



Transparency by Preferential Tax Regimes – BEPS Action Plan 5 Transparency – TP documentation and CbCR, Indian Rules – BEPS Action Plan 13

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Action Plan 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

Setting the Context

The Apple case

Almost all profits allocated to head office existing only on paper – left untaxed

Payment to US to finance R&D

Apple Sales International - Ireland

Almost Nil profit taxed in Ireland
(Effective rate – 0.005% in 2014)

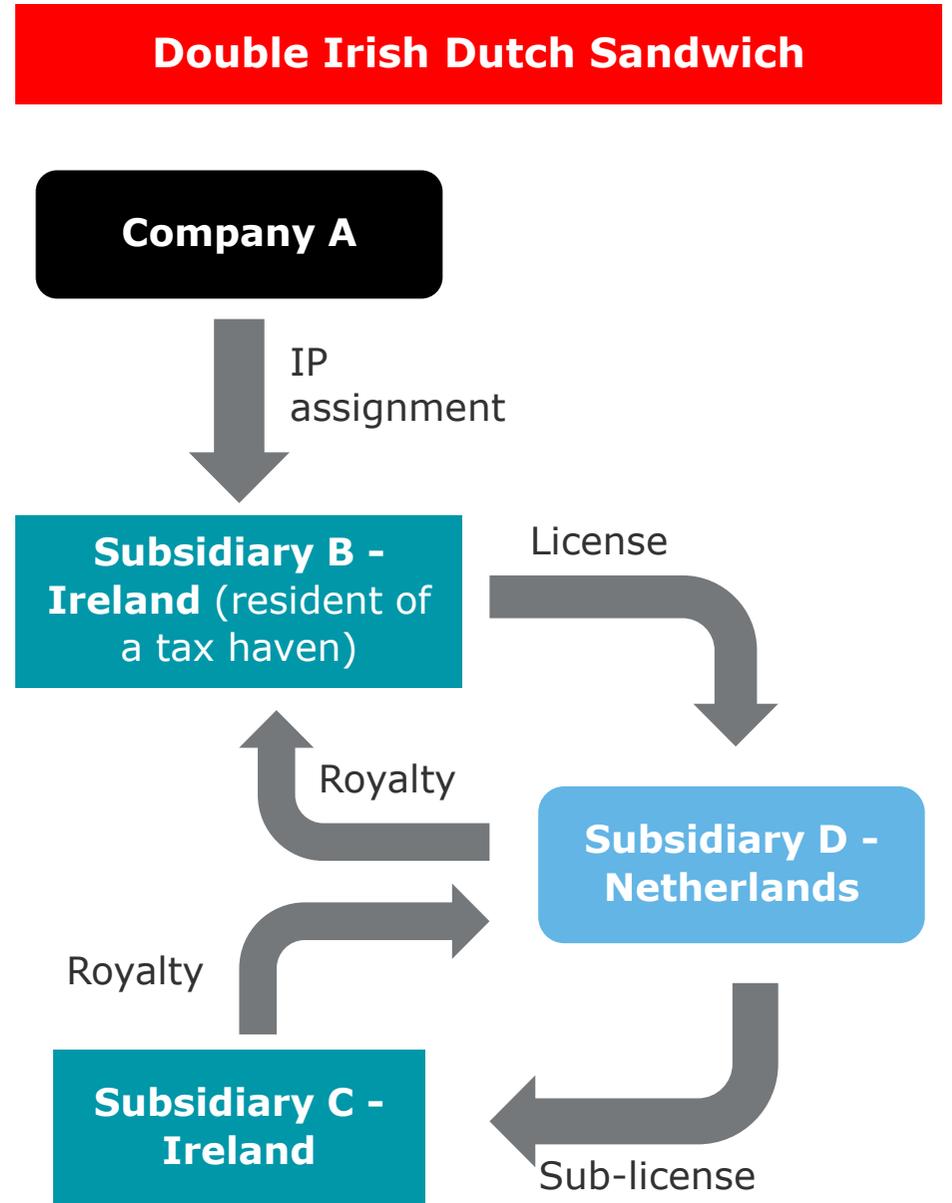
All profits from international sales recorded in Ireland

Apple sales international – FY 2011

- Profit – US\$ 22 billion (€ 16 billion)
- Taxable income – € 50 million
- Tax paid – € 10 million

Setting the Context

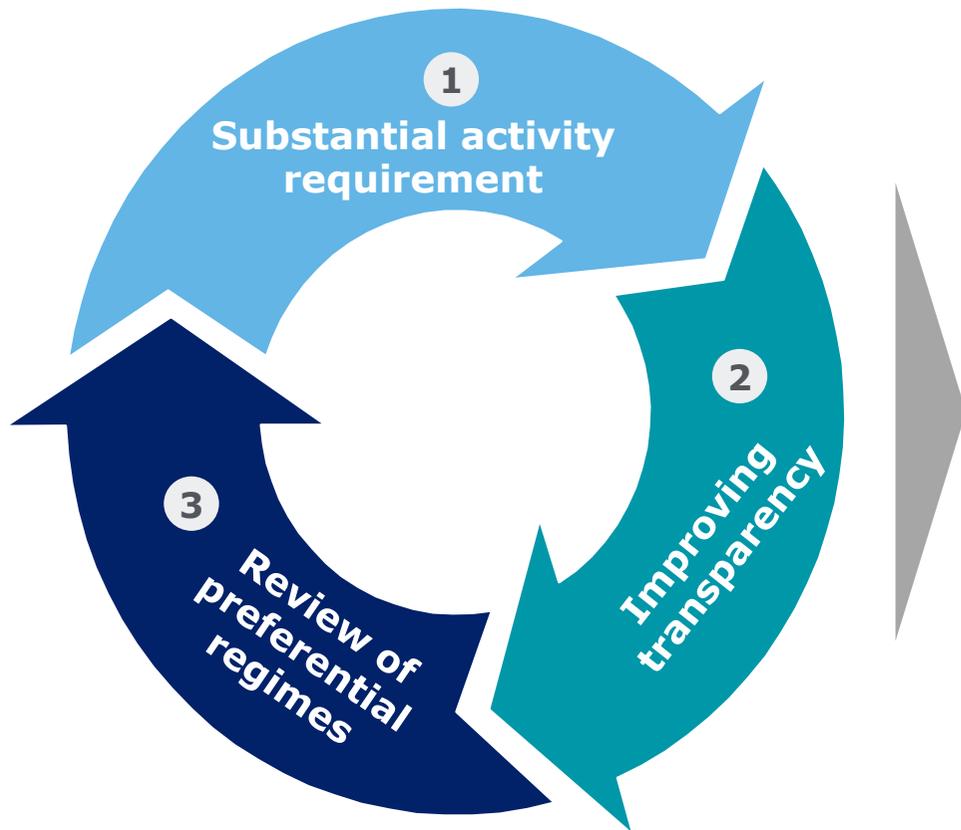
- Avoidance of withholding tax on royalty payment made by C to D (EU royalty directive)
- No withholding tax on royalty payment made by D to B (EU royalty directive)
- C can charge royalty paid to D against its profit
- D can charge royalty paid to B against its profit
- B is a resident of a tax haven – hence no tax on income received
- Profit ultimately shifted to a beneficial tax jurisdiction



Introduction

- Existence of such structures / arrangements rely heavily upon the availability of a preferential tax regime
- Such preferential tax regimes may create harmful economic effects
- OECD started work on addressing such harmful tax competition in late 1990's, resulting in a 1998 report – *Harmful Tax Competition: An Emerging Global Issue*
- OECD also created a forum on Harmful Tax Practices ('FHTP') to take this work forward
- In Action Plan 5, OECD builds on the conclusions of 1998 report
- It focuses on revamping the work on harmful tax practices with a priority on **improving transparency** and on requiring **substantial activity** for any preferential regime

Introduction



1 Substantial activity requirement

Used to assess preferential regimes in order to realign taxing of profits with substantial activities that generate them - **Nexus approach**

2 Improving transparency

A framework for exchange of all rulings in connection with BEPS concerns

3 Review of preferential regimes

Holistic approach to evaluate preferential tax regimes

Engage with non-OECD members to consider revisions or additions to the existing framework

Substantial activity requirements

Preferential Regime

Which “regimes” are within the scope of work of FHTP

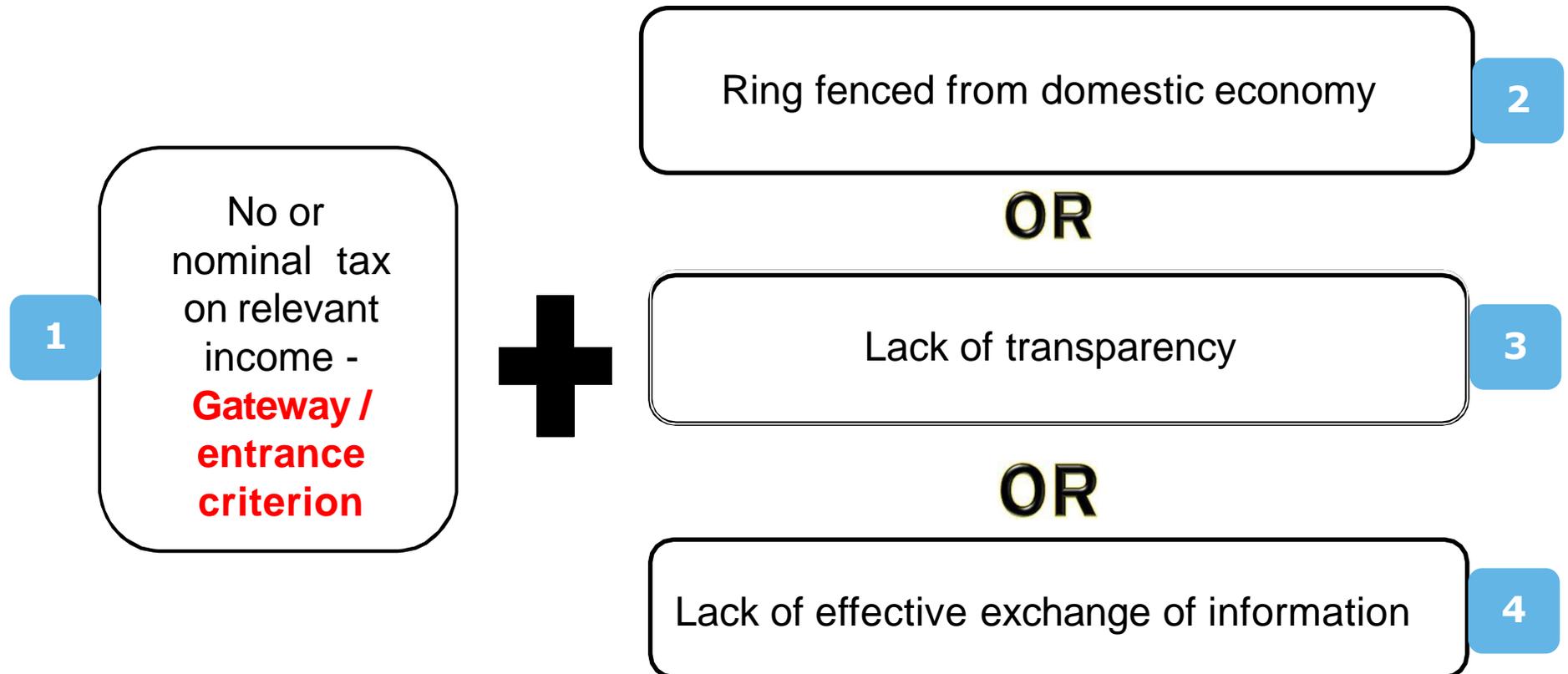
- Regimes applying to income from “geographically mobile activities” such as financial and other services activities, including provision of intangibles
- Preferential regimes designed to attract investment in plant, building and equipment are outside the scope
- Focus is mostly on business taxation – Consumption taxes are explicitly excluded

What is “preferential” regime?

- A regime is considered preferential if it offers tax preference in comparison with general principles of taxation in that country
 - Does not focus on whether a regime is preferential in comparison with other countries
- Preference may be reduced rate of tax, or preferential terms of payment or repayment of taxes

When does preferential regime become “potentially” harmful?

Once a regime has been identified as “preferential”, **four key factors** and eight other factors are used to determine whether such regime is “potentially” harmful



“Substance” is now added as an additional key factor

When does preferential regime become “potentially” harmful?

Eight other factors of relevance in evaluation of potentially harmful regimes

Artificial definition of tax base

01

Non-adherence to international transfer pricing principles

02

Foreign source income exempt from residence country taxation

03

Negotiable tax rate or tax base

04

05

Existence of secrecy provisions

06

Access to a wide network of tax treaties

07

Promotion of regime as a tax minimization vehicle

08

Encouragement of purely tax-driven activities and involve no substantial activity

Harmful Regime

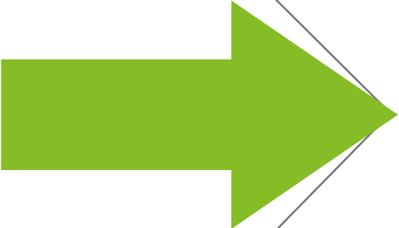
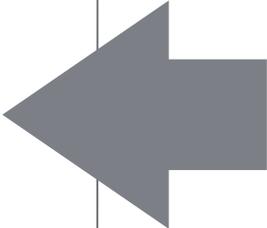
When does preferential regime become “actually” harmful?

- Results in shift of activity from one country to country providing regime without generating significant new activity
- If level of activities in host country is not commensurate with the amount of income
- If tax preference is the primary motive for location of an activity

Consequences of a regime being found harmful

- Country is given opportunity to abolish the regime OR remove the features that create harmful effect
- Other countries may take defense measures to counter the effects of the harmful regime

Added Focus on 'substantial activity' test to justify preferential regime

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- Substantial activity was already considered as one of the eight factors in 1998 report
 - However, very limited guidance was available on what constitutes “substantial activity”
 - Action Plan 5 elevates the “substantial activity requirement” in importance
 - Going forward, it will be considered alongside the four key factors to determine whether a regime is potentially harmful
 - In order to avail the benefits under preferential regime, **substantial activity** test is a vital criteria
 - FHTP has considered various approaches to applying substantial activity test in the context of IP and non-IP regimes

Substantial activity in the context of IP regime



Intention not to discourage introduction of IP regime but to **limit benefit to income based on substantial activity**



Nexus approach has been endorsed by G20



As per nexus approach, benefits would be conditional to the extent of R&D activities of taxpayers receiving benefits

"Expenditures act as proxy for substantial activity"
– OECD



Nexus Ratio

$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{Overall income from IP asset} = \text{Income receiving tax benefits}$$

Notes:

- Qualifying expenditure = represents R & D expenditures incurred by Taxpayer itself + expenditures for unrelated party outsourcing
- Overall expenditure = Qualifying expenditure + acquisition cost of IPs + expenditures for related party outsourcing
- While calculating qualifying expenditures, countries may permit taxpayers to apply a 30% "up-lift"

Illustration

Company in IP regime		A Co.	B Co.	C Co.
Qualifying expenditure incurred by taxpayer itself + third party expenditure	(a+b)	100	100	-
Acquisition cost	(c)	10	5	100
Expenditure outsourced to related party	(d)	40	20	-
Overall expenditure	e = (a+b+c+d)	150	125	100
IP income generated from asset	(f)	200	200	200
Uplift of 30%	[g = (a + b) x 130%]	130	125 (restricted to overall expenditure)	-
Income eligible for benefit	$\frac{g}{e} * f$	173.33	200	NIL

Substantial activity in other than IP regimes context

- Similar principle as that of IP regimes
- Nexus approach should establish a link between the income qualifying for benefits and “core activities” to earn the income
- Core activities are geographically mobile financial and other services activities (exclusive focus of FHTP)
- Harmful Tax Practices Report points out certain core income generating activities that could be used to establish substance under some common preferential tax regimes, such as:
 - Headquarters regimes
 - Distribution and service centre regimes
 - Financing and leasing regimes
 - Fund Management regimes
 - Banking and insurance regimes
 - Shipping regimes
 - Holding Company regimes

Improving Transparency

Improving Transparency

- Second priority under Action Plan 5 for revamping the work on HTP is to Improve Transparency
- Action Plan 5 encourages compulsory spontaneous information on certain Rulings
 - Rulings are defined as any advice, information or undertaking provided by tax authority to specific /group of taxpayer concerning their tax situation
- 6 categories of rulings identified for sharing information are:
 1. Rulings related to preferential regimes,
 2. Cross border unilateral advance pricing arrangements, or other unilateral transfer pricing rulings,
 3. Rulings giving downward adjustment to profits,
 4. Permanent establishment rulings,
 5. Conduit rulings and
 6. Any other type of ruling where FHTP agrees in future that absence of exchange would give rise to “BEPS concerns”

“Lack of transparency” - One of the key factors in considering whether a regime is potentially harmful

Improving Transparency

- Per se exchange does not lead to being preferential or giving rise to base erosion but it acknowledges that a lack of transparency in operation of regime or administrative process can give rise to mismatches in tax treatment and instances of double non-taxation
- Information would have to be exchanged with any affected country
 - Definition of Affected country: depending on category of ruling concerned, but includes in all cases country of ultimate parent and immediate parent company and related parties (with which Taxpayer enters into a transaction covered by the ruling)

Review of preferential regimes

Review of preferential regimes

- i. On-going work including monitoring of preferential regimes:
 - **IP regime** - monitoring will specifically cover legislative processes undertaken by countries to update IP regimes that do not meet the nexus approach (*16 regimes were reviewed and considered as inconsistent with nexus approach*)
 - **Non IP regime** – To be reviewed under the elaborated substantial activity factor
 - **Transparency** - Mechanism to be put in place to ensure countries compliance with obligation to spontaneously exchange information
- ii. Development of a strategy to expand participation to third countries: To ensure level playing field and avoid risk of harmful tax practices being simply displaced to third countries, FHTP will engage with non-OECD / G20 member countries
- iii. Revision or additions to existing FHTP criteria: Identify areas in which existing criteria might fall short (*includes the fifth factor set out in 1998 report – artificial definition of tax base and application of ring fencing factor*)

India's standpoint

India's standpoint

- India has always been an advocator of the substantial activity test
- Framework for spontaneous exchange of preferential rulings will further strengthen the automatic exchange of information, to which India has consented to be a part of

India has introduced a concessional tax regime for patents



Royalty income to be taxed at 10% (plus surcharge and cess) on gross basis

- Patent to be developed and registered in India
- Patentee to be true and first inventor and an Indian resident



Restrictive in nature

- Income from exploitation of patent outside India
- Does not cover IPR other than patents



Concessional tax regime vis-à-vis the "nexus approach" as per BEPS Action 5

- India's regime appears to be in line with the nexus approach – prohibitions on acquisition of IP and on outsourcing in place under the regime

General anti-avoidance rule applicable from 1 April 2017



The Concept

- To deny tax benefit in an arrangement which:
 - Has been entered into with the main purpose to obtain tax benefit
 - Which lacks commercial substance
 - Creates rights and obligations which are not at arm's length principle
 - Results in misuse of tax law provisions or is carried out by means or in a manner which are not ordinarily employed for bona fide purposes
- Such an arrangement is termed as "impermissible avoidance agreement"
- As regards foreign investors, GAAR provisions would mainly impact those investors who claim treaty benefits to eliminate or minimise tax outgo in India



Application & exemption

- Under the current provisions, GAAR not applicable to:
 - Arrangements where tax benefit does not exceed INR 30 million
 - Investors in FPIs
 - FPIs if they do not claim treaty benefits
- Investments made prior to 1 April 2017 will be grandfathered

- GAAR is akin to principal purposes test (PPT) envisaged under BEPS action 6 dealing with tax treaty abuse
- GAAR is very wide in nature and applies in a variety of situations, i.e. even when tax treaty benefit is not claimed

Key Takeaways

Key Takeaways

- With the development of nexus approach to define substantial activity, OECD's work is expected to have significant impact not only on the design of preferential tax regime but on Taxpayers operating internationally in general – Increased controversy?
 - May impact Indian companies carrying R&D activities and having companies in IP regime holding the IP
 - Also overseas companies in IP regime which has outsourced its R&D activities to its related party companies in India
 - Action Plan 5 has acknowledged that the Indian regimes for expenditure deductions are “**NOT HARMFUL**” in nature
- Framework for spontaneous exchange of ruling is vital step in OECD's push for transparency and exchange of information – However, may raise constitutional law and privacy concerns in some countries

Action Plan 13 - Three tier transfer pricing documentation

OECD recommendations

Background

OECD BEPS Action 13 has provided for a three-tier structure for TP documentation, namely Master File, Local File and Country by Country (“CbC”) reporting framework. Majority of the countries having TP regulations have adopted BEPS Action 13 as a part of their regulatory framework, increasing onus of compliance by the enterprises operating in multiple geographies.

Three components of transfer pricing documentation based on BEPS guidance



CbC Reporting

MNEs are required to provide a global financial snapshot of the MNE Group. The CbC report sets out for each jurisdiction, specified data pertaining to revenue, income, taxes, number of employees, capital and tangible assets



Master File

MNEs are required to provide the tax administration with high level information regarding their global business operations and transfer pricing policies



Local File

MNEs are required to maintain a detailed transactional transfer pricing documentation specific to each country and company’s transfer pricing determination

Enhancing “transparency” – mandating alignment with all Action Plans

COUNTRY-BY-COUNTRY REPORT

- Applicable to MNE group having consolidated revenue exceeding € 750 million in the immediately preceding fiscal year
- Aggregate tax jurisdiction-wide information
- Contents - 2 main tables + 1 for additional information
- To be filed by the ultimate parent entity or the alternate reporting entity in its tax jurisdiction
- To be finalized within 1 year following the last day of FY of the Ultimate Parent
- Constituent entities to notify the details of ultimate parent entity or alternate reporting entity to their local tax jurisdiction

MASTER FILE

- No threshold prescribed by OECD
- “Blueprint” of the Group as a whole
- Contents - 5 main categories
- To be submitted by local constituent entities with local tax administrations

LOCAL FILE

- No threshold prescribed by OECD
- Focus on specific intercompany transactions
- To be submitted by local constituent entities with local tax administrations

CbC Report

Overview of CbC reporting

What is CbC reporting?

CbC reporting is part of the OECD's BEPS Action Plan 13. In essence, large MNEs have to provide an annual return, the CbC report, that breaks down key elements of the financial statements by jurisdiction. A CbC report provides local tax authorities visibility to revenue, income, tax paid and accrued, employment, capital, retained earnings, tangible assets and activities.

Who is impacted?

CbCR will apply to MNEs with a combined group revenue of 750 million Euros or more and who prepare or would be required to prepare the consolidated financial statements.

What is the governing principle to determine the constituents of an MNE group for CbC reporting ?

The governing principle to determine an MNE Group for the purpose of CbC reporting is to follow the accounting consolidation rules governed in the tax jurisdiction of the parent entity.

When does it take effect?

This depends on when countries implement CbCR into their own legal system, but the intention is that reports will be required for the fiscal years starting on or after the 1st of January 2016 and should be filed within 12 months of the relevant year end.

Overview of CbC reporting

Where is a CbC report filed?

CbC reports are primarily to be filed where the parent company is headquartered (HQ). If the HQ country has not implemented CbCR, MNEs should file in the country with CbC reporting where their most significant activities occur.

Which jurisdictions will have access to the CbC report filed by the parent company?

The countries participating in the BEPS project will exchange CbC report through Multilateral Competent Authority Agreement/bilateral tax agreements for exchange of CbC report.

With respect to confidentiality, the participating countries have agreed to have in place and be prepared to enforce legal protections of the confidentiality of the information in the CbC report equivalent to those under the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, a tax information exchange agreement (TIEA) or a tax treaty.

Why are CbC reports needed?

CbCR provides tax authorities information to help them assess transfer pricing risks and make determinations on how they allocate tax audit resources.

Contents of Country by Country report - Table 1, Table 2 and Table 3

Table 1: Information included in CbC

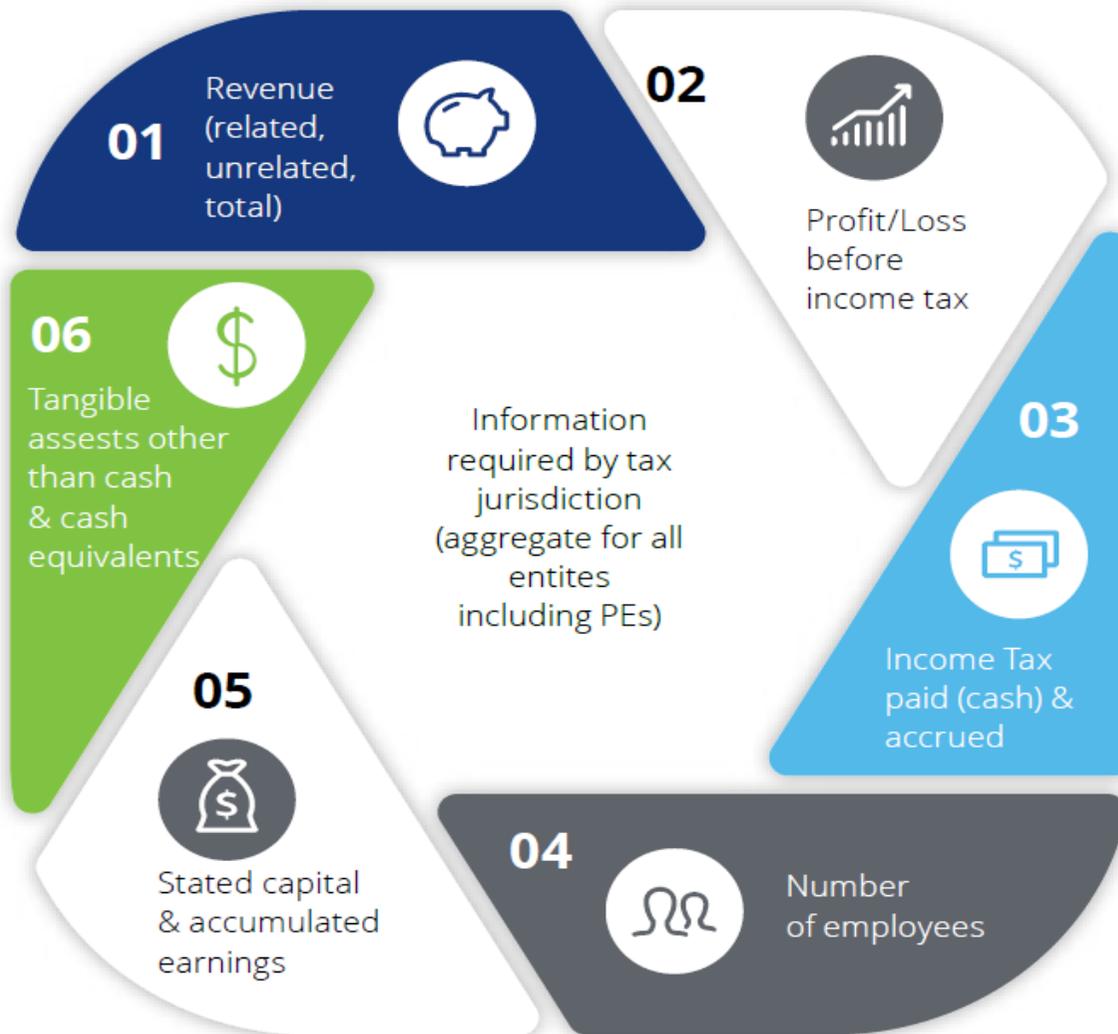


Table 2: Information included in CbC – for each tax jurisdiction

Tax Jurisdiction of organization or incorporation if different

Main business activity of each of the entity

Main business activity(ies)

- Research and development
- Holding or managing intellectual property
- Purchasing or procurement, Manufacturing or production
- Sales, marketing or distribution
- Provision of services to unrelated parties
- Internal financial services
- Holding shares or equity instruments, Dormant, Others

Table 3:

To include any further brief information or explanation that taxpayer may consider necessary or that would facilitate the understanding of the compulsory information provided in the CbC Report.

Contents of CbC report

Model template - Table 1

A model template for the Country-by-Country Report

Table 1. Overview of allocation of income, taxes and business activities by tax jurisdiction

Name of the MNE group: Fiscal year concerned:										
Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income Tax Paid (on cash basis)	Income Tax Accrued – Current Year	Stated capital	Accumulated earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

GUIDANCE ON TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING © OECD 2014

Contents of CbC report

Model template - Table 2

Table 2. List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction

Name of the MNE group: Fiscal year concerned:															
Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organisation or incorporation if different from Tax Jurisdiction of Residence	Main business activity(ies)												
			Research and Development	Holding or Managing intellectual property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management or Support Services	Provision of Services to unrelated parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding shares or other equity instruments	Dormant	Other ²
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

² Please specify the nature of the activity of the Constituent Entity in the “Additional Information” section.

Contents of CbC report

Model template – Table 3

Table 3. Additional Information

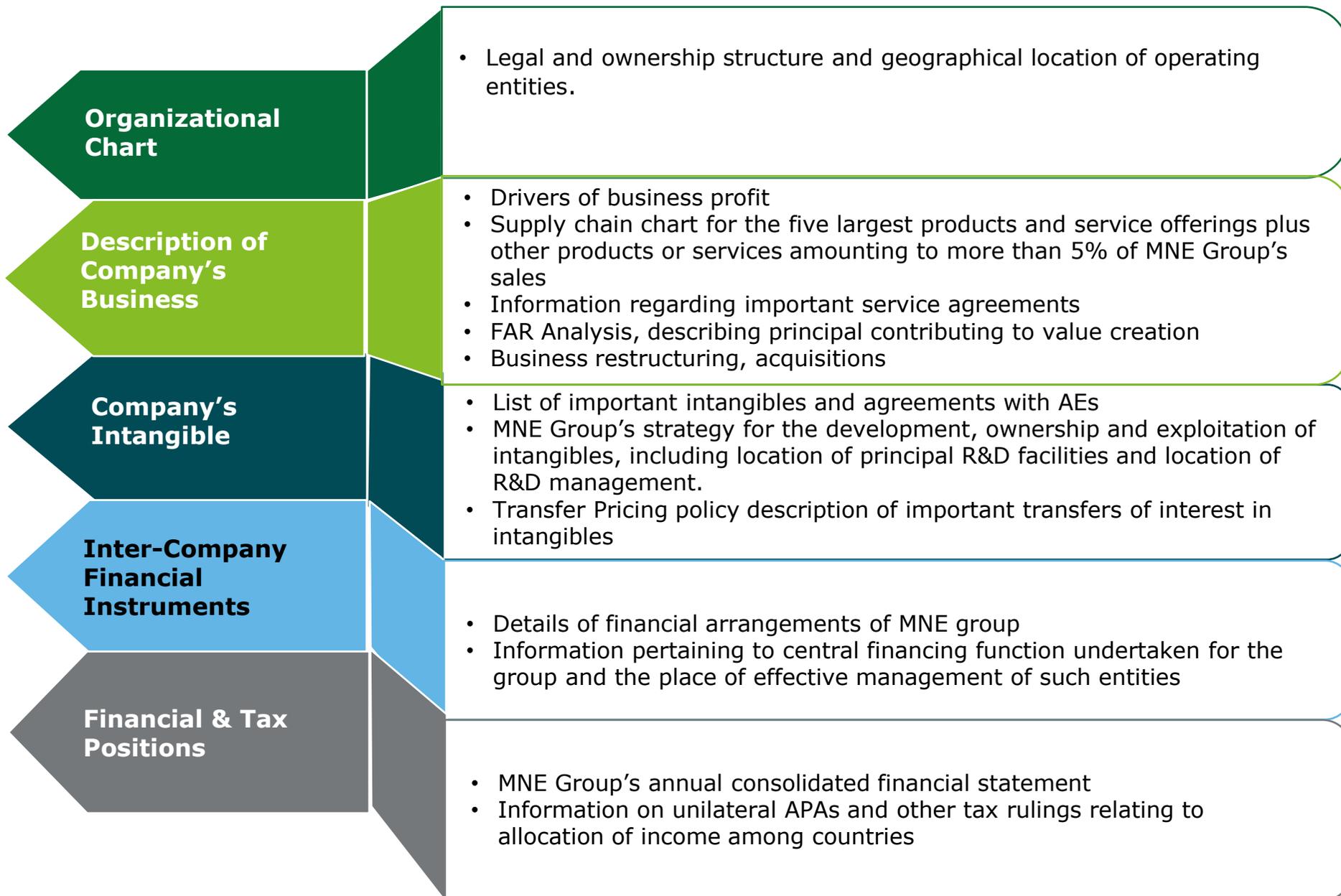
Name of the MNE group: Fiscal year concerned:
<i>Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in the country-by-country report.</i>

Practical Aspects

- Identifying the Ultimate Parent Entity and the constituents of an MNE Group
 - Group is held by individuals or Funds or where listed entities are held by an unlisted ultimate parent
 - Application of CbC reporting to joint ventures
- Inconsistency in the CbC reporting regulations across the globe
 - Timelines for CbC reporting
 - CbC reporting threshold
- Determining the appropriate data for CbC reporting
 - Harmonizing of accounting policy
 - Reporting the data per jurisdictions – aggregation of entity level data or consolidated jurisdictional data after eliminations
 - Interpretation of the data definitions
- Local country nuances in addition to BEPS Action 13 requirements (*eg. Indian regulations requires the Indian constituent entity to file CbC Report in India if the parent entity is not "obligated" to file the CbC Report in its jurisdiction*)
- Challenges relating to sharing mechanism for exchange of CbC report (eg. USA not a signatory to MCAA)

Master File

Master File – Contents



Importance of “Value Creation” vis-a-vis “Supply Chain”

- Master File requires the Taxpayers to disclose “Supply Chain” of five largest products and service offerings plus other products or services amounting to more than 5% of MNE Group’s sales;
- Focus on functional analysis describing the principal’s contribution to “value creation” by individual entities within the group;
- Though, the supply chain would help understand the flow of goods / services in the entire organization chart, Master File has laid emphasis on the “Value created” by each individual entities in such supply chain;

Important for Taxpayers to examine their TP policy and align with “Value creation” in their Supply Chain

Documentation requirements introduced in India

Documentation requirements introduced in India



Master file

- Finance Act 2016 introduced the concept to maintain Master File - Final rules for maintaining and furnishing Master File notified - Largely consistent with guidance provided under Action 13, however few additional and important data requirements have been introduced in the Indian rules
- Master File to be filed within the due date for filing of return of income
- Threshold: **Part A** is required to be filed by every constituent entity and **Part B** - If consolidated revenue exceeds INR 500 crores AND aggregate value of international transactions exceed INR 50 crores OR Aggregate value of international transactions relating to intangible property crosses INR 10 crores.
- Penalty for non-furnishing of prescribed information and document is ₹ 500,000



CbC Reporting

Requirements	Threshold	Timeline	Penalty
<ul style="list-style-type: none"> • Filing CbC report in India or notification of parent entity • Effective from Financial Year 2016-17 	<ul style="list-style-type: none"> • MNE group having consolidated revenue exceeding INR 5500 crores (in line with BEPS) 	<ul style="list-style-type: none"> • CbC report to be filed in prescribed format within 12 months from the end of the Reporting accounting year 	Graded penalty structure from ₹ 5,000 to ₹ 50,000 per day for: <ul style="list-style-type: none"> • Non-furnishing of CbC report • Non- submission of required information Penalty of ₹ 500,000 for: <ul style="list-style-type: none"> • Furnishing of inaccurate particulars • Non-furnishing of master file data



Local file

- Existing local transfer pricing documentation requirements retained

Documentation requirements – India Master File vs OECD Three tier

Master File Requirement	OECD requirement	Additional requirements as per Indian Rules
Organization structure	<ul style="list-style-type: none"> Chart illustrating IG's legal and ownership structure and geographical location of operating entities 	<ul style="list-style-type: none"> Address of all entities of the IG (draft rules had earlier only prescribed details of all operating entities)
Description of IG's business	<ul style="list-style-type: none"> Description of important drivers of business profit Description of supply chain for the specified category of products Functional analysis of the principal contributors to value creation Description of important business restructuring transactions, acquisitions and divestments during the reporting year 	<ul style="list-style-type: none"> Functions, assets and risk analysis of entities contributing at least 10% of the IG's revenue OR assets OR profits
IG's intangible property	<ul style="list-style-type: none"> IG's strategy for ownership, development and exploitation of intangibles List of important intangibles with ownership Important agreements and corresponding transfer pricing policies in relation to R&D and intangibles 	<ul style="list-style-type: none"> Names and addresses of all entities of the IG engaged in development and management of intangible property Addresses of entities legally owning important intangible property and entities involved in important transfers of interest in intangible property
IG's intercompany financial activities	<ul style="list-style-type: none"> Description of how the IG is financed, including identification of important financing arrangements with unrelated lenders Identification of entities performing central financing function including their place of operation and effective management 	<ul style="list-style-type: none"> Names and addresses of top ten unrelated lenders Names and addresses of entities providing central financing functions including their place of operation and effective management

Contents of Master File are largely consistent with the BEPS Action 13 requirements - Few important additional data requirements introduced requiring MNEs to customize their Master File for India

Documentation requirements – India Local File vs OECD Three tier

India documentation (Rule 10D)	OECD documentation – Three tier
Ownership structure	Requirements of Master File
Profile of MNE group	Requirements of Master File
Description of business and industry	Requirements of Master File
Details of international transaction	Requirements of Local File
Functional, asset and risk analysis	Requirements of Local File
Financial estimates	Requirements of Local File
Uncontrolled transactions	Requirements of Local File
Comparability of uncontrolled transactions with relevant transaction	Requirements of Local File
Arms length price	Requirements of Local File
Not specified under existing Rule 10D requirement	Requirements of Local File: <ul style="list-style-type: none"> • Local management and organization chart • Copy of existing APAs and other tax rulings which are related to the controlled transactions (but do not involve the local entity)

Interplay with POEM

Interplay with POEM

Three tier documentation provides key information about the group's global operations to the tax authorities

- Organisational structure of the group
- Description of group's business – **Important drivers of profit**
- Group's intangible – **DEMPE function**
- Groups' financial activities - Identification of entities in the group that provide a central financing function, **including the PoEM of such entities**
- Group's financial and tax position
- Group's income, taxes paid and activity for each subsidiary

Constituents of BEPS Master File / CbC



- Tax authorities would have visibility of operations and structure of the group
- Tax authorities can identify companies that could have PoEM in India, based on passive income in such companies
- IP structures would be visible through analysis of DEMPE function
- Highlight group companies enjoying high income with low ETR

Potential risk for PoEM



Thorough analysis of Master File and CbC reporting could help Indian MNEs to identify any possible exposures around tax residency rules for their foreign subsidiary under the new regulations of POEM, and mitigate any such unnecessary exposure through valid corrective measures, strictly within the four corners of the law

Key Takeaways

Key Takeaways

- Three-tier documentation will provide tax authorities with substantial information and transparency regarding the financial results of a taxpayer's global transfer pricing policies
- Increase in global transparency is likely to mean that deviations from a company's transfer pricing policy or implementation of that policy will become more apparent to tax authorities around the world
- MNEs that currently do not establish and monitor transfer pricing policies on a global basis may find a need to do so in the near future
- MNEs are likely to find it necessary to prepare or coordinate their TP documentation centrally to ensure consistent information about global and local operations and transfer pricing policies
- Taxpayers should prepare by compiling ratios based on parameters in CbC report to preempt questions about certain constituent entities (which for example have low number of employees vis-à-vis total revenue)
- Tax authorities around the world could potentially compare the mark-ups on costs given by the MNE to different administrations and demand a more consistent approach world-wide:
- Proactive approaches to manage the uncertainty could include considering the APA/MAP route

In this environment, it is important for MNEs to undertake **risk assessment exercise**

Glossary

Glossary

Terms	Meaning
AEs	Associate Enterprises
APA	Advance Pricing Agreement
BEPS	Base Erosion & Profit Shifting
CbCR	Country-by-Country Report
DEMPE	Development, Enhancement, Maintenance, Protection or Exploitation of Intangibles
ETR	Effective Tax Rate
EU	European Union
FAR	Functions, Assets and Risk
FHTP	Forum of Harmful Tax Practices
FPIs	Foreign Portfolio Investors
GAAR	General Anti-Avoidance Rules
HTP	Harmful Tax Practices
IP	Intellectual Property
MAP	Mutual Agreement Procedure
MNEs	Multi-National Enterprises
OECD	Organisation for Economic Co-operation & Development
POEM	Place of Effective Management
R&D	Research & Development
TIEA	Tax Information Exchange Agreement

Thank You

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