Emerging trends in BEPS arena

Background
OECD’s BEPS Project was launched after one of the most severe financial and economic crisis period during 2008, with an ambitious goal: to revise the tax rules to align them to developments in the world economy, and ensure that profits are taxed where economic activities are carried out and the value is created. OECD identified 15 actions centred along three fundamental pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards and improving transparency, as well as certainty for businesses that do not take aggressive positions.

OECD and UN have been prompt in embracing BEPS recommendations through their revamped articles and commentaries in relation thereto. The recently introduced Multi-Lateral Instrument (MLI) is a medium to effect simultaneous modification of tax treaties on the suggested lines. In this context, in November 2016, over 100 jurisdictions concluded negotiations on the MLI.

Alongside the MLI, several countries have begun to unilaterally amend its domestic laws to incorporate the BEPS recommendations. The UK Diverted Profits tax, the Australian Multinational Anti-Avoidance Law (MAAL), the “Significant Economic Presence” test by Israel, Italy’s levy on digital transactions, Hungary’s advertisement tax, France’s tax on online and Physical distribution of audio-visual content and Virtual Service PE rules in Saudi Arabia. The European Commission has also issued draft directives on the taxation of digital economy. The Tax Reforms recently enacted by US Congress also significantly modifies key areas of US tax law, including many international tax provisions. These changes will have far-reaching implications, both domestically in the US, as well as in a cross-border context. Provisions like BEAT under the US tax reforms clearly signify the country’s need to protect its tax base. We expect this trend to continue as countries around the world go about protecting its tax base.
Being a proponent of the BEPS project, the Indian tax landscape has also seen radical changes over the last few years with the renegotiation of its tax treaties with Mauritius, Cyprus and Singapore, the introduction of the buyback tax, introduction of equalisation levy, limiting interest deduction, phasing-out of tax holidays, introduction of GAAR and more recently, revision of agency PE definition and introduction of concept of Significant Economic Presence as part of its domestic law to tax digital economy. India signed the MLI along with 67 other jurisdictions on 7 June 2017. Some of these emerging trends are discussed below:

### Permanent establishment (“PE”) definition rehashed

Have you reviewed the activities carried on by the Indian entities on behalf of the overseas concern under the refreshed PE definition?

- Amongst the key actions, modifications to the Model Tax Conventions have been suggested to ensure that treaties solely aim at elimination of double taxation, rather than being medium of structuring transactions leading to erosion of country's tax bases viz. through dual residency, splitting up contracts, artificial avoidance of PE status, etc. As per BEPS Action Plan, the minimum standard in the area of treaty shopping will ensure that treaty benefits are only granted to those entities that are entitled to them. The definition of Permanent Establishment has been modified to better reflect today's business reality and avoid widespread circumvention of the principle that underlines it.

- One such modification is a significant change to the definition of “agency PE”. The traditional definition covered only situations where there is a formal conclusion of contracts by the agent in the source jurisdiction. The new definition seeks to include activities of agents “playing a principal role leading to the conclusion of contracts”.

- In line with BEPS recommendations, India has already amended its domestic law and adopted the agency PE definition via Finance Act 2018, which is applicable from 1 April 2019 and onwards. This change has been bought to bring domestic law at par with the tax treaty which will be amended post applicability of MLI.

- In view of these developments, organisations must exercise care and diligence in reviewing their arrangements in India. It is not only critical to review the scope of arrangement in terms of the authority given, but also check periodically whether it is followed in substance.

### The long drawn debate - exclusion from PE: core activities vs. non-core activities

- An exclusion from a fixed place PE has been granted under the tax treaties, for certain activities. These include the use of facilities solely for the purpose of storage, display or delivery of goods, or for collecting information or for purchase of goods.

- Tax authorities have often felt the need to evaluate corporate operational structures on a holistic basis rather than review it in piece meal as applicable to the individual jurisdiction. The idea over here is to evaluate whether the supply chain has been realigned in order to optimise tax.

- The anti-fragmentation rule proposes to address fragmenting operations in different jurisdictions to obtain a tax advantage. In addition to this, every exclusion from a PE will specifically be suffixed with the condition that the exclusion will be available only if the activity carried on is that of a preparatory and auxiliary nature.

- The amended provision will ensure that a business’ core activities cannot inappropriately benefit from the exception for preparatory and auxiliary activities, and that the PE status will no longer be circumvented via the use of commissionaires or similar structures, or via the fragmentation of activities among different group entities.

- Organisations will need to review the operational structure from a global perspective, to identify if any structure does result in a tax advantage. This will include review of the sourcing function, purchase function, production, research and development, parking of the IP rights, sales and marketing activities and finally the delivery of products under different arrangements.

### The digital era and the interpretation of PE in the context of e-commerce

- With digital transformation that industries at large are undergoing, the need to have a physical presence in order to conduct transactions is rapidly disappearing. This enables companies to transact and sell into geographies with no physical presence. In other words, tax authorities could potentially have issues in determining a PE–historically PE being associated to a physical/geographical presence– and then attributing profits to the transactions. This was an issue dealt with in depth under Action 1 of the BEPS report.

- OECD’s interim report of March 2018 on ‘Tax Challenges arising from digitalisation’ indicates that countries have divergent views on the need to address the challenges of the digital economy. Digital economy, characterised by cross-jurisdictional scale without mass reliance on intangibles, and data and user participation, is an area where the impact of BEPS is likely to be seen gradually but significantly in the next few years. Current digital businesses models are largely Value Chains (Online retailer model), Value Network (Collaborative Platform Model) or Value Shop (on demand solving/transforming).
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• Taxpayers in the e-commerce and digital space may no longer be able to effectively establish structures that separate the income from the value-added activities of their business (which itself is being debated), a phenomenon that was particularly intensified by the key features and business models of the digital economy. The BEPS measures, and in particular the ones on PE and transfer pricing, will also address BEPS issues intensified by the digital economy. Possible technical options have been proposed to deal with the broader challenges raised by the digital economy. The country of taxation of business profits and the allocation factors in light of the economic reality is a subject matter of great debate in the context of digital economy and the BEPS Action Plan seeks to address these aspects. The options include alternatives to the existing threshold for taxing non-residents (a “significant economic presence” test); the imposition of a withholding tax on certain types of digital transactions; and the introduction of an “equalisation levy”. We expect more from OECD on this in the coming years, for example, consensus is required on the value drivers such as users, importance of data or the tax issues arising out of data localisation on account of domestic regulatory requirements.

• In India, domestic tax law has been amended to include that where a non-resident has a Significant Economic Presence (SEP) in India, then, that could trigger a taxable presence.

• The insertion of this definition has raised questions on the interpretation of the definition and the application to facts. For example, other than the “revenue threshold” and “user threshold” for which there could be a guidance, there is no clarity as to what other factors could be applied and how will these factors address the situation. The Central Board of Direct Taxes (CBDT) has recently sought public/stakeholder’s comments in respect of “revenue threshold” and “user threshold”. The final circular may throw some light on aspects besides laying down thresholds.
Physical presence not necessary to satisfy the definition of “service PE”?

- Traditionally, the term “furnishing of services” used in a typical tax treaty in respect of “service PE” required physical presence of employees or other personnel in the source jurisdiction to trigger “service PE” based on number of days of stay in the source jurisdiction. Recently, in the case of ABB FZ LLC, the Bangalore Tribunal observed that physical presence is not a criteria. This means that the term “furnishing of services” can be stretched to include services performed from a remote location provided the other requirements of the PE definition are met (e.g., duration test). This broad interpretation, sometimes referred to as the “virtual service PE”, has its own ramifications.

- The above interpretation is open to debate. However, if interpreted in the above manner, the impact could potentially go far beyond online activities, and include any remote services supplied to a market (e.g., consultancy services, call centres).

Permanent Establishment (PE) triggered under any of the above scenarios - Transfer pricing perspective

- With the proposed changes in Action 7 of the BEPS report and their adoption in domestic laws and bi-lateral treaties (by the way of MLIs), it is conceivable that more PEs will be asserted. Determination of profits attributable to a PE has historically been a litigious transfer pricing issue. Profits that are attributable to the PE ought to be attributed in compliance with the arm’s length principle, from a transfer pricing perspective.

- Accordingly, it has become critical to identify and address the implications of Actions 8-10 - Aligning transfer pricing outcome with value creation, which would impact the determination of whether the profits attributable to the PE are at arm’s length.

- While BEPS Action 8 to 10 discusses about aligning transfer pricing with value creation, the definition of what is value creation is not clearly defined. The BEPS Action 8 to 10 refers to certain factors that could result in value creation. E.g., location of employees, location of customers,
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production capacity etc. Thus, the idea of value creation is open for interpretation based on specific facts with limited guidance available. Therefore, a robust transfer pricing analysis on the touchstones of the OECD recommendations in Action 8-10 and extent of people functions exercised/risk assumed by the enterprise in the source state would be key factors for determination of profit to PE’s (established under any scenarios, whether fixed place, agency or service PE).

- Further, given the focus on aligning transfer pricing outcomes with value creation and the enhanced reporting requirements under Action 13, the detailed analysis of the value chain is going to be extremely crucial. This analysis should be undertaken comprehensively for the entire value chain vis-à-vis the single sided approach for a transaction, adopted in the past.
- Also, the Non Residents with Liaison Offices/marketing activities in the source state would require to evaluate their activities more closely and need to take into account the combined functional analysis, in cases where they also have presence in the source state in some other form or if any group company has a presence. Separately, additional PEs emanating from the anti-fragmentation rules could also pose similar challenges (mentioned above) in relation to the tax and transfer pricing implications and compliances for the PE. Further, given the nature of Digital Economy, where operations are largely based on intangible assets, economic ownership of intangible assets and allocation of revenue generated by them would be based on the functional and risk profile of the key entities contributing to value creation. A detailed transfer pricing analysis would also be required to defend a transaction from a GAAR perspective.
- It is imperative to note that BEPS Actions 13’s focus on transparency has resulted in tax authorities globally getting access to transfer pricing documentation for the group and their jurisdictions. Accordingly, PEs will need to ensure that the information submitted in the three-tier documentation is consistent and there is coherence in disclosure made through all three reporting
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(Pursuant to the end of the first year of compliances, having access to the significant data through the Action 13 disclosures, revenue authorities will be well equipped to undertake the next step to analyse data and make targeted enquiries to undertake a high level BEPS risk assessment.

In view of these developments (and given the extent of information disclosed in the CbC Report and Master File), from a readiness perspective, organisations should endeavour to perform a robust transfer pricing analysis to enable them to undertake a proactive risk assessment to be prepared for queries likely to be raised by the tax authorities.

General anti-avoidance Rule in India:

- Domestic anti avoidance rules is another trend which we are witnessing in some of the jurisdictions. General Anti-Avoidance Rule ["GAAR"] is effective in India from 1 April 2017 and is broadly applicable, where the revenue authorities believes that a transaction has been arranged in a manner where the main purpose of the arrangement (whether whole or part) is to obtain a tax benefit; and such arrangement satisfies at least one of the conditions laid down therein.

- Generally, there may be business justification to execute a transaction in a particular manner. Further, where there is an option to execute a transaction in different ways, the tax payer is likely to adopt an option entailing least tax cost. However, challenge from revenue authorities cannot be ruled out if the business justifications are not robust enough.

- Further, business decisions such as “change of business model”, “choice of business entity”, etc. could also be scrutinised under GAAR, besides restructuring decisions such as “merger”, “demerger”, etc. What is relevant to note is that GAAR not only apply to complex structuring transactions but some of the routine transactions undertaken by taxpayers could also pose a challenge.

- Taxpayers thus need to evaluate the readiness in light of the evolving provisions under GAAR.
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Closing remarks:
The key drivers of evolving global tax policies are not only in terms of raising of revenue and redistribution of wealth, but also regulating corporate behaviour. MNEs will need to be increasingly mindful of evolving trends and seek to balance business growth with effective management of tax and financial risks. In a world of constantly evolving global tax norms, it is of utmost importance for MNEs to constantly track the global tax and transfer pricing policy changes and evaluate its corresponding impact on the business models and supply chain.