations adopting the simplified approach to low-value-adding intragroup services may include an appropriate threshold to qualify as simplified approach

Chapter V: Cost Contribution Arrangements (CCA)

CCA is a Contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles or tangible assets or services. An example would be Joint R & D.

The guidance suggests that the contributions from the participants to CCAs should be assessed at value which corresponds to their respective proportionate shares of expected benefits and not on the basis of costs.

An Indian perspective

As per the revised guidance issued under BEPS precedence of economic ownership over legal ownership is significant and would be used by the tax authorities to protect its tax base. For example:

- Indian subsidiaries of foreign MNE performing various functions (e.g., R&D), and assume risks related to the intangible without legally owning the intangible. Further, the distinction between funding related return and intangible related return as provided in revised guidance is critical since most of the contract R&D activities undertaken in India (by captive service providers) are funded by the foreign MNE. The Indian government had issued circulars stipulating conditions when a development centre would qualify as a contract R&D centre with insignificant risks.
- In the case of Indian subsidiary acting as a distributor of the foreign MNE and incurring significant Advertising, Marketing and Promotional (AMP) expenses, the Indian tax authorities may demand additional or higher compensation for development of the marketing intangibles in India. This is so because, the Indian distributor is not the legal owner of such marketing intangibles irrespective of the fact whether the Indian distributor is assuming limited risk or full risk. We have already witnessed controversy in this area in the recent past.

The report provides for linking profit attribution to the 'value creation', what constitutes value creation needs to be defined in the domestic tax provisions.

The current Indian Transfer Pricing Regulations provide no guidance regarding CCAs or intra-group services and the revised guidance under BEPS may help in this direction. The BEPS report however, has not touched upon high value intra-group services like Sales and Marketing, Brand development, etc which has been the bone of contention with the tax authorities in India.

Action 11:
Measuring and Monitoring BEPS

Highlights of the BEPS Report

This Action is intended to operate at a Governmental level to help address uncertainties surrounding the impact of BEPS on economic activity and government revenues. The report identifies indicators of BEPS activity using various sources of data and metrics, which can determine the existence and scale of BEPS. These indicators include profit rates of multinational affiliates located in low tax jurisdictions vis-à-vis average profit rates, effective tax rates of multinational companies vis-à-vis pure domestic companies, concentration of FDI etc.

An Indian perspective

Any such analysis in an Indian context is potentially likely to be constrained by the non-availability of comprehensive data with the Income-tax department. Nonetheless, it will be necessary to ensure that the appropriate tools and data in this regard are available, if one is to measure the extent of BEPS as well as test the efficacy of the various measures proposed as part of the BEPS final measures.

Action 12:
Mandatory disclosure rules

Highlights of the BEPS Report

This Action aims at providing a framework for countries to design a disclosure regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes.

The Report also sets out specific recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations.

The objective of such a framework is to increase transparency as well as to deter taxpayers from entering into aggressive schemes. Factors such as who is required to report, what is required to be reported, the timing of the reporting as well as the consequences of non-reporting are considered in detail in the Report.

An Indian perspective

In an Indian context, the Expert Committee on GAAR constituted under the chairmanship of Dr. Parthasarathi Shome had recommended modifications to the format of the tax audit report to require reporting of tax avoidance schemes in excess of certain specified limits. Further details of what would constitute an 'avoidance' scheme, the details required to be reported etc. were not set out. This recommendation has not been incorporated in the rules so far.

Action 13:
Transfer Pricing Documentation and Country-by-Country Reporting

Highlights of the BEPS Report

This report has substituted the existing guidelines on 'Documentation' as contained in Chapter V of the OECD Transfer Pricing Guidelines, 2010 by providing revised standards for transfer pricing documentation and a template for Country-by-Country Reporting of income, taxes paid and certain measures of economic activity. The important highlights of this report are:

- Adoption of three tier structure for the transfer pricing documentation:
  - **Master File**: This should contain high-level information regarding overview of MNE group business operations, legal and ownership structures, overall transfer pricing policies, description of intangibles and intercompany financial activities and tax positions.
  - **Local File**: This file is country specific file and supplements the Master file. It contains detailed information relating to specific intercompany transactions i.e., detailed business description and management structure of the local entity, information regarding material related party/ controlled transactions such as quantum involved, taxpayers analysis regarding arm's length determination including functional analysis, comparability analysis, selection of appropriate method, financial information of local entity and comparables used, etc.
  - **Country-by-Country (CbC) Reporting**: provides for aggregate, jurisdiction wide information on the amount of revenue earned, profit before tax, taxes paid, stated capital, number of employees and tangible assets, etc.
- The CbC reporting would start for the fiscal years commencing on or after 1 January 2016 and the monetary threshold or reporting is revenues equal to or exceeding EUR 750 million.
- The information contained in the CbC report should not be used as a substitute for a detailed transfer pricing analysis of the Individual transactions. It is also stated that, the jurisdictional tax administrations shall not propose TP adjustments based on the global formulary apportionment of income, as available in the CbC report.
- The report recommends individual countries to establish their own materiality standards for the Local file purpose, based on the size and nature of local economy, etc.
- The report recommends that the searches in databases for comparable, supporting part of the local file, be updated every three years rather than annually - as long as the operating conditions remain unchanged. However, the financial data for the comparable should be updated every year in order to apply the arm's length principle reliably.
- The report also recommends that;
  - Master file and Local file shall be filed directly with the tax administrations in each relevant jurisdiction.
  - CbC reports shall be filed in the jurisdiction of tax residence of ultimate parent entity and can be shared between tax jurisdictions through automatic exchange of information agreements. It further states that when the ultimate parent company is not obliged to file in its jurisdiction, a secondary mechanism of filing with the country in which the MNE group company has a presence would be accepted.
- This report also provides for the guidelines for implementing the CbC report for countries participating in the BEPS project:
  - A model legislation requiring the ultimate parent entity of an MNE group to file the CbC Report in its jurisdiction of residence has been developed and the member countries can adapt this model legislation in their legal system
  - Arrangements for the automatic exchange of the CbC Reports under the international agreements have been developed which include competent authority agreements based on existing international agreements (Multilateral Convention, Bilateral tax treaties and Tax Information Exchange Agreement).

An Indian perspective

In line with the Action Plan 13, the Finance Act, 2016 has included the essential elements of CbC reporting and Master File in the domestic tax laws. The reporting requirements shall apply only if the consolidated revenues of the taxpayer group based on consolidated financial statements exceed the prescribed threshold limit of Euro 750 million for the preceding accounting year. The report would, inter-alia, include aggregate information in respect of the amount of revenue, profit or loss before income-tax, amount of income-tax paid, amount of income-tax accrued, stated capital, accumulated earnings, number of employees and tangible assets not being cash or cash equivalents, with regard to each country or territory in which the group operates.

The implementation of the guidelines provided by this Report may potentially increase the documentation/ compliance burden for enterprises in India in the initial years of implementation.

India has already witnessed the aggressive tax assessments by the revenue authorities in the last couple of years where the arm's length pricing has been questioned. The availability of the CbC and the Master file of the MNE could increase the litigation risk further, as enterprises may be called upon to justify the value created by it as compared to other group companies for the similar transaction.

The suggestions in the report that comparable should be accepted for 3 years with only changes in the financial data for each of the subsequent years to meet the arm's length requirement, if accepted in India, will ease the compliance burden to some extent.

Action 14: Making dispute resolutions mechanisms more effective

Highlights of the BEPS Report

This Action acknowledges the consensus view that the introduction of measures to tackle BEPS should not lead to uncertainty for taxpayers and to unintended double taxation. Improving dispute resolution mechanisms was therefore considered to be an integral part of the BEPS project.

The measures developed under this Action are aimed at strengthening the effectiveness and efficiency of the MAP process under tax treaties. It is expected that this will minimise the risks of uncertainty and unintended double taxation by ensuring the consistent and proper implementation of tax treaties, including the effective and timely resolution of disputes. The measures are sought to be supported by a strong political commitment to ensuring effective and timely resolution of MAP disputes.

A minimum standard has been developed, which coupled with a set of best practices, is aimed at:

- Ensuring that treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that MAP cases are resolved in a timely manner;
- Ensuring the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and
- Ensuring that taxpayers can access the MAP when eligible.

In addition to the commitment to implement the minimum standard by all countries adhering to the outcomes of the BEPS Project, several countries have declared their commitment to provide for mandatory binding MAP arbitration in their bilateral tax treaties as a mechanism to guarantee that treaty-related disputes will be resolved within a specified timeframe.

An Indian perspective

While MAPs are invoked frequently in the context of tax disputes involving India, the need for strengthening this process with a view to making it more efficacious is often felt. There is also currently no time limit for settlement of MAP disputes (except in the context of UK and US where a 2 year period has been agreed upon), which often leads to long delays.

Given that India is not among the countries that have agreed to implement binding arbitration to resolve treaty disputes under MAP, there is an urgent need to take administrative steps to ensure that the MAP process becomes more efficacious and timely.

Action 15: Developing a multilateral instrument to modify bilateral tax treaties

Highlights of the BEPS Report

The objective of this Action is to expedite and streamline the implementation of the BEPS measures by providing for an alternative mechanism for modifying bilateral tax treaties. This is to avoid the need for a simultaneous renegotiation of thousands of bilateral tax treaties. The report analyses the tax and public international law issues related to the development of such an instrument.

An ad hoc group was constituted and it began its work in May 2015 with the objective of opening the multilateral instrument for signature by 31 December 2016. The group comprises of participation from over 80 countries (US being a notable absentee at this stage).

An Indian perspective

India is a member of the ad hoc group constituted for the development of the multilateral instrument. Given that section 90 of the Income-tax Act, 1961 does not expressly envisage entering into multilateral agreements for avoidance of double taxation, it may be necessary to examine whether legislative changes in this regard are to be made in order for such multi-lateral treaties to have effect under Indian law.

Implementation Mechanics – a summary

The implementation of the BEPS measures is expected to be either through necessary changes to domestic law or changes to treaties. In respect of treaties, several of the changes are likely to be made to the OECD Model Convention (and supporting commentary). These changes are also likely to be proposed for inclusion in the multilateral instrument envisaged in Action 15. A brief summary of the implementation mechanics for each of the Action items is set out below:

Action No.	Subject	Primary Means of Implementation
1	Addressing the Tax Challenges of the Digital Economy	See Action Items 3, 7 and 8-10
2	Neutralising the Effects of Hybrid Mismatch Arrangements	Changes to domestic law as well as to the OECD Model Convention – could also potentially be included in the multilateral instrument
3	Designing Effective Controlled Foreign Company Rules	Changes to domestic law
4	Limiting Base Erosion Involving Interest Deductions and Other Financial Payments	Changes to domestic law
5	Countering Harmful Tax Practices	Changes to domestic law
6	Preventing the granting of Treaty Benefits in Inappropriate circumstances	Changes to the OECD Model Convention – could also be included in the multilateral instrument
7	Preventing the Artificial Avoidance of PE Status	Changes to the OECD Model Convention – could also be included in the multilateral instrument
8 -10	Aligning Transfer Pricing Outcomes with Value Creation	Changes to domestic law
11	Measuring and Monitoring BEPS	NA
12	Mandatory Disclosure Rules	Changes to domestic law
13	Transfer Pricing Documentation and Country-by-Country Reporting	Changes to domestic law
14	Making Dispute Resolution Mechanisms more effective	Changes to treaties to provide for MAP arbitration – could also be included in the multilateral instrument
15	Developing a Multilateral Instrument to modify Bilateral Tax Treaties	NA

About Dhruva

Dhruva Advisors LLP is a boutique tax and regulatory services organization, working with some of the largest multinational and Indian corporate groups.

We bring a unique blend of experience, having worked for the largest investors in India, advising on the largest transactions and on several of the largest litigation cases in the tax space. We work closely with regulators on policy issues and our clients on tax advocacy matters. We believe in thinking out of the box, handholding our clients in implementation and working to provide results.

Key differentiators:

- Strategic approach to complex problems
- In-depth, specialised and robust advice
- Strong track record of designing and implementing pioneering solutions
- Trailblazers in tax controversy management
- Close relationships with the government coupled with a long history of involvement in policy reform
- Technical depth and quality

Our team comprises of 19 Partners and over 175 people located in Mumbai, Ahmedabad, Bengaluru, Delhi and Singapore. The key industries the team advises include financial services, IT and IT-enabled services (ITES), real estate and infrastructure, telecommunications, oil and gas, pharmaceuticals, chemicals, consumer goods, power, as well as media and entertainment.

Dhruva Advisors is a member of the WTS Alliance, a global network of selected firms represented in more than 100 countries worldwide.

Our recognitions

- Dhruva Advisors has been consecutively recognized as a Tier 1 Firm in the International Tax Review, World Tax Guide 2016 and 2017 to the world's leading tax firms.
- Dhruva Advisors has also been awarded the Best Newcomer of the Year 2016 - ASIA by the International Tax Review.

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