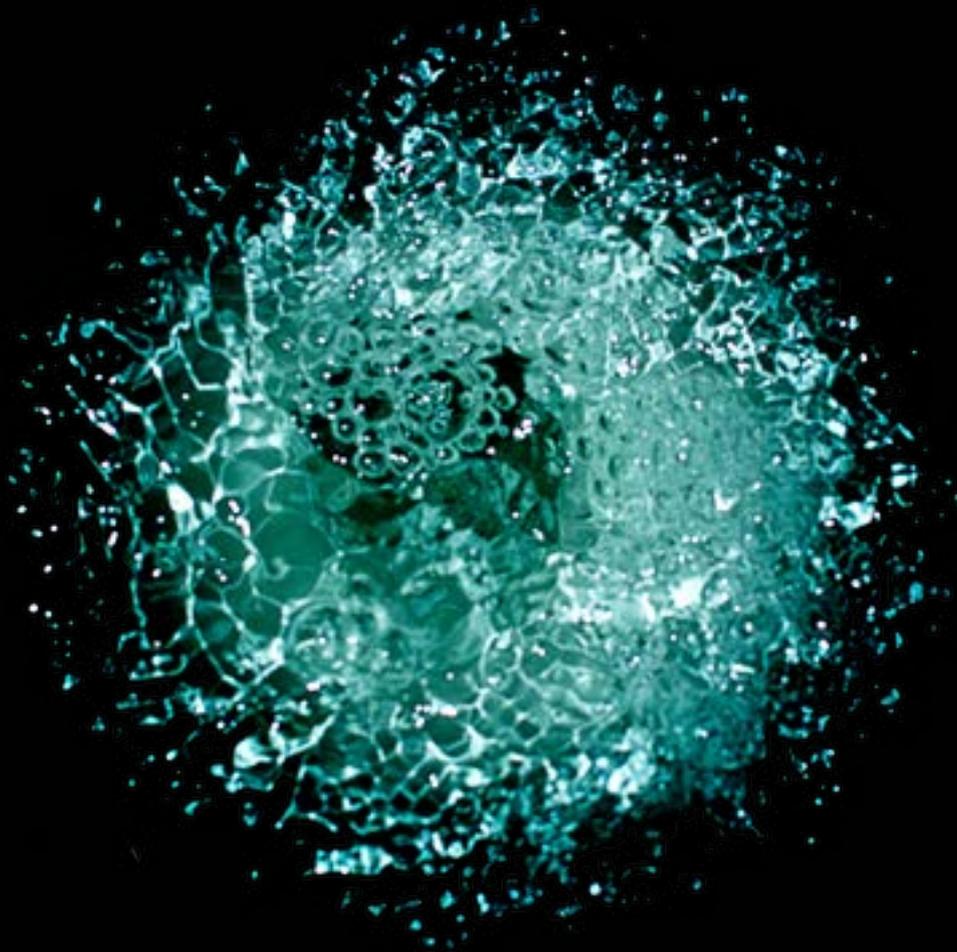


Deloitte.



**Base Erosion and
Profit Shifting [BEPS]**
Analysis and India perspective
2017

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Introduction

For past few years, the Organisation for Economic Co-operation and Development [OECD] and G20 countries have actively worked on base erosion and profit shifting [BEPS] project. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profit 'disappear' for tax purpose or to shift profits to locations where there is little or no real activity but taxes are low, resulting in little or no overall corporate tax being paid. The OECD and G20 has released their recommendations on BEPS action plans (15 action plans) on 5 October 2015.

The BEPS action plans are structured around three fundamental pillars:

- Introducing coherence in domestic rules that affect cross-border activities: These actions include aspects relating to limitations on interest deductions, countering tax avoidance using hybrid mismatches, challenging harmful tax practices, etc.
- Reinforcing substance requirements in international standards to ensure alignment of taxation with the location of economic activity and value creation: There are aspects to prevent tax treaty abuse (i.e. treaty shopping), strengthen rules relating to creation of a permanent establishment for taxation in the source country, ensuring transfer pricing outcomes are in line with value creation in relation to intangibles, etc.

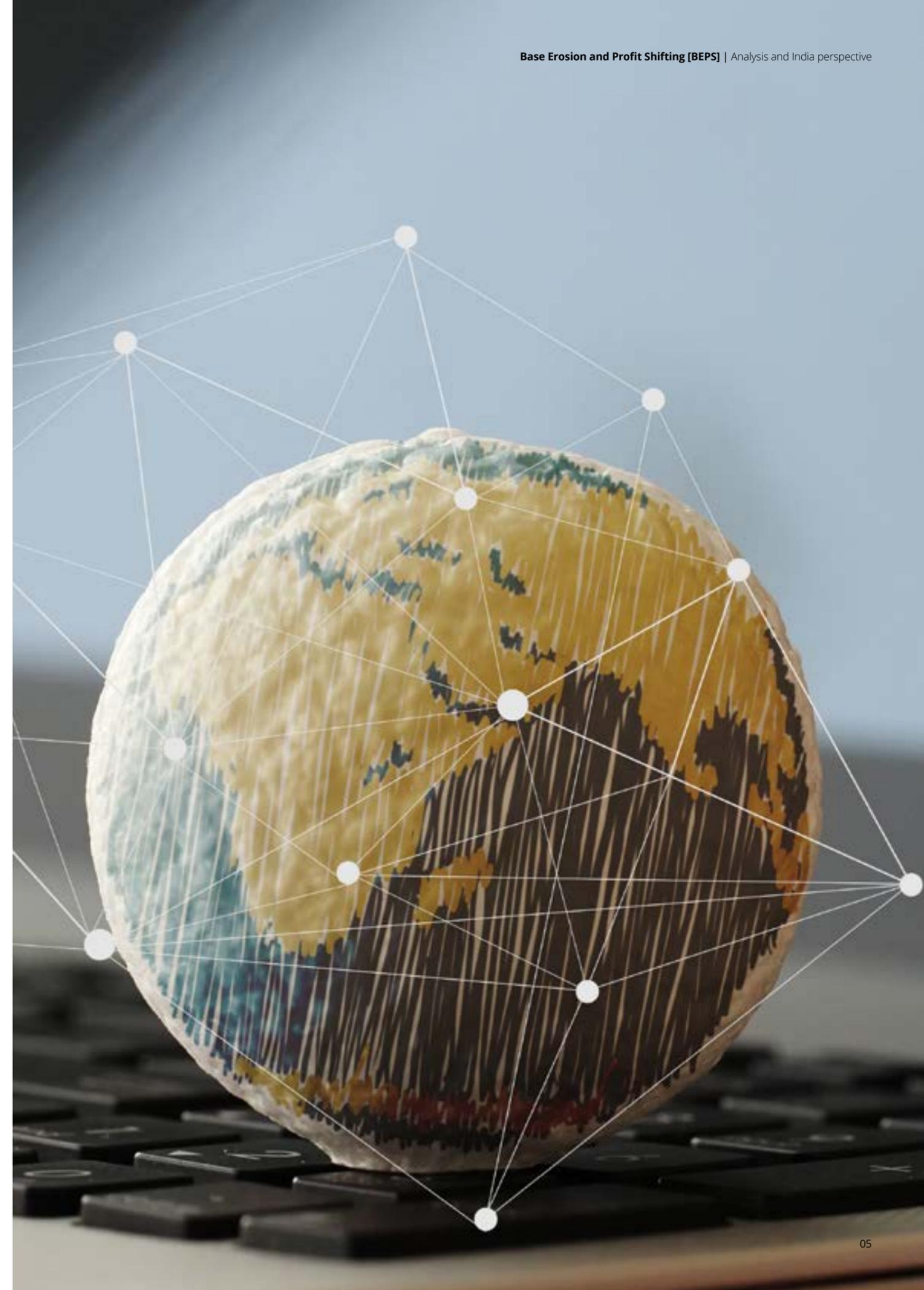
India is committed to the BEPS outcome

- Improving transparency, as well as certainty for businesses and governments: The key action relates to transfer pricing documentation, which will provide significant information to the revenue authorities in relation to global operations and financial information of companies.

The BEPS action plans also deal with the digital economy across all the three areas discussed above.

As a member of G20 and an active participant of the BEPS project, India is committed to the BEPS outcome. To implement the BEPS actions, India has been amending its domestic tax law as well as tax treaties.

This publication analyses key issues around BEPS as well as outlines the Indian perspective in relation to these issues.



Preventing treaty abuse and counter harmful tax practices

Tax treaty abuse

Treaty abuse and in particular, treaty shopping is the most significant source of BEPS concerns as governments are probing ways to tackle this issue.

Treaty shopping can be defined as the use of the tax treaty by a person who is not the resident of either of the treaty countries, usually through the use of a conduit entity resident in one of the countries. The major concern for the developing and emerging economies like India is that they face no taxation or lower taxation where a person takes advantage of the treaty in an unintended manner.

BEPS Action 6 targets tax treaty shopping by multinational enterprises that establish 'letterbox', 'shell' or 'conduit' companies in countries with favourable tax treaties - although such companies exist on paper, they may have no (or very little) substance in reality and may exist only to take advantage of tax treaty benefits.

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

01. To clarify that tax treaties are not intended to be used to generate double non-taxation.
02. To identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.
03. 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 this action, recommending measures to combat treaty shopping and treaty abuse through agreed minimum standards, with some flexibility in the implementation of these standards, in order to allow adaptation of each country's specific circumstances and negotiated bilateral tax treaties. The final version of the report supersedes the interim version issued in September 2014 with number of changes to the rules proposed in the September 2014 report.

BEPS Action 6 targets tax treaty shopping by multinational enterprises that establish 'letterbox', 'shell' or 'conduit' companies in countries with favourable tax treaties

The report is divided into 3 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. For this purpose, countries would implement in their tax treaties:

01. The combined approach of an LOB and PPT rule;
02. The PPT rule alone; or
03. The LOB 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:

01. Dividend transfer transaction that artificially lower withholding tax on dividends;
02. Transaction that circumvent the rule that prevents source taxation of sale of shares deriving value primarily from immovable property;
03. Dual residency of entities;
04. 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

The Indian Government has recognised that treaty shopping results in tax leakages

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 they should enter into a tax treaty and also whether they should modify (or ultimately terminate) a treaty in the event of change of circumstances.

India perspective

Historically, the Indian jurisprudence has respected the form of the transaction, unless the form itself is sham, and thus, have rejected the approach of the tax authorities to deny treaty benefits on the ground of treaty shopping. The Supreme Court in the landmark judgement of Azadi Bachao Andolan, has held that in absence of LOB clause in the tax treaty, treaty benefit would prevail. This principle has been reiterated in the Vodafone case as well. The Court held that in the absence of LOB rules in a tax treaty, the tax treaty benefit cannot be denied unless the tax authorities establish on facts that the company has been interposed (as the owner of shares in India) at the time of disposal of shares to a third party solely with a view to avoid tax and without any commercial substance.

Coming to treaty negotiations, India has been asserting upon inclusion of a clause in the tax treaties to combat treaty shopping where multinational enterprises take benefits of a favourable tax jurisdiction. An example is the clause introduced in the India-Singapore tax treaty for determining the eligibility to claim exemption from capital gains tax. The India-Singapore tax treaty also provides for an expenditure test i.e.

considering the substance of the entity for granting treaty benefits.

Certain tax treaties which India has concluded contains LOB rules on the lines of that contained in the India-US tax treaty (for e.g. tax treaties with Armenia, Iceland and Mexico). On the other hand, the India-Kuwait and India-Finland tax treaties contain a clause in respect of arrangement of affairs with the main purpose of avoiding taxes i.e. the PPT rule. Hence the taxpayers have to convince the tax authorities that the transactions have not been carried out with the primary purpose of tax avoidance. The India-Luxembourg tax treaty, apart from the PPT rule, also contains a provision for supremacy of domestic anti-abuse provisions.

India has also initiated the process of renegotiating some of its existing bilateral tax treaties, to combat treaty shopping by inserting anti-abuse rules. Recently India's tax treaties with Mauritius, Singapore and Cyprus have been amended to provide anti-abuse rules on taxation of capital gains.

On the legislative front, the Indian Government has recognised that treaty shopping results in tax leakages. Therefore, over the past few years, the Indian government has been working to tighten the rules in the Indian tax law for granting tax treaty benefits. India has included various clauses in its domestic law, some of which are as under:

- mandating requirement to furnish a tax residency certificate along with a self-declaration confirming certain basic information, as a minimum threshold to claim tax treaty benefits;

The proposed Indian GAAR also overrides tax treaties, which is consistent with the OECD commentary on anti-avoidance rules

- the provision of levying higher withholding tax in the absence of Indian PAN/ specified documents;
- reporting and taxing of indirect transfers materially modifying the ownership structure or control of an Indian entity;
- adoption of place of effective management as a threshold for determining residency; and
- limiting interest deduction on borrowings from non-resident associated enterprises.

Additionally, in 2012, the Indian Government codified the general anti-avoidance rule [GAAR], though the implementation has been made effective from 1 April 2017. Interestingly, the implementation of GAAR was deferred in 2015, to be aligned with the BEPS actions.

The PPT rule as recommended under Action 6 of BEPS is akin to the main purpose test as proposed under the Indian GAAR. The Indian GAAR would empower the revenue authorities to go deeper into the transactions and/or arrangements (e.g. looking at ownership structures, beneficial ownership, voting rights, etc.) and would enable them to draw inference, whether a particular entity is a conduit entity without any real economic substance/activity with the main purpose being obtaining a preferential tax benefit.

The Indian GAAR also overrides tax treaties, which is consistent with the OECD commentary on anti-avoidance rules – this is specifically included in various bilateral treaties that India has entered into e.g. the India-Luxembourg, India-Malaysia and other tax treaties signed by India with Singapore, Israel, Indonesia, Korea, Macedonia and Thailand.

To conclude, the GAAR and LOB/PPT rule may impact intermediate holding companies for investing into India, which lacks 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 LOB/PPT rule and anti-avoidance rules.

The latest update on this is the signing of the Multilateral Instrument ('MLI') under BEPS Action 15. India has signed on the minimum standard for tax treaty abuse applicable to all Indian tax treaties by adopting the PPT and simplified LOB. Moreover, it has introduced the

express statement in the preamble of the treaties that common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.

Counter harmful tax practices

Action 5 of BEPS aims to identify and counter harmful tax practices, taking into account transparency and substance. The Action looks at developing recommendations on the definition of harmful tax practices, and developing a strategy to expand to non-OECD members. The final report released on 5 October 2015 establishes minimum standards with regard to both determining whether preferential regimes take sufficient account of the need to reward only substantial activities, and ensuring that there is transparency in relation to rulings. It also sets out minimum standards for domestic law provisions in respect of intellectual property [IP] regimes, such as patent box regimes.

Several approaches have been considered to determine a lack or otherwise of substantial activity. The OECD has achieved consensus on the 'nexus approach'. The nexus approach uses expenditure as a proxy for activity, and this principle can be applied to all types of preferential regimes. In the context of IP regimes, a relevant connection (i.e. a nexus) is to be established between firstly, taxpayer's performance of R&D which resulted in development of the IP asset, and secondly, taxpayer's income from the IP asset.

The IP regimes have been considered as inconsistent, either in whole or in part, with the nexus approach as described in the BEPS report. Hence, countries with such regimes will now proceed with a review of possible amendments of the relevant features of their regimes.

The OECD has achieved consensus on the 'nexus approach' to determine a lack or otherwise of substantial activity

The report also analyses non-IP regimes as existing in different countries. As regards Indian non-IP regimes, it has been concluded in the report that the following regimes are not considered as harmful from the BEPS perspective, subject to analysing these regimes in the context of the 'substantial activities' test:

- Deductions in respect of certain incomes of offshore banking units and international financial services centre
- Special provisions in respect of newly established units in special economic zones
- Special provisions relating to income of shipping companies – tonnage tax scheme
- Taxation of profits and gains of life insurance business

Improving transparency effectively would mean a framework for the compulsory spontaneous exchange of information, between tax authorities, on taxpayer-specific rulings.

Thus, BEPS proposes to revamp the work on harmful tax practices requiring substantial activity for preferential regime.

India perspective

India has always been an advocator of the substantial activity test and does not have a harmful IP or other regime. A framework for mandatory spontaneous exchange of certain preferential rulings will further strengthen the automatic exchange of information, to which India has consented to be a part of.

From an Indian perspective, this action is likely to impact Indian multinational enterprises that have opted for some of the 'harmful' IP regimes in overseas jurisdictions.

India has introduced a special regime for taxation of income from patents taking a cue from Action 5 of BEPS. This regime is applicable from financial year 2016-17 and covers existing and new patents. The royalty income from patents developed and registered in India is taxable at 10 percent (plus surcharge and education cess) on the gross amount of royalty. No expenditure or allowance is allowable in such cases. The benefits of this regime is available to a person resident in India, who is the true and first inventor of the invention and whose name is entered on the patent register as the patentee in accordance with Patents Act, 1970.

Intangibles: Addressing alignment of ‘outcomes with value creation’

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, introduced guidance to 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’).

Definition of intangibles

The guidance also provides a broad definition of intangibles. The new guidance defines an intangible as something i) that is not a physical asset or a financial asset, ii) that is capable of being owned or

The guidance clarifies that legal ownership and funding by an entity, without performing any of the important functions in relation to the intangible, does not necessarily generate a right to all of the intangible related return

controlled for use in commercial activities; and iii) whose use of transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.

This definition of intangible acknowledges the existence of intangibles, irrespective of accounting for / reporting of intangibles in financials by the MNE. The new guidance notes that a transfer pricing analysis should carefully consider whether an intangible exists and whether an intangible has been used or transferred. 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.

Intangibles for tax purposes

Patents
 Know-how and trade secrets
 Trademark, trade names and brands
 Rights under contracts and government licenses
 Licenses and similar limited rights in intangibles
 Goodwill and ongoing concern value

Not intangibles for tax purposes (not owned or controlled by a single associated enterprise)

Group synergies
 Market specific characteristics
 Assembled workforce



Entitlement to return from intangibles

The report emphasises 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 analysing 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).

According to the new guidance, to be termed and priced as an ‘outsourced service’, the control over such services (considered as ability to understand and evaluate the performance of functions, and taking the final decisions regarding important aspects) needs to be exercised by the enterprise claiming entitlement of intangibles related return. Accordingly, an enterprise neither performing nor controlling the important functions and

The guidance seeks to ensure that economic analysis will not be weakened by information asymmetries between the tax administration and the taxpayer

not assuming relevant risks, would not be entitled to intangible related returns. The 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.

Addressing information asymmetries

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 guidance 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]. 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.

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. Therefore, businesses could expect more audits and adjustments in relation to the pricing of HTVI and would be required to prepare a robust documentation considering all assumptions used for preparation of projections and valuation of the HTVI.

The discussion draft also provides that MAP will apply to disputes in respect of HTVI as it applies to other treaty-related transactions – this will assist businesses in resolving complex disputes relating to pricing of HTVI through MAPs.

Comparability and options realistically available

Supplemental guidance regarding transfers of intangibles or rights in intangibles, including comparability, has also been provided in the 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 guidance provides for evaluating the options realistically available to the parties and cautions that one-sided comparability analysis would be insufficient. The 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 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.

It is also interesting to refer to Action 5¹, where FHTP² 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

Some of the important guidance by OECD and its relevance in the Indian context has been discussed below.

R&D activities and resulting intangibles

With the establishment of numerous research and development [R&D] centres in India, abundant availability of talent pool, discussions on transfer pricing aspects of intangibles have dominated the Indian TP landscape in the past few years. In respect of such R&D centres, there has been debate over the entitlement of both parties over the intangibles related return.

The 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 guidance are in line with the practices followed by the Indian tax authorities. The guidance, for instance, emphasises 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 issued to classify the contract R&D centres of overseas MNEs as R&D centres bearing insignificant risk, does emphasise 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 and accordingly, on this aspect the view of Indian tax authorities appears to be aligned to the OECD. Also, the jurisprudence in India, with respect to intangible transactions, emphasises on the detailed analysis of the functions, assets and risks profile of the parties to the transaction and the contractual arrangements and their comparability with the selected comparables. Therefore, as BEPS guidance is more and more internalised by TP authorities as well as practitioners, it is likely that TP audits would have a greater focus on functional characterisation.

Marketing intangibles

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 guidelines discuss the application of the principles in respect of development and enhancement of marketing intangibles (para 6.76 to para

The taxpayers can draw support from the revised guidance for supporting their contention on marketing intangible / location savings

6.78), along with several examples which are very relevant in the Indian context.

It is pertinent to note that the guidance, as in the original draft guidance, discusses the concept of marketing intangible in case of a distributor and not for manufacturers. However, the Indian revenue authorities have applied the concept of marketing intangible irrespective of the functionality (distributor/ manufacturer) and characterisation (limited risk / entrepreneur) of the Indian entity.

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 and therefore, separate remuneration from overseas entity for such activities is not warranted.

Also, the 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 others³. The taxpayers can draw support from the 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.) while putting forth the contentions. However, it remains to be seen if and how the BEPS Guidance impacts the view of

Indian revenue authorities. It is important to note that several court rulings⁴ have emphasized that tax authorities need to demonstrate existence of an "arrangement" between Indian entity and the overseas entity for the marketing spend before raising concern over compensation payable to Indian entity for developing marketing intangible. Considering the same, the guidance on intangible in BEPS and increased focus on the granular functional analysis, it is likely that TP audits would have a much greater focus on arrangement between Indian taxpayer and overseas group entities for the marketing and advertisement in India (including factors such as global marketing strategy, communication between Indian entity and overseas entity regarding marketing/advertisement in India, role of overseas entities in finalisation of Indian marketing content, Indian marketing budgets, modes of advertisement etc.).

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

² Forum on Harmful Tax Practices

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 Notably Maruti Suzuki India Limited vs CIT, Delhi High Court, ITA No. 110/ 2014 and ITA No. 710/ 2015; dated 11 December, 2015 "

Location savings/location specific advantages

The OECD guidance states that no separate compensation is required for location savings / location-specific advantages, if there exist local comparable uncontrolled transactions. But, the Indian tax authorities believe that there is benefit from location savings which can be computed by taking into account the difference between costs across countries. In this respect, it is pertinent to note that the jurisprudence in India (decision in case of Watson Pharma) and the views expressed in Rangachary Committee report on Safe Harbour Rules are in line with the view presented in the 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 guidance also puts notable emphasis on whether the location saving is retained by a member or members of the MNE group or are passed on to independent

customers or suppliers. Accordingly, in cases where the location saving is completely passed on to the customer or supplier (demonstrating a perfectly competitive business scenario wherein the cost reduction due to location saving is vital to compete in the market), the return for location saving is not relevant. A similar view was taken by the Hon'ble Delhi High Court in case of Li & Fung wherein the adjustment to income was deleted on the ground that the Indian tax administration failed to demonstrate the extent to which the overseas related party benefitted from locational advantages before rejecting the taxpayer's economic analysis. The taxpayers, in addition to the available judicial precedence, can rely upon the guidelines to support their argument.

Way forward

Overall, the 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. The guidelines is a step forward in ensuring that the intangible related returns are not being retained based only on the contractual framework but is appropriately supplemented by a comprehensive functional analysis in respect of intangibles.

From an Indian perspective, the courts in India have often acknowledged the role of OECD TP Guidelines while applying the TP principles. The tax authorities are also likely to leverage upon the TP Guidelines particularly for identifying the detailed demarcated roles and responsibilities of the Indian taxpayer and overseas entity, determining the "existence of transactions" and contribution of each side to value creation. Therefore, the 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.



The revised guidelines is a step forward in ensuring that the intangible related returns are not being retained based only on the contractual framework but is appropriately supplemented by a comprehensive functional analysis in respect of intangibles

Permanent establishment

Most countries, including India, tax their residents on their global income under residence based taxation, and tax non-residents by applying source based taxation. The permanent establishment [PE] concept is used to analyse the taxation of non-residents in the source country.

The concept finds its mention under tax treaties, and is broadly similar to the 'business connection' test as prescribed under the Indian domestic tax law. In the context of business profits, typically, a tax treaty would allocate taxing rights to the source country only if the foreign enterprise carries on its business in the source country through a PE situated therein, and only to the extent that profits are attributable to such a PE.

The Indian appellate authorities and Courts have, time and again, evaluated the issue of a PE and have laid down certain principles, such as 'close nexus', 'inextricable links', 'enduring and permanent presence' etc. in deciding the issue.

One may refer to the landmark judgment in the case of Vishakhapatnam Port Trust which held that a PE postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another, which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country onto the soil of another country.

Historically, the concept of PE developed in the late 19th century in the era of the second industrial revolution. The prevalent business operations and models laid emphasis on elements such as geographical location, physical presence, business nexus, place of business, permanency, etc. However, with the evolution of business models such as franchise, outsourcing, and especially cyberspace (digital economy), a non-

The changes suggested will restrict the application of a number of exceptions to the definition of PE to activities that are preparatory or auxiliary nature

resident could be significantly involved in the economic life of another country, and earn substantial profits, without having a taxable presence or a PE. The governments felt that the traditional approaches to a PE was leading to tax base erosion and therefore there was a need to align international tax laws with contemporary business models.

In the aforesaid context, the OECD and the G20 nations agreed to strengthen the existing international standards, including avoiding the artificial avoidance of PE status (Action 7).

The final report builds on proposals put forward in the G20/OECD's discussion drafts of October 2014 and May 2015, and seeks to update the definition of PE in Article 5 of the OECD's model tax treaty, and also provides detailed explanation in the associated Commentary.

The changes suggested in the final report seek to ensure that where the activities of an intermediary 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, unless the intermediary is performing the activities in the course of its independent business. The changes will restrict the application of a number of exceptions to the definition of PE to activities that are preparatory or auxiliary 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. Also, the report proposes to address situations where the minimum threshold (number of days) applicable to construction sites is circumvented through the splitting-up contracts between closely related enterprises of a multinational group.



The report is divided into three parts, which are discussed below along with the India perspective.

71 jurisdictions (including India) have signed the Multilateral Instrument (MLI) for implementing the BEPS actions. The MLI contains the following articles dealing with PE:

Article	Particulars	India's position
12	Artificial avoidance of PE status through commissionaire arrangements and similar strategies	Adopted
13	Artificial avoidance of PE status through the specific activity exemptions	Adopted
14	Splitting-up of contracts	Adopted

Part A: Artificial avoidance of PE through commissionaire arrangements and similar arrangements (Article 12 of MLI)

Many multinational enterprises adopt intermediary models/marketing agency/commissionaire arrangements to operate in another country without setting up a legal entity in the other country. A commissionaire/intermediary arrangement is one which enables the intermediary enterprise to sell products of the owner of the product; the intermediary enterprise is entitled to compensation/commission.

- The proposals in the report target to uncover any undisclosed agency or commissionaire agreements as well as other agency agreements as under:
01. Tightening the agency PE rules to include not only contracts in the name of the non-resident entity, but also 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.
 02. Modification and narrowing the requirements for an agent to be considered 'independent', such that this will not be the case where the agent acts exclusively or almost exclusively for one or more enterprises to which it is closely related.

The proposed expansion of agency PE 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

Article 12 of MLI seeks to amend Article 5 of the tax treaties, which defines the term PE, on the following aspects:

- Scope of agency PE to counter the commissionaire arrangement entered into by foreign enterprise in order to avoid PE in the source state;
- Creation of agency PE when the agent habitually plays principle role leading to conclusion of contracts with routine approval of the principal;
- Agent will not be considered to be an independent agent if he acts exclusively or almost exclusively on behalf of a closely related enterprise.

As per the provisional notifications, India would adopt this Article in its tax treaties. However, certain countries (Canada, Cyprus, Luxembourg, Singapore, UK, etc.), have opted not to adopt this Article, while certain countries (e.g. France, Japan, Netherlands) would adopt the Article. This Article can get adopted in Indian treaties, subject to matching.

India perspective

India, being a common law country, may not be much impacted by commissionaire arrangements as such structures are not permissible under the provisions of the Indian Contract Act.

The changes could however impact foreign companies having subsidiaries in India which undertakes marketing and sales support activities. Where such subsidiaries habitually play the principal role leading to the conclusion of contracts that are routinely concluded by the foreign principal without material modification, it could create a PE of the foreign principal in India. The terms 'principal role', 'routinely concluded' and 'material modification' have not been defined and could, therefore, lead to different tests being applied by different taxing authorities. The mischief sought to be avoided seems to be where all essential activities in relation to the conclusion of sale is performed by the agent in the source country, but the final contract or order is 'rubber stamped' by the foreign principal outside the source country.

The proposed expansion of the definition of agency PE in the context of conclusion of contracts, and the inability of the Indian subsidiary to be regarded as an 'independent agent', could expose a part of the overseas group entity's profit on sale of products to be taxed in India, depending on the facts of the case.

Hence, maintaining robust documentation on the roles and responsibilities, and detailed mapping of the activities of the agent and the principal in relation to the generation of Indian sales of the foreign principal would be of critical importance.

Part B: Artificial avoidance of PE through specific activity exemptions (Article 13 of MLI)

Approach 1

Changes to the model treaty will mean that exceptions from creating a fixed place PE for specific activities (such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing or the collection of information) will only apply where the activity or activities in question is only preparatory or auxiliary in relation to the business as a whole. This is to reflect modern ways of doing business, where such activities may represent a key part of a business' value chain (particularly relevant for supply chains involving digital sales).

A number of helpful examples are included in the revised Commentary, together with limited guidance on the meaning of 'preparatory or auxiliary'. 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.

Approach 2

The Commentary includes an alternative for countries who consider that the specific activities referred to are intrinsically preparatory or auxiliary and prefer the certainty of retaining their blanket exception status. Such countries' consider that BEPS concerns will be sufficiently addressed by the anti-fragmentation rule. 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. Examination would not happen in isolation, and only genuine preparatory and auxiliary activities would be accepted as exceptions to PE.

The primary objective of Article 13 of MLI is to ensure that the benefit of Article 5(4) [i.e. certain activities do not result in PE even when carried out through fixed place] is allowed only when the activities, carried on either individually or collectively, are preparatory or auxiliary in nature. It also contains an anti-fragmentation provision to prevent breaking of activities in order to benefit from the preparatory or auxiliary exemption. As per the provisional notifications, while India would adopt this provision (Approach 1), certain countries (e.g. Canada, Cyprus, France, Luxembourg, Singapore, etc.), have opted not to adopt this provision in the tax treaties. This Article can get adopted in Indian treaties, subject to matching.

India perspective

Indian Courts have dealt with the term 'preparatory or auxiliary' and are generally of a similar view as expressed in the

Depending on the facts and circumstances of digital businesses, the narrowing of the specific activity exemptions and proposed widening of the agency PE rule, could lead to creation of a PE of such digital businesses in India

BEPS report on Action 7. However, what constitutes 'preparatory or auxiliary' activities has always been a contentious issue with revenue authorities around the world. The challenge faced by the revenue authorities around the world was to examine a stand-alone activity in a scenario where a multinational enterprise was carrying out procurement, sales and marketing functions in India through different group companies around the world.

- **Liaison offices:** 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 functioning of liaison offices in greater detail.
- **Spurt of e-commerce in India:** With the tremendous growth of e-commerce business in India, functions such as warehousing, display, delivery, and supply chain model may not be considered as 'preparatory or auxiliary' activity. Depending on the facts and circumstances of digital businesses, the narrowing of the specific activity exemptions (say, proposal that delivery of goods needs to be a preparatory or auxiliary activity to qualify for the exemption) and proposed widening of the agency PE rule, could lead to creation of a PE of such digital businesses in India.



Part C: Splitting up of contracts (Article 14 of MLI)

The report addresses the splitting up of contracts between group companies with an objective to circumvent the specific 12-month time period for establishing a PE for a building site, construction or installation project. The key changes are as follows:

- Adding an example to illustrate the application of the principal purposes test for the prevention of treaty abuse (Action 6 of the BEPS Action Plan) to deal with splitting up of contracts.
- Suggesting an alternative provision (for treaties that do not include the principal purposes test) to add

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.

- Article 14 of MLI addresses avoidance of PE by splitting the contracts between related enterprises to circumvent the threshold of creation of PE. As per the provisional statement, India has not made any reservation against adoption of this Article, while certain countries (e.g. Canada, Cyprus, Japan, Luxembourg, Singapore, UK, etc.) have opted not to adopt this provision in the tax treaties. This Article can get adopted in Indian treaties, subject to matching.

India perspective

India has a significant number of turnkey or EPC contracts being executed by multinational enterprises, especially in the infrastructure sector. In many cases, business considerations may drive the requirement of various group entities executing different parts of the project, thereby necessitating the need to enter into respective contracts with the end customer. It will be interesting to see the approach of the Indian tax authorities towards such projects and contracts.

Digital economy

Action 1 of BEPS deals with addressing 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 Action 1 outlines conclusions regarding the digital economy, the BEPS issues, the resultant tax challenges and the recommended next steps.

With the evolution of businesses and also increasing use of digital platform to conduct business, both taxpayers and tax authorities have noticed complexities involved in determining the tax implications of a transaction as well as determining the jurisdiction in which the tax implications arise.

This 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. In other words, it would be hard to frame a separate set of tax rules independently for digital transactions. This report aims to tackle the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these rules. This is the only report that takes a holistic approach and discusses indirect taxes as well.

A key observation in the report is that while the digital economy and its business models do not generate unique BEPS issues, 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.

While the digital economy and its business models do not generate unique BEPS concerns, the key features exacerbate BEPS risks

Modification of the exceptions to permanent establishment [PE]

Action 7 deals with preventing the artificial avoidance of PE status. This Action suggests 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 having a PE in any State.

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. Under current circumstances, it may be possible for an online seller to fall under an exception to PE in the State of sale despite housing a warehouse. Pursuant to modifications to the exception to PE, the online seller may have a PE in the country where the warehouse is located depending on the business model.

Tightening of the agency PE rule

Action 7 of BEPS also deals with 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 foreign 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 conclusion of contracts, whereas the enterprise routinely approves such contracts. In such a situation, an agency PE of the enterprise should be constituted.

Controlled Foreign Corporation [CFC] rules

CFC rules attempt to tackle the issue of a taxpayer shifting income from the State of residence to a State where the tax rates are low. A CFC company is situated typically, in a low tax jurisdiction and controlled by an entity situated in a higher tax jurisdiction. Implementation of CFC rules are governed by the domestic tax laws of respective countries.

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 passive 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 transfer pricing rules dealing with aligning transfer pricing outcomes with value creation to 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 should 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. should ensure that BEPS issues arising in both – the ultimate parent company jurisdiction and the source State – should be addressed.

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



01. Nexus in the form of significant economic presence
02. Withholding tax on certain types of digital transactions
03. An equalisation levy

The above three options are not recommended by the OECD as it is expected that the other BEPS actions should address the broader tax challenges of the digital economy. The introduction of these measures is left to the decision of the respective countries.

India perspective

Business environment is becoming India has introduced equalisation levy (from June 1, 2016) on certain digital transactions.

'Equalisation levy' of 6% is imposed on amount paid or payable to non-residents for 'specified services', viz., online advertisement, provision of digital advertising space, or any other facility for the purposes of online advertisement. The Government is empowered to specify any other service on which such levy shall apply. (1) Every person, being a resident in India carrying on business or profession or (2) a non-resident having a PE in India, shall

deposit such levy on the consideration payable to a non-resident not having PE in India. Such levy does not apply where the aggregate amount payable to a non-resident does not exceed INR 100,000 in a year. The person deducting and depositing equalisation levy is required to file an annual return reporting particulars such as gross amount, equalisation levy details. The corresponding income should be exempt from income-tax in India the hands of such non-resident payee. In this connection, an issue arises in the hands of non-resident payee regarding grant of tax credit in home country for equalisation levy.

During the period 1 June 2016 to 31 March 2017, equalisation levy has contributed an amount of INR 3,166 million⁵ to the Government treasury.

Insights on indirect taxes

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 Value Added Tax [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 i.e. VAT / Goods and Services Tax [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

BEPS has recommended steps to collect VAT/GST based on the destination principle, i.e. where consumption takes place

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 categorised 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.

⁵ Based on response to application under Right to Information

Contracts, risks and recognition

On 5 October 2015, the OECD released the 15 final action plans in connection with BEPS. Amongst the action plans, Action 9 and 10 inter-alia deal with identification and allocation of risks for comparability analysis taking into account the contractual arrangement between the parties and their conduct, provide guidance on the recognition of the transaction by the tax authorities.

The guidance goes to the root of the transfer pricing analysis and reinforces the 'substance over form' principle which is consistently upheld by the Indian Tax Tribunals and emphasised by the tax authorities and tax experts. The guidance replaces Section D of Chapter I of the OECD Transfer Pricing Guidelines⁶.

In brief, the guidance focuses on the importance of delineating the transaction between related parties with utmost specificity, having regard to the economically relevant characteristics of the transactions and how the functions performed by the parties relate to the generation of economic value by the multinational enterprises [MNEs]. Also, the guidance emphasises on the need for considering the options realistically available to the parties to the transaction

In recognition of the transaction, importance is placed on the commercial rationale or the business reasons of the transaction

in determining the arm's length nature of such a transaction.

Per the guidance, in delineating a controlled transaction, understanding the contractual arrangement between the parties in relation to such transaction is considered as a first step, though the primary importance is placed on the conduct of the parties. The conduct of the parties is recognised through a detailed analysis of functions performed, assets employed and risks borne by the parties with respect to the transaction.

The guidance places significant importance on the risks borne by the parties since the assumption of risks would influence the prices and other economic conditions of the transaction.

The framework for analysing risks include, identifying significant risks in connection

with the transaction, determining who contractually assumes the risks, who manages and controls the risks including who performs risk mitigation functions, consistency between contractual assumption of risks with the conduct of the parties, identifying whether the entity bearing the risks has the financial capacity to bear the risks.

Per the guidance, assumption of risks by an entity should be compensated with an appropriate return. Any risk mitigation activities, which can generally be delegated to other parties by the party controlling the risks, should be appropriately remunerated at arm's length. Therefore, a party performing only financing activities in relation to a transaction without exercising any control over the risks, is entitled to only a risk adjusted return for its financing activities.

For the recognition of the transaction between the associated enterprises by the tax authorities, importance is placed on the commercial rationale or the business reasons of the transaction. The guidance provides that the actual transactions between the associated enterprises may be disregarded by the tax authorities for transfer pricing purposes, if the arrangement between the associated enterprises, viewed in its totality, differs from what would have been entered into between two unrelated parties behaving in a commercially rational manner. In recognising the transaction, the tax authorities should also consider the alternatives that are realistically available to the parties. An analysis of whether the MNE group would be worse off on a pre-tax basis due to the transaction / arrangement can be used as an indicator that the transaction viewed in its entirety lacks the commercial rationality.

However, the guidance cautions tax authorities on the re-characterisation / replacement of the transactions, as it can be a source of double taxation and dispute. It is recommended in the guidance that 'every effort' should be made to determine the actual nature of the transaction (taking into account contractual arrangements and the conduct) and apply arm's length pricing to it. Absence of a similar transaction between unrelated parties should not lead to a conclusion of a commercially rational transaction between associated enterprises as not being carried out at arm's length.

India perspective

The guidance echoes the sentiment of the developing nations including India on the identification and allocation of risks based on the conduct of the parties and attributing appropriate return for such allocation / assumption of risks.

In fact, specifically for the Information Technology sector, the Central Board of Direct Taxes, which is the premiere governing body for corporate taxes, through Circular No. 6/2013 dated 29 June 2013, had set out a framework for identifying Research and Development [R&D] entities that can be considered as bearing insignificant risks in connection with rendering R&D services to the group companies. The Circular was issued to clarify the circumstance in which Transactional Net Margin Method can be applied as the most appropriate method to justify the R&D services rendered by a taxpayer.

The framework in the Circular resonates the principles provided in the guidance for accurately delineating the controlled transaction by considering the conduct of the parties and the risks assumed. In the referred Circular, importance is given to; identifying the party performing the economically significant functions, identifying the party providing economically significant assets including funding of the activities, party exercising control over the functions performed by the other party and finally identification of assumption of risks by the parties through a detailed analysis of conduct of the parties and not based on the contractual arrangement between the parties alone.

In this context, as highlighted by India in the UN Transfer Pricing Manual, core functions, key responsibilities, key decision making and levels of individual responsibility for the key decisions, gain importance in identifying the party which has control over the risks.

In the event a taxpayer could not demonstrate that insignificant risks are borne in performing services, the tax authorities may consider disregarding the Transactional Net Margin Method as the

most appropriate method in determining the arm's length price of the transaction. Instead, the tax authorities can consider applying Transactional Profit Split method, or demand a higher mark-up on the costs for the performance of economically significant functions and bearing critical risks by the taxpayer in the transaction.

Therefore, it is important on the part of the taxpayers to clearly document and detail the activities performed and risks borne in transactions and how these activities contribute to the economic value creation by the MNE group.

Following the recommendation in Action 13 of OECD BEPS action plan, India introduced the CbC reporting requirement from financial year 2016-17. Therefore, it is expected that with the increased availability of substantial information relating to the controlled transactions, the taxpayers may not have significant challenge in demonstrating before the tax authorities, the specific activity carried and risks borne in the context of the overall operations of the MNE group.

Although, in the light of the guidance and introduction of CbC requirements in India, the taxpayers may want to revisit and ensure that the transfer price followed in respect of the controlled transactions are in conformity with the level of risks borne and activities performed to avoid any dispute in the scrutiny proceedings by the tax authorities.

As mentioned earlier, the guidance cautions the tax authorities on disregarding the actual transactions entered into between associated enterprises or substituting the transaction with other transactions as it may create double tax incidence on the taxpayer. Importance in this regard is placed on the commercial rationality in entering into the transaction



⁶OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, July 2010

by the parties after considering the options that are realistically available to them.

The Indian Transfer Pricing Regulations provide that the income arising from transactions between associated enterprises should be computed having regard to the arm's length price⁷. The word 'having regard to' is not specifically defined in the Income-Tax Act, 1961. However, the judicial precedence⁸ available in this regard, provides that the term 'having regard to' include 'commercial rationale' or 'business reasons'. Therefore, the Indian Transfer Pricing Regulations require the tax payers and the tax authorities to determine the arm's length nature of a transaction by duly considering, inter-alia the 'business reasons' or 'commercial rationale' behind the transactions.

However, in practice, it has been our experience, that the taxpayers have generally given less weightage to document and detail the commercial rationale behind entering into a transaction especially when transactions involve intangibles or centralised services for which a perfect comparable transaction is generally not found in the open market.

Further, the tax authorities, in performing a transfer pricing scrutiny, had lack of appreciation for the commercial rationale behind a taxpayer entering into a transaction with group companies, possibly due to lack of relevant industry expertise to appreciate the commercial reasons, leading to arbitrary transfer pricing adjustments and prolonged disputes. Also, the term 'options realistically available to the parties' is interpreted to have a wider connotation by the tax authorities in determining the commercial rationale behind the transactions.

For example: Obtaining centralised services by a taxpayer from a group company is disregarded by the tax authorities on

It is important on the part of the taxpayers to document and demonstrate, how the activities performed contributes to the economic value creation by the group

the premise that similar services can be obtained by the tax payer domestically by incurring a lower cost or the taxpayer has people providing similar services in-house therefore, the services received are duplicative in nature.

However, the Indian Tax Courts⁹ have largely ruled on this issue in favour of the taxpayers in few cases, wherein it is observed that the tax authorities should respect the commercial wisdom of the taxpayer and determine the arm's length nature of the transaction having regard to the relevant facts and circumstances of the case.

Conclusion

Most of the guidance on the importance of conduct of the parties over the contractual arrangements and identification and allocation of risks with appropriate compensation for assumption of risks have been followed by the developing nations including India even before the introduction of BEPS action plans.

However, in view of the guidance, it is important on the part of the taxpayers to document the commercial rationality behind entering into the transactions with associated enterprises especially in respect of transactions that have no comparable transactions in the open market. Also, the tax authorities should appreciate the concepts like 'commercial rationality' in recognising the transactions between the associated enterprises and

adopt a broader view in scrutiny of the transactions.

Hopefully, the access to additional information on the MNE group and automatic exchange of critical information relating to taxpayers through Country by Country reporting are positively considered by the tax authorities in determining the arm's length nature of the transactions and not used as a tool for subjective interpretation of the transaction and arbitrary adjustments.

Financial transactions and interest deductions

Financial transactions and interest deductions are dealt with under the following action plans of the BEPS project:

- Action 2: Neutralising the effects of hybrid mismatch arrangements
- Action 4: Interest deductions and other financial payments

Financial transactions

The recommendations under Action 2 are designed to neutralise hybrid mismatches by targeting the following types of arrangements:

- Deduction/no inclusion (D/NI) outcomes: A deduction/no inclusion outcome is achieved when a tax deduction is claimed for a payment in the payer jurisdiction and the corresponding income is not taxed in the payee jurisdiction on account of a hybrid mismatch where the mismatch is attributed to terms of the instrument.
- Double deduction (D/D) outcomes: A deduction is claimed for a payment by a hybrid entity in two different jurisdictions and set-off against non-dual included income in the second jurisdiction.
- Indirect deduction/no inclusion (indirect D/NI) outcomes: An indirect deduction/no inclusion outcome is achieved in case of a hybrid mismatch arrangement by interposing a company (in another jurisdiction) and importing the outcome (deduction/no inclusion) to a third jurisdiction.

It is relevant that the 'hybrid' element is present in the arrangement. Examples of such arrangements are hybrid entities (opaque or transparent) and hybrid instruments (debt or equity) which generally involve conflicts in categorisation of such entities or instruments.

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Specific hybrid mismatch rules are recommended to address each of the targeted arrangements. The recommendations are in the form of 'linking' rules to be adopted under the domestic tax laws:

- Primary rule (denying a deduction) in the payer jurisdiction
- Secondary/ defensive rule (taxing the income) to apply in the payee jurisdiction in circumstances where the primary rule does not apply.



⁷Section 92(1) of the Income-tax Act, 1961

⁸[1959] 35 ITR 290 (PC) – CIT vs Williamson Diamonds Ltd and [1965] 57 ITR 176 (SC) – CIT vs Gangadhar Banerjee

⁹ITA No. 182 to 2013 and 172 of 2013 M/s Knorr – Bremse India Pvt Ltd (P&H High Court), ITA No. 8753/Mum/2010 Dresser Rand India Pvt Ltd

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
D/NI	Hybrid financial management	No dividend exceptions for deductible payments. Proportionate limitation of withholding tax credits	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements ¹⁰
	Disregarded payment made by a hybrid		Deny payer deduction	Include as ordinary income	Controlled group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime. Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque	Deny payer deduction	-	Controlled group and structured arrangements
DD	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response; defensive rule applies to controlled group and structured arrangements
	Deductible payment made by a dual resident		Deny resident deduction	-	No limitation on response
Indirect D/NI	Imported mismatch arrangements		Deny payer deduction	-	Members of a controlled group and structured arrangements

Payments that are deemed to be made only for tax purposes (e.g. transfer pricing adjustment) are excluded from the above treatment, since they do not involve the creation of any economic rights between parties. Additionally, the hybrid instrument rule generally does not apply to timing differences i.e. if the payment under such instrument is expected to be included in income within a reasonable period of time (in an accounting period that commences

within twelve months of the end of the payer's accounting period).

India perspective

A deduction/no inclusion outcome is relevant from the perspective of hybrid instruments. A large number of multinational companies invest in India through hybrid instruments such as convertible debentures/ bonds issued by the Indian subsidiaries. Till the time of

conversion of such instruments into equity shares, they are treated as debt and the interest payments under such instruments are considered as tax deductible interest expenditure (subject to appropriate withholding tax). In case the home country of the convertible instrument holder regards such instrument as equity shares and not debt, then the interest payment should consequentially be considered as dividend by the home country. If the home country does not tax such dividend (say on account of participation exemption), then under the linking rules India may deny a deduction for the entire interest expenditure. Considering this, multinational companies need to review their existing funding structures and ascertain whether existing structures lead to a deduction/ no inclusion outcome which has potential tax risks.

It may be noted that the withholding tax implications on such interest (i.e. hybrid) payments in the source country (i.e. India in this case) and taxability of the convertible instrument holder on such interest would continue to apply independently.

Mainly changes to domestic tax laws are recommended to counter hybrid mismatches and therefore, the impact on multinational companies would depend on if and when India chooses to implement the new rules, and the finer aspects in the manner in which such rules are implemented.

71 jurisdictions (including India) have signed the Multilateral Instrument (MLI) for implementing the BEPS actions

Article 3 addresses income earned through transparent entities. It inter alia provides that income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either contracting jurisdiction, shall be considered to be income of a resident of the jurisdiction. However, this shall be only to the extent that the income is treated for purposes of taxation by that contracting jurisdiction as the income of a resident. As per the provisional reservation, India has opted not to adopt this provision in its tax treaties.

Applies not only to multinational companies but also Indian companies having presence in other countries i.e. presence in more than one country

Article 5 addresses the situations arising from the exemption method followed by countries to avoid double taxation and situations where income paid on an instrument is deductible in the source country, but not subject to tax in the hands of the recipient as per the tax laws of the country of residence. It gives three options in which parties may address the aforesaid issue. As per the provisional reservation, India has opted not to adopt this Article in its tax treaties.

Interest deductions

Action 4 focuses on the use of third-party, related party and intra-group debt to obtain 'excessive' deductions or to 'finance exempt or deferred income'. For this purpose, interest would include (i) interest on all forms of debt; (ii) payments economically equivalent to interest; and (iii) expenses incurred in connection with the raising of finance. Action 4 is intended to apply after the disallowances for hybrid mismatch arrangements (Action 2) are carried out.

This is similar to some extent, in principle, to thin capitalisation rules prevalent in some countries. This would apply not only to multinational companies but also Indian companies having presence in other countries i.e. presence in more than one country. The recommended approach is based on a fixed ratio rule, with a potential range considering countries may not be in an equivalent position. An entity's net deductions for interest payments are restricted to a percentage of its earnings before interest, taxes, depreciation and amortisation [EBITDA]. The percentage restriction could be set by each jurisdiction at a fixed ratio between 10% and 30% of EBITDA. This fixed ratio approach can be supplemented by a worldwide group ratio rule as well as certain targeted rules.

Recognising that some groups are highly leveraged with third-party debt for non-tax reasons, and that the fixed ratio rule is a 'blunt tool', a group ratio rule is proposed as fall-back. This rule could be introduced as a separate rule or as an integral part of an overall rule that includes a fixed ratio rule.

A group ratio rule aims to match net interest expense within a consolidated group to its economic activity, so that the group's aggregate interest deductions should not exceed its actual third-party interest expense. The first stage in applying the group ratio rule is to calculate the group's worldwide net third-party interest/ EBITDA ratio, using third-party interest and EBITDA amounts from audited, consolidated financial statements.

The OECD has released a discussion draft on elements of the design and operation of the group ratio rule in July 2016. Thereafter, the OECD released an updated version of the BEPS Action 4 Report (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments), which includes further guidance on the design and operation of the group ratio rule. In order to reduce the administrative burden on taxpayers, exemptions are proposed to be granted including a de minimis threshold to carve out entities with low levels of net interest (respective jurisdictions to set the level of threshold).

Additionally, a country may choose to allow taxpayers: (i) to carry forward disallowed interest expense; (ii) to carry forward disallowed interest expense and unused interest capacity; (iii) to carry forward and carry back disallowed interest expense.

¹⁰Arrangement is designed to produce the mismatch in tax outcomes

It is recognised that the fixed ratio and group ratio rules may not be effective in addressing BEPS in case of the banking and insurance sectors on account of specific features of such sectors. Accordingly, further work was undertaken and a public discussion draft which deals with approaches to address BEPS involving interest in the banking and insurance sector was released in July 2016. Thereafter, the OECD released an updated version of the BEPS Action 4 Report (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments), which includes further guidance on the approaches to deal with risks posed by the banking and insurance sectors.

It is pertinent to note that due to increase in potential costs of multinational companies arising from changes in the interest deductibility rules, transition and grandfathering provisions are considered to be introduced.

India perspective

The Indian tax provisions have been amended with effect from financial year 2017-18 to limit interest deduction in certain cases. The deduction of interest expense or similar consideration paid or payable by an entity to its Associated Enterprise (AE) is limited to 30% of its earnings before interest, taxes, depreciation and amortisation.

Limitation of interest deduction could lead to double taxation and would increase the compliance cost for taxpayers

The provision is applicable to an Indian company, or a PE of a foreign company in India, being the borrower, who pays interest or similar consideration in respect of any debt issued by a non-resident AE. Limitation on interest deduction is applicable where interest or similar consideration to its AE exceeds INR 10 million. Debt shall be deemed to be treated as issued by an AE where it provides an implicit or explicit guarantee to a non-AE lender or deposits a corresponding and matching amount of funds with the non-AE lender

Disallowed interest expense shall be carried forward up to 8 years and can be claimed as deduction subject to limitation on interest deduction in respective years.

The term 'debt' has been defined to mean any loan, financial instrument, finance lease, financial derivative, or any arrangement that gives rise to interest, discounts or other finance charges that are deductible in the computation of income

chargeable under the head "Profits and gains of business or profession".

The restriction on interest deduction will not to apply to Indian company or PE of a foreign company which is engaged in the business of banking or insurance.

It is pertinent to note that the way the Indian rules have been introduced, it is more likely to impact inbound investments into India, as against outbound investments. The outbound investments will generally be impacted if there is an overseas borrowing by a group entity, which in turn lends to its Indian group entity. However, Indian MNEs will need to consider similar rules introduced in the jurisdictions where they operate globally.

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 guidelines 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

The simplified approach, which a group may elect to adopt, recognises that the arm's length price of low value-adding intra-group services is closely related to costs

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.). It is pertinent to note that services of corporate senior management (other than management supervision of services that qualify as low value-adding intra-group services) has been excluded from the definition of low value-adding services. Developing countries have usually considered such payments as one of the major BEPS challenge and excluding such services from the definition of low value-adding services should, to an extent, address the concern of the developing countries. 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 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 guidelines 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 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

Under the revised guideline, a simplified benefits test is recommended, whereby tax authorities should consider benefits only by categories of services

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; though 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 all arguments irrespective of their technical merit.

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 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. Further, the mark-up required to be earned by the Indian service providers from provision of services to overseas group companies has been a contentious issue in India, wherein the Indian tax authorities expect significantly high mark-ups. It is important to recognise that mark-up levels are determined by the economic condition of a jurisdiction; hence having a uniform global mark-up for all service providers across jurisdictions may not be plausible.

In addition to the mark-up, the guidelines address several other issues faced by MNEs (such as through adoption of the

Important to recognise that mark-up levels are determined by the economic condition of a jurisdiction; hence having a uniform global mark-up for all service providers across jurisdictions may not be plausible

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). However, the benefit to MNEs in Indian context would depend upon the adoption of the said guidelines by the Indian tax authorities in its entire form.

It is pertinent to note that, the recently revised Indian safe harbour rules include within its purview the international transaction relating to receipt of low value-adding services by the Indian group entity. The safe harbour rules specify a mark-up of not exceeding 5% and have prescribed few restrictions on applicability of such regulations in the context of threshold of transaction value and practical protocol to be followed to avail the safe harbour provisions (including slight deviation to the definition of low value-adding services). Accordingly, it could be considered that the revised safe harbour rules on low-value adding services is broadly aligned with the treatment recommended by the OECD in the BEPS Action 8-10 report, for receipt of low-value adding services.

However, the safe harbour provisions are not applicable for provision of low value adding services by Indian group entities. In light of these new developments, it will be important to track whether Indian authorities would also adopt the simplified approach for provision of low value-adding services by Indian entities.

Transfer pricing documentation and country-by-country report

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, which includes:

The G20/OECD having agreed on very significant changes to compliance and reporting requirements, global transfer pricing documentation will never be the same again

Local file

It provides an entity and transaction level transfer pricing analysis for each jurisdiction.

Master file

A high level overview of the MNE's global operations along with an overview of the group's transfer pricing policies

Country-by-Country report

A global financial snapshot of an MNE

Transfer pricing local file

The local file is required to provide information and support for 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. The local file requirements 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 (including related transfer pricing policies)

Financial and tax information including annual consolidated financial statements

Details of unilateral advance pricing agreements [APAs] and other tax rulings relating to allocation of income among countries.

Country-by-country [CbC] report

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 on documentation. 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 groups¹¹ 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 entities¹² by country of residence and indication of their activities.

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.



CbC report is a 'minimum standard' requirement – it's not an option – countries participating in the BEPS project are expected to commit to and adopt this measure

¹¹From an applicability perspective, a 'Group' is defined as a collection of enterprises related through ownership or control such that it 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.

¹²Constituent 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)

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. Where the ultimate parent company jurisdiction will not be able to implement the CbC reporting requirement with respect to fiscal period beginning or after 1 January 2016, they may be able to accommodate voluntary filing for the ultimate parent entities resident in their jurisdiction for the fiscal period beginning or after 1 January 2016 (referred to as “parent surrogate filing”). If the CbC report is not shared by the tax jurisdiction of the ultimate parent company (or the nominated surrogate), constituent entities of such MNE may be required to file the CbC report locally in their respective jurisdictions. The model agreements provide that information shared as a result of these agreements must be kept confidential and used appropriately. It is pertinent to note that the agreements emphasise that the CbC information should not be used as a substitute for detailed transfer pricing analysis of individual transactions, and that transfer pricing adjustments should not be made on the basis of CbC reporting alone.

Timelines

CbC report is required to be filed annually by the MNE within 12 months of the end of its financial reporting year (for years beginning on or after 1 January 2016). 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

CbC report may be one of the first BEPS initiatives to be implemented – reporting requirements commence from January 2016 – first CBC report expected in December 2017

end of the financial reporting year for the first year (thereafter within 15 months of the financial reporting year of the MNE). 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 have developed 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.

Global adoption of the OECD documentation requirements

It remains to be seen how coordinated will be the approach and the extent to which the various jurisdictions around the world adopt the OECD documentation requirements. Since the release of the Action Plan 13 final report in October 2015, there has been a constant increase in the number of countries that have implemented the CbC reporting requirement in their local legislation.

India perspective

In order to implement the international consensus on Action 13 of the BEPS project, the Finance Act 2016 introduced the Country by Country (CbC) reporting requirement and the concept of master file in the Indian Income Tax Act, 1961.

The CbC reporting requirement is introduced with effect from Assessment Year 2017-18 (financial year 2016-17), requiring Indian headquartered Multi-national Enterprises (“MNEs”) and certain other Indian entities of global MNEs to file the CbC report with the Indian Authority. India will adhere to the OECD prescribed group revenue threshold of Euro 750 million (INR equivalent) for the applicability of the CbC requirement. The CbC report is required to be filed on or before the due date for filing the return of income in India (typically on 30 November following the end of the Indian financial year in March). The core provisions are included in the Act and the balance detailed provisions in the Income Tax Rules. Stringent penalty provisions have also been prescribed for non-furnishing and/or furnishing inaccurate particulars.

In the present environment, it remains to be seen how tax authorities will use the information provided in the CbC report. Even though the OECD has emphasized that the CbC report is only meant for high level risk assessment purposes, there is a risk that Indian authorities may apply formulary apportionment.

The impact of OECD's reporting requirement is that it raises the benchmark for the quality of information reported to Indian authorities even if it is not explicitly adopted in the Indian rules. Taxpayers will need to be more meticulous in preparing documentation as the Indian authorities may demand information and



documentation of the MNE group (such as the master file and the CbC report maintained by the ultimate parent entity).

Indian authorities in trying to protect their revenue base, may take a greater interest in the MNE's global value chain to ensure that the allocation of profit is consistent with the value creation in India. Given the emphasis in examining the actual conduct of parties rather than the contractual form, MNE's will be required to substantiate that they have delineated the transaction accurately as reflected in the documentation.

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 now. 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.

Tax authorities are likely to compile ratios to examine tax structures that do not align with value creation. Taxpayers should prepare by compiling ratios based on the parameters in the CbC report to pre-empt questions about certain constituent entities (which for example have low number of employees vis-à-vis total revenue). Tax authorities around the world could potentially compare the mark-ups on costs given by the MNE to

Today it's critical for multinational enterprises to undertake risk assessment and evaluate how the new documentation guidance will impact their current transfer pricing policies

different administrations and demand a more consistent approach world-wide. Proactive approaches to manage the uncertainty could include considering the APA/MAP route.

In this environment, 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 globally.

Other important BEPS focus areas

A. Controlled foreign company rules

Controlled foreign company [CFC] rules attempt to tackle the issue of a taxpayer shifting income from the State of residence to a State where the tax rates are low. A CFC is a company situated, typically, in a low tax jurisdiction and controlled by an entity situated in a higher tax jurisdiction. While the rules applicable to CFCs and the attributes of a CFC differ from country to country, the hallmark of CFC regimes in general is that they eliminate the non-taxation or deferral of income earned by a CFC and tax residents upfront on their proportionate share of a CFC's income.

Among the countries participating in OECD/G20 BEPS project, 30 countries have CFC rules and many others are interested in implementing them. However, considering the current CFC rules have not kept pace with the developments in the international business environment, there was a need to firm up a design for CFC rules.

Unlike many of the other BEPS reports, where countries agree on minimum standards that they wish to adopt, this report seeks to lay down 'building blocks'. These building blocks are a set of recommendations that countries who choose to implement effective CFC rules could adopt and some of these are discussed below.

- **Definition of CFC:** In defining a CFC, there are two broad principles a jurisdiction should look into: (a) the entity; and (b) control over the entity. While CFC has largely been applied to corporates, it has been recommended that CFCs also include trusts, partnerships, permanent establishments to the extent that such entities raise BEPS concerns. As regards control, the recommendations seek to lay down how to determine when shareholders have sufficient control over

CFC rules attempt to tackle the issue of a taxpayer shifting income from the State of residence to a State where the tax rates are low

a foreign company for that company to be a CFC.

- **CFC exemptions and threshold requirements:** In many countries, the CFC may be availing of a tax exemption that results in a lower effective tax rate. Under the current CFC laws, the foreign enterprise may regard the income earned by the CFC as a CFC income. However, it has been recommended that CFC rules should be applied only in cases where the company is subject to an effective tax rate which is meaningfully lower than the rate at the parent jurisdiction.
- **Definition, computation and attribution of income:** The recommendation here is that the income items should be comprehensively defined. Further, CFC rules use the rules of the parent jurisdiction to compute CFC income. The attribution of income should be guided by the control threshold/proportionate ownership or influence.
- **Prevention and elimination of double taxation:** It is essential that when a country designs an effective CFC rule, it does not lead to double taxation. Further, if where there is a double taxation involved, then CFC rules should grant a credit for the taxes paid.

Considering CFC rules are governed by domestic laws, this Action recommends that if these rules are designed in the manner laid down, it will address BEPS concerns.

India perspective

India currently does not have CFC rules under its domestic tax law. However, there was a proposal to introduce CFC regulations under the Direct Taxes Code [DTC]. The introduction of DTC to replace the current tax law is presently under cold storage.

The Government of India has however introduced the concept of Place of effective management ('PoEM') for determining the residential status of the company in order to ensure that companies incorporated outside India but controlled from India do not escape taxation in India.

The intent of PoEM provisions is to target shell / conduit companies which are created to retain income outside India and not Indian MNC's engaged in the active business outside India.

Though the concept of PoEM, per se is not an anti-abuse tool but guidelines for determining PoEM, especially taxing the company on the basis of active and passive income, takes the colour of an anti-abuse measure which typically is a characteristic of CFC rules.

It is anticipated that in this year Budget, The Government is likely to introduce the concept of 'Controlled Foreign Corporation' (CFC) regulations replacing the concept of taxing a foreign company if its 'place of effective management' (PoEM) is in India.

CFC rules are generally meant to counter tendency on the part of MNCs to defer taxes through parking of passive incomes (e.g. royalties, fees, interests, capital gains, profits made from buying and selling products from and to related parties, etc.) at the level of foreign subsidiaries, instead of repatriating the same back as dividends.

Assuming that the passive incomes in question pass the necessary tests of legitimacy, or else, such incomes would anyway would be taxed in India under specific or general anti avoidance rules, it is doubtful whether Indian MNCs would prefer to park these incomes abroad, purely to avoid taxes in India, since India currently encourages Indian companies to bring back foreign sourced income as dividends, by granting a lower base tax rate of 15% for such income, when compared to the base corporate tax rate of 30%.

CFC regulations could also help in avoiding the subjective nature of applying PoEM criteria for Outbound Indian Companies as CFC will tax only the passive income of certain foreign entities located in low-tax jurisdiction and being controlled from India, as against the potential risk of global income being exposed for Taxation in India under PoEM

Though designing effective CFC rules is one of the mandates of BEPS Action Plans, yet, one would need to evaluate and see how the CFC regulations would be introduced in the Indian domestic tax law



B. Dispute Resolution and Implementation (Multilateral Instrument)

Countries participating in BEPS agree that the introduction of the measures developed to address BEPS should not lead to uncertainty for taxpayers and unintended double taxation. Therefore, refining dispute resolution mechanism is a vital and integral component of the work on BEPS issues.

With the above in view, the guidance in Action 14 of the BEPS Action provides for implementing “minimum standards” and “best practices” to enhance the effectiveness/ efficiency of the Mutual Agreement Procedure [MAP] process. The minimum standards requires countries to ensure that:

- treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner
- implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes and
- taxpayers can access the MAP when eligible.

As part of minimum standard, important aspects include seeking to resolve MAP cases within an average time frame of 24 months and guidance that countries should not use performance indicators for the competent authorities which are based on amount of adjustment sustained and observes that number of MAPs resolved/ time taken in resolving MAPs may be more appropriate indicators. For easy access to MAPs, the guidance also suggests permitting a request to either competent authority, implementation of a bilateral notification system, publishing of MAP guidance etc.

Refining dispute resolution mechanism is a vital and integral component of the work on BEPS issues

In addition to above minimum standards, a set of best practices have been provided for. Such best practices includes implementation of bilateral advanced pricing arrangements, suspension of collection during pendency of MAP cases, training for tax examiners, access to MAPs for taxpayer-initiated adjustments etc.

The countries are also devoted to effective implementation of the above guidance through the establishment of a robust peer-based monitoring mechanism. Further, with a view to ensure timely resolution of treaty related disputes, several countries¹³ have also declared their commitment to provide for mandatory binding MAP arbitration in their bilateral tax treaties. The countries committing to mandatory binding MAPs were involved in more than 90 percent of outstanding MAP cases at the end of 2013, as reported to the OECD.

In line with BEPS Action 14, the multilateral instrument includes chapter V on “Improving Dispute Resolution”, which includes a specific Article on MAP. It inter alia provides for inclusion of Articles 25(1) to 25(3) of the OECD Model Convention on MAP in all tax treaties. If a tax treaty-related case qualifies to be considered under the MAP the taxpayer can approach the competent authority of either of the contracting jurisdiction. The multilateral instrument also includes a separate chapter VI on “Arbitration”.

India perspective

Several multinational companies operating in India have protracted litigations, in particular for transfer pricing matters. The double taxation arising from such litigation couple with extensive time taken in concluding the MAPs has been a major area of concern for the multinational companies. The Indian revenue authorities, at several forums, have also expressed their reluctance to include arbitration within the Double Taxation Avoidance Agreement, which does not provide requisite level of comfort to the global investors. Moreover, Indian revenue authorities believe that absence of Article 9(2) in the tax treaty precludes MAPs in respect of economic double taxation (transfer pricing) and therefore, the multinational companies from several large jurisdictions¹⁴ have not been able

The Indian revenue authorities, at several forums, have expressed their reluctance to include arbitration within the tax treaties

to access MAP/ bilateral advance pricing arrangements. Considering the above, the guidance provided under Action 14 would be of significant interest/ relevance to such multinational companies particularly aspects such as resolution of MAP cases in two years.

the competent authority of either of the contracting jurisdiction. However, as this is a minimum standard, India has opted for bilateral notification or consultation process. India has not opted for chapter VI of the multilateral instrument dealing with mandatory arbitration.

As per the provisional list of reservation to the multilateral instrument, India has opted not to adopt a provision according to which the tax payer can approach



¹³ Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States

¹⁴ Such as Singapore, Germany, France etc.

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