MLI &BEPS –An Overview

5th December 2019 – Hyderabad Study Circle

BEPS implementation
What and how?

Coherence

- Hybrid mismatch arrangements (2)
- Controlled foreign company (CFC) rules (3)
- Interest deductions (4)
- Harmful tax practices (5)

Substance

- Preventing tax treaty abuse (6)
- Avoidance of permanent establishment status (7)
- Transfer pricing (TP): intangibles (8)
- TP: risk and capital (9)
- TP: high risk transactions (10)

Transparency

- Methodologies and data analysis (11)
- Disclosure rules (12)
- TP documentation (13)
- Dispute resolution (14)

Changes to domestic legislation needed

Changes to bilateral tax treaties needed

- Digital economy (1)
- Multilateral instrument (15)

Implementation of BEPS Action Plan in India

Action 1	Introduction of Equalization Levy at the rate of 6% on certain digital advertising transactions in 2016 Union Budget	**Action 4**	Introduction of the interest deduction limitation rule in the 2017 Union Budget
Action 5	Amendment to AAR forms for improving transparency through exchange of information on 13 July 2018 and introduction of Patent regime	**Action 6**	Re-negotiation of tax treaties to ensure greater source based taxation/ prevent treaty abuse
Action 8-10	Tax administration and taxpayers expected to give consideration while applying arm's length principles	**Action 13**	Introduction of Country by Country Reporting (CbCR) and Master File TP documentation in the 2016 Union Budget
Action 14	Committed to minimum standards for improving effectiveness on Mutual Agreement Procedures (MAP)	**Action 15**	The Indian Government ratified the MLI to implement tax treaty related measures to prevent BEPS on 27 May 2019 vide press release dated 12 June 2019

BEPS Action 15

Multi-lateral Instruments

Background

- The multilateral instrument (MLI) has been developed to implement tax treaty related measures of the BEPS project
  - MLI modifies bilateral tax treaties in a synchronised, fast and consistent manner. Though MLI does not amend a tax treaty, it needs to be read along with an existing tax treaty based on matching positions
  - 100+ countries (OECD and G20), including India, worked on development of MLI
  - One negotiation, one signature, one ratification - Avoids renegotiation of each tax treaty
  - Each signatory to notify the tax treaties it wants to amend through the MLI – covered tax agreement or “CTA”

- The MLI has been signed by 88 countries out of which 25 countries have already submitted the ratified copy of MLI with OECD. India signed the MLI on 7 June 2017 and at the time of signature, India submitted its provisional list of tax treaties and provisional positions on various articles of the MLI.

- The Indian Government ratified the MLI to Implement Tax Treaty Related Measures to Prevent BEPS on 27 May 2019 vide press release dated 12 June 2019.

Features of MLI

What is MLI, it's objective

- Single Instrument that modifies bilateral tax treaties in a synchronised, fast and consistent manner
- One negotiation, one signature, one ratification

Impact

- MLI intended to cover 3000+ existing tax treaties

BEPS action Implemented Through MLI

- Action 2 (Hybrid mismatches)
- Action 6 (Treaty abuse)
- Action 7 (PE)
- Action 14 (Dispute resolution)

Legal Status

- MLI does not function as protocol, need to be read with existing treaties
- Does not replace existing tax treaties but modifies them

Evolution of MLI

Stage 1: Adoption of MLI on 24 November 2016

In principle approval to the text of MLI.

Stage 2: Signing of MLI

Each signatory to submit provisional list of tax treaties along with provisional reservations/ notifications.

Stage 3: Filing ratified copy of MLI with OECD along with final reservations and notifications.

Through ratification, a country establishes its consent to be bound by a treaty at an international level

Stage 4: Filing of final reservations (along with ratification)

Reservation is opting out of a MLI provision without assigning reasons.

Stage 5: Filing of final notification (along with ratification)

Notification is a sign of acceptance and willingness to implement BEPS measure – **Converse of reservation**

Stage 6: Covered Tax Agreements (CTA)

CTA is a bilateral treaty to the extent modified by MLI if both signatories have ratified and deposited the ratification copy to OECD

Stage 7 and 8: Date of entry into force and entry in to effect

Stage 9: Option to withdraw from MLI

Every signatory has the option to withdraw from MLI before CTA. Once CTA is established can withdraw only bilaterally.

Impact of ratification and entry into effect

Further to ratification, India needs to undertake following steps to make MLI effective for India's CTA

- Submit the ratified copy of MLI with OECD along with the final list of tax treaties that India wishes to be modified by MLI; and India's final positions on MLI articles
- Complete its internal procedures for each CTA to make MLI effective for withholding taxes and other taxes
- Notify OECD and CTA partner of completion of its internal procedures

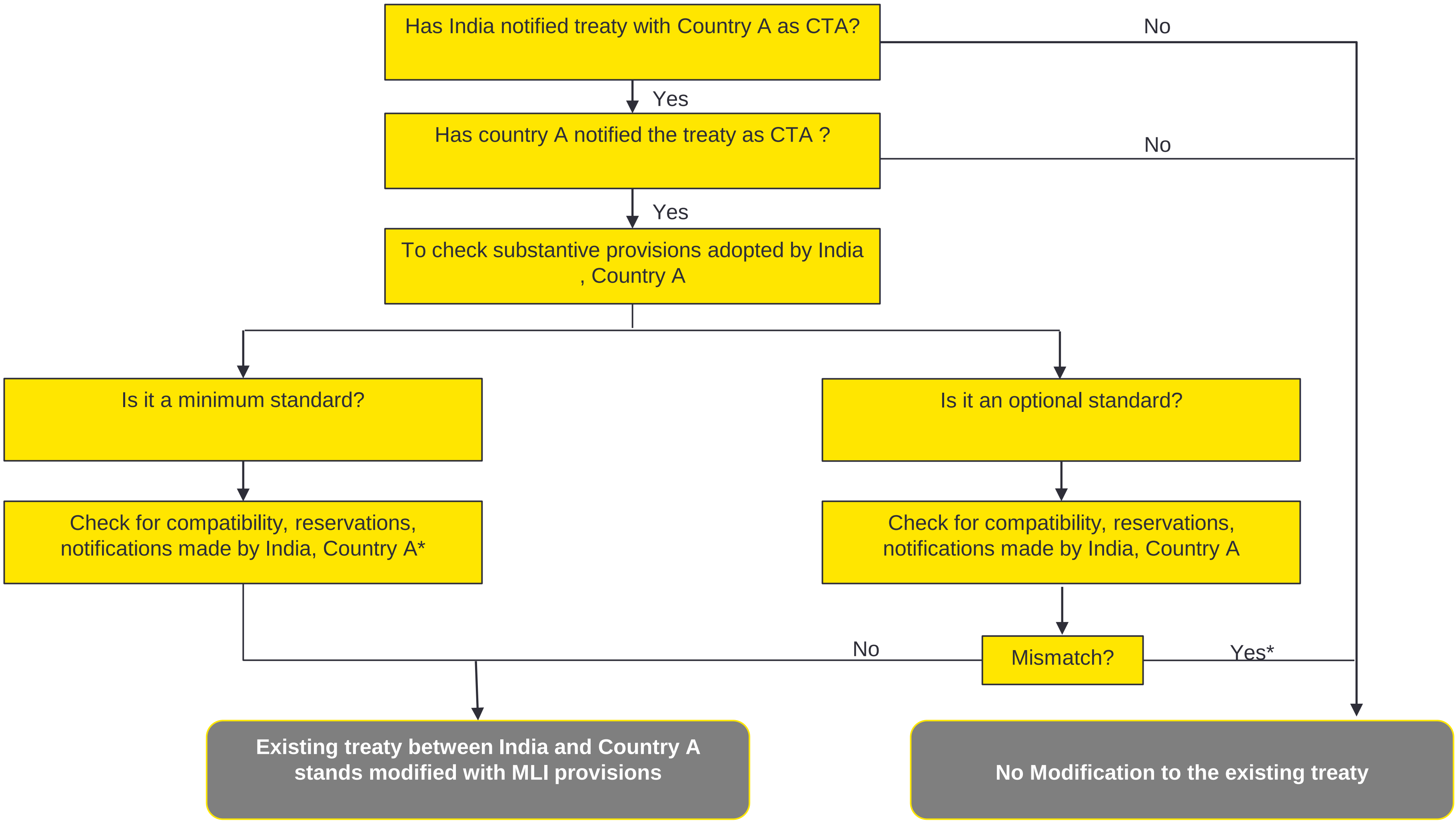
Entry into force and entry into effect (EIE)

- The MLI shall enter into force for India on the 1st day of the month after the expiry of 3 months from the date of deposit of ratified copy of the MLI with OECD.
- Once MLI has come into force for both the treaty countries, the latter date of coming into force is relevant for determining the date of EIE of the MLI
- India has opted for an optional provision – EIE for India's CTAs - 30 days from latter of the dates on which OECD receives notification from CTA partners about completion of its respective internal procedures – 'optional relevant date (ORD)'

Particulars	**Date of EIE of Indian CTAs**
For withholding tax	1st day of next taxable period/ calendar year that begins on or after the ORD
For other taxes	Taxable period that begins on or after expiry of six calendar months from the ORD

If India and its CTA partners notify about completion of their respective internal procedures by 31 August 2019, the MLI may be effective for India's such CTAs from 1 April 2020 with respect to withholding taxes as well as other taxes.

Application of MLI to CTA



*A country can opt out of minimum standard only if the treaty already meets the minimum standard or if it is willing to bilaterally negotiate the minimum standard

India’s position on key MLI provisions

Illustrative impact of MLI signing by key trading, investment treaty partners

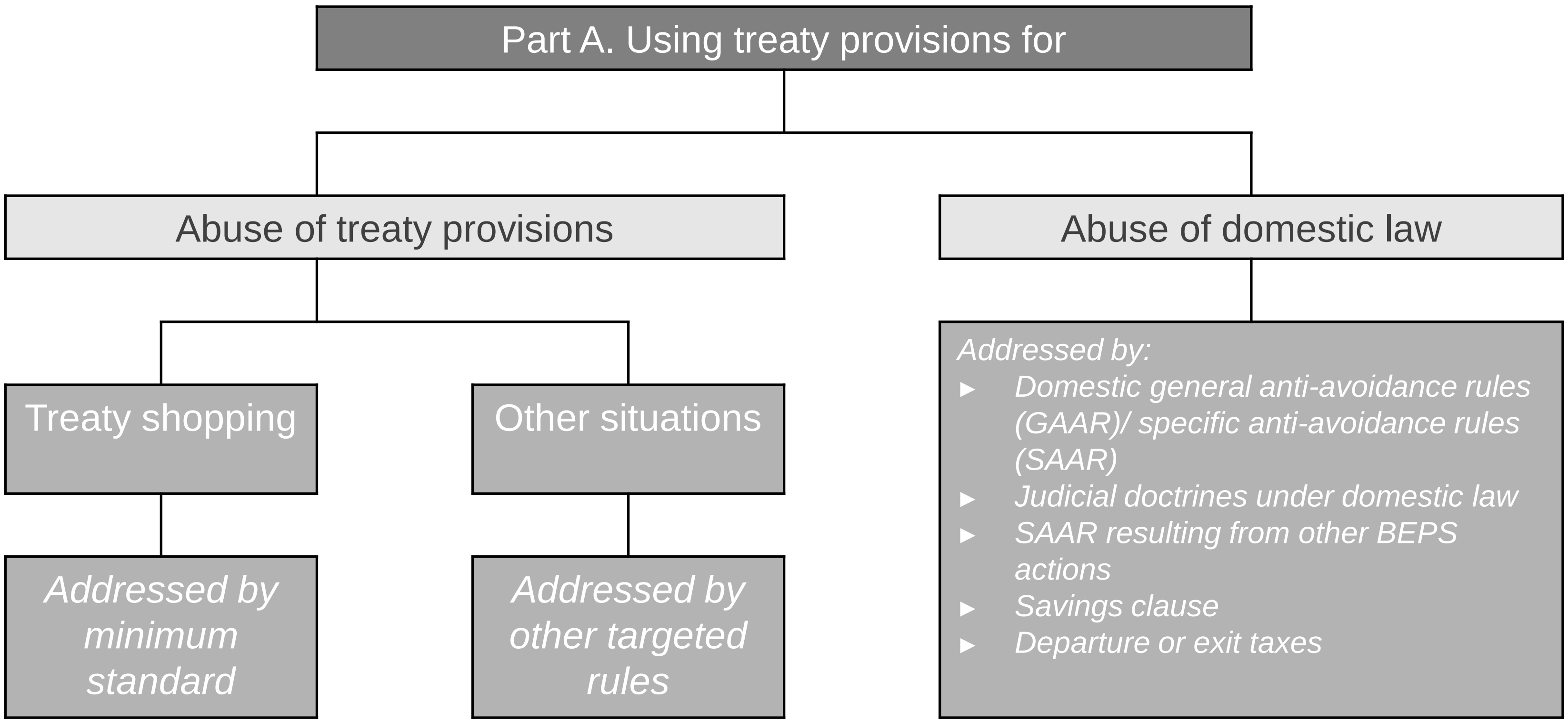
Key India treaty partners who have not signed MLI yet – Existing treaties remain unaffected	US, Brazil, Thailand
Treaty partners who have signed MLI but have not included India as CTA in its provisional list – Existing treaties remain unaffected	Mauritius, China, Germany
Key India treaty partners who have signed MLI and notified India as CTA - Existing treaties to be modified based on matching of MLI position of both countries	Australia, Canada, Cyprus, France, Japan, Netherlands, UK, Luxemburg, Ireland, Italy, Russia, South Africa, Singapore

MLI coverage

Action 2	▶ Revision of Article 1 to address fiscally transparent entities ▶ Measures to address issues with the application of the exemption method ▶ Dual-resident entities
Action 6	▶ Minimum standard on treaty abuse: principal purpose test (PPT), PPT plus simplified limitation on benefits (LOB), or detailed LOB supplemented by anti-conduit rules ▶ A “saving clause” ▶ Specific anti-abuse rules: ▶ Certain dividend transfer transactions ▶ Transactions involving immovable property holding companies ▶ Treaty shopping using third-country permanent establishments (PEs)
Action 7	▶ Measures to address commissionnaire arrangements and similar strategies ▶ Modifications to the specific activity exemptions under Article 5(4) ▶ Measures to address the splitting-up of contracts to abuse the exception in Article 5(3)
Action 14	▶ Measures included in the minimum standards and best practices, including: ▶ Changes to paragraphs 1 through 3 of Article 25 ▶ Inclusion of paragraph 2 of Article 9 of the OECD model ▶ Option for mandatory binding MAP arbitration

Prevention of treaty abuse

Coverage of BEPS Action 6



Part B. Clarification that tax treaties are not intended to be used to generate double non-taxation (forms part of agreed minimum standard)

Part C. Tax policy considerations that should be considered by the countries before entering into a tax treaty with another country

Principal purposes test (PPT) rule (subjective rule)

- Text of PPT rule (same text is given in MI as well):

  "Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."

- PPT rule provides that benefits under a treaties shall not be granted in respect of an item of income or capital:

✓	Positive test with a lower threshold to determine 'one of the principal purposes of any arrangement or transaction'	If it is ***reasonable to conclude*** that obtaining the benefit was ***one of the principal purposes*** of any ***arrangement or transaction that directly or indirectly resulted in that benefit***
❖	Negative test with strict condition of establishment	Unless it is 'established' that granting of the benefits would be in accordance with the object and purpose of the treaties

Prevention of Treaty abuse
Minimum standards – Article 6, 7

Expression of common intention to avoid double taxation without creating opportunities for low/no taxation through tax avoidance/ evasion (Mandatory standard as per MLI)

+

Principal Purpose Test (PPT) Rule

Mandatory standard to be adopted in all treaties unless countries adopt DLOB+ Anti-conduit measures

OR

PPT Rule and Limitation-on-benefits (LOB) Rule

Optional standard, to be included when all the countries agree to the adoption of SLOB in addition to PPT Rule

OR

LOB Rule, supplemented by specific anti-conduit rules

Countries can adopt this option instead of PPT through bilateral negotiation

Treaty shopping

▶ *PPT rule - broad and subjective*

1 One of the principal purposes

- Obtaining the benefit under a treaty need not be the ***sole or dominant purpose*** of a particular arrangement or transaction
- It is also "perceived" that obtaining treaty benefits is a reason for the transaction

2 Reasonable to conclude

- PPT rule is triggered where "it is reasonable to conclude" that treaty abuse motives were present
- Tax authorities do not have to ***conclusively*** establish that obtaining a treaty benefit was one of the principal motives.

3 Broad interpretation of 'Arrangement or transaction'

- "Arrangement" includes understanding, scheme, transaction or series of transactions whether or not legally enforceable. Also, includes "creation", assignment, acquisition or transfer of income
- It could be single step or a part of arrangement
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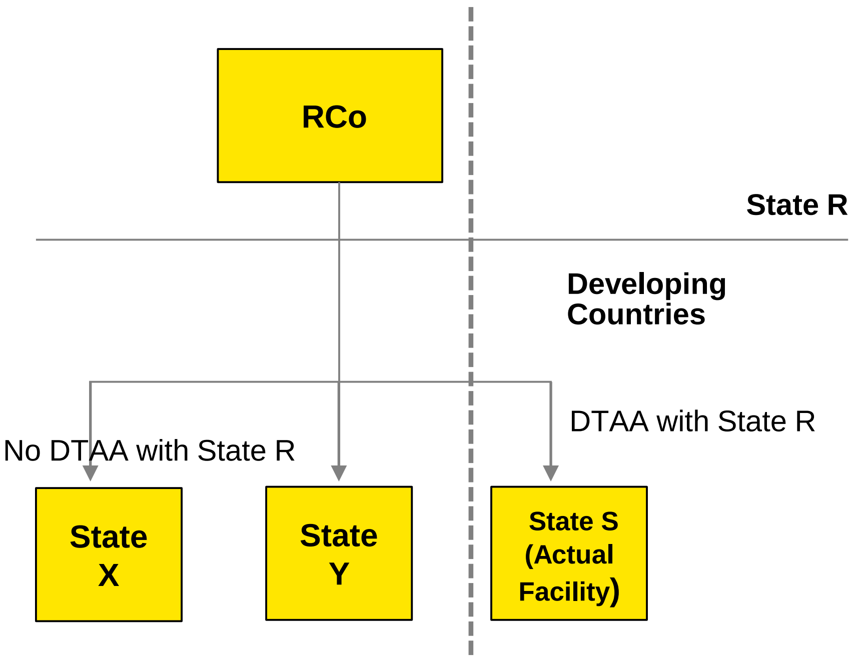
4 Benefit covers all limitations on taxation

- Example: tax reduction, exemption, deferral, tax refund, benefit of tax sparing etc.

Examples on PPT rule



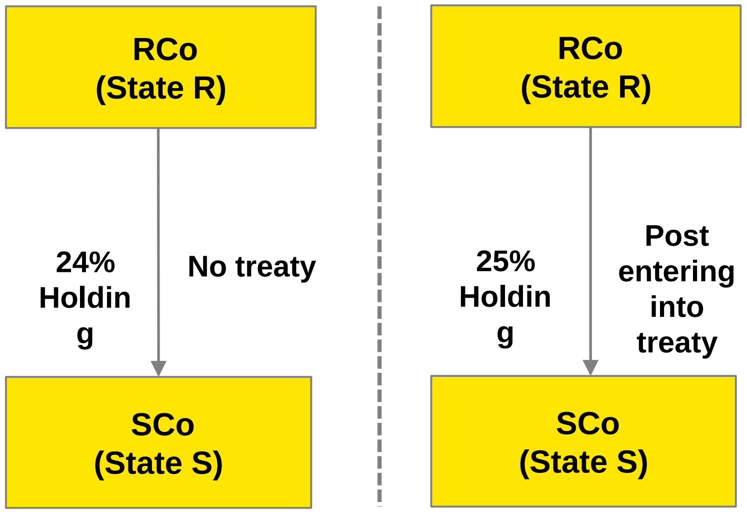
Facts:

- R Co is a manufacturing entity and has the option of setting up a manufacturing unit in three states i.e. State X, State Y and State S
- All three locations were comparable economically and politically, however only State S has a Treaty with State R
- R Co decided to set up the facility in State S due to the presence of treaty

Analysis:

- Though all three locations were comparable economically and politically, presence of treaty with State S tilted the choice.
- Though tax is one of the principal factors in decision making, PPT should not be triggered to deny treaty benefit.
- Encouraging cross border investment and availing treaty benefit for actual plant set up in State S meets with object and purpose of the treaty.
- However, if State Y was better politically and economically and choice of State S is made only to obtain benefits under R-S Treaty, PPT may be invoked to deny treaty benefits

Examples on PPT rule



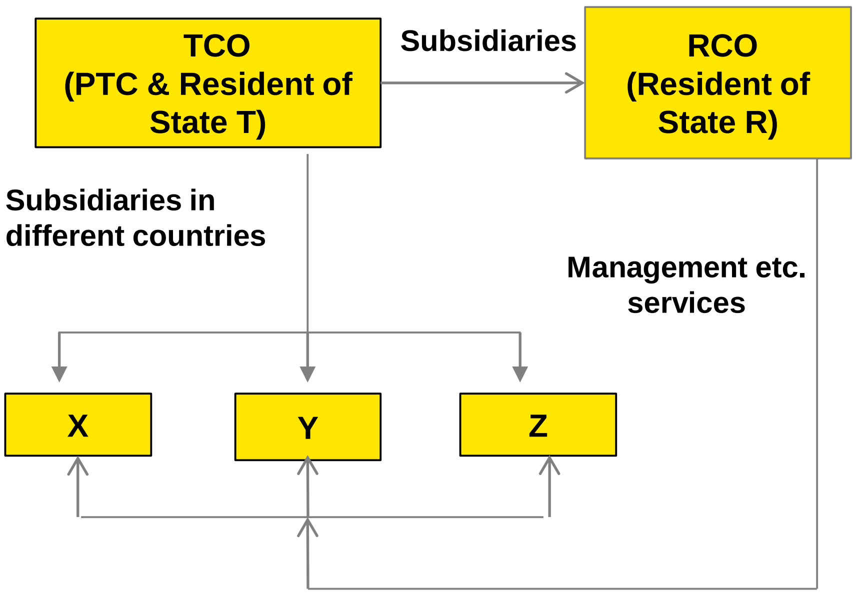
Facts:

- R Co a resident of State R holds 24% in S Co, a resident of State S. There was no treaty between State S and State R
- Subsequently R-S Treaty was entered into which provided for 5% WHT rate on dividends subject to threshold of 25% holding
- R Co increased its holding to 25% to avail concessional rate

Analysis:

- The facts and circumstances reveal that one of the principal purposes for the transaction through which the additional shares are acquired is clearly to obtain the benefit the benefit of the lower WHT rate provided by R-S Treaty
- However, granting benefit under this Article is permitted to a taxpayer who genuinely increases its participation in a company in order to satisfy the arbitrary threshold of 25%.

Examples on PPT rule



Facts:

- T Co has subsidiaries in different countries, but State T does not have treaty with any of these countries
- R Co is established in State R for the purpose of providing managerial services to group companies. State R has treaties with each of the countries where the subsidiaries are located
- The decision to invest in State R is driven by the skilled labour force, reliable legal system, business friendly environment, and the comprehensive double taxation treaty network of State R which provide lower WHT rates

Analysis:

- Merely reviewing the effects of the treaties on future payments by the subsidiaries to R Co should not considered to be the purposes for the establishment of R Co.
- Treaty benefits should not be denied to R Co provided it makes decisions necessary for the conduct of its business, constitute a real business, exercises substantive economic functions, uses real assets and assumes real risks, and carries on the business through its own personnel.

Treaty shopping PPT rule - Applicability under various scenarios

- **Application of PPT rule is explained with 10 examples* in the OECD Commentary**

  - **Circumstances where PPT rule is not applicable if the arrangement:**
    - Aims at expanding the business or for other business efficiency
    - Encourages cross-border investment or obtains treaty benefit legitimately
    - Is driven by commercial considerations and availability of requisite infrastructure
    - Constitute a real business activity

  - **Circumstances where PPT rule is applicable**
    - Splitting up of contracts in order to abuse the time threshold for PE and to avoid the existence of PE in source State
    - Arrangements resulting in no/ low taxation in source State by assigning debt / right to dividend etc. (Without any other objective)

*Examples are as per Action 6 recommendations in OECD Commentary and Multi-lateral Instrument (MLI) does not provide any guidance

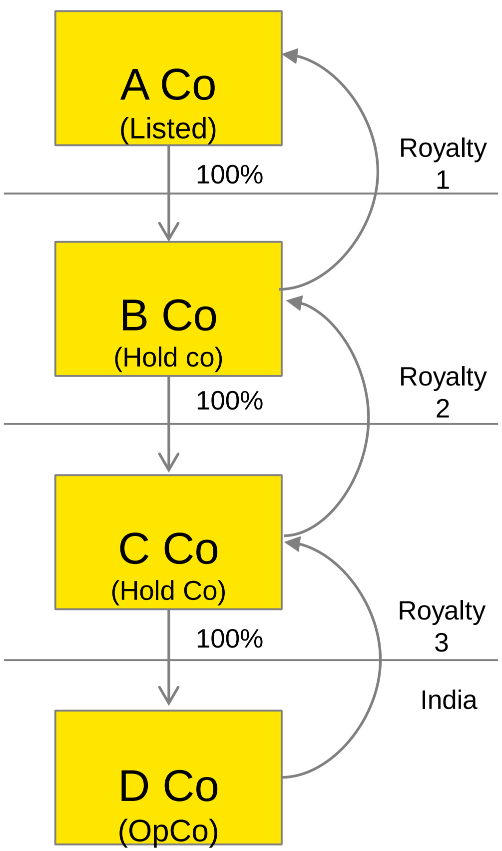
Treaty shopping - Simplified Limitation-on-benefits (SLOB) rule - Conditions

- SLOB is a specific anti-abuse rule aimed to address treaty shopping
  - Based on SLOB provisions found in treaties concluded by the United States
  - As per MI, SLOB rule shall be included in a treaty if all the parties to that treaty adopt

- As per SLOB clause, treaty benefits are available if any of the following requirements are satisfied:

Requirement	Description
Qualified person	► Categories of "qualified person" detailed; (includes individuals, Government and Government owned entities, publicly traded companies/ entities etc.)
Active trade or business test	► Income is derived by a person engaged in active conduct of a trade or business in its residence country; and Income derived is in connection with or is incidental to that business
Derivative benefits rule	► If at least 75% of that entity is owned by certain persons who are Equivalent beneficiaries (EB) ► EB - any person who would be entitled to an equivalent or more favourable benefit with respect to an item of income, under the CTA or the Domestic law of source country
Exclusion from term 'active conduct of business'	► Operating as a holding company ► Providing overall supervision or administration of a group of companies ► Providing group financing (including cash pooling) or ► Making or managing investments, unless these activities are carried on by a bank, insurance company or registered securities dealer in the ordinary course of its business as such.

Case study – on SLOB rule



Facts:

- A Co holds 100% in A Co and B Co holds 100% in C Co
- A Co is a listed entity, while B Co and C Co act as holding companies and are unlisted entities
- D Co is a operating company in India
- There is a back to back royalty payment between D Co, C Co and B Co

Income	Eligibility for DTAA	Reason
Royalty 1	Yes	Since A Co is a listed company, A Co qualifies as a EB and hence A Co will qualify for Treaty benefits
Royalty 2	May be available?	Will depend on whether • B Co is a QP? • 'Active Business' test is satisfied by B Co? • 'Derivative benefit' test is satisfied by B Co? • If B Co is a QP or if B Co satisfies Active Business Test or the Derivative Benefits Test then treaty benefits shall be available
Royalty 3	No?	Will depend on whether • C Co is a QP? • 'Active Business' test is satisfied by C Co? • 'Derivative benefit' test is satisfied by C Co?

Table indicating applicability of PPT and SLOB

Country A	Country B	Impact on A-B CTA
PPT	PPT	A-B CTA will have MLI PPT in place of existing PPT
PPT + SLOB	PPT + SLOB	A - B CTA will have PPT + SLOB
PPT + SLOB	PPT	1. A - B CTA will have PPT+SLOB if Country B also agrees to the application of SLOB 2. If Country B agrees to apply the SLOB asymmetrically then i) Country A to apply PPT+SLOB to grant treaty benefits ii) Country B to apply PPT to grant treaty benefits 3. Country A may opt out from including treaty abuse provisions ➔ Both countries to bilaterally negotiate to meet minimum standard 4. If both Countries fail to adopt any of the above options then PPT may as default option apply in A-B CTA
Opts out of PPT	Opts out of PPT	Existing PPT of A - B CTA to apply.
Opts for DLOB	PPT	CJs shall endeavour to reach a mutually satisfactory solution to meet minimum standard

India positions – Article 6, 7

- Preamble - Since India has not notified any of the preambles, mandatory preamble shall be added to the existing preamble of India's CTAs

- India has adopted for PPT to apply to all its CTAs
  - Over 36 Indian CTAs already contain a provision similar to PPT - MLI PPT to replace/ supersede existing similar provisions or added to a CTA in the absence of PPT
  - India has not opted to apply the competent authority (CA) rule
    - CA may grant the intended benefit or any other benefit in respect of an item of income or capital where treaty benefits are denied to a person under the PPT Rule

- India has opted for SLOB for all its CTAs in addition to PPT – SLOB to apply if treaty partner adopts it or allows India to apply it asymmetrically
  - India has also notified a list of 9 countries which contain certain provisions similar to the MLI SLOB
    - Where all CJs agree, MLI SLOB replaces existing LOB in respective CTA

Impact on Indian treaties – Article 6, 7

MLI Provision	Impacted Indian treaties based on based on matching of MLI Positions
Anti abuse provision already existing in the tax treaty- MLI PPT to replace existing provisions	• Finland, Israel, Korea, UK (Scope of PPT likely to get widened to the extent of incompatibility)
PPT only	• Australia, Belgium, Canada, Cyprus, France, Ireland, Italy, Japan, Netherlands, Sweden (Existing treaties do not contain PPT rule. MLI PPT rule will be inserted across treaty) • Singapore, Switzerland (PPT rule applicable across treaty unlike present treaties where PPT is applied only for specific incomes such as capital gains, dividend, interest, royalty/FTS) • Latvia, Lithuania (existing PPT rule to get widened – will include the term ‘one of the principal’ purpose instead of the “main purpose” test)
PPT + SLOB	• Denmark, Russia (Treaties did not contain PPT/LOB clause, PPT+SLOB shall be added to treaties)

India-Singapore tax treaty
- *Impact of MLI on capital gain benefit*

- Whether the PPT of MLI will apply to grandfathering provisions and taxability of capital gains on derivative instruments in relation to Article on capital gains under the IS Treaty is a contentious issue. There are three alternative approach on the same which has been discussed below:

Sr. No	Alternatives	Arguments in favour	Remarks
1	PPT in MLI will not override specific provisions of IS treaty	• SC case law and Circular 789 indicate intent of treaty is to encourage cross border benefit • IS treaty was amended in Dec '16 as of that date it was known that PPT would be a part of MLI • Grandfathering under treaty aligned to GAAR • Specific rule would prevail over general rule	Weak
2	PPT in MLI will override IS treaty	• Insertion of PPT is at par with any bilateral amendment to treaty • PPT is a non-obstante provision • PPT read along with preamble will empower tax authority to deny tax benefits particularly availed by a resident of a third country	Strong
3	PPT in MLI can be applied with an exception to capital gain benefit provided in the IS treaty.	• Intent behind grandfathering is to avoid disruptive transition and provide certainty to investors. • On needs to look at the context of the treaty at the time shares were acquired. • The second limb of PPT rule operates as an exception to cases which are otherwise hit by first limb.	Arguable

Improving dispute resolution

Dispute resolution measures - Article 16,17

- BEPS Action 14 required commitment by CJs to improve dispute resolution process – Provides minimum standards and best practices
- Some of them require treaty changes while others require changes to commentary or domestic laws
- Snapshot of provisions

BEPS Action 14 - Improving the effectiveness of dispute resolution mechanism

Agreed Minimum Standards	Best Practices	Commitment to mandatory binding arbitration

• There are 3 categories
  • Implementation of treaty in good faith (Category 1)
  • Ensure admin. procedure do not block MAP access (Category 2)
  • Ensure Taxpayers can access MAP when eligible (Category 3)
• OECD and G20 Countries are obligated to implement
• Peer review mechanism to monitor implementation of mandatory standards
	• Has subjective or qualitative character that cannot be readily monitored; or
	• Not all OECD and G20 countries have committed to it
		• Some Countries have agreed to adopt mandatory binding arbitration
		• India has made its stand clear that it does not wish to adopt mandatory arbitration

Dispute resolution measures - Article 16,17

MLI provisions and India positions :

MAP access in "either" state	Reserved its right not to include MLI provision • Adopted allowing MAP access to resident State, implement bilateral notification/ consultation process • Largely all India treaties allow MAP access in resident State. Bilateral notification process to be set up
Minimum period of 3 years for MAP access	Agreed to insert a 3 year condition in its treaties • Notified 4 treaties which provide a lesser time threshold – It will be modified to provide a period of 3 years • Notified 80+ treaties already having a minimum of 3 year period – Will not be impacted by MLI.
Bilateral resolution of MAP cases	Accepted to include bilateral resolution of MAP cases • Notified treaties which do not have comparable provision • Hence all treaties to now contain parallel MLI provision (subject to other State's position)

Dispute resolution measures - Article 16,17

MAP implementation irrespective of domestic time limits	Agreed to allow MAP implementation irrespective of domestic law time limits • Notified 7 treaties which do not have this language • Not opted for optional provision of making domestic law change to allow MAP implementation and limit the time period of making primary adjustments
Suo moto resolution of issues related to treaty interpretation and double taxation in consultation with CA of other State	Accepted to include • Notified treaties which do not contain comparable provision • Hence all treaties to now contain parallel MLI provision (subject to other State's position)
Inclusion of Article 9(2) of OECD MC – Secondary TP adjustment	Agreed to include 9(2) in its treaties. • Not adopted optional provision of domestic laws changes, inclusion of 9(2) by bilateral negotiation and limiting period of primary adjustment

Artificial avoidance of PE status

Broader Agency PE rules – Article 12

MLI provision

Wider scope of Agency PE

- Dependent agency PE (DAPE) rule extended to cover persons who habitually plays a principal role leading to conclusion of contracts that are routinely concluded without material changes

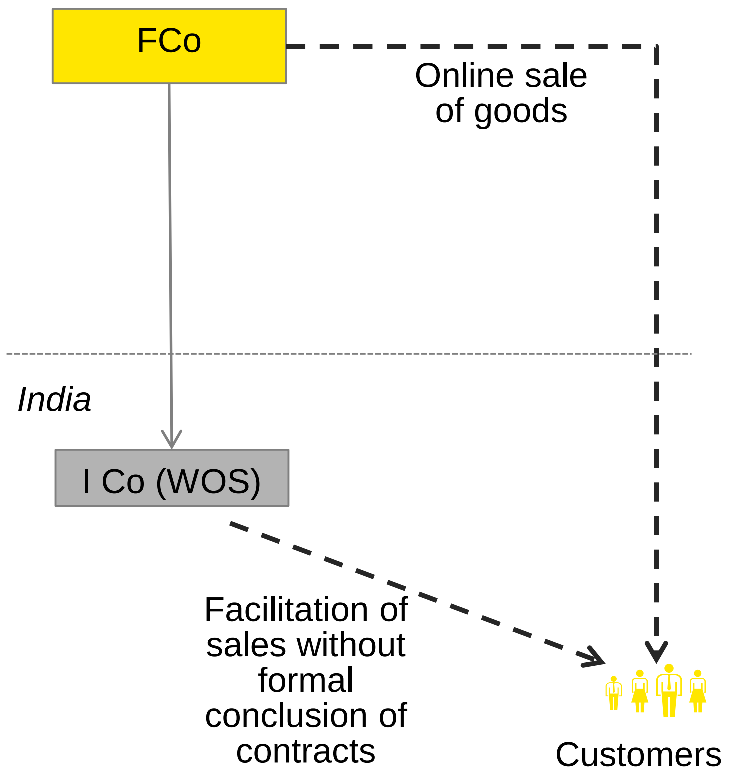
Stringent condition for independent agent exclusion

- Not available to agents acting exclusively or almost exclusively on behalf of foreign enterprise, its closely related enterprises (CREs)
- CRE defined with respect to control/ beneficial holding with threshold of 50% of voting/beneficial/equity interest

India's stand

- India has opted for broader agency PE rule and independent agent to all its treaties
- Applicable where the treaty partner has also notified India's treaty in this respect
- Replaces DAPE provision only to the extent refers to agents having authority to conclude contracts) - other activities triggering agency PE like maintenance of stock or securing of orders remain unaffected by MLI.

Case study : Online distribution triggering DAPE



Contract with standard terms may have difficulty in getting out of Agency PE unless the activities in India are not substantive or do not directly result in conclusion of contract

Facts

- FCo is a global distributor of goods and services through its website.
- Employees of I Co facilitate sales of F Co in India;
  - Identify potential customers
  - Use relationship building skills to understand need of customers
  - Convince them to buy the products/ services offered by F Co through emails, visits to large organisations
  - Explain standard terms (viz. fixed price, quantity, mode of concluding contracts online etc.)
  - No authority to modify price structure
- Contracts are concluded online between FCo and the customers basis price structure presented and discussed

Issue

- PE exposure under existing OECD provision?
- PE exposure under Action 7 proposed PE provision?

Tightened independent agency criteria

Exclusion to independent agent

- He acts as an independent agent, and
- He acts in the ordinary course of business, and
- **He does not act exclusively or almost exclusively on behalf of one or more closely related enterprise (CRE)**

Result: Agent that acts exclusively or almost exclusively for related enterprise(s) is not independent

- Inclusion of additional condition on “exclusively or almost exclusively” for FE & CRE
- Concept of ‘CRE’ - based on beneficial holding and control with 50% threshold
- Acting “almost exclusively” - where agent has no significant business activities apart from activities conducted for FE/CREs;
  - Commentary gives threshold of 90% (based on total agency turnover of agent) to deny the independence status

Impact analysis – Independent agent criteria – BEPS Action 7

- **Cumulative conditions –**
  - A person working for more than one enterprise does not automatically become independent. Other Article 5(6) conditions (i.e. legal/economic independence, ordinary course of business) needs to be fulfilled
- Some Indian DTAAs already cover activities for entities under common control (Singapore, UK, Italy, Denmark, Australia);
  - S. 9 of the Act (business connections) also covers such activities
- “Exclusively, almost exclusively” vs. “wholly or almost wholly”
  - Condition present in UN MC 2011, many Indian treaties and S. 9 of the Act
  - Indian Courts have interpreted “wholly or almost wholly” ; AAR* sets 90%+ threshold to categorise as dependent agent
  - No significant difference in the two criterion, used interchangeably
  - Whether commentary on “exclusively or almost exclusively” can be used to interpret “wholly or almost wholly” in Indian treaties

* *Speciality Magazines (274 ITR 310),*

Impact on Indian treaties – Article 12

MLI Provision	Impacted Indian treaties based on based on matching of MLI Positions
Agency PE provisions (Article 12)	
Broader DAPE rule inserted	• France, Israel, Netherlands • Japan, Russia (Marginal impact due to existing broad agency PE rule)
Independent agent rule modified	• France, Israel, Japan, Netherlands • Russia (Marginal impact due to narrow definition under existing treaty - Treaties already contain a ‘wholly almost wholly condition’ for FE and controlled entities also)
Treaties not modified due to incompatibility	• Australia, Belgium, Canada, Cyprus, Denmark, Finland, Ireland, Italy, Korea, Singapore, Sweden, Switzerland, UK etc (Reservation on article 12)

Specific activity exemptions – Article 13

Option A

PE exemption to specified activities subject to activities being "preparatory or auxiliary" (PoA) in nature

OR

Option B

Automatic exemption to the listed activities

+

Anti-fragmentation rule - Denies specific activity exemption to a place of business maintained by the enterprise or a CRE in specific circumstances.

India position - Option A and Anti-fragmentation Rule

- **Option A – Applicable to the treaties with countries which have chosen the same option and notified India**
- **Anti-frag Rule - Applicable only where both the countries make a notification for application of this Rule (irrespective of option chosen above)**

BEPS Action 7 - Proposed changes to PE exemptions

- Modification to make all activities in Art. 5(4) subject to preparatory or auxiliary (PoA) condition

Art. 5(4) →

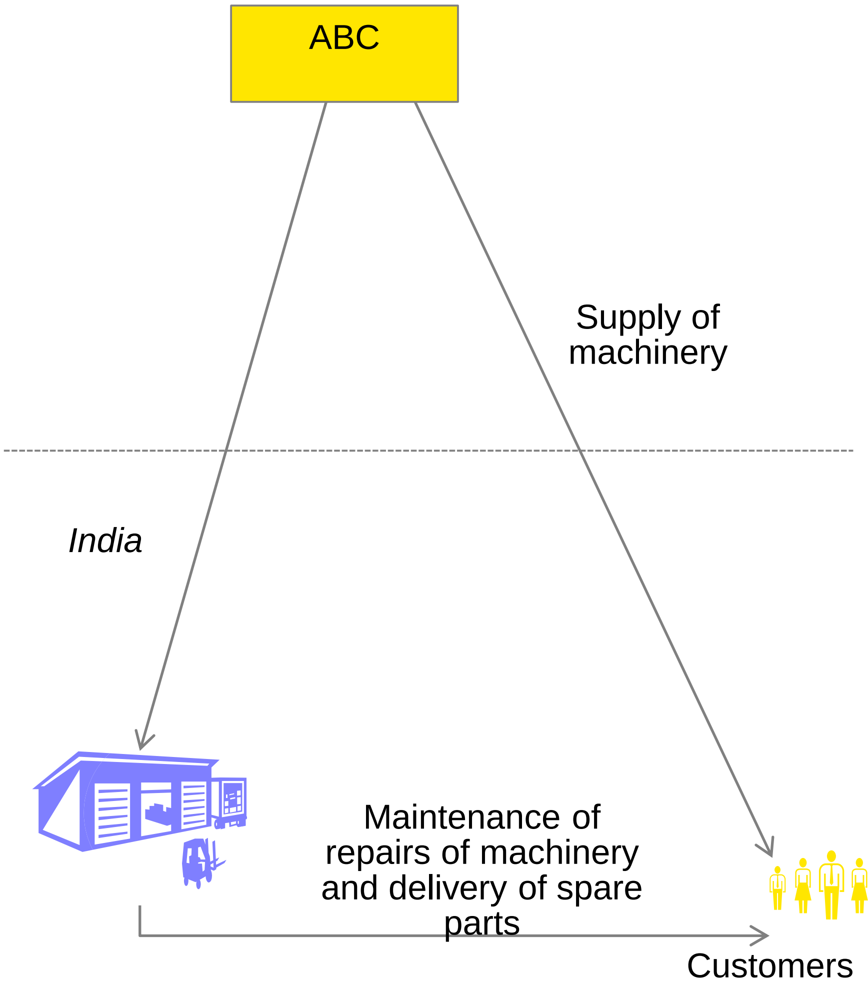
Activities listed under Art. 5(4) to be exempted only if they are of a PoA character

Preparatory: carried on in contemplation of essential and significant part of the activity of the enterprise as a whole

Auxiliary: carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole

- Activities are PoA depending on whether or not the activity of the fixed place of business itself forms an essential and significant part of the activity of the enterprise as a whole
- Presently, none of Indian treaties provide for such a condition

Case study : Activities not PoA in nature



Facts

- ABC is engaged into business of supply of machinery to Indian customers.
- It maintains a fixed place in India for maintenance of repairs and delivery of spare parts to such customers.

Whether PoA in nature under proposed provision of article 5(4)

- Not qualify as PoA activity, since:
  - Repairs and delivery of spare parts together amount to after sale functions which form essential and significant part of ABC's business
  - Beyond pure delivery functions as mentioned in 5(4)(a)

- Unlikely to apply in the context of most Indian treaties which do not provide Article 5(4) exclusion to 'delivery' functions

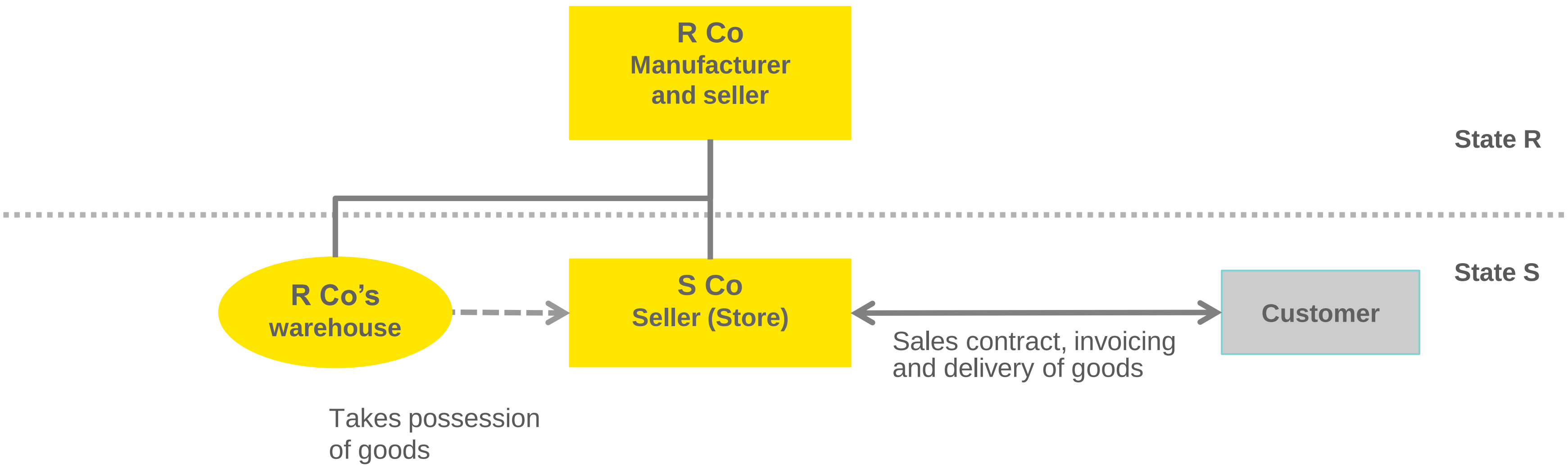
New Anti-fragmentation Rule

- Anti-fragmentation provision covers situations where the combined activities of CREs at the same place or different places in the same country exceed what is considered to be PoA
- Exemption does not apply where :

Condition 1		Condition 2		Condition 3
Same enterprise or CRE carries on business activities at the same place or another place in the state	+	at least one of the places constitute a PE, **OR** overall activity resulting from the combination of the activities carried on by the two enterprises is not of a PoA character;	+	Aggregate business activities constitute complementary functions that are part of cohesive business operation

Case study : Application of anti-fragmentation rule

- The facts below would create a PE because:



- S Co and R Co are closely related enterprises
- S Co's store is a PE of R Co in State S
- The business activities carried on by R Co at its warehouse and by S Co at its store constitute complementary functions that are part of a cohesive business operation (i.e., the storing of goods in one place and the selling of these goods through another place)

Anti-splitting of contracts - Article 14

BEFORE

Activities carried out under separate contracts by different companies: No PE if each contract does not exceed 12-month threshold

AFTER

PE deemed to exist if contracts are concluded with principal purpose of claiming short duration exemption

Under the alternative proposal, it is necessary to evaluate activities carried on by one or more CREs to determine whether the connected activities need to be aggregated

- Automatic aggregation rule for computing threshold for construction or similar PE (for construction/ installation/ supervisory or any PE provision in relation to similar activities/projects which are based on a time threshold)
- Aggregation of time spent on connected activities by CREs at the "same project", to determine whether specific time threshold as given in a treaty is exceeded
- The provision is optional. However, it does not apply only when a specific reservation made by either country to not apply to a CTA

India Position - No reservation

Unless reserved by other country, provision supersedes the existing CTA to the extent incompatible

Impact on Indian treaties – Article 13, 14

MLI Provision	Impacted Indian treaties on based on matching of MLI Positions
Specific Activity Exemption (Article 13)	
Option A + Anti-frag Rule	• Australia, Israel, Italy, Japan, Netherlands, Russia
Only Option A included	• Austria (reservation on Anti-frag rule)
Only Anti-Frag Rule	• UK (Opted only for Anti-frag rule) • Belgium, France, Ireland (Incompatibility in choice of option A/B)
Treaties not modified due to incompatibility	• Canada, Cyprus, Denmark, Finland, Korea, Sweden, Switzerland (reservation on article 13) • Singapore (Incompatibility in choice of option and reservation on anti-frag Rule)
Automatic Aggregation Rule (Article 14)	
Automatic aggregation rule	• Australia, France, Ireland, Israel, Netherlands, Russia etc.
Treaties not modified due to incompatibility	• Belgium, Canada, Cyprus, Denmark, Finland, Italy, Japan, Korea, Singapore, Sweden, Switzerland, UK etc. (Reservation on article 14)

MLI Impact on India-Hong Kong Treaty

- On 30 November 2018, the income tax treaty between Hong Kong and India (the Treaty), signed on 19 March 2018, entered into force. The Treaty will become effective for tax years beginning on or after 1 April 2019. Significant provisions include:
  - Source based taxation for almost all types of income on capital gains (including derivatives and debt securities)
  - Beneficial rate of 10% on the interest, royalty, FTS income (on gross basis) in source country - no condition of 'make available' in FTS clause [beneficial tax rates cannot be availed if main purpose or one of the main purpose is to take advantage of these articles]
  - Scope of PE covers fixed place PE, Construction PE, Service PE and Agency PE
  - ***Certain provisions are influenced by the OECD's MLI on BEPS which consist of minimum standards such as the PPT, CA as the tie-breaker test for dual resident entities, MAP provisions, among others***

    PPT : treaty benefits shall not be granted if the main purpose or one of the main purposes of any persons is non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the DTAA for the indirect benefit of residents of third jurisdictions)

    Dual residency: In absence of mutual agreement procedures (MAP), dual residents are not entitled to any relief or exemption from tax under the tax treaty, except as may be agreed by the Competent Authority
  - ***Corresponding adjustment in the profits of the AEs, subject to certain conditions***

    To relieve double taxation in the other contracting state wherein profits are taxed in the hands of entity and same profits are taxed in the hands of its AE.
  - The treaty does not include any of the MLI proposals on PE.
  - Hong Kong, being one of the major jurisdictions of GS group, the evaluation of eligibility of the Hong Kong GS entities to claim benefits under the India Hong Kong treaty is relevant.

Action Plan 1: Addressing the Tax Challenges of the Digital Economy

Action Plan 1 – Key findings of the BEPS Report

- The tax challenges of the digitalisation of the economy were identified as one of the main areas of focus of the BEPS Project, leading to the 2015 BEPS Action 1 Report.

- The Report observed to following key aspects
  - whole economy was digitalising and it would be difficult to ring-fence the digital economy.
  - digitalisation also raises tax challenges, which it identified as nexus, data and characterisation.

- On 31 May 2019, the OECD released its document Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy (the Workplan).

- The Workplan describes the planned approach for addressing the tax challenges of the digitalization of the economy.

- Following a Policy Note released in January 2019, the Inclusive Framework has continued to develop the proposals presented earlier under the two Pillars used to organize the ongoing work:
  - Pillar One: focuses on the allocation of taxing rights, and seeks to undertake a coherent and concurrent review of the profit allocation and nexus rules with a view to assigning additional taxing rights to market jurisdictions.
  - Pillar Two: focuses on what is described as the remaining BEPS issues and seeks to develop a global anti-base erosion proposal consisting of rules that would provide a jurisdiction with a right to “tax back” where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

Action Plan 1 – OECD Workplan

- The Workplan acknowledges that there is overlap between the two Pillars that will need to be considered. The Workplan is organized into chapters, importantly including the following:
  - Chapter II on Revised Nexus and Profit Allocation Rules (Pillar One) describes a wide range of technical issues that needs to be addressed in revising the profit allocation and nexus rules.
    - Pillar One involves three alternative proposals: the "user participation" proposal, the "marketing intangibles" proposal and the "significant economic presence" proposal.
    - The aim of these proposals is to amend the existing global international rules to recognize and tax the value created by a business's activities.
    - The three proposals have important differences relating to the objective and scope of the reallocation of taxing rights.
    - However, the Workplan states that the common aspects in these proposals will allow the technical issues that need to be resolved under Pillar One to be grouped into three building blocks:
      - new profit allocation rules,
      - new nexus rules, and
      - implementation of the new market jurisdiction taxing right.

  - Chapter III on Global anti-base erosion proposal (Pillar Two) describes the work to be undertaken to develop rules to address the perceived continued risk of profit shifting to entities subject to no or very low taxation.

Implications of the Workplan: The proposals addressed in the Workplan will have implications well beyond digital businesses. These proposals could lead to significant changes to the overall international tax rules under which multinational businesses currently operate.

Action Plan 1 – India implementation

- India began its “digital tax” journey in 2012 with the amendment of the definition of “royalty” in the domestic tax law.
- The concept of “permanent establishment” as a nexus for taxing business profits has come under significant pressure, with tax authorities sometimes asserting a “virtual PE” even under the traditional PE definition.
- India was the first country to implement an equalization levy of 6% of the amount received or receivable by a non-resident for providing specified digital services and facilities.
- India also introduced the concept of “Significant Economic Presence” (SEP) vide Finance Act, 2018 to expand the scope of “Business Connection" .
- More recently, the CBDT has sought public comments on its proposals to amend rules on profit attribution to a PE.
- India's approach to deal with the tax challenges posed by the digital economy seems to consider the needs of India as a capital-importing country and seeks to develop a new configuration of the source principle to tax profits derived from the ”market jurisdiction.”
- As a significant contributor to user base of digital economy business models, India's reaction to the proposals would keenly be watched.

Significant Economic Presence [Finance Act 2018]

- Finance Act 2018 amended the definition of business connection. As per amended definition 'significant economic presence' (SEP) would constitute business connection

- SEP has been defined as under :
  - transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India, if aggregate of the payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed
  - Systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed, in India through a digital means

- The transactions or activities to constitute SEP in India, whether or not,
  - The agreement for such transactions or activities is entered in India; or
  - The non-resident has a residence or place of business in India; or
  - The non-resident renders services in India

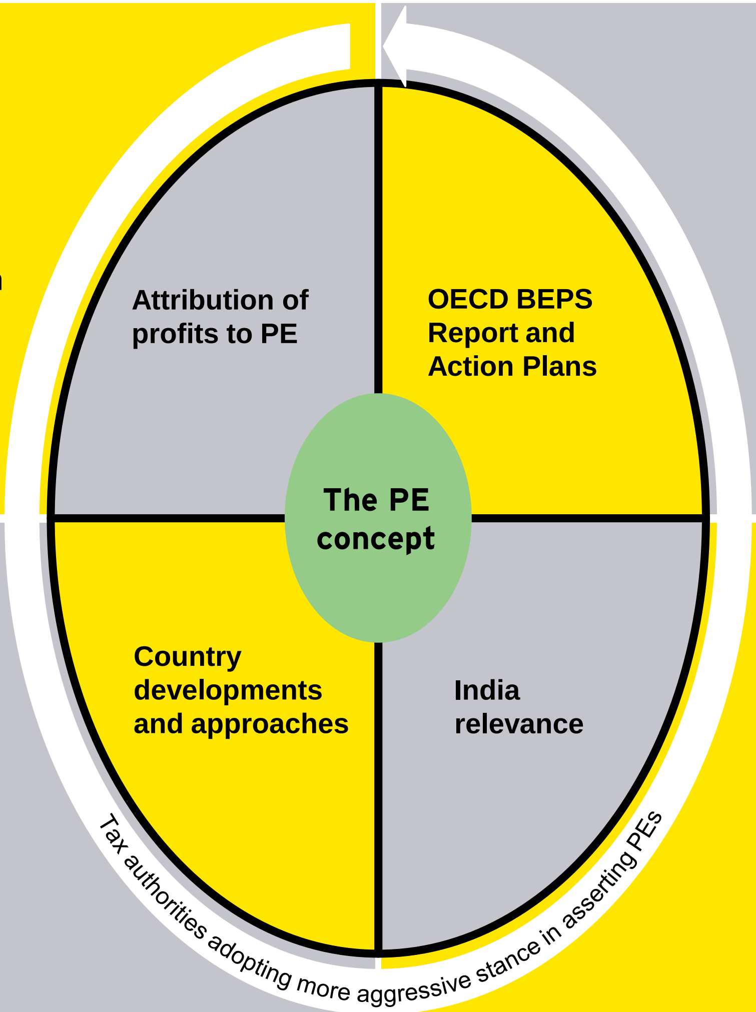
"No corresponding amendment in tax treaties entered into by India through MLI or otherwise to include concept of SEP "

Profit Attribution to PE

Profit attribution concept
Overview of recent developments

- Business profits – one of the most important category of incomes
- Taxing rights limited to income which is attributable to PE
- Broadly two approaches based on OECD Model Tax Convention (MTC) & UN MTC
- Use of “separate and distinct enterprise” approach

- “Key pressure areas” of BEPS include application of treaty concepts to profits derived from the delivery of digital goods and services
- Action 1 aims to address the tax challenges of the digital economy
- Action 7 aims to make changes to the PE definition to prevent the artificial avoidance of PE status



- Local country policy considerations drive approaches
- Significant case law development in Europe on PE
- Unilateral actions continue to play out at national level

- Uncertainty despite several judicial decisions given the factual nature of issues
- Absence of harmonious approach by courts
- Observations suggest arm’s length approach, but conclusions based on apportionment
- India’s reservation on revised Article 7 of the OECD MTC & authorized OECD approach (AOA)

CBDT committee's key observations and policy rationale for "fractional apportionment"

- Revised Article 7 of the OECD MTC 2010 resulted in shift from a broader approach to a purely supply approach

- OECD's AOA restricts the taxing rights of the source jurisdiction and is not favourable for developing countries
  - Sales revenue depends on both demand & supply, attribution on the basis of FAR excludes the role of demand

- Profit attribution by apportionment under Rule 10 should be in accordance with India's position and views
  - Formulary apportionment method, may not be feasible in practice
  - The option of fractional apportionment method is in line with India tax treaties

- Need to avoid double taxation of profits derived from Indian operations
  - No taxes payable by PE if no sales in India & profits allocated to subsidiary is already taxed

- European Union Common Consolidated Corporate Tax Base (EU CCCTB) approach followed for profit attribution to SEP
  - However, with different weights assigned to different categories of digital businesses depending upon the level of user intensity

Profit attribution to PE based on "fractional apportionment"

For cases other than "SEP"

- **Step 1:** Determine profit derived from India, i.e., higher of the following amounts:
  - The revenue derived from India x Global operational profit margin.
  - 2% of the revenue derived from India.
- **Step 2:** Apportionment of the profits derived from India based on a three equally weighted factors of sales, employees (manpower and wages) and assets.

Profits attributable to operations in India = Profits derived from India x $[S_I/3xS_T + (N_I/6xN_T) + (W_I/6xW_T) + (A_I/3xA_T)$

- **Step 3:** Deduction of profits that have already been taxed in the hands of an Indian resident AE in case the business connection is due to the activities of the resident AE and the foreign enterprise receives income from sales or services from any resident beyond the de minimis amount (no profit attribution if sales revenue is less than de minimis and AE is fully remunerated by the non-resident enterprise at ALP)

** User threshold yet to be prescribed; further, no adequate clarification provided on the below parameters
S_I = sales revenue derived by Indian operations from sales in India
S_T = total sales revenue derived by Indian operations from sales in India and outside India
N_I =number of employees employed with respect to Indian operations and located in India
N_T = total number of employees employed with respect to Indian operations and located in India and outside India
W_I= wages paid to employees employed with respect to Indian operations and located in India
W_T = total wages paid to employees employed with respect to Indian operations and located in India and outside India
A_I = assets deployed for Indian operations and located in India
A_T = total assets deployed for Indian operations and located in India and outside India

Profit attribution to PE based on “fractional apportionment”

For cases covering “SEP”

- **Step 1:** As earlier.

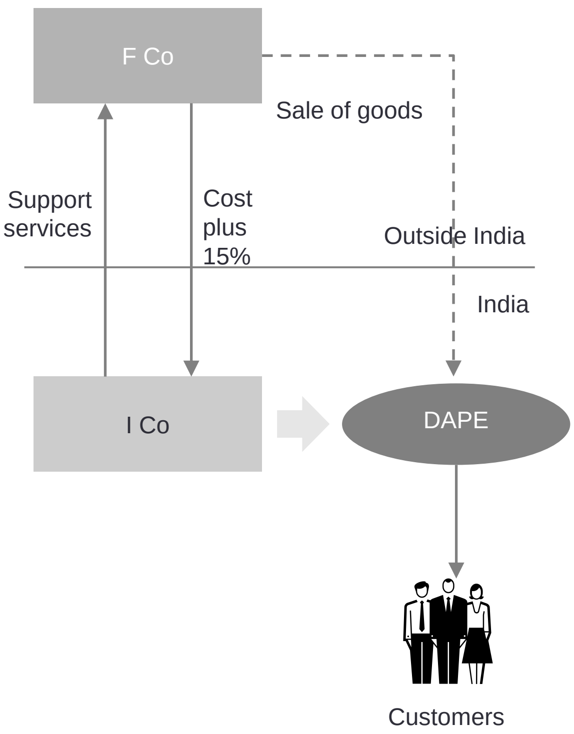
- **Step 2:** Apportionment of the profits derived from India based on a four factor approach consisting of sales, employees (manpower and wages), assets and users wherein the following weights are assigned.

User intensity**	Weights	Formula
Low and medium	10% weight to users and 30% each to other three factors	Profits derived from India x $[0.3 \times S_I/S_T + (0.15 \times N_I/N_T) + (0.15 \times W_I/W_T) + (0.3 \times A_I/3xA_T)] + 0.1]$
High	20% weight to user, 25% each to assets and employees and 30% to sales	Profits derived from India x $[0.3 \times S_I/S_T + (0.125 \times N_I/N_T) + (0.125 \times W_I/W_T) + (0.25 A_I/3xA_T)] + 0.2]$

- **Step 3:** As earlier.

** User threshold yet to be prescribed; further, no adequate clarification provided on the below parameters
S_I = sales revenue derived by Indian operations from sales in India
S_T = total sales revenue derived by Indian operations from sales in India and outside India
N_I =number of employees employed with respect to Indian operations and located in India
N_T = total number of employees employed with respect to Indian operations and located in India and outside India
W_I= wages paid to employees employed with respect to Indian operations and located in India
W_T = total wages paid to employees employed with respect to Indian operations and located in India and outside India
A_I = assets deployed for Indian operations and located in India
A_T = total assets deployed for Indian operations and located in India and outside India

Illustration 1
Dependent Agent PE (DAPE) in India



- F Co (non-resident) is engaged in trading of watches across the world.
- I Co, resident in India, provides marketing and sales support services for the direct sales made by F Co in India.
- I Co personnel play a principal role in concluding contracts and also are responsible for warehousing the inventory as well as determining and monitoring the appropriate inventory levels.
- It is determined that I Co activities constitutes a DAPE of F Co in India.
- Key data points are as follows for the India operations of F Co*:

Particulars	**Amount**
India sales revenue (S_I)	1,000
Sales from India & outside India (S_T)	1,000
No of staff in India (N_I)	50
No of staff in India & outside India (N_T)	52
Wages paid to Indian staff (W_I)	350
Wages paid to Indian staff as well as overseas staff (W_T)	400
Assets deployed in India (A_I)	25*
Assets deployed in India & outside India (A_T)	25*

*Assuming minimum assets such as computer etc.

Illustration 1: DAPE
Computation of taxable profits in India: AOA

- Step 1 - The functional and factual analysis demonstrates that the significant people functions relevant to the assumption of inventory risk and to the disposition of the inventory are performed by the personnel of I Co on behalf of F Co in India. Accordingly, the PE is hypothesized to be the economic owner of the inventory and the party assuming the inventory risk.
  - Taking into consideration the SPFs performed, it is determined that the identified dealing between HO and PE is that of import of goods for distribution.

- Step 2 - The profits of the hypothetical separate enterprise (DAPE) need to be determined based on the principles outlined in OECD Transfer Pricing Guidelines (TPG).

Particulars	I Co	DAPE of F Co
Income (Based on cost plus 15%)	403	1,000
Less: Purchase of traded goods from F Co (as per Step 2)	-	(550)
Less: Other administrative expenses	350	(20)
Less: Remuneration paid to I Co	-	(403)
Net profit/ Profit attributable to PE	**53**	**27**
Total taxable profit in India for F Co i.e. I Co + DAPE	**80**	

Would the answer be same under the UN approach?

Illustration 1: DAPE
Computation of taxable profits in India: Formulary apportionment approach

Particulars	**Formula**	**Global OM = 3%**	**Global OM = 12%**	**Global OM = (1)%**
Step 1: Determine profit derived from India, i.e., higher of the following amounts: (a) The revenue derived from India x Global operational profit margin; (b) 2 percent of the revenue derived from India.		30	120	20
Step 2: Apportionment of the profits derived from India based on a three equally weighted factors of sales, employees (manpower and wages) and assets.				
Sales factor	$S_I/3xS_T$	0.333	0.333	0.333
Manpower factor	$N_I/6xN_T$	0.160	0.160	0.160
Wages factor	$W_I/6xW_T$	0.146	0.146	0.146
Assets factor	$A_I/3xA_T$	0.333	0.333	0.333
Profits attributable to India operations (rounded off)	Profits derived from India x $[S_I/3xS_T + (N_I/6xN_T) + (W_I/6xW_T) + (A_I/3xA_T)]$	29	117	19
Step 3: Deduction of profits already subject to tax in India.		53	53	53
Balance profit attributable to PE in India.		NIL	64	Nil

Reactions to CBDT's committee report

- Arm's length principle vis-à-vis apportionment method
  - The standard tax treaty practice (whether pre- or post-2010) for business profits (Article 7) is on an arm's length basis
  - Both the OECD and UN have rejected recourse to any "formulary apportionment"
  - Arm's length approach applies symmetric principles of FAR as determinants for ALP both for demand and supply side activities
  - Apportionment method - Same result among taxpayers with "different" functional attributes and risk profiles
  - Contrary to the tax practices prevailing at the non-resident HO country

- Inherent limitations of formula based approach
  - Risk of failure of charge due to non-availability of any limb of the formula or in the case PEs with supply chain functions only
  - Highly prone to manipulation and would not ensure that profits are truly aligned with values
  - Caution should be exercised, such that no revenue is lost by ignoring supply side functions/ local value additions

- Violation of neutrality principle

- Risk of double taxation and MAP resolutions may be a challenge as most treaty parties apply arm's length principle

- With strengthening of the arm's length principle under BEPS Action 8-10, proper application of the arm's length standard to attribute profits may enable India to meet its policy objectives

CBDT’s committee report – Some Recommendations

- Implement the proposed “fractional apportionment” formula as a “safe harbour” option
  - Proposal if implemented as “safe harbour” will meet the treaty obligation providing requisite clarity and objectivity.
  - Better addresses the inherent limitations of “fractional apportionment” specifically concerning PE with supply side functions
  - If implemented as “safe harbour” no recourse to MAP.
  - Exceptions in case of banking sector, global trading of financial instruments and insurance sector.

- Alternative approaches to secure “source country” tax share.
  - Consider anti-avoidance measures rather than profit attribution rules – e.g., UK Diverted Profits Tax
  - Encourage more bilateral APAs to provide greater certainty and mitigate double taxation risks

- Clarifications on application of the proposed formula

- Allowance of carry forward of losses or introduce a mechanism to allow credit for the taxes paid based on deemed profits

- Appropriate clarifications/definitions of variables

- Clarification on interplay between the proposed Rule 10 and the TP provisions

- Profit attribution to digital PE/ SEP

- CBDT should participate in the global consultation process before formulating any unilateral proposals for taxing SEP

BEPS Action 2

Neutralising the effects of Hybrid Mismatch Arrangements

General Overview of HMA Report

- The Report sets out the issues and recommendations in two parts:

Part I
Recommendations to domestic law

- The Report sets out some general recommendations for changes to domestic law;
- Specific recommendations for hybrid mismatch rules designed to neutralise tax effects of arrangements
- Practical examples for operation of rules

Part II
Recommendations to Tax treaty issues

- Recommended changes to the OECD Model Tax Convention (OECD MC) to deal with Dual Resident Companies, Transparent Entities, including hybrid entities
- Also provides comments on treaty interactions of Part – I recommendations

What are the outcomes of HMAs

Deduction/ No inclusion Mismatch (D/NI)

- Occurs when payment is deductible under the laws of one jurisdiction but does not correspond to the inclusion as ordinary income by any other jurisdiction

Double deduction (DD)

- Arises to the extent that all or part of the payment is deductible under the laws of more than one jurisdiction

Foreign tax credit

- Generating foreign tax credit in excess of what may be consistent with the treaty object

Others

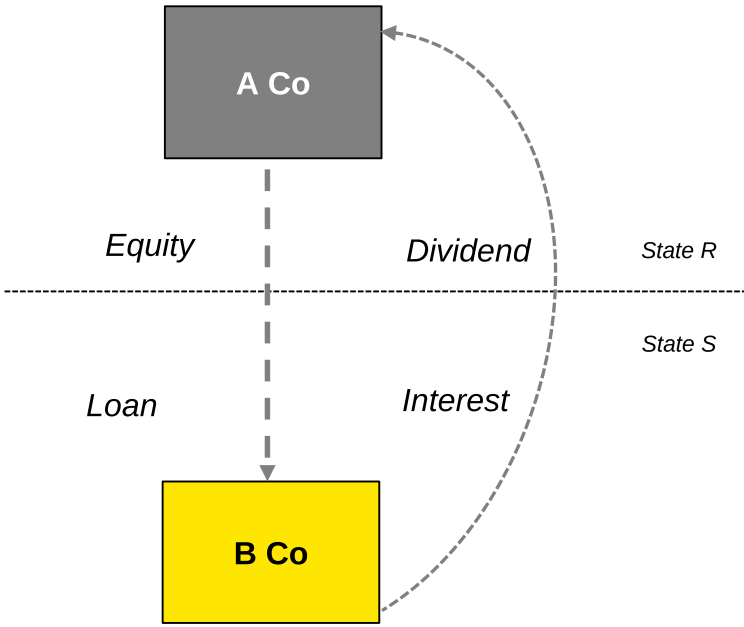
- Collective tax base of countries around the world is reduced

Net result – Negative impact on competition, efficiency, transparency and fairness

Hybrid Financial Instrument Rule
Actions proposed

- **Primary rule:** Deny deduction in payer jurisdiction
- **Defensive rule:** Include as ordinary income in payee jurisdiction, if deduction granted in payer jurisdiction
  - Dividend exemption is not to be denied if the payer is not granted deduction for interest payment

Hybrid Financial Instruments (HFI)
Deduction/ No-Inclusion (D/NI) rule



Facts:

- A Co funds B Co through a Hybrid Instrument (HI)
- HI is treated as Equity in State R and as Debt in State S
- Interest payments deductible in State S whereas dividend exempt in State R

Outcome due to Mismatch:

- Deduction claimed in State S
- Income claimed exempt in State R

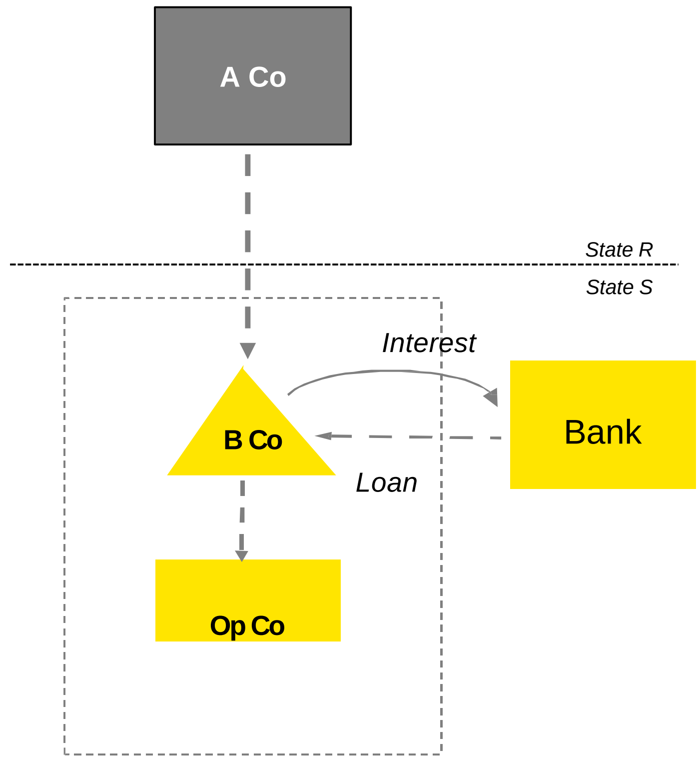
Action 2 recommends:

Neutralize the mismatch to extent payment gives rise to a D/NI

- **Primary rule:** The payer jurisdiction (State S) to deny deduction
- **Defensive rule:** To be included as ordinary income in the payee jurisdiction (State R)

How HFIs lead to BEPS?
Double Deduction (DD) rule

‘Hybrid’ financial instruments (FI) are those which are treated differently in two jurisdictions (e.g. debt in one country and equity in another)



Fact s:

▶A Co holds all the shares of B Co which in turn holds shares of Op Co.

▶B Co borrows loan from Bank and pays interest on loan and derives no other income

▶B Co is transparent (i.e. treated as branch) for tax purposes in State R.

▶B Co and Op Co file consolidated tax return in State S & claim deduction of interest

Probable Out come:

▶**State R:** A Co is treated as the borrower and gets interest deduction without inclusion of any income of OpCo

▶**State S:** B Co and Op Co are consolidated, and claim interest deduction

Recommendation:

Neutralize the mismatch to extent payment gives rise to a DD

- **Primary Response:** The Parent jurisdiction (State R) to deny a deduction to the extent of DD outcome
- **Defensive rule:** The payer jurisdiction (State S) to deny a deduction to the extent of DD outcome

India: Inbound Scenario
(India recipient of funds)

- Presently, use of debt financing in India is tax efficient as:
  - May attract lower withholding @5% under s.194LC / LD
  - Many treaties offer source taxation withholding rate of 10%
  - Since India is high debt cost country, TP benchmarked rate is generally on a higher side
  - Re-characterisation under GAAR is restricted to impermissible avoidance arrangement where tax benefit is from India perspective
  - CCD is at par with equity for FDI purposes
- Disallowance under HMA should not impact MAT

<u>Impact on GS</u>

Typically, GS entities are funded from jurisdictions like US, Mauritius and Singapore and given that US has not signed MLI and Mauritius having signed MLI but have not included India as CTA in its provisional list – Existing treaties remain unaffected of India- US and India- Mauritius

Whereas, Singapore has included India as CTA, the characterization of instruments in India and Singapore are similar and hence this Action may not affect GS.

Action Plan 4 : Limit base erosion via interest deductions and other financial payments

BEPS Concern

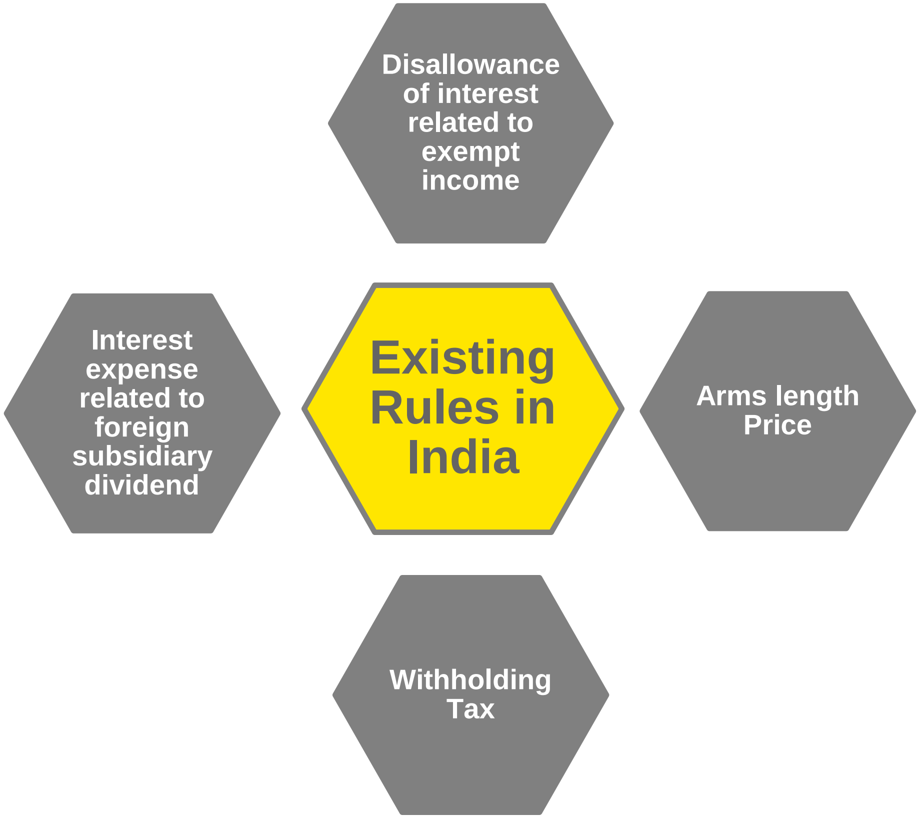
- BEPS Concern

> "no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it"

- Use of interest (related and third party interest) is perceived to be one of the most simple profit-shifting techniques used in international tax planning.

- Adjusting the mix of debt and equity in a multinational group/ individual group entities leads to BEPS illustratively due to
  - Location of third party interest in high tax countries
  - Use of third party or intragroup financing to fund the generation of tax exempt income
  - Use of structures/ hybrid entities to claim multiple interest deductions
  - Highly leveraging entity in a high tax jurisdiction in excess of group's actual third party interest cost

Existing rules to tackle excessive interest deduction



Globally, other countries use Thin Capitalisation Rules, Fixed Ratio Rules, Group Ratio Rules, etc.

Section 94B - Overview

What?

- Sec 94B starts with non-obstante clause; and will override any other provision of the Act that allows or regulates interest deduction

- Regulates disallowance of *interest or similar consideration* in respect of any 'debt' issued by *Non-Resident* ***AE***

Whereby debt is widely defined to mean

- Any loan, financial instrument, finance lease, financial derivative, or
- Any arrangement that gives rise to interest, discounts or other finance charges

Deeming fiction

- Debt issued by lender who is non-AE is deemed to have been issued by AE if:
  - AE provides an implicit or explicit guarantee to the lender; or
  - AE deposits a corresponding and matching amount of funds with the lender

- Disallowance of interest u/s 94B irrespective of interest payment being at ALP

Not applicable to taxpayer engaged in the business of banking or insurance

Section 94B - Overview

When?

- Applicable if all the following conditions are cumulatively fulfilled:
  - Taxpayer is an Indian company or a PE of a foreign company in India, who;
  - Pays interest or similar consideration in respect of any ‘debt’ issued by a NR being an AE of the Taxpayer, and;
  - Such payment is deductible in computing income chargeable under the head PGBP, and;
  - Such payment (AE interest) exceeds 1 Crore

How?

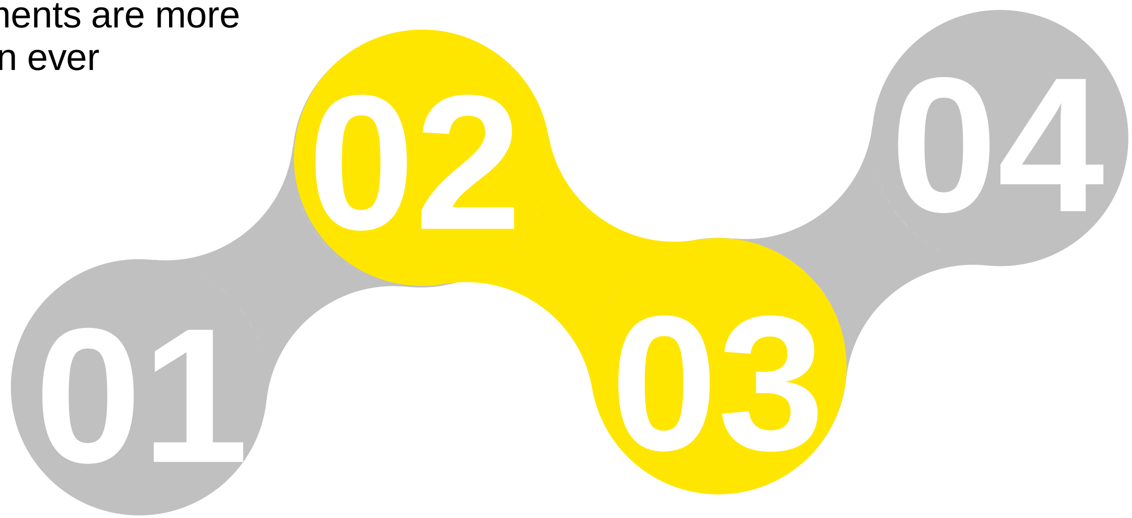
- Disallowance of interest expense Restricted to lower of the following:
  - Total interest paid or payable on debt which is in excess of 30% of EBIDTA; or
  - Interest paid or payable to AE Carry forward of disallowed interest Interest disallowed can be carried forward to be set off against taxable profits of any business or profession carried on in a subsequent year
  - Maximum carry forward for 8 succeeding assessment years
  - Set off in a subsequent year is also subject to restriction as per aforesaid formula

BEPS Action 5 - Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

Objective of BEPS Action 5

Addressing BEPS in timely manner, to prevent the existing consensus based international tax framework from unravelling, which would increase uncertainty for businesses at a time when cross-border investments are more necessary than ever

Improving transparency through compulsory spontaneous exchange on rulings related to existing “**preferential regimes”**



Ensuring profits are taxed where economic activities generating profits are performed and where value is created

Elaborating a methodology to define a substantial activity requirement in the context of Intellectual Properties (IPs)

When does preferential regime become "potentially" harmful ? (Four key factors)

Gateway / entrance criterion
No or nominal tax on relevant income

+

Ring fenced from domestic economy

OR

Lack of transparency

OR

Lack of effective exchange of information

If primary / gateway criterion is not met, regime is not potentially harmful
If primary plus any one of remaining key factors are met, regime is considered as potentially harmful
Substantial activity requirement to now be considered along with the key factors

Consequences of a regime being found to be harmful

02

A regime is treated as eliminated if it is in the process of being eliminated and if:

(i) no new entrants are permitted into the regime,

(ii) a definite date for complete abolition of the regime has been announced, and

(iii) the regime is transparent and has effective exchange of information

01

Country that hosts a harmful regime is given an opportunity:

- To abolish the regime or
- To remove the features creating the harmful effect

03

Other countries to take defensive measures to counter the harmful regime

Action Plan 8-10 : Aligning TP Outcomes with Value Creation

Overview of the final report

BEPS Action 8, 9 and 10
Assure that transfer pricing outcomes are in line with value creation

Action 8: Intangibles

- Wider and clearer definition of "intangibles"
- Introduction of a six step framework to analyse transfer pricing aspects of intangibles
- Legal ownership alone does not generate a right to the return generated by the exploitation of an intangible
- Focus on Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions
- Hard-to-Value Intangibles (HTVIs)
- Cost-Contribution Arrangements (CCAs)

Action 9: Risk and Capital

- Focus on conduct of parties and their capability and functionality to manage risks. Assumption of risk without 'control' over that risk is likely to be problematic
- Separate consideration regarding an appropriate return to any cash investment
- Introduction of a six step framework to analyse risks for transfer pricing purposes

Action 10: Other high-risk transactions

- Intra-group services / low value-add services
- Profit Splits
- Recognition of transactions
- Commodity transactions

- BEPS triggers a shift from "arm's length pricing" to "arm's length profit allocation"
- Risks should be allocated to enterprise that exercises control and has financial capacity to assume the risk

Action Plan 13: Transfer Pricing Documentation

What is Action 13 and why does it matter?

Action 13 focuses on transfer pricing (TP) documentation and includes the CbC report.

- Action 13 is designed to increase transparency by providing tax authorities with sufficient information to allow them to conduct transfer pricing risk assessments and consider whether groups have engaged in BEPS-type activities.
- It requires companies to use a consistent three-tier framework for providing information on global allocation of income, economic activity and intercompany pricing across all of a company's global operations.
- CbC reporting applies to all multinational enterprises (MNEs).

Master file

High-level information about the MNE's business, transfer pricing policies and agreements with tax authorities in a single document available to all tax authorities where the MNE has operations

Local file

Detailed information about the local business, including related-party payments and receipts for products, services, royalties, interest, etc.

CbC report

High-level information about the jurisdictional allocation of profits, revenues, employees and assets

India MF and CbCR regulations

	Master File	CbCR
Who has to report?	Part B of Form 3CEAA to be filed if : • Consolidated revenue of the group exceeds INR 500 crores • Aggregate value of the international transaction exceeds INR 50 crores (tangibles) or INR 10 crores (sale, purchase, transfer or lease of intangible property)	• Consolidated revenue above INR 5,500 crores converted on basis of exchange rate as on the last day of each year);
When to report?	• 30 November 2018 for FY 2017-18 onwards	• Report to be furnished with income tax department on or before 12 months from end of reporting accounting year
What to report?	• Information about the MNE's business, transfer pricing policies and agreements in a single document available to all tax authorities where the MNE has operations	• For Indian Parent entity/ Alternate reporting entity (ARE) - details as prescribed (covered in the ensuing slides) • Indian subsidiaries of MNE groups to file CbC notification at least two months prior to due date of CbC filing (for Indian parent entity/ARE)
Filing mechanism	Direct filing to DGIT (Risk Assessment) through electronic mode	
Local File	Local file is the regular TP documentation	

OECD Master File vs. India Master File

Organization structure

- Structure chart: List of all the entities along with their addresses
- Legal status and ownership

Business description

- **Nature of business**
- **Important drivers of business profit**
- **Supply chain of: i) Five largest products/services by turnover ii) Products/services generating more than 5% of consolidated group revenue**
- **Main geographic markets for the products/services**
- **Description of important service arrangements along with their capabilities**
- Functional analysis of the entities that contribute at least 10% of the revenue or assets or profits of the MNE group
- TP policy for service cost allocation and pricing intra-group services
- Business restructuring/acquisitions/divestments during the financial year

Intangibles

- **Overall strategy description**
- List of entities (with address) engaged in development and management of intangibles
- List of important intangibles and legal owners
- List of important intangible/cost contribution/research/license agreements
- TP policy for R&D and intangible
- Details of important transfers

Intercompany financial activities

- Financing arrangements of the group, including names and address of top 10 unrelated lenders
- List of entities providing central financing functions with address of operation and effective management
- Details of financial TP policies

Financial and tax positions

- **Annual consolidated financial statements**
- **List and description of existing unilateral advance pricing agreements ('APA's) and other tax rulings**

Highlights indicate specific requirements as compared to OECD's BEPS Action 13.

India : Guidance on appropriate use of CbC reports (CBDT Instruction No. 2/2018)

- Access to CbC reports
  - TPO to have access to CbC report when the relevant entity is picked up for TP assessment
  - TPO to follow standard operating procedures which will be formulated

- CbC reports to be used for high level TP risk assessment
  - Centralised Risks Assessment Unit (CRAU) of CBDT shall first evaluate the CbC reports (both filed and received) which could provide some perspectives on the potential risks arising from the TP arrangements between the Indian constituent entity and its affiliates
  - Constituent entity may be selected for audit for further examination for particular financial year
  - TPO during the course of TP assessment may make enquiries based on information made available in CbC report in addition to other available information
  - No restriction on the TPO's scope that the enquiries should only be limited to the potential risks identified by the CRAU

- CBC reports to be also used for assessment of other BEPS related risks and economic and statistical purposes

- CbC reports filed in India and received from other jurisdictions will be subject to strict confidentiality norms under provisions of Indian tax laws and tax treaties

- Use of CbC reports by TPO to be monitored by jurisdictional commissioner. Breach of appropriate to be reported to Indian competent authority and appropriate disclosure of such breaches to be made to Coordinating Body Secretariat in the OECD

Thank You