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Impact on Life Sciences and Health Care

Enterprises in Life Sciences and Healthcare Sector: A BEPS perspective

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 economic 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 (globally) 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.

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The 15 action plans can be categorized under the following key pillars: Overview Action Plans for addressing BEPS

Establishing coherence in corporate taxation

- Action plan 2# Hybrid mismatch
- Action plan 3# CFC rules
- Action plan 4# Limit base erosion
- Action plan 5# Harmful tax practices

Restoring effects of international standards

- 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

Ensuring transparency while promoting predictability

- 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

Turning tax polices in to tax rules

- Action plan 15# Develop multilateral instruments

This paper seeks to capture some of the key potential impacts of BEPS for companies operating in Life Sciences and Healthcare (LSHC) – Indian MNEs having global operations and MNEs operating in India.

To implement the BEPS actions, India, in the recent past, amended certain provisions of its domestic tax law as well as its positions in a few bilateral tax treaties.

Permanent establishment [PE]

Marketing subsidiaries: Many MNEs operate in India through a subsidiary to provide marketing support to the group –typically the Indian subsidiary receives a fee or commission that is taxable in India, whereas the overseas group entity is not taxable in India on the profit of the sales,in the absence of a PE in India. The proposed expansion of the definition of agency PE in the context of conclusion of contracts 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, depending on the facts of the case.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.

Digital Business

Some of the medical services and products are now sold online. Also, certain pharma companies are considering the opportunity to sell the products online. Action plan 1 of BEPS aims to address tax challenges of the digital economy. The report observes that the digital economy is increasingly becoming the economy 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,

01. 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;
02. Modifying the definition of a PE to address artificial arrangements of conclusion of contracts within MNEs;

03. Revised Transfer Pricing Guidelines on intangibles; and
04. 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.

As a member of the G20 and an active participant of the BEPS project, India is committed to the BEPS outcome. Accordingly, India has proposed to tackle this issue with the introduction of Equalisation levy on certain digital transactions, which is discussed below.

Equalisation levy on digital transactions

'Equalisation levy' of 6% has been introduced on consideration for 'specified services', viz., online advertisement, provision of digital advertising space, or any other facility or service for the purposes of online advertisement. The Government is empowered to specify any other service on which such levy shall apply.

Every person, being a resident carrying on business or profession in India or a non-resident having permanent establishment in India, shall deposit the levy on the considerations payable to non-resident not having permanent establishment in India. Such levy does not apply where the aggregate amount payable to non-resident does not exceeds ₹ 100,000 in a year. The corresponding income would be exempt from income-tax in the hands of such non-resident.

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. E-commerce 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.

With the introduction of Equalization Levy, MNEs will be required to undertake the requisite compliances, and may also re-examine their business models to analyse the overall tax costs.

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.

Preventing tax treaty abuse and counter harmful tax practices

- BEPS Action 5 aims to identify and counter harmful tax practices, taking into account transparency and substance. The final report establishes minimum standards with regard to both determining

whether preferential regimes take sufficient account of need to reward only substantial activities, and ensuring that there is transparency in relation to rulings.

- BEPS Action 6 targets tax treaty shopping by MNEs that establish ‘letterbox’, ‘shell’, or ‘conduit’ companies in countries with favourable tax treaties – although such companies exist on paper, they may have no (or very little) substance in reality and may exist only to take advantage of tax treaty benefits.
- Intermediary holding companies: A significant amount of investment flows into India from companies incorporated in intermediary jurisdictions, which have favourable tax treaties with India. To counter tax treaty abuse, the BEPS project has laid down minimum standards, involving a limitation on benefits [LOB] rule and/or a principal purposes test [PPT] rule. The LOB rule limits treaty benefits to entities that meet the prescribed conditions whereas the PPT rule is akin to a general anti-avoidance rule [GAAR] for denial of treaty benefits. The Revenue authorities could challenge intermediary holding structures for investment into India under the proposed LOB / PPT rule under tax treaties and the GAAR under the Indian tax law that will be effective from 1 April 2017.

In this regard, we would also like to draw your attention to the Protocol to India-Mauritius Double Taxation Avoidance Agreement which come into force from 19 July 2016. As per the terms of the said Protocol:

- India gets taxation rights on capital gains arising from sale of shares of an Indian resident company acquired on or after 1 April 2017. The investments made prior to 1 April 2017 are grandfathered.
- In respect of capital gains arising during the transition period from 1 April 2017 to 31 March 2019 will be limited to 50% of the domestic tax rate of India, subject to fulfillment of conditions in the LOB Article
- Taxation in India at full domestic capital gains tax rate will be applicable for capital gains arising from 1 April 2019 onwards.

LOB Article has been introduced which provides that a resident of the state is deemed to be shell/ conduit company, if its expenditure on operations in that state is less than INR 2.7 million (Mauritius Rupees 1.5 million) in the immediately preceding 12 months from the date the gains arise. Such residents is deemed not to be a shell/ conduit company if it is listed on a recognised stock exchange of the state or its expenditure on operation is equal to or more than the amount specified above. It further provides that a resident of the state shall not be eligible to the beneficial tax rate of 50% (applicable from 1 April 2017 to 31 March 2019) on capital gains if its affairs were arranged with the primary purpose to take advantage of such benefits.

The General Anti-Avoidance Rule [GAAR] has also been introduced in the Indian tax law, and is to be implemented from 1 April 2017. The Indian GAAR overrides tax treaties, which is consistent with the OECD commentary on anti-avoidance rules. Interestingly, such a treaty override provision has been specifically included in certain recent bilateral tax treaties that India has entered into (e.g. Indian-Luxembourg tax treaty and India-Malaysia tax treaty). The PPT rule as recommended under Action 6 of BEPS is akin to the main purpose test as proposed under the Indian GAAR.

In light of the above provisions, foreign investors will be required

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to review their group holding structures and transactions including documentation to consider whether they are sufficiently robust to withstand tests under the LOB / PPT rule and GAAR provisions.

Determining lack or otherwise of a substantial activity – The OECD has achieved consensus on the 'nexus approach' that uses expenditure as a proxy for activity. In the context of IP regimes, a relevant connection (i.e. a nexus) is to be established between firstly, taxpayer's performance of R&D which resulted in development of IP asset, and secondly, taxpayer's income from the IP asset.

India has always been an advocator of the substantial activity test and does not have a harmful IP or other regime. India has been a sizeable outsourcing destination for R&D activities. In order to sufficiently capitalize on the vast intellectual resources of our country, and fully reap the attendant economic benefits, it was imperative to develop patents indigenously and provide a conducive framework to encourage this process.

India did not have a specific framework to tax income from patents developed and registered in India; royalty earned by resident taxpayers was taxed at 30% on net basis, similar to most other streams of income.

With recent initiatives such as Make in India and Skill India, a concessional taxation regime is introduced in respect of income from patents, which is aimed at encouraging indigenous research and development activities and to make India a global R&D hub. This regime is applicable from financial year 2016-17 to resident taxpayers and would cover patents (existing and new) developed and registered in India; 'developed' would mean that at least 75% of the expenditure is incurred in India by the patentee. The royalty income from such patents would be taxable at 10 percent (plus surcharge and education cess) on the gross amount of royalty. No expenditure or allowance would be allowable in such cases

This regime would be beneficial to a person resident in India, who is the true and first inventor of the invention and whose name is entered on the patent register as the patentee in accordance with Patents Act, 1970.

If any eligible taxpayer opts for this concessional tax regime in any tax year, but opts out of the regime in any of five tax years succeeding such tax year, it would be ineligible to opt into the regime for five years from the year of opting out of the regime.

Financial transactions and interest deductions

- A large number of foreign companies invest in India by subscribing to Compulsory Convertible Debentures [CCDs] issued by their Indian subsidiaries. Till the time of conversion to equity, India would generally regard the CCDs as debt and grant a tax deduction for interest on such CCDs. With the proposed linking rules in relation to hybrid instruments contemplated under BEPS, if the home country of the CCD-holder regards the instrument as equity and does not tax the dividend, India may deny a deduction for such interest.

Another related rule in relation to hybrid instruments is imported hybrid mismatches – pursuant to this proposal, the Indian Revenue authorities may investigate overseas borrowings transactions.

India is typically regarded as a high tax jurisdiction from the corporate tax perspective. The BEPS proposal to limit interest deductions by following a fixed ratio rule may also impact the Indian tax position of MNEs.

- Various Indian MNEs while structuring their operations outside India might have considered structures leading to hybrid mismatches. Following are the targeted arrangements:
  - Deduction / no inclusion outcomes – When a tax deduction is claimed for a payment in the payer jurisdiction and the corresponding income is not taxed in the payee jurisdiction.
  - Double deduction outcomes – A deduction is claimed for

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  a payment by a hybrid entity in two different jurisdictions and set-off against non-dual included income in second jurisdiction.
- Indirect deduction / no inclusion - Interposing a company (in another jurisdiction) and importing the outcome (deduction or no inclusion) to a third jurisdiction.

Considering the implementation of BEPS recommendations by various countries in near future, MNEs need to review their existing funding structures and ascertain whether existing structures lead to a deduction / no inclusion outcomes which has potential tax risks.

Transfer pricing considerations

- Non-recognition: The Indian tax authorities have historically resorted to re-characterising transactions challenging the substance of the transaction, in the pre-BEPS period as well. Indian tax authorities have usually re-characterised transactions such as:
  (i) advertising and marketing expenses as provision of brand building services;
  (ii) outstanding receivables or shortfall in price of shares issued to overseas associated enterprises as loan extended.

  Indian MNEs, vis-à-vis their global operations need to evaluate their positions in the backdrop of this guidance which goes to the root of the transfer pricing analysis and reinforces the 'substance over form' principle. The guidance provides that the actual transactions between the associated enterprises may be disregarded by the tax authorities for transfer pricing purposes, if the arrangement between the associated enterprises, viewed in its totality, differs from what would have been entered into between two unrelated parties behaving in a commercially rational manner.

- Intangibles and risk: India has emerged as an important location for research and development (R&D) centres for MNEs. These centres function as in-house resource centres where all investments are done by the global affiliates. The Indian tax authorities have, in the past, in some cases contended that the Indian entity (that houses the R&D centre) is the economic owner of the intangible and is entitled to receive a portion of the non-routine returns derived from the intangibles developed by the Indian R&D centre. In such cases, the Indian authorities have argued that application of the profit split method is more appropriate than expecting a routine cost-plus return. With a view to

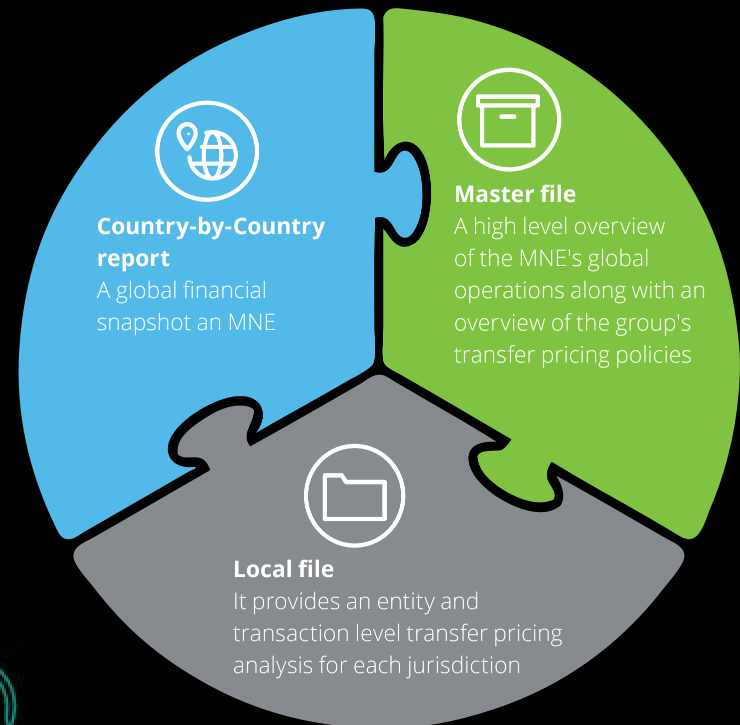
establishing a degree of certainty and uniformity in the audits of development centres engaged in R&D activities, guidance was provided vide Circular No. 6/2013. Circular indicates that contracts could be the starting point of the analysis, although the conduct of the parties is the ultimate determinant when focusing on functions, risks and costs. The revised BEPS guidance also emphasises supplementing the contractual arrangement through examination of the actual conduct of the parties and also emphasises on value created by the group companies through functions performed, assets used and risk assumed in development, enhancement, maintenance, protection and exploitation [DEMPE] of the intangible. The guidance also states that the risk related returns are to be aligned to control of risk and financial capacity to assume risk.

- Location savings: Various pharma companies work on contract manufacturing business model in India where entire output is exported to associated enterprises outside India. Indian tax authorities at lower level have been of the view that the part of the benefit of location savings (referred to the cost savings attributable to operating in particular low cost jurisdictions, such as India), should be retained by the Indian group entity. However, such an approach has not been favoured by the Indian judiciary in several judicial precedents.

Documentation and CbCreport

Three Tier Transfer Pricing Documentation

The G20/OECD have agreed on very significant changes to the compliance and reporting of global information, for risk assessment and transfer pricing purposes. The OECD has adopted a three-tiered approach to documentation, which includes:



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As an active member in the BEPS initiative, for implementing the international consensus on Action 13 of the BEPS project, India has introduced the Country by Country (CbC) reporting requirement and the concept of master file in the Indian Income-tax Act, 1961 (through the Finance Act 2016).

Country-by-Country (CbC) report
The CbC reporting requirement is introduced with effect from Assessment Year 2017-18 (financial year 2016-17). India will adhere to the OECD prescribed group revenue threshold of Euro 750 million (INR equivalent) for the applicability of the CbC requirement. Indian headquartered MNEs having consolidated group revenues above approx INR 5395 crore (equivalent to Euro 750 million) will be required to file the CbC report in India for Assessment Year 2017-18 (financial year 2016-17) onwards.

MNEs (not headquartered in India) having group companies resident in India, will require the Indian entity(s) to notify Indian income-tax authorities of the details of the parent entity/alternate reporting entity and its jurisdiction. In certain scenarios, such companies will also be required to file the CbC report in India (such as when India does not have an exchange of information agreement with their parent entity jurisdiction or, where there has been a systemic failure in exchange of such reports).

As per existing Indian regulations, the information requirements of the CbC report are similar to those prescribed by the OECD BEPS Action Plan 13. The CbC report is required to be filed in India on or before the due date for filing the return of income in India, i.e., typically on 30 November following the end of the Indian financial year (April to March). Stringent penalty provisions have also been prescribed for non-furnishing and/ or furnishing inaccurate particulars.

Master File
The Memorandum to the Finance Bill 2016 introduced the concept of 'Master File', whereby entities being constituent of an international group shall be required to maintain and furnish the Master File. The Memorandum provided that the rules prescribing the information and document as mandated for Master File under OECD BEPS Action 13 report shall be prescribed in the rules. The Memorandum also provides for the penalty leviable for non-furnishing of the information and document to the prescribed authority. The Master File is intended to provide a high-level overview of the MNE groups' business, including the nature of its global business operations, value drivers, supply chain analysis, intangibles employed, financial arrangements, overall transfer pricing policies, and financial and tax positions.

Local File
Existing local transfer pricing documentation requirements are retained. Currently, no amendments have been made to incorporate additional information requirements as per Action 13.

Way forward
Considering the business model of entities operating in LSHC sector, MNEs need to align their tax models in line with the OECD BEPS Actions. From both inbound and outbound investment perspective the MNEs in LSHC sector need to revisit the supply chain models (especially keeping intangibles in perspective), review the group holding structure along with inter-company transactions, evaluate the tax aspect of digital transactions in order to meet the level of compliance requirements and undertake risk assessment of the transfer pricing policy and documentation along with the reporting requirements.

All in all, the MNEs need to align the business models having regard to actual 'value generation' and 'economic activity'.

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