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BEPS
Impact on TMT Sector

January 2016

“Let’s be crystal clear: What is at stake is to restore the confidence of your people in the fairness of our tax systems.”
– Angel Gurría, OECD Secretary-General, speaking at G20 Ankara Meeting of Finance Ministers and Central Bank Governors on 5 September 2015

“The international tax system is outdated, we are bringing it up to date.”
– Pascal Saint-Amans Director, Centre of Tax Policy and Administration, OECD

The growth of international businesses has been accompanied by the development of strategies and structures designed to minimize taxes across the jurisdictions in which they operate. These actions have been countered by the tax authorities attempts to control what they consider to be abuses of the tax system through exploitation of the differences and asymmetries in the domestic and international tax rules. Multinational Companies have been under fire for not paying their “fair share” of taxes. Yet they have all emphasized that they are following the tax laws to the letter, and have been planning their affairs in a legally permissible manner. The negative media coverage and the public ire towards these multinational companies have put political parties under pressure to look at this matter. In September 2013, G20 Leaders endorsed the ambitious and comprehensive Action Plan on BEPS. 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.

The Organization for Economic Co-operation and Development (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. The 15 final reports[1] released by OECD on 5 October 2015 under the BEPS project have the following broad objectives

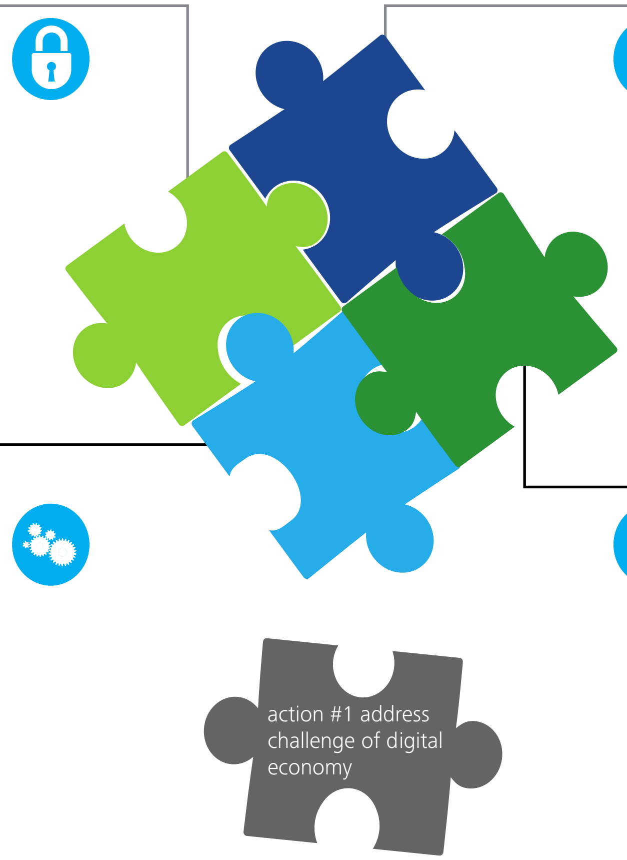
[1] On 8 October 2015, the G-20 Finance Ministers at their meeting in Lima, Peru endorsed these reports.

Establishing coherence in corporate taxation

- action #2 hybrid mismatches
- action #3 CFC rules
- action #4 limit base erosion
- action #5 harmful practices

Restoring effects of international standards

- action #6 prevent treaty abuses
- action #7 artificial avoidance of PE
- action #8, 9, 10 value creation intangibles, risks and capital, high risks transactions



Turning tax policies into tax rules

- #15 develop multilateral instrument.

Ensuring transparency while promoting predictability

- action #11 data collection & analysis
- action #12 disclosure aggressive tax planning
- action #13 TP documentation & CbC reporting
- action #14 dispute resolution mechanisms

Under the BEPS action plan, a comprehensive package of measures has been agreed upon and the participating countries have committed to its implementation. The countries have agreed to a minimum standard (preventing treaty shopping, country by country reporting, harmful tax practices, and dispute resolution) to tackle issues where no action by some countries would have created negative impact on other countries. Existing standards have been updated and will be implemented despite the fact that not all BEPS participating countries have endorsed the standards on tax treaties and transfer pricing. In other areas viz., hybrid mismatch arrangements and interest deductibility countries have agreed a general tax policy and are expected to come together over a period of time. BEPS outcomes prescribed although not legally binding, but there is an expectation that they will be implemented accordingly by countries that are part of the consensus.

BEPS and Companies in Technology, Media and Telecom (TMT) space

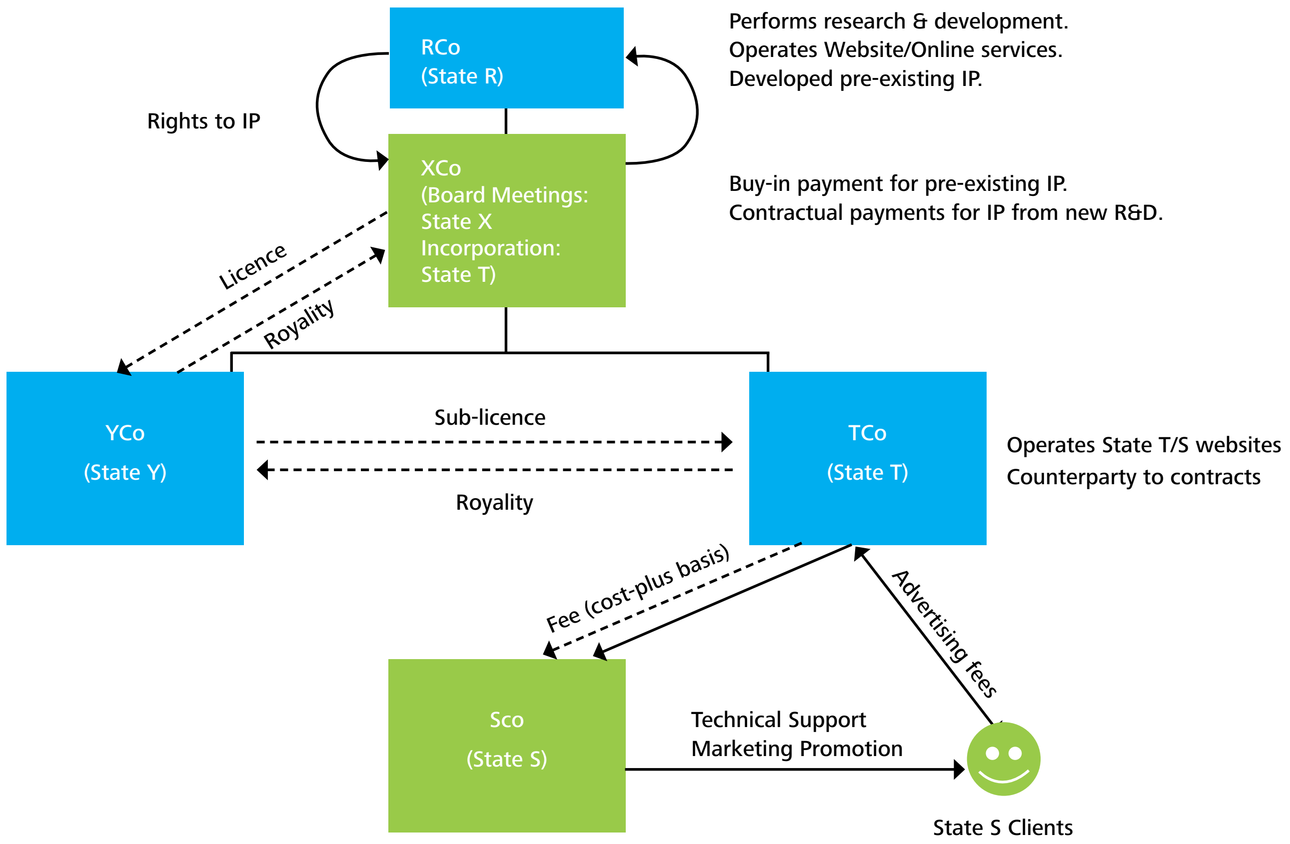
India, being a member of the G20 nations, has actively participated in the OECD BEPS project and is committed to its outcome. The BEPS project is extremely relevant for India especially Action 1 on the Digital economy as it has revolutionized traditional ways of conducting business around the world including India and a digital revolution is taking place. The digital economy is based on conventional production of goods and services such as software development, IT services, telecommunications, advertising, or content creation. The global companies serving millions of users are changing the rules of the game and bringing far-reaching changes in various sectors of the economy through - intense reliance on digital technologies and innovative business models. India is on the brink of internet revolution with the latest figures indicating that India has more internet users than the population of the US and has become the country with the second largest population of internet users after China. With new Government initiatives, like Digital India, there will be an increased usage of various services and so will be the complexity in business models that are likely to evolve over time.

Challenges in Digital Economy – India illustration

The digital economy is increasingly pervading all aspects of the traditional economy. Action Item 1 observes that "it is increasingly becoming the economy itself". While there is a view that the digital and the traditional economy ought to be viewed through the same lens and be evaluated on the same traditional standards, there are several aspect of the digital economy that significantly exacerbate the BEPS risks.

One of the key characteristics of many digital economy business structures is the ease by which the traditional business roles can be disaggregated. Another key characteristic is the heavy dependence on intangibles in creating value and producing income. Both these characteristics can deliver either minimal or zero taxation in the market country. Many BEPS structures also involve the transfer of intangibles to a tax advantaged location.

The example below illustrates this:



In the pre BEPS scenario, questions arise whether T Co, located outside India could, in the absence of a permanent establishment, be taxed for advertising revenues earned from various advertisers in India. The attempts by Indian tax authorities to tax such transactions in the past have not yielded much success so far and matters are pending before the higher courts for resolution.

BEPS Package and Digital economy

The digital economy and its business models present however some key features which are potentially relevant from a tax perspective. These features include mobility, reliance on data, network effects, the spread of multi-sided business models, a tendency toward monopoly or oligopoly and volatility. The Report identifies four main broader tax challenges raised by the digital economy:

Nexus - The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence to carry on business raises questions as to whether the current rules are appropriate.

Data - The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, and of how to characterise for tax purposes a person's or entity's supply of data in a transaction, for example, as a free supply of a good, as a barter transaction or some other way.

Characterisation -The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models, particularly in relation to cloud computing.

VAT Collection - Cross-border trade in both goods and services creates challenges for VAT systems, particularly where such goods and services are acquired by private consumers from suppliers abroad.

The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services.

The BEPS package provides a detailed analysis of the digital economy, including its business models and key features. While the Digital Economy does not create unique BEPS issues, some of its features exacerbate the existing ones and these have been addressed via the modifications to the definition of permanent establishment, the new transfer pricing rules, in particular regard to hard-to-value intangibles and recommendations on how to strengthen so-called "Controlled Foreign Corporation" rules. Building on the OECD International VAT/GST Guidelines, the BEPS package also recommends that VAT on digital transactions be collected in the country where the customer is located and provides agreed mechanisms to do so in an efficient manner. Accordingly, 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 expected that the implementation of these measures, as well as the other measures developed in the BEPS Project (e.g. minimum standard to address treaty shopping arrangements, best practices in the design of domestic rules on interest and other deductible financial payments, application to IP regimes of a substantial activity requirement with a "nexus approach"), will substantially address the BEPS issues exacerbated by the digital economy at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so-called stateless income.

Potential options evaluated but not recommended

The following options analysed namely –

1. a new nexus in the form of a significant economic presence – purposeful and sustained interaction of an enterprise with the economy of a country via technology and other automated tools to create taxable presence;
2. a withholding tax on certain types of digital transactions (digital goods and services) ; and
3. an equalisation levy – an alternative for profit attribution under the new nexus based on 'significant economic presence'

These measures were not recommended at this stage because it is expected that the other measures developed in the BEPS Project will have a substantial impact on issues identified in the digital economy and that certain BEPS measures will mitigate some aspects of the tax challenges with digital economy. However, it has been left open for the countries to introduce any of these three options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties.

Impact of other BEPS action on TMT Companies

Actions 8, 9 and 10: Aligning Transfer Pricing Outcomes with Value Creation

The objective of these Action points is that transfer pricing outcomes are in line with value creation, by requiring that the attribution of value for tax purposes is consistent with economic activity generating that value. 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.

Treaty Shopping

Additionally, multinational enterprises in TMT space in India would also need to analyse their group investment holding structure in terms of Action Plan 6 which provides for prevention of treaty abuse. The Action recommends either adopting a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or "PPT" rule) or Limitation of Benefit (LOB) rule that limits benefit to treaty entitlement to entities that meet certain criteria or a combination of the two. Given the risk to revenues posed by treaty shopping, the countries have committed to ensure a minimum level of protection against treaty shopping - the minimum standard.

Others

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 and Compliance and reporting requirement in light of the global transfer pricing documentation requirement and country by country reporting requirement.

Way forward

BEPS measures seeks to improve the coherence of international tax rules, reinforce their focus on economic substance and ensure a more transparent tax environment. Having regard to the BEPS recommendations, business models are likely to be subjected to increased scrutiny in India specially- assertion of permanent establishment on accessibility of websites from India, presence of marketing or sales personnel in India or for presence of some equipment. It is likely that the revenue authorities may attempt to tax on account of 'significant digital presence' in India. Further, there is a likelihood of increased focus on withholding tax implications on digital products and services to non- residents. It is imperative that MNEs in this space need to align their tax models in line with the OECD BEPS action plans and also need to track tax policy changes as regards assertion of PE and taxation of digital products