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Confederation of Indian Industry

BEPS
An India perspective on critical areas

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Foreword

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.

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. The relevance of BEPS is from an India outbound as well as India inbound perspective.

Implementation of BEPS would involve amendments being undertaken to the domestic tax laws and tax treaties by various countries, including India. Some countries have already started taking unilateral actions to deal with the BEPS measures. The multilateral instrument (amending the bilateral tax treaties) would be open for signature by all interested countries in December 2016. There would be some more policy developments in 2016 and 2017, but the main activity around BEPS would be each country's adoption of the BEPS measures.

It is now time for the multinational enterprises to be 'BEPS-ready'. At the outset, such multinational enterprises need to understand the implications of the BEPS actions, evaluate the potential impact, identify the potential tax risks associated and possibly restructure existing arrangements, if the need arises. The implementation of BEPS measures would make tax management a challenge in the initial years for multinational enterprises, tax professionals and the Revenue authorities worldwide.

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Action Item 6 – Preventing treaty abuse

Action 6 of BEPS was conceptualised to address the three broad objectives in relation to treaty abuse and treaty shopping:

i. To clarify that tax treaties are not intended to be used to generate double non-taxation

ii. To identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

iii. To develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.

The OECD on 5 October 2015 has released its final report on Action 6, recommending measures to combat treaty shopping and treaty abuse through an agreed minimum standard, with some flexibility in the implementation of this standard, in order to allow adaptation of each country's specific circumstances and negotiated bilateral tax treaties. The report is divided into three sections.

Section A provides for the inclusion of anti-abuse provisions in the tax treaties including a minimum standard to counter treaty shopping. This section discusses a limitation on benefits [LOB] rule and a principal purposes test [PPT] rule. An LOB rule is typically included in the tax treaties of the US, including some treaties concluded by Japan and India – the LOB rule essentially limits the availability of tax treaty benefits that meet certain conditions (based on legal nature, ownership and general activities of the entity) and is objective in nature. On the other hand, the PPT rule seeks to deny tax treaty benefits if one of the principal purposes of the transaction or arrangement was to obtain treaty benefits – this is more subjective in nature. The minimum standard in this regard is to include in tax treaties:

i. The combined approach of an LOB and PPT rule;

ii. The PPT rule alone; or

iii. The LOB rule plus a mechanism to deal with conduit financing arrangements.

In addition to the above, there are targeted rules to address other forms of treaty abuse:

i. Dividend transfer transaction that artificially lower withholding tax on dividends;

ii. Transaction that circumvent the rule that prevents source taxation of sale of shares deriving value primarily from immovable property;

iii. Dual residency of entities;

iv. Transfer of property and assets to a permanent establishment.

A new rule is proposed to provide that tax treaties do not generally restrict the taxability in the State of residence. It is also proposed to clarify that departure or exit taxes and not in conflict with tax treaties.

Section B provides for the reformulation of the title and preamble of the Model Tax Convention, which would clearly state that the intention of the parties to the tax treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance, in particular through treaty shopping arrangements. This is also a minimum standard that has been laid down.

Section C provides for identifying the tax policy considerations relevant for deciding whether countries should enter into a tax treaty and also whether they should modify (or ultimately terminate) a treaty in the event of change of circumstances.

The implementation of the proposals discussed above, including the minimum standard, will require amendment to bilateral tax treaties. Under BEPS action 15, a multilateral instrument is being developed to be signed by all interested countries that effectively would amend existing tax treaties to implement measures to combat BEPS. India is among the participants in the group developing the multilateral instrument, which is expected to be ready for signature by 31 December 2016.

India perspective

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 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.

Currently, there is an anti-abuse rule in very few of India's tax treaties – UK, Luxembourg, Norway, Poland, Finland, UAE, Malaysia, etc. This is normally a general anti-abuse rule, under which tax treaty benefits can be denied if the main purpose or one of the main purposes is to obtain tax treaty benefits. While the term used in such treaties is typically 'Limitation of Benefits', but in essence the rule is akin to the PPT rule. On the other hand, India's tax treaty with the US contains a detailed anti-abuse rule based on the US model convention – this is the LOB rule envisaged under Action 6 of BEPS.

India has also initiated the process of renegotiating some of its existing bilateral tax treaties, to combat treaty shopping by inserting anti-abuse rules. As per newspaper reports, one of the key treaties under discussion is the India-Mauritius tax treaty, which may require foreign investors from Mauritius to satisfy certain requirements for claiming tax treaty benefits.

The GAAR and LOB / PPT rule may impact intermediate holding companies for investing into India, which lack substance and have been interposed only to avail tax treaty benefits. Foreign investors that have made investments or are doing business in India need to review their existing operational structure, arrangements, agreements and investment modes to consider whether they are sufficiently robust to withstand a potential challenge under the proposed GAAR regime and / or the LOB / PPT rule.

Action Item 1 – Digital economy

Action 1 of BEPS deals with addressing the tax challenges of the digital economy. To study the tax issues raised by the digital economy and also to address them, a special body called the Task Force on the Digital Economy [TFDE] was setup in September 2013. The TFDE, after many rounds of consultation, published an interim report in September 2014 and the final report in October 2015. The conclusions regarding the digital economy, the BEPS issues and the broader tax challenges it raises and the recommended next steps are contained in Action 1.

With the evolution of businesses and the trend of conducting business using a digital platform, there is a substantial increase in the complexity involved around the cross border taxation of such businesses. While the traditional problems of cross border business was to avoid double taxation, revenue authorities believe that the taxpayers are structuring operations to achieve double non-taxation – that is – no tax in the seller or buyer's State.

The report observes that the digital economy is increasingly becoming the economy itself and it would be difficult to ring fence the digital economy from the rest of the economy for tax purposes. It calls for the identification of the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these rules. One of the interesting aspects of the report 1 is that it takes a holistic approach and is the only Action which discusses indirect taxes as well.

The report states that while the digital economy and its business models do not generate unique BEPS concerns, the key features exacerbate BEPS risks. From a direct tax perspective, the report by itself does not suggest any recommendations – it however indicates that the work on certain other actions are expected to tackle issues faced in the digital economy as discussed below.

- **Modification of the exceptions to permanent establishment [PE]**

  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. Another related rule is the anti-fragmentation rule that prevents activities being split up within group entities to avoid creation of a PE.

  In the context of the digital economy, an example is of an online seller of goods that maintains a large warehouse with significant number of personnel, which is essential for proximity to customers and quick delivery. Pursuant to modifications to the exception to PE, the online seller would create a PE in the country where the warehouse is located.

- **Tightening of the agency PE rule**

  Action 7 of BEPS also proposes tightening the agency PE rules to include contracts for the transfer of, or the granting of the right to use, property, or the provision of services by the non-resident, where the intermediary habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.

  In the digital world, one example to be considered is where the sales force of a local subsidiary of an online seller of goods habitually plays a crucial part in the negotiation and conclusion of contracts, whereas the enterprise routinely approves such contracts. In such a situation, an agency PE of the enterprise would be created.

- **Controlled Foreign Corporation [CFC] rules**

  Implementation of CFC rules are governed by the domestic tax laws of a country. BEPS Action 3 lays down the building blocks on how effective CFC rules should be framed. The framing of effective CFC rules would enable pulling back income in the digital economy, which is parked in a low tax jurisdiction and is passive in nature, for taxation in the hands of the ultimate parent company.

- **Transfer pricing rules**

  The proposed transfer pricing rules dealing with aligning transfer pricing outcomes with value creation will ensure that legal ownership of intangibles per se does not result in right to all or some of the income arising from exploitation of the intangibles. This is proposed to ensure equitable distribution of income in the digital world.

  The above rules, coupled with other actions dealing with treaty shopping, deductibility of interest, requirement of substantial activity for an IP regime, etc. will ensure that BEPS issues arising in both – the ultimate parent company jurisdiction and the source State – will be addressed.

The TFDE had also analysed various other options to deal with BEPS issues in the digital economy as under:

i. Nexus in the form of significant economic presence

ii. Withholding tax on certain types of digital transactions

iii. An equalisation levy

The above options are not recommended by the OECD at this stage as it is expected that the other BEPS actions discussed above will address the broader tax challenges of the digital economy. The introduction of these measures currently is left to the decision of the individual countries.

India perspective

Business environment is becoming complicated and dynamic with the advent of new business models coupled with e-commerce transactions. The link or connection between 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. India has been no different on this front, with tax litigation on account of various e-commerce issues e.g. online advertising, subscription for electronic databases, payments for bandwidth, etc.

In the Indian context, the following key aspects need to be re-looked at in light of global developments:

i. Existence of business presence / permanent establishment or nexus with a jurisdiction

ii. Accrual / source of income

iii. Characterisation of income (e.g. royalties / fees for technical services)

Although Action 1 of BEPS addresses some of the issues relating to PE / source rules, the key issue in relation to the digital world in India is characterisation of income – this issue has not been addressed by Action 1.

As a member of the G20 and an active participant of the BEPS project, India is committed to the BEPS outcome. It is quite likely that some or all of the recommendations suggested in various actions impacting digital businesses will be implemented through amendments to the Indian tax law or tax treaties. It would be interesting to however see whether India considers the other options analysed by the TFDE relating to significant economic presence, withholding tax on digital transactions, equalisation levy, etc.

Insights on indirect tax

In view of the increasing dynamics of digital economy, the global economy is undergoing a tremendous change with technology shaping the way that businesses operate, people work and customers consume. The digitisation of economies has greatly facilitated ability of various inbound investors to acquire a wide range of services and intangibles from suppliers in other jurisdictions around the world and to structure their operations worldwide. These developments have allowed exempt businesses to avoid and minimise the amount of unrecoverable VAT they pay on their inputs.

Considering these transformative changes, OECD has specifically identified some of the peculiar features and business models of digital economy that increases the BEPS risks in order to safeguard the revenue concerns of Governments and the business dynamics of domestic suppliers of competing services. In Action 1, OECD has specifically identified the risks in the context of effective indirect taxes (VAT / GST) collection on the cross-border supply of digital goods and services. Therefore, in transactions evolving around digital economy, OECD has addressed the tax challenges and recommended steps to collect VAT / GST based on the destination principle, i.e. where consumption takes place.

However, considering the dynamic nature of transactions in digital economy, BEPS concerns arise since it becomes extremely difficult to identify the destination where the supply has actually taken place. Cases such as remote supplies to exempt businesses and consumers, remote digital supplies to companies having global presence, exemptions in relation to low value imports, etc. are few of the major concern areas. OECD has discussed in details the likely concerns that may arise in view of the above supplies and has categorized the solutions into broad buckets of B2B and B2C supplies. The approach and steps suggested in Action 1 are intended to carve out any difference between domestic supplier and foreign investor / supplier and facilitate the efficient collection of VAT due on these transactions in the appropriate jurisdictions.

In view of the above recommendations by OECD that links indirect taxes to BEPS shall require an in-depth analysis / consideration of businesses having global presence or making investments in businesses of other countries to manage their impact, which could be significant within a supply chain. With these changes in business transformation, indirect taxes shall also have a significant impact and play a vital role especially in India where GST, which is going to be a destination based tax, is likely to be introduced.

Although the linkage between VAT / GST and BEPS may be unintended in any other actions other than Action 1, there are other areas which specifically touch upon various indirect tax aspects in other action plans suggested by OECD also. Therefore a timely examination of potential actions is advisable, keeping in mind the significant resources and lead-times required for any operational and structural business changes.

Action Item 7 – Permanent establishment

As part of the 2015 BEPS reports, the OECD issued a final report in relation to Action 7 dealing with preventing the artificial avoidance of permanent establishment [PE] status. The report builds on proposals put forward in the G20 / OECD's discussion drafts from October 2014 and May 2015.

This report includes changes to the definition of PE in the OECD Model Tax Convention, which addresses strategies used to avoid having a taxable presence or a PE in a country under tax treaties. These changes are targeted to ensure that where the activities that an agent conducts 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. The changes will also 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. Similarly, it also address situations where the creation of a PE in relation to construction sites is circumvented through the splitting-up contracts between closely related enterprises. Work on the attribution of profits to PE is to be continued and guidance to be provided before end of 2016.

The implementation of the proposals discussed below, will require amendment to bilateral tax treaties. Under BEPS action 15, a multilateral instrument is being developed to be signed by all interested countries that effectively would amend existing tax treaties to implement measures to combat BEPS. India is among the participants in the group developing the multilateral instrument, which is expected to be ready for signature by 31 December 2016.

The proposals for amendments to Article 5 of the OECD Model Tax Convention, dealing with PE, are discussed below.

Artificial avoidance of PE through an agent

Many multinational enterprises operate and sell goods in another country, without setting up a direct presence in the other country – they typically set up a subsidiary to carry on the marketing and sales activities in the source State, or operate through a third party selling agent in the source State. Typically the foreign enterprises would not be taxable in the source State as they does not have a presence or PE in that State. There are two proposals to deal with these situations.

i. Tightening the agency PE rules to include contracts for the transfer of, or the granting of the right to use, property, or the provision of services by the foreign enterprise where the intermediary habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.

ii. Modification and narrowing the requirements for an agent to be considered 'independent', such that an agent will not be regarded as independent where the agent acts exclusively or almost exclusively for one or more enterprises to which it is closely related.

India perspective

Many multinational enterprises operate in India through a subsidiary to 'market' the products of 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 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.

Interestingly, the Indian revenue authorities have interpreted the term 'conclude contracts' widely to include various activities which facilitate conclusion of contracts – the proposed modification of the agency PE definition will support the case of the revenue authorities.

Artificial avoidance of PE through specific activity exemptions

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. This change will mean that 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).

A number of helpful examples are included in the proposed draft of the revised Commentary. For example, storing and delivering goods to fulfil online sales may not be considered as preparatory or auxiliary in character if such activities are an essential part of the company's sales or distribution business, whereas storing of goods in a bonded warehouse during the custom clearance process would be considered as preparatory and auxiliary.

Another related rule is the anti-fragmentation rule that prevents activities being split up within group entities to avoid creation of a PE. The rule aims to prevent an enterprise or a group of closely related enterprises from fragmenting a cohesive business operations into several small operations in order to argue that each is merely engaged in preparatory or auxiliary services.

India perspective

Indian Courts have dealt with the issue relating to 'preparatory or auxiliary' activities and are broadly of the same view as expressed in BEPS report.

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

The other important area where this proposal could impact is, of course, the digital economy. Given the tremendous growth of e-commerce in India, functions such as warehousing, display, delivery, and its impact on the entire supply chain model may have to be analysed in the context of preparatory or auxiliary activities.

Splitting up of contracts

The report addresses the issue of splitting up of contracts between group companies in order to circumvent the threshold for creating PE for building sites and construction or installation projects. The alternatives suggested in the report to deal with this are:

i. The principal purposes test rule, which would be subjective in nature, but would cover cases only where contracts are artificially split up.

ii. Adding connected activities (exceeding 30 days' duration) carried on by closely related enterprises to the period of time on site for the purposes of determining the 12-month period – this would be objective, but would impact even genuine cases.

India perspective

India has a significant number of EPC contracts being executed by multinational enterprises – in many cases, various group entities execute different parts of the project and individually no PE is created for the group entities. The proposed rules relating to splitting up of contracts could lead to the various group entities creating a PE in India and being taxed in India.

Action Item 8-10 – Intangibles

The arm's length principle has been the cornerstone of transfer pricing rules. It is embedded in treaties and appears as Article 9(1) of the OECD and UN Model Tax Conventions. 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. The OECD in the BEPS action plan has tried to correct that imbalance through Action 8, as it brings out how misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting. The OECD report, to achieve that, proposes revised guidance which can ensure that the transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them. The report also provides additional guidance on aspects of location saving, local market features, assembled workforce and passive association ('guidance on comparability factors').

The revised guidance also provides a broad definition of intangible. This definition of intangible acknowledges the existence of intangibles, irrespective of accounting for / reporting of intangibles in financials by the MNE. The guidance also clarifies that legal ownership alone does not necessarily generate a right to all of the return that is generated by the exploitation of the intangible.

The 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. The deliverable leverages on the framework for analyzing risk provided in Chapter I (exercising control over functions and having financial capacity to assume the risk) to determine which parties assumed risk in relation to intangibles, and for assessing which member of the MNE group controlled the performance of DEMPE functions in relation to intangibles (and consequent entitlement to profit or loss relating to differences between actual and expected profits). The revised guidance also elucidates in clear terms that the legal ownership/ funding of the intangible does not determine entitlement, as already stated, to intangible related returns. The guidance 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 guidance also seeks to ensure that this analysis will not be weakened by information asymmetries between the tax administration and the taxpayer. To tackle the problem of information asymmetry, the revised guidelines provide a new tool to tax administrations, which is based on evaluation of ex-post outcomes vis-à-vis ex-ante expenditure/spend to price hard-to-value intangibles (HTVI). In several cases the tax authorities, during TP Audit, may have considered the actual results in place of the projected results at the time of transactions for making any TP adjustments—the above guidance would support the said position. The revised guidance also provides safeguards to taxpayers by providing certain exemptions where such an approach will not apply to transactions involving the transfer or use of HTVI.

Supplemental guidance regarding transfers of intangibles or rights in intangibles, including comparability, has also been provided in the revised guidelines. The guidelines provide for several factors for comparability of intangibles or rights in intangibles, though one may feel that the guidance raises the comparability bar too high to be complied with, given the lack of available data in the public domain with respect to transactions involving intangibles/rights in intangibles. Also, in performing the comparability analysis and determining the arm's length compensation for an intangible transaction, the revised guidance provides for evaluating the options realistically available to the parties and cautions that one-sided comparability analysis would be insufficient. The revised guidance further provides that specific circumstances of one of the parties should not be used to support an outcome which is contrary to the realistically available options of the other party. Also, given the unique nature of the intangible transaction, the revised guidance observes that the CUP method, transactional profit split and discounted cash flow techniques could

be highly useful. However, any selected method and the comparability adjustment, if any, should take into account all the relevant factors that materially contribute to the creation of value and not just the intangible or routine functions.

Overall, the revised guidelines on intangibles support the remuneration linked to value creation with formidable emphasis on performance of important value-creating functions/assumption of risks related to the DEMPE of the intangibles.

It is also interesting to refer to Action 5[1] , where FHTP[2] has evaluated three different approaches to requiring substantial activities in an IP regime in order for the MNE group to avail associated tax benefits. Out of the three approaches, namely 'Value creation approach', 'Transfer Pricing approach' and 'Nexus approach', the Nexus approach (which is developed in the context of IP Regimes and allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying R&D expenditures that gave rise to the IP income) was agreed upon by FHTP under Action 5 for evaluating eligible activities in IP regimes. But, in Action 8, the thrust is on functions performed, assets used and risk assumed in relation to DEMPE of the intangible, and not on the level/amount of expenditure incurred by entities. The taxpayers would need to keep in view the above while evaluating their IP structures.

India perspective

With the establishment of numerous R&D centres in India, availability of abundant and economical talent pool, and increased focus on brand-positioning for augmenting the business/market share, discussions on transfer pricing aspects of intangibles have dominated the Indian TP landscape in the past few years. The Indian TP provisions were amended in 2012 and an extensive definition of intangibles was provided under the Income-tax Act encompassing marketing intangible, workforce, customer contracts, etc.

The revised guidance by OECD on intangible provides clarity on the approach to be followed for identification of the intangible, ownership (legal or economic), approach for the comparability and selection of transfer pricing method for determination of the arm's length price. In this respect, several aspects of the revised guidance are in line with the practices followed by the Indian tax authorities. The revised guidance, for instance, emphasizes supplementing (or replacing, where appropriate) the contractual arrangement through examination of the actual conduct of the parties based on the functions performed, assets used, and risks assumed, including control of important functions and economically significant risks. This approach finds support in the Indian context as the CBDT Circular No. 6/ 2013 ('Circular') issued to classify the contract research and development (R&D) centres of overseas MNEs as R&D centres bearing insignificant risk, does emphasize on the conduct of the parties rather than the contractual arrangement. The alignment of functional contributions and financial investment with legal rights is seen in the circular as well. The exercise of important functions by the foreign principal and control over service providers are factors that are in line with the OECD Guidelines.

Also, the jurisprudence in India, with respect to intangible transactions, emphasizes on the detailed analysis of the functions, assets and risks profile of the parties to the transaction and the contractual arrangements. Indian tax authorities have in recent audits raised the issue of the arm's length returns to entities that are not legal owners of intangible assets but are seen to have economic ownership. Depending on the facts and circumstances of the cases, such an approach by the Indian tax authorities would be in line with the revised guidance on intangibles if the conduct of the parties suggests such economic ownership.

1. Action 5 - Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
2. Forum on Harmful Tax Practices

There are also certain views of the Indian tax authorities that contradict the position in the revised guidance. The guidance that no separate compensation is required for location savings / location-specific advantages, if there exist local comparable uncontrolled transactions, may not find support with the Indian tax authorities. It is the belief of the Indian tax authorities that such an approach may not consider the benefit of location savings which can be computed by taking into account the cost difference between costs in the low-cost country and in the high-cost country from where the business activity was relocated. In this respect, it is pertinent to note that the jurisprudence in India is also of a similar view as presented in the revised guidelines, i.e., where local comparables are considered for determining the arm's length price of transactions, no separate compensation is required for location saving/local market features. The taxpayers, in addition to the available judicial precedence, can rely upon the revised guideline to support their argument.

Further, in the revised guidance, assembled workforce has been considered as a comparability factor and not an intangible, likely because work force cannot be owned or controlled by a single enterprise as per the definition of intangibles in the revised guidance on intangibles. However, the Indian TP regulations consider trained and organized work force as an intangible property requiring compensation for any related transaction.

Determination of the arm's length price of intangibles/rights in intangibles, as well as bearing cost associated with development/maintenance of intangibles, has been one of the most significant TP litigation in India, with amount under litigation exceeding thousands of crores. The revised guidelines discuss the application of the principles in specific fact patterns of development and enhancement of marketing intangibles (para 6.76 to para 6.78), research, development and process improvement arrangements (para 6.79 to para 6.80), payments for use of the company name (para 6.81 to para 6.85) along with several examples which are very relevant in the Indian context.

The 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[3]. The taxpayers can draw support from the revised guidance on such aspects (e.g., long-term contract by virtue of conduct, exclusive rights to do business in specified territory, performance and control of functions, etc.).

Way forward

The courts in India have often acknowledged the role of OECD TP Guidelines while applying the TP principles and, therefore, the revised guidance on the intangibles, and the guidance on comparability factors, is likely to impact both the tax authorities and taxpayers, warranting a review of the existing practices and arrangements. At this juncture, it would also be pertinent to refer to the recent ruling by the Delhi Tribunal in case of Baker Hughes[4] where ITAT, discussing with respect to the BEPS considerations, observed: *The judicial neutrality must not only be neutral vis-à-vis the party but also value neutral vis-à-vis competing ideologies. Judicial authorities are to interpret the law as it exists and not as it ought to be in the light of certain underlying value notions.* Considering all of the above, it would be interesting to see how the perceived impact of the revised guidelines unfolds in reality.

3. Sony Ericsson Mobile Communications India Pvt. Ltd. and others v. CIT, ITA No.16/2014, Delhi HC, Date of decision 16 March 2015
4. Additional Director of Income Tax Vs. Baker Hughes Singapore Pte Ltd (I.T.A. No.: 745 /Del/13)

Action Item 8-10 – Low value-adding intra-group services

Action 10 of the BEPS Action Plan focuses on developing transfer pricing rules to provide protection against common types of base eroding payments such as management fees and head office expenses. The revised guideline introduces an elective, simplified approach for low value-adding services and some changes/clarifications to other paragraphs of Chapter VII of the OECD transfer pricing Guidelines. The guidance on low value-adding intra-group services provides for achieving the necessary balance between appropriately allocating, to multinational enterprise [MNE] group members, charges for intra-group services, in accordance with the arm's length principle and the need to protect the tax base of payer countries.

The simplified approach, which a group may elect to adopt, recognises that the arm's length price is closely related to costs, allocates the costs for providing each category of such services to those group companies which benefit from using these services, using a consistent group-wide allocation keys with a small mark-up.

Low value-adding services

The guidance defines the low value-adding intra group services performed by one member or more than one member of an MNE group on behalf of one or more other group members which:

- are supportive in nature,
- are not part of the core business of the group,
- do not use or create unique and valuable intangibles, and
- do not involve significant risk.

The guidance provides examples of qualifying services (e.g. accounting and auditing, processing and management of accounts receivable and accounts payable, human resource activities etc.) and non-qualifying services (e.g. services constituting the core business of the MNE group, R&D services, manufacturing and production services etc.). For some services, a fact-specific functional analysis will be required.

Determination of arm's length charges for low value-adding intra-group services

A group that 'elects' to apply the simplified method is required to identify, on an annual basis, a pool of costs (direct as well as indirect) associated with categories of low value-adding services which are provided to multiple members of its group (excluding costs that are attributable to an in-house activity that solely benefits the company performing the activity such as shareholder activities and cost related to services performed solely on behalf of one other group member).

The costs so identified need to be allocated among members by selecting an allocation key, dependent on the nature of the services. It is expected that the same allocation key or keys should be applied in determining the allocation to all group companies of the same category of low value-adding services year on year unless there is a valid reason to change it.

The guidance provides that 5% mark-up on cost (excluding the pass-through cost) should be used for all low value-adding services, irrespective of the categories of services and the same does not need to be justified by a benchmarking study. Though, considering the concern raised by number of countries that excessive charges for intragroup management services and head office expenses constitute one of their major BEPS challenges, the deliverable also provides that countries may implement these provisions with the introduction of a threshold. In cases where the payments for low-value adding intra-group services required under the approach exceed this threshold, the tax administrations may perform a full transfer pricing analysis.

Supporting the charge for low value-adding services

Under the revised BEPS guideline, a simplified benefits test is recommended, whereby tax authorities should consider benefits only by categories of services. The application of approach is likely to reduce the compliance burden of the MNEs and provide them greater certainty while at the same time providing tax administrations with targeted documentation. The revised guideline provides that a single annual invoice, describing a category of services, would suffice to support the charge and correspondence or other evidence of individual services should not be necessary. Documentation would, inter alia, also include:

- Reasons justifying why the services meet the definition and expected benefits of each category of service;
- Written contracts or agreements for the provision of services and any modifications to those contracts and agreements
- Description and justification of choice of allocation keys and confirmation of mark-up applied;
- Calculations showing the determination of the cost pool and the application of the specified allocation keys.

The revised guidelines also encourage the tax administrations to levy withholding tax only to the amount of the profit element or mark-up included in the charge for low value-adding services (and not the total charge). This is a welcome move as in several cases, the tax required to be deducted by the tax authorities on the total payment cannot be utilised / observed by the taxpayer in its home jurisdiction, leading to cost in hand of the taxpayers.

India perspective

India, in its response to the United Nations' questionnaire on BEPS, had indicated that one of the major ways in which base erosion takes place is through excessive payments to foreign affiliated companies in respect of service charges, management and technical fees, royalties and interest. Thus, Indian tax authorities consider transfer pricing of intra-group services as one of the high risk areas, which is also clearly evident from the widespread litigation in India over the payment of intra-group services. The tax authorities in numerous cases have demanded quantification of benefit from each service received by the taxpayer and have challenged the payment on factors such as failure to demonstrate actual receipt of services, no benefits derived from the services, lack of documentation, etc.

While collation of documentary evidence and quantification of benefits received in monetary terms is a difficult and cumbersome exercise for taxpayers, the tax authorities continue to challenge the payments on various grounds mentioned above. The judicial precedence too has been mixed with judgements supporting both the taxpayers, as well as the revenue authorities. In several cases, the taxpayers as well as the judgements have also relied upon the financial performance of the Indian entity for justifying the charge; considering the fundamentals of transfer pricing, doing so may not be appropriate in all cases. However, being faced by flurry of queries raised by the tax authorities and request for demonstrating the benefits received from each and every service, taxpayers are also constrained to take every arguments irrespective of technical merit of arguments.

Considering the above background, the simplified approach to low-value adding services will be helpful for MNE groups, especially in instances where it has proved difficult or too costly to provide sufficient evidence to support what may be small amounts of individual charges across a wide number of jurisdictions, leading to double taxation. In addition, the simplified approach would reduce the burden of tax authorities, with limited resources, in respect of the routine low value-adding services.

Further, as per the revised guidance, the back-office / shared service centres may qualify for low-value adding intra-group services. The provision of such services may be the principal business activity of the legal entity providing the service (e.g. a shared service centre), however, from the MNE group's perspective, it may not form part of the core business activity.

In this respect, the mark-up of 5%, as provided in the revised guidelines for the low value adding intra-group services, is lower than the Safe Harbour rates prescribed by the Indian tax authorities, as well as the mark-up agreed in Advance Pricing Agreements/Mutual Agreement Procedures. Further, the mark-up required to be earned by the service providers has been a contentious issue in India, wherein the Indian tax authorities expect significantly high mark-ups. It is important to recognize that mark-up levels are determined by the economic condition of a jurisdiction; hence having a uniform global mark-up across jurisdictions may not be plausible.

The revised guidelines have several aspects which address various concerns of the MNEs (such as simplified approach, suggestion to withhold taxes only on the profit mark-up) while balancing the concerns/requirements of tax authorities (such as providing the option to set a threshold to address BEPS concern) at the same time. However, the benefit to MNEs in Indian context would depend upon the adoption of the said guidelines by the Indian tax authorities which, considering the past positions adopted by the Indian tax authorities, would not be an easy task. While the taxpayers would wish for adoption of these guidelines by Indian tax authorities, considering the litigation background in India in respect of services, and the way low value adding services are presently defined, the suggested approach in the revised guidelines is not likely to be adopted in its present form by the Indian tax authorities.

Action Item 13 – Transfer pricing documentation and country-by-country reporting

Global transfer pricing documentation will never be the same again, after the release of the final report on Action 13 in relation to transfer pricing documentation and country-by-country reporting.

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, that includes: a) a local file to provide an entity and transaction level transfer pricing analysis for each jurisdiction, b) a master file to provide a high-level view of a company's business operations and global transfer pricing policies, and c) a country-by-country report to provide a global financial snapshot of an multinational enterprise [MNE].

Transfer pricing local file

The local file is required to provide information and support of the intercompany transactions that the local company engages in with related parties. It needs to contain most of the information traditionally included in domestic transfer pricing documentation, though specific additional requirements have been introduced, that include:

- Local management structure and an organisation chart, and disclosure of local management reporting lines
- Details of intercompany transactions and financial information
- Detailed functional and economic analysis for the intercompany transactions:
  - With preference for local comparables
  - With search for comparable companies once every three years for same functional profile and annual data update
- Details of bilateral and unilateral APAs, and other rulings 'related to' the transactions of the entity.

The local file is to be filed locally and it is recommended that it be finalised by the filing date for the local tax return.

Transfer pricing master file

The report requires businesses to prepare a transfer pricing master file providing a high-level overview of the MNE's global operations along with an overview of the group's transfer pricing policies. The master file requirements include:

- Legal ownership structure chart, including geographies;
- Description of the business, including drivers of profit, supply chain for large products/services, important service arrangements including locations, capabilities, cost allocations and pricing;
- Description of overall strategy for development, ownership and exploitation of intangibles, including of principal R&D facilities and R&D management and details of intangibles related intra-group agreements (including related transfer pricing policies);
- Financing arrangements with third parties, group financing companies and their location and transfer pricing policies; and
- Financial and tax information including annual consolidated financial statements and details of unilateral APAs and other tax rulings relating to income allocation.

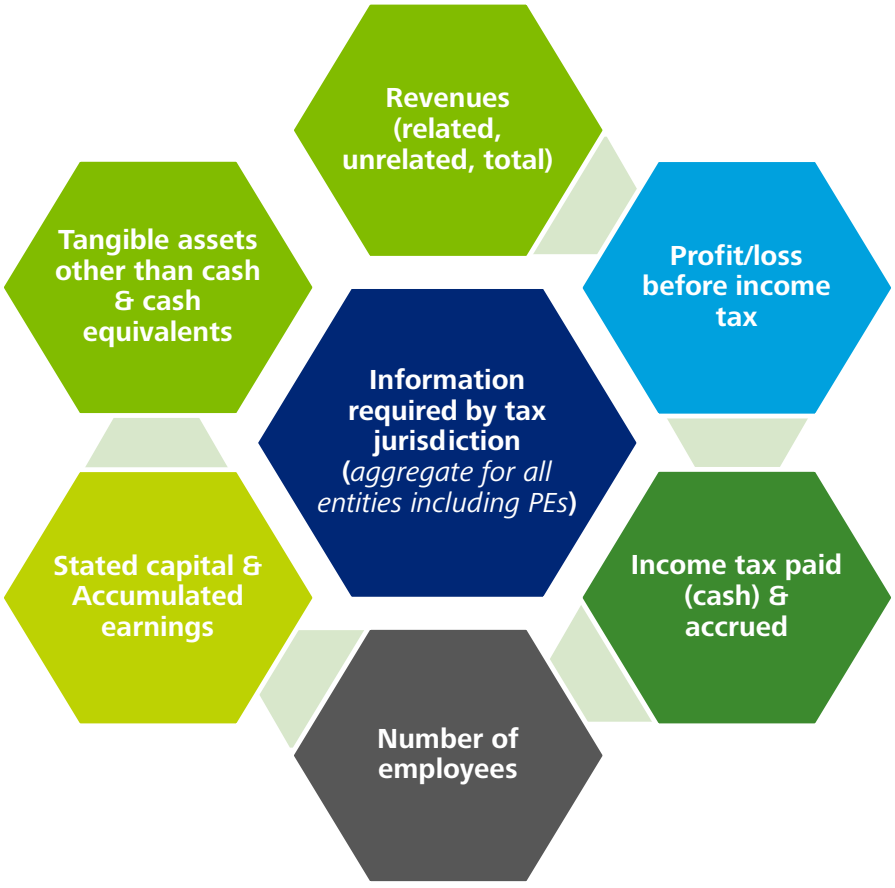
The master file is to be filed locally with tax authorities and it is recommended that the master file be finalised by the filing date for the tax return of the ultimate parent entity.

Country-by-country report [CbC]

The CbC report requires each MNE to provide key financial information on an aggregate country basis with an activity code for each member of the MNE. CbC report is a new concept for the international tax world and represents the biggest change to the existing Guidelines. The provision of the CbC report to the tax authorities is a 'minimum standard' requirement, and the report makes clear that countries participating in the BEPS project are expected to commit to and adopt this measure. It will provide tax authorities with global information for the purposes of risk assessment.

Multinational groups[5] with consolidated revenue of more than €750 million (or equivalent in local currency) in the previous fiscal year will have to file a CbC report. The filing requirement is effective for fiscal years beginning on or after 1 January 2016. The 'Reporting Entity' of the group will be required to file the CbC report, which will usually be the 'Ultimate Parent Entity', the company that prepares consolidated financial statements for the group. Alternatively, the group can nominate a 'Surrogate Parent Entity' that will be responsible for filing the CbC.

The CbC report should set out the specified financial data (diagrammatically represented) of the Group by tax jurisdiction, in a prescribed template together with a list of constituent entities[6] by country of residence and indication of their activities.



5. From an applicability perspective, a 'Group' is defined as a collection of enterprises related through ownership or control that is either required to prepare consolidated financial reporting statements, or would be so required if 'equity interests in any of the enterprises' were publically traded on a stock exchange.
6. 'Constituent Entity' being defined as any separate business unit of the group, including companies together with permanent establishments that prepare a separate financial statement for any purpose (including management control and tax compliance

The report provides for flexibility of data sources for preparation of the CbC report. Each MNE may choose to use data from its consolidated reporting packages, separate entity statutory financial statements, or internal management accounts. Each MNE is required to provide a short description of the sources of data used in CbC reporting and should use the same data source year on year (any changes in source data need to be explained). Additionally, no accounting adjustments or reconciliations are required.

Submission, exchange and use

The CbC is to be filed in the tax jurisdiction of the ultimate parent entity (or nominated surrogate parent entity) and will be exchanged widely by governments, including with many developing countries, via various sharing mechanisms. If the CbC report is not filed with and shared by the tax jurisdiction of the ultimate parent company (or the nominated surrogate), then companies may be required to file the CbC report locally. The report includes three model competent authority agreements that can be used by tax authorities to facilitate implementation of the exchange of CbC reports. The agreements make it clear that information shared as a result of these agreements must be kept confidential and used appropriately. In particular, the agreements emphasize that the information should not be used as a substitute for detailed transfer pricing analysis of individual transactions based on full functional and comparability analysis, and that transfer pricing adjustments should not be made on the basis of the CbC reporting alone.

Timelines

The CbC reports are required to be filed annually within 12 months of the end of the financial reporting year. In addition, each constituent entity will need to notify their local tax authority by the last day of the financial reporting year either (i) that it will be filing the CbC report for the year, or (ii) the name and tax residence of the company that will file the report for that fiscal year. Tax authorities will be required to share the CbC report with other relevant tax authorities within 18 months of the end of the financial reporting year for the first year (then within 15 months). Therefore the first CbC report would be required to be filed by 31 December 2017, which then would be shared with other relevant tax authorities by 30 June 2018. Thus, the CbC report may be one of the first initiatives to be implemented under the BEPS Action Plan.

The G20/OECD are developing an XML Schema and a related User Guide to allow for electronic tagging of data in the CbC reports to facilitate their exchange electronically. Countries will be monitored on their implementation of the CbC reporting requirements and associated exchange of information. The G20/ OECD governments have agreed to review the standards to ensure they are working effectively by 2020.

India perspective

The Indian transfer pricing regulations (Section 92D read with Rule 10D of the Income Tax Rules 1962) require every person who has entered into an international transaction to maintain prescribed information /documents for substantiating the arm's length price (ALP) of its transactions with the related parties. While the above documentation requirements broadly cover most of the content of local file, the Indian transfer pricing regulations presently do not provide maintenance of the information contemplated in the Master file and CbC template (and the additional requirements of local file). Accordingly, under the Indian transfer pricing regulations, additional rules will need to be framed to provide for maintenance of information contained in the Master file and CBC (and the additional requirements of local file).

Given that the CbC reporting requirements are to be implemented for fiscal years beginning on or after 1 January 2016, in the Indian context, data for Indian entities may be reported for the financial year beginning 1 April 2016. Accordingly, it is expected that the Indian tax authorities will introduce the legislation incorporating the required amendments before April 2016, through the annual Finance Bill (typically introduced in February) or through separate notifications.

The report has prescribed a threshold of consolidated group revenue of more than €750 million (or equivalent in local currency) in the previous fiscal year, as the requirement for filing the CbC report. Indian authorities have indicated that in the Indian legislation they may maintain the same global threshold in Indian currency (INR equivalent of €750 million, i.e. INR 5250 crores approx).

With reference to the local file, the reporting requires disclosure of only material transactions, without specifying the materiality thresholds. Each country considers materiality thresholds based on factors like size and nature of the economy, importance of the MNE group in the concerned economy and size and nature of the local operating entity. Therefore, it needs to be seen what measure of materiality would be adopted in India as Indian transfer pricing regulations currently stipulate reporting of all transactions.

Further, India together with few countries from emerging markets have expressed the requirement for additional transactional data (beyond that available in the master file and local file) regarding related party interest payments, royalty payments and especially related party service fees, which MNEs having Indian operations need to bear in mind. Accordingly, countries will carefully review the implementation of these new standards and will reassess no later than the end of 2020 whether modifications to the content of these reports should be made to require reporting of additional or different data.

Way forward

The new guidance will provide tax authorities with substantial information and transparency regarding the financial results of a taxpayer's global transfer pricing policies. This increase in global transparency is likely to mean that deviations from a company's transfer pricing policy or the implementation of that policy will become more apparent to tax authorities around the world. Therefore, 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. Businesses are likely to find it necessary to prepare or coordinate their transfer pricing documentation centrally to ensure that the CbC report, master file and local files provide consistent information about global and local operations and transfer pricing policies.

Thus, it is important for MNEs 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 as well as prepare for greater level of scrutiny by the tax authorities.

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