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Analysing BEPS impact  
Manufacturing Sector

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# Base Erosion and Profit Shifting

Tax has been in the headlines in a manner few could have predicted a few years ago. The Organisation for Economic Co-operation and Development [OECD] commenced work on the Base Erosion and Profit Shifting [BEPS] project to address concerns that existing principles of domestic and international taxation were failing to keep pace with the global nature of modern business models. In particular, governments, revenue authorities and social organisations are of the belief that existing rules give businesses excessive opportunity for arbitraging tax rates and regimes.

The final BEPS reports were released on 5 October 2015 and ratified by the G-20 Finance Ministers at their meeting in Lima, Peru on 8 October 2015. This paper seeks to capture some of the key potential impacts of BEPS for Indian multinational enterprises [MNEs] in Manufacturing sector having global operations and MNEs operating in India.

**What is BEPS?**

Base erosion and Profit Shifting 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

Final BEPS Action Plans were released on October 5, 2015

Local countries to enact / amend laws and tax treaties to implement BEPS action plans

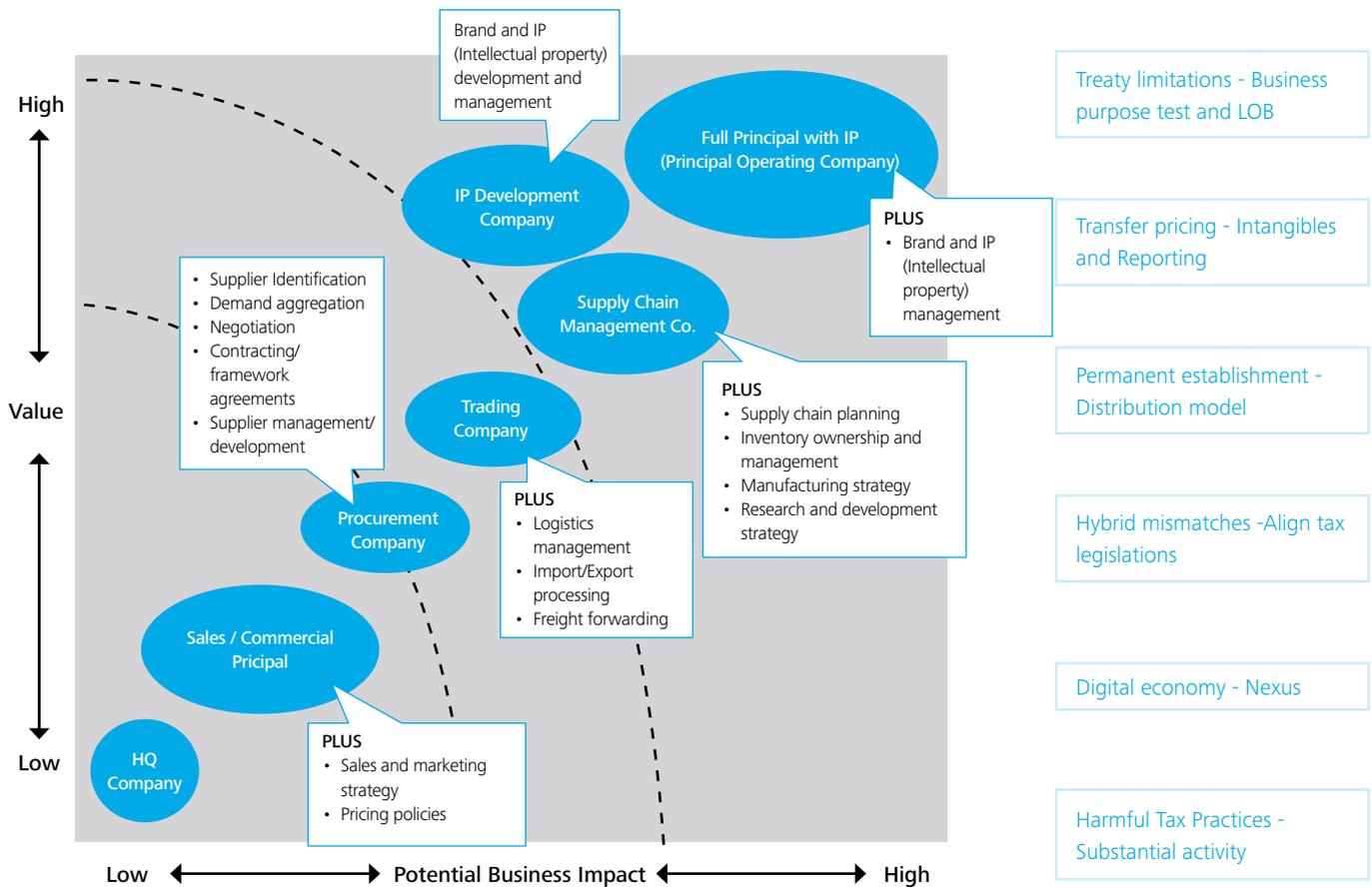
**Overview of action plans**

The BEPS action plans are structured around three fundamental pillars of Coherence, Substance and transparency. The action plans can be classified as follows:



# BEPS impact on Manufacturing Sector

BEPS action plans shall impact the overall business model of the MNEs in manufacturing sector. The below diagrammatic representation highlights the business models and the actions plans that are likely to impact MNEs in manufacturing sector:



## Impact on Investment holding structure

### Intermediate holding structure

A significant amount of investment flows into India from companies incorporated within 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 general anti-avoidance rule [GAAR] has 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. The GAAR would allow the revenue authorities to analyse and go deeper into the transactions and / or arrangements (e.g. judging their ownership structures, beneficial ownerships, voting rights, etc.) and would permit them to draw inference as to whether a particular entity is a conduit entity without any real economic substance / activity and the main purpose of setting up the entity is to obtain preferential tax benefit.



### Substance based approach

The GAAR and LOB / PPT rule may impact intermediate holding structure put in place by MNEs in manufacturing sector, which lack substance and have been interposed only to avail tax treaty benefits. Foreign investors need to review their group structures and investment modes including documentation to consider whether they are sufficiently robust to withstand a potential challenge under the LOB / PPT rule.

India has always been an advocator of the substantial activity test and does not have a harmful IP or other regime. Action Plan 8 of the BEPS report emphasizes that the group companies performing important functions, controlling economically significant risks and contributing assets in development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangible, as determined through the accurate delineation of the actual transaction, shall also be entitled to an appropriate return reflecting the value of their contributions. Indian MNEs that may have opted for some of the 'harmful' IP regime to house patents and copyrights in overseas jurisdictions need to relook at their IP holding structure and align the value creation activities with the economic activities undertaken in India.

### Impact on Operation and contracting arrangements

#### Supply chain model

Many multinational enterprises operate in India through a subsidiary to provide marketing support – 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 discussed above 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.

One of the recommendations in Action 7 dealing with preventing the artificial avoidance of PE status is that the PE exceptions will be modified to ensure that all activities that qualify for exemption are purely in the nature of preparatory and auxiliary activities. In the light of the recommendations under action plan 7, exceptions from creating a PE for specific activities (such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing or collection of information) will only apply where the activity in question is of preparatory or auxiliary character. This is to reflect modern ways of doing business, where such activities may represent a key part of the value chain of a business (particularly relevant for supply chain involving digital sales).

Significant number of foreign manufacturing MNEs companies have setup liaison offices in India – the argument taken in such cases is that the activities of the liaison office are preparatory and auxiliary in nature and, accordingly, no PE is created in India. With the proposed tightening of the conditions relating to preparatory and auxiliary activities, coupled with the anti-fragmentation rule for specific activity exemptions, the Revenue authorities are likely to look at such liaison office in greater detail.





## Impact on funding structure

### Hybrid mismatch

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 should 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 borrowing transactions.

### Interest deduction

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 impact the interest deductibility of manufacturing MNEs in India.

## 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 authorities have usually re-characterised transactions such as: (i) domestic advertising and marketing expenses as provision of brand building services; (ii) Management fees. Given that the new guidance focuses on commercial rationality rather than substance, MNEs need to factor in and evaluate the impact of the new guidance on the positions adopted by them.

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 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. 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 emphasizes supplementing the contractual arrangement through examination of the actual conduct of the parties and also emphasizes on value created by the group companies through functions performed, assets used and risk assumed in DEMPE of the intangible.

**Location savings:** Various MNCs 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. The divergent Indian view would need to be aligned to the BEPS guidance which provides a step wise approach to determine the allocation of location savings.

### Documentation and CbC report

#### Transfer pricing documentation

From an Indian perspective, rules may need to be framed to provide for maintenance of information contained in master file and Country-by-Country [CbC] report as the Indian transfer pricing regulations currently do not require maintenance of such information.

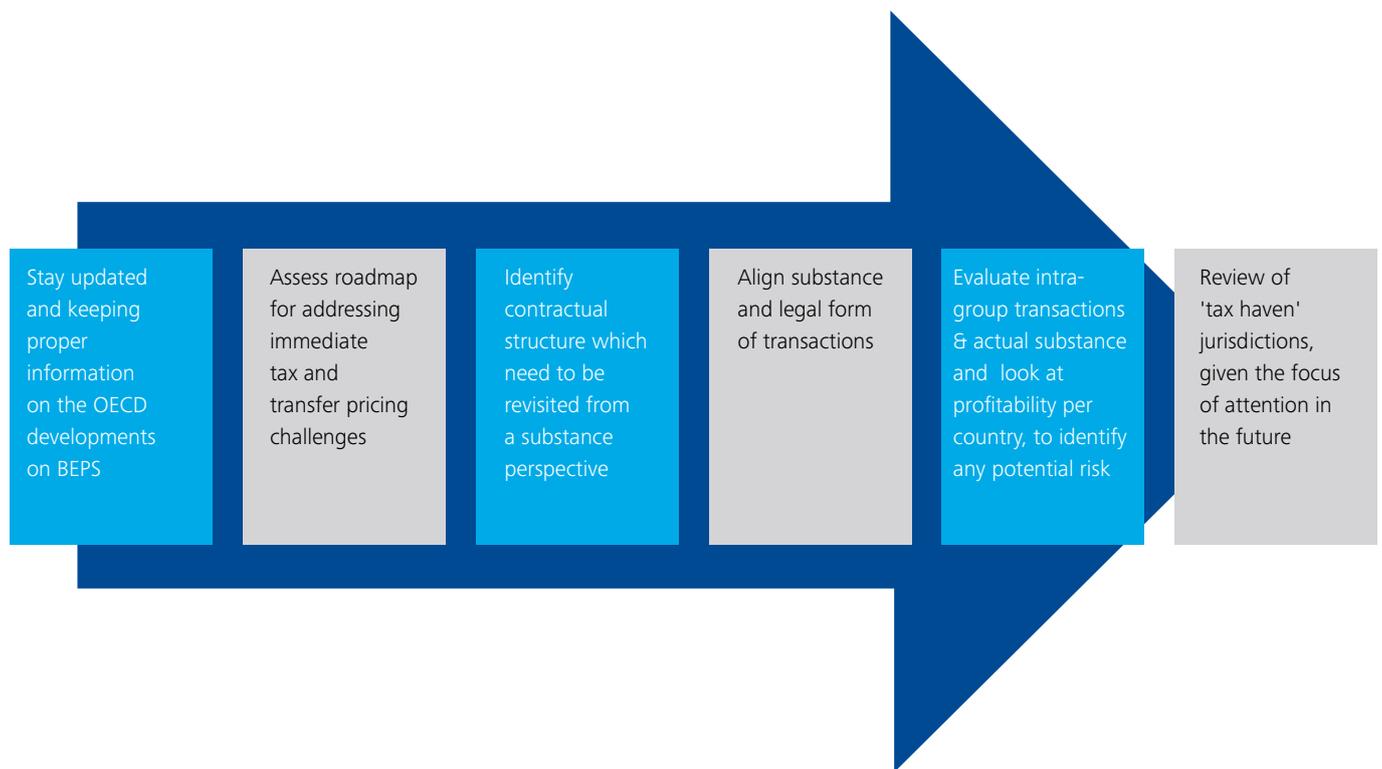
It is expected that the CbC reporting and other documentation requirements will be introduced in upcoming budget 2016 and Indian MNEs with annual consolidated group revenue of or above Euro 750 million (approximately INR 5,250 crores) will need to comply with the rules. CbC template as provided in the Guidelines is intended to be used only for risk assessment purposes, CbC report is not a conclusive evidence on whether transfer prices are appropriate or not. It will be imperative for MNEs to evaluate the existing data, data gaps, economic inconsistencies and non-compliance with transfer pricing policies. MNEs would need to undertake a risk assessment exercise to evaluate how the new documentation guidance will impact their current transfer pricing policies and their process for implementing, monitoring, and defending those policies.

It is worth noting that both the Master File and CbC Reporting have their main relevance for the headquarter or ultimate parent of an MNE group. Further, the Master File and CbC Reporting should not be looked at as a mere compliance requirement under the TP regulations. It provides an opportunity to revisit the overall supply chain models of the businesses of Indian MNEs. A thorough analyses of the organizational and operating structure could help mitigate exposure through valid corrective measures.



### A Step wise plan

Way forward for manufacturing business



As a member of the G20 and an active participant in the BEPS project, India is committed to the BEPS project outcome and implementation. Therefore companies operating in India and Indian MNEs need to be aware of and constantly monitor the changes that India and other countries may bring about in their domestic laws and tax treaties, including positions on the multilateral instrument, in order to evaluate the BEPS impact in relation to their operations.



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