Analysing BEPS impact
Consumer Business

January 2016

In the backdrop of concerns raised by Governments, revenue authorities and social organizations that multinational enterprises (MNEs) are not paying their 'fair share' of taxes and are shifting profits to low tax jurisdiction, the G20 nations requested the Organisation for Economic Co-operation and Development (OECD) to develop action plans to tackle Base Erosion and Profit Shifting (BEPS) in a comprehensive manner. The BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profit 'disappear' for tax purpose or to shift profits to locations where there is little or no real activity but taxes are low, resulting in little or no overall corporate tax being paid.

The OECD commenced work on the BEPS project to address concerns that existing principles of domestic and international taxation were failing to keep pace with the development of modern business models. Under a two-year long project the OECD on 5 October 2015 has issued 15 final reports on focus areas and the same has been endorsed by the G-20 Finance Ministers at their meeting in Lima, Peru on 8 October 2015.

The 15 action plans can be categorized under the following key pillars:

Overview Action Plans for addressing BEPS

Establishing coherence in corporate taxation	Restoring effects of international standards	Ensuring transparency while promoting predictability	Turning tax polices in to tax rules
• Action plan 2 # Hybrid mismatch • Action plan 3 # CFC rules • Action plan 4 # Limit base erosion involving interest deduction and other financial payments • Action plan 5 # Harmful tax practices	• Action plan 6 # Prevent treaty abuse • Action plan 7 # Artificial avoidance of PE • Action plan 8, 9, 10 # Value creation, intangibles, risk and capital, high risk transaction	• Action plan 11 # Data collection and analysis • Action plan 12 # Disclosure of aggressive tax planning • Action plan 13 # TP documentation and CbC reporting • Action plan 14 # Dispute resolution mechanisms	• Action plan 15 # Develop multilateral instruments

BEPS and India

India, being a member of the G20 nations, has actively participated in the OECD BEPS project and is committed to its outcome. The BEPS action plans will impact both outbound as well as inbound investment holding structures, financing and operating arrangements put in place by MNEs.

The BEPS project is extremely relevant for India, especially the action plans dealing with treaty abuse, permanent establishment, intangibles, digital economy, and transfer pricing documentation and country-by-country reporting.

Consumer business

MNEs in consumer business sector especially companies engaged in FMCG, retail, ecommerce, travel, hospitality and leisure products are highly driven from client perceptions of their brands and products. They carry a huge reputation risk with regard to tax paid and liabilities arising in a given country which do not correspond to scale of operations in that country.

Considering the same, MNEs engaged in consumer businesses need to review their business model viz. their investment holding structures, funding and operating arrangements from BEPS viewpoint. We have briefly discussed the effects of some of the key action plans which would specifically impact consumer business sector. The steps taken by the respective countries to implement the action plans could have significant impact on the bottom line of a large number of consumer business MNEs by increasing their overall effective corporate income tax rate.

Action Plan 1 – Digital Economy

Action plan 1 of BEPS aims to address tax challenges of the digital economy. The report observes that the digital economy is increasingly becoming an economy in itself and it will be difficult to ring fence the digital economy from the rest of the economy for tax purposes. The report states that while the digital economy and its business models do not generate unique BEPS concerns, the key features exacerbate BEPS risks. It calls for identifications of the main difficulties that the digital economy possess for the application of existing international tax rules and develops detailed options to address these difficulties by taking a holistic approach.It is the only action which discusses indirect taxes as well.

From a direct tax perspective, the report by itself does not suggest any recommendations. However it indicates that work on certain other actions like,

1. Modifying the list of exceptions to the definition of Permanent Establishment (PE) regarding preparatory or auxiliary activities and introducing new anti-fragmentation rules to deny benefits from these exceptions through the fragmentation of certain business activities among closely related enterprises;
2. Modifying the definition of a PE to address artificial arrangements of conclusion of contracts within MNEs;
3. Revised Transfer Pricing Guidelines on intangibles; and
4. Changes to the controlled foreign company (CFC) rules.

It is the only action plan which proposes changes in indirect tax laws to lesser thresholds for low value imports, requiring vendors to register and account for VAT in the jurisdiction of importation, facilitated by simplified registration mechanism.

Impact on MNEs in consumer business sector in India

With the advent of digital economy, the interlink between the revenue generating activity and geographical location is more obscured as compared to the past wherein a geographical connection with some economic activity entailed taxation in the said jurisdiction. Similar to countries around the world, MNEs in India have been facing tax litigation on account of various e-commerce issues e.g. online advertising, subscription for electronic databases, etc.

The introduction of anti-fragmentation rules through modification of the 'preparatory and auxiliary' definition shall create a PE risk in India especially for ecommerce companies following instant delivery or just in time delivery model wherein storage and delivery functions are key part of the companies' sales and distribution model. Ecommerce MNEs generally use services of subsidiaries for conclusion of contracts for their products or services and these contracts are routinely concluded without material modification, which shall create a PE risk for ecommerce companies post BEPS implementation in India. Further, the tax authorities in India have been challenging the characterisation of income and withholding tax on income earned by digital services provider viz. business profits, fees for technical services, PE income via distribution arrangement and server management charges, bandwidth & security services, etc.

It may also be noted that India in its recommendation to United Nations Questionnaire on BEPS has advised for withholding tax to be levied on certain digital transactions. Further, through the introduction of the proposed General and Services Tax (GST), India may consider opting for consumption based levy of VAT/GST on digital transactions.

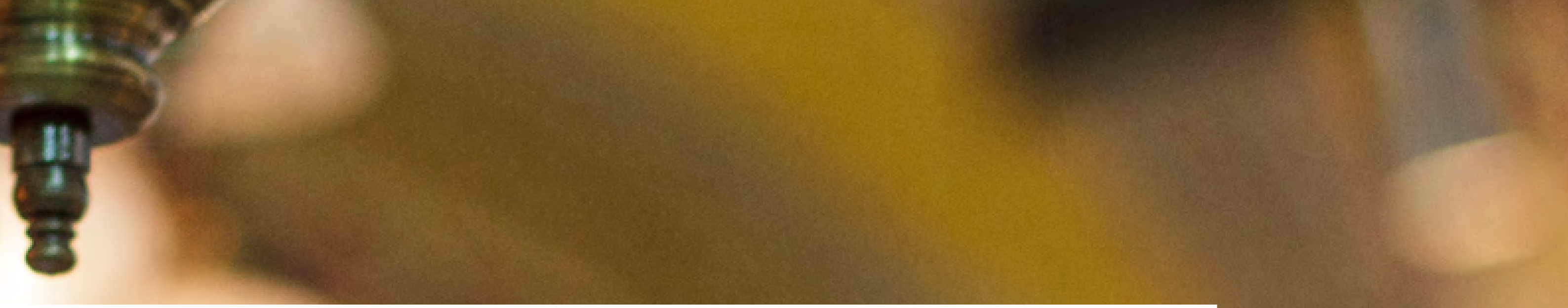
Action Plan 7 – Permanent Establishments

Action Plan 7 deals with preventing the artificial avoidance of PE status. The report provides for changes to the definition of PE under the tax treaties, which address strategies used to avoid having a taxable presence or a PE in a country under tax treaties.

The changes suggested in the report seek to ensure that where the activities of an intermediary (intermediary models, marketing agency, agency function, etc) in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise will be considered to have a taxable presence in that country, unless the intermediary is performing those activities in the course of its independent business. The Action Plan provides for changes to restrict the application of a number of exceptions to the definition of PE to activities that are preparatory or auxiliary in nature and will ensure that it is not possible to take advantage of these exceptions by the fragmentation of a cohesive operating business into several small operations.

Impact on MNEs in consumer business sector in India

The proposed expansion of ambit of agency PE and the inability of the Indian subsidiary to be regarded as an 'independent agent' could expose a part of the overseas group entity's profit on sale of products to be taxed in India. MNEs in consumer business sector need to analyse PE risk arising from supply chain model especially activities carried out through marketing and distribution intermediaries and function performed by liaison offices incorporated in India. In case, MNEs create a PE on account of activities undertaken by intermediaries then the same could result in tax cost in/outside India and impact the overall tax cost of the group.



Action Plan 8 – Intangibles

The existing international rules for transfer pricing have been found to be misapplied or considered insufficient to the extent that the allocation of profits is not aligned with the economic activity that results in profits. Action Plan 8 tries to correct the arising imbalance, as it brings out how misallocation of profits generated by valuable intangibles has contributed to BEPS. It proposes revised guidance on transfer pricing rules to ensure that operational profits are allocated to economic activities which generate them.

The report emphasizes that the group companies performing important functions, controlling economically significant risks and contributing in development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangible, as determined through the accurate delineation of the actual transaction, should be entitled to an appropriate return reflecting the value of their contributions. The guidance also clarifies that legal ownership alone does not generate a right to all of the return that is generated by the exploitation of the intangible.

The guidance further provides that mere funding of the DEMPE of an intangible by an entity, without performing any of the important functions in relation to the intangible, and without exercising control over the financial risk, will entitle the entity only to a risk-free return. The revised guidance also seeks to ensure that transfer pricing analysis will not be weakened by information asymmetries between the tax administration and the taxpayer by providing a new tool to tax administrations, which is based on evaluation of ex-post outcomes vis-à-vis ex-ante projections to price hard-to-value intangibles.

Impact on MNEs in consumer business sector in India

The consumer business sector is highly competitive and branding and technology are vital factors for the success of any enterprise in this industry. Considering the significance of "brands" and "market presence" in achieving the sales/market share, the companies have been investing considerably in the marketing campaign in India. Due to significance and magnitude of investment in marketing and sales activities, marketing intangible has been one of the most significant litigious TP issues in India for consumer business sector, with amount under litigation exceeding thousands of crores.

The revised guidance observes that under long-term contract of sole distributor rights of the trademarked product, the efforts of the distributor may enhance the value of its own intangible viz its distribution rights. A similar line of contention has been adopted by numerous Indian taxpayers where the expenditure incurred by them is for exploiting the intangible in their prescribed territory, thereby increasing the value of 'their intangible' and not that of the legal owner of the intangible. Also, the revised guidelines opine that the remuneration for such functions can come in several forms such as separate compensation, reduction in price of goods, reduction in royalty rates, etc., which is similar to the view taken by the Delhi High Court in case of Sony Ericsson and others . The taxpayers can draw support from the revised guidance on such aspects (e.g., long-term contract, exclusive rights to do business in specified territory, performance and control of functions, etc.) while putting forth the contentions. However, it remains to be seen if and how the BEPS Guidance impacts the view of Indian Revenue authorities.

Further, for several constituents of the consumer business sectors, technology plays a crucial role in the product differentiation. In Indian context, MNEs have incorporated R&D centers in India to take advantage of the availability of abundant and economical talent pool. Further increased focus on brand-positioning for augmenting the business/market share is also a key objective for their Indian presence. In this regard, exercising important functions by the foreign principal and control over service providers are important factors for determination of ownership and entitlement to intangible related return.

Accordingly, MNEs in consumer business sector need to review their current IP holding structure and how they manage the ownership and DEMPE related functions of intangibles. It would be of paramount importance for the MNEs to prepare robust documentation with regards to development and exploitation of intangibles in various jurisdictions and link the same to the allocation of value/profits arising from such activities.

Another important aspect is on the generation of intangibles through digital medium wherein consumer business entities collect, analyse and use consumer data by tracking behaviors which in itself could constitute an intangible property in the country in which the data is collected, analysed and thereby result in allocation of profit for such activities.

In addition to the above action plans, MNEs in consumer business should also consider,

1. Analyzing their group investment holding structure in terms of Action Plan 6 which provides for prevention of treaty abuse especially in light of the General Anti-Avoidance Rule (GAAR) that has been introduced and is to be implemented from 1 April 2017 in India;
2. Evaluate the impact on deduction of interest cost in light of funding through hybrid instruments like compulsory convertible debentures and limitation of interest deduction under the fixed ratio rule under Action plan 4;
3. Compliance and reporting requirement in light of the global transfer pricing documentation requirement and country by country reporting requirement.

Conclusion

Considering the consumer centric business model of consumer business sector entities, MNEs in this sector need to align their tax models in line with the OECD BEPS action plans. From both inbound and outbound investment perspective, the MNEs in consumer business need to track tax policy changes as regards management of intangibles particularly brands, remodel their supply chain models and evaluate the tax aspect of digital transactions in order to meet the level of compliance requirements.

All in all the MNEs in consumer business need to align their business models with regards to the actual 'value generation' to 'economic activity' in countries which they operate.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