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# BEPS

Impact on Consumer Business

# BEPS – Impact on Consumer Business

In the backdrop of concerns raised by Governments, revenue authorities and social organizations that multinational enterprises (MNEs) are not paying their 'fair share' of taxes and are shifting profits to low tax jurisdiction, the G20 nations requested the Organisation for Economic Co-operation and Development (OECD) to develop action plans to tackle Base Erosion and Profit Shifting (BEPS) in a comprehensive manner. The 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 commenced work on the BEPS project to address concerns that existing principles of domestic and international taxation were failing to keep pace with the development of modern business models. Under a two-year long project the OECD on 5 October 2015 has issued 15 final reports on focus areas and the same has been endorsed by the G-20 Finance Ministers at their meeting in Lima, Peru on 8 October 2015.

**The 15 action plans can be categorized under the following key pillars:**
**Overview Action Plans for addressing BEPS**

**Establishing coherence in corporate taxation**

- Action plan 2# Hybrid mismatch
- Action plan 3# CFC rules
- Action plan 4# Limit base erosion
- Action plan 5# Harmful tax practices

**Restoring effects of international standards**

- Action plan 6# Prevent treaty abuse
- Action plan 7# Artificial avoidance of PE
- Action plan 8, 9, 10 #Value creation, intangibles, risk and capital, high risk transaction

**Ensuring transparency while promoting predictability**

- Action plan 11# Data collection and analysis
- Action plan 12# Disclosure of aggressive tax planning
- Action plan 13# TP documentation and CbC reporting
- Action plan 14# Dispute resolution mechanisms

**Turning tax polices in to tax rules**

- Action plan 15# Develop multilateral instruments


**BEPS and India**

India, being a member of the G20 nations, has actively participated in the OECD BEPS projectand is committed to its outcome. The BEPS action plans will impact both outbound as well as inbound investment holding structures, financing and operating arrangements put in place by MNEs.

The BEPS project is extremely relevant for India, especially the action plans dealing with treaty abuse, permanent establishment, intangibles, digital economy, and transfer pricing documentation and country-by-country reporting.

Implementation of the BEPS Final package entails amendment to domestic tax laws of the countries, amendment to the tax treaties signed by various countries, amendments to the OECD Commentary and other administrative measures by the revenue authorities. While, India has amended certain provisions of its domestic tax law as well as certain tax treaties, amendments in tax treaties involve a bilateral processes which are lengthy and hence, time consuming.To swiftly enable modification of various tax treaties, Action 15 of the BEPS Action Plan provided for development of a Multilateral Instrument [MLI] to implement tax treaty related BEPS measures. On this front, the negotiations have been concluded on the MLI and the final version of the negotiated MLI as adopted by more than one hundred jurisdictions has now been released by the OECD. MLI is a Convention which will be signed by several parties and this will have the impact of changing the bilateral tax treaties signed by these countries. A signing ceremony is proposed to be held in June 2017 in Paris.Once the MLI is signed and it enters in to effect, the existing bilateral tax treaties of the countries signatory to the MLI would be modified by the MLI.

**Consumer business**

MNEs in consumer business sector especially companies engaged in FMCG, retail, ecommerce, travel, hospitality and leisure products are highly driven from client perceptions of their brands and products. They carry a huge reputation risk with regard to tax paid and liabilities arising in a given country which do not correspond to scale of operations in that country.

Considering the same, MNEs engaged in consumer businesses need to review their business model viz. their investment holding structures, funding and operating arrangements from BEPS viewpoint. We have briefly discussed the effects of some of the key action plans which would specifically impact consumer business sector. The steps taken by the respective countries to implement the action plans could have significant impact on the bottom line of a large number of consumer business MNEs by increasing their overall effective corporate income tax rate.

**Action Plan 1 – Digital Economy**

Action plan 1 of BEPS aims to address tax challenges of the digital economy. The report observes that the digital economy is increasingly becoming the economy itself and it will be difficult to ring fence the digital economy from the rest of the economy for tax purposes. The report states that while the digital economy and its business models do not generate unique BEPS concerns, the key features exacerbate BEPS risks. It calls for identifications of the main difficulties that the digital economy possess for the application of existing international tax rules and develops detailed options to address these difficulties by taking a holistic approach.It is the only action which discusses indirect taxes as well.

From a direct tax perspective, the report by itself does not suggest any recommendations. However it indicates that work on certain other actions like,

i. Modifying the list of exceptions to the definition of PermanentEstablishment (PE) regarding preparatory or auxiliary activities and introducing new anti-fragmentation rules to deny benefits from these exceptions through the fragmentation of certain business activities among closely related enterprises;
ii. Modifying the definition of a PE to address artificial arrangements of conclusion of contracts within MNEs;
iii. Revised TransferPricing Guidelines on intangibles; and
iv. Changes to the controlled foreign company (CFC)rules.

It is the only action plan which proposes changes in indirect tax laws to lesser thresholds for low value imports, requiring vendors to register and account for VAT in the jurisdiction of importation, facilitated by simplified registration mechanism.

As a member of the G20 and an active participant of the BEPS project, India is committed to the BEPS outcome. Accordingly, India has proposed to tackle this issue with the introduction of Equalisation levy on certain digital transactions, which is discussed below.

**Equalisation levy on digital transactions**

'Equalisation levy' of 6% has been introduced on consideration being made 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.

Every person, being a resident carrying on business or profession in India or a non-resident having permanent establishment in India, shall deposit the levy on the considerations payable to non-resident not having permanent establishment in India. Such levy does not apply where the aggregate amount payable to non-resident does not exceeds INR 100,000 in a year. The corresponding income would be exempt from income-tax in the hands of such non-resident.

**Impact on MNEs in consumer business sector in India:** With the advent of digital economy, the interlink between the revenue generating activity and geographical location is more obscured as compared to the past wherein a geographical connection with some economic activity entailed taxation in the said jurisdiction. Similar to countries around the world, MNEs in India have been facing tax litigation on account of various e-commerce issues e.g. online advertising, subscription for electronic databases, etc.

The introduction of anti-fragmentation rules through modification of the 'preparatory and auxiliary' definition shall create a PE risk in India especially for ecommerce companies following instant delivery or just in time delivery model wherein storage and delivery functions are key part of the companies' sales and distribution model. Ecommerce MNEs generally use services of subsidiaries for conclusion of contracts for their products or services and these contracts are routinely concluded without material modification, which shall create a PE risk for ecommerce companies post BEPS implementation in India. Further, the tax authorities in India have been challenging the characterisation of income and withholding tax on income earned by digital services provider viz. business profits, fees for technical services, PE income via distribution arrangement and server management charges, bandwidth & security services, etc.

With the introduction of Equalization Levy, MNEs will be required to undertake the requisite compliances, and may also re-examine their business models to analyse the overall tax costs.

It may also be noted that India in its recommendation to United Nations Questionnaire on BEPS has advised for withholding tax to be levied on certain digital transactions. Further, through the introduction of the proposed General and Services Tax (GST), India may consider opting for consumption based levy of VAT/GST on digital transactions.

**Action Plan 5 - Harmful tax practices**

Action plan 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. It 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.

**Impact on MNEs in consumer business sector in India**: India has always been an advocator of the substantial activity test and does not have a harmful IP or other regime. India has been a sizeable outsourcing destination for R&D activities. In order to sufficiently capitalize on the vast intellectual resources of our country, and fully reap the attendant economic benefits, it was imperative to develop patents indigenously and provide a conducive framework to encourage this process.

India did not have a specific framework to tax income from patents developed and registered in India; royalty earned by resident taxpayers was taxed at 30% on net basis, similar to most other streams of income.

With recent initiatives such as Make in India and Skill India, a concessional taxation regime is introduced in respect of income from patents, which is aimed at encouraging indigenous research and development activities and to make India a global R&D hub. This regime is applicable from financial year 2016-17 and would cover existing and new patents. The royalty income from patents developed and registered in India would be taxable at 10 percent (plus surcharge and education cess) on the gross amount of royalty. No expenditure or allowance would be allowable in such cases.

This regime would be beneficial 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.

**Action Plan 6 –Treaty Abuse**
To counter tax treaty abuse, the BEPS project has laid down minimum standards, involving a limitation on benefits [LOB] rule and / or a principal purposes test [PPT] rule.

In this regard, we would also like to draw your attention to the Protocol to India-Mauritius Double Taxation Avoidance Agreement which come into force from 19 July 2016. As per the terms of the said Protocol:

- India gets taxation rights on capital gains arising from sale of shares of an Indian resident company acquired on or after 1 April 2017. The investments made prior to 1 April 2017 are grandfathered.
- In respect of capital gains arising during the transition period from 1 April 2017 to 31 March 2019 will be limited to 50% of the domestic tax rate of India, subject to fulfillment of conditions in the LOB Article.
- Taxation in India at full domestic capital gains tax rate will be applicable for capital gains arising from 1 April 2019 onwards.

LOB Article has been introduced which provides that a resident of the state is deemed to be shell/ conduit company, if its expenditure on operations in that state is less than INR 2.7 million (Mauritius Rupees 1.5 million) in the immediately preceding 12 months from the date the gains arise. Such residents is deemed not to be a shell/ conduit company if it is listed on a recognised stock exchange of the state or its expenditure on operation is equal to or more than the amount specified above. It further provides that a resident of the state shall not be eligible to the beneficial tax rate of 50% (applicable from 1 April 2017 to 31 March 2019) on capital gains if its affairs were arranged with the primary purpose to take advantage of such benefits.

The General Anti-Avoidance Rule [GAAR] has also been introduced in the Indian tax law, and is to be implemented from 1 April 2017. The Indian GAAR overrides tax treaties, which is consistent with the OECD commentary on anti-avoidance rules. Interestingly, such a treaty override provision has been specifically included in certain recent bilateral tax treaties that India has entered into (e.g. Indian-Luxembourg tax treaty and India-Malaysia tax treaty). The PPT rule as recommended under Action 6 of BEPS is akin to the main purpose test as proposed under the Indian GAAR.

**Impact on MNEs in consumer business sector in India**: Foreign investors will be required to review their group holding structures and transactions including documentation to consider whether they are sufficiently robust to withstand tests under the LOB / PPT rule and GAAR provisions.

**Action Plan 7 – Permanent Establishments**
Action Plan 7 deals with preventing the artificial avoidance of PE status. The report provides for changes to the definition of PE under the tax treaties, which address strategies used to avoid

having a taxable presence or a PE in a country under tax treaties.

The changes suggested in the report seek to ensure that where the activities of an intermediary (intermediary models, marketing agency, agency function, etc.) 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 those activities in the course of its independent business. The Action Plan provides for changes to restrict the application of a number of exceptions to the definition of PE to activities that are preparatory or auxiliary in nature and will ensure that it is not possible to take advantage of these exceptions by the fragmentation of a cohesive operating business into several small operations.

As a follow up to the final report on Action 7, the OECD has released a Discussion Draft on the attribution of profits to PEs. The Discussion Draft draws on the existing guidance on the attribution of profits to PEs set out in the OECD's 2010 Report on the Attribution of Profits to PEs. The Discussion Draft sets out proposed guidance concerning the attribution of profits to PEs in two areas:

i. dependent agent PEs, including those created through commissionaire and similar arrangements; and
ii. warehouse operations that are no longer excepted from being fixed place of business PEs by virtue of their specific activities.

**Impact on MNEs in consumer business sector in India:** The proposed expansion of ambit 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. MNEs in consumer business sector need to analyse PE risk arising from supply chain model especially activities carried out through marketing and distribution intermediaries and function performed by liaison offices incorporated in India. In case, MNEs create a PE on account of activities undertaken by intermediaries then the same could result in tax cost in/outside India and impact the overall tax cost of the group.

**Action Plan 8 – Intangibles**

The existing international rules for transfer pricing have been found to be misapplied or considered insufficient to the extent that the allocation of profits is not aligned with the economic activity that results in profits. Action Plan 8 tries to correct the arising imbalance, as it brings out how misallocation of profits generated by valuable intangibles has contributed to BEPS. It proposes revised guidance on transfer pricing rules to ensure that operational profits are allocated to economic activities which generate them.

The report emphasizes that the group companies performing important





functions, controlling economically significant risks and contributing in development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangible, as determined through the accurate delineation of the actual transaction, should be entitled to an appropriate return reflecting the value of their contributions.The guidance also clarifies that legal ownership alone does not generate a right to all of the return that is generated by the exploitation of the intangible.

The guidance further provides that mere funding of the DEMPE of an intangible by an entity, without performing any of the important functions in relation to the intangible, and without exercising control over the financial risk, will entitle the entity only to a risk-free return. The revised guidance also seeks to ensure that transfer pricing analysis will not be weakened by information asymmetries between the tax administration and the taxpayer by providing a new tool to tax administrations, which is based on evaluation of ex-post outcomes vis-à-vis ex-ante projections to price hard-to-value intangibles.

**Impact on MNEs in consumer business sector in India:** The consumer business sector is highly competitive and branding and technology are vital factors for the success of any enterprise in this industry. Considering the significance of "brands" and "market presence" in achieving the sales/market share, the companies have been investing considerably in the marketing campaign in India. Due to significance and magnitude of investment in marketing and sales activities, marketing intangible




has been one of the most significant litigious TP issues in India for consumer business sector, with amount under litigation exceeding thousands of crore.

The revised guidance observes that under long-term contract of sole distributor rights of the trademarked product, the efforts of the distributor may enhance the value of its own intangible viz its distribution rights. A similar line of contention has been adopted by numerous Indian taxpayers where the expenditure incurred by them is for exploiting the intangible in their prescribed territory, thereby increasing the value of 'their intangible' and not that of the legal owner of the intangible. Also, the revised guidelines opine that the remuneration for such functions can come in several forms such as separate compensation, reduction in price of goods, reduction in royalty rates, etc., which is similar to the view taken by the Delhi High Court in case of Sony Ericsson and others . The taxpayers can draw support from the revised guidance on such aspects (e.g., long-term contract, 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.

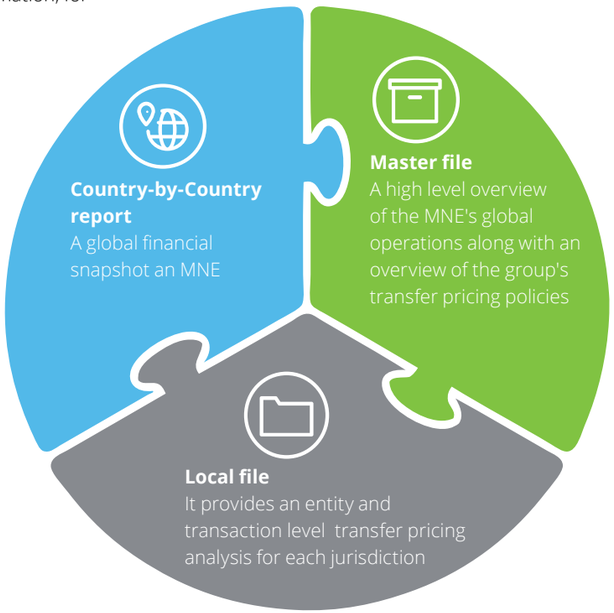
Further, for several constituents of the consumer business sectors, technology plays a crucial role in the product differentiation. In Indian context, MNEs have incorporated R&D centers in India to take advantage of the availability of abundant and economical talent pool. Further increased focus on brand-positioning for augmenting the business/ market share is also a key objective for their Indian presence.In this regard, exercising important functions by the foreign principal and control over service providers are important factors for determination of ownership and entitlement to intangible related return.

Accordingly, MNEs in consumer business sector need to review their current IP holding structure and how they manage the ownership and DEMPE related functions of intangibles. It would be of paramount importance for the MNEs to prepare robust documentation with regards to development and exploitation of intangibles in various jurisdictions and link the same to the allocation of value/ profits arising from such activities.

Another important aspect is on the generation of intangibles through digital medium wherein consumer business entities collect, analyse and use consumer data by tracking behaviors which in itself could constitute an intangible property in the country in which the data is collected, analysed and thereby result in allocation of profit for such activities.

**Action Plan 13 Three Tier Transfer Pricing Documentation**

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:




As an active member in the BEPS initiative, for implementing the international consensus on Action 13 of the BEPS project, India has introduced the Country by Country (CbC) reporting requirement and the concept of master file in the Indian Income Tax Act, 1961 (through the Finance Act 2016).

**CbC reporting**

The CbC reporting requirement is introduced with effect from Assessment Year 2017-18 (financial year 2016-17). India will adhere to the OECD prescribed group revenue threshold of Euro 750 million (INR equivalent) for the applicability of the CbC requirement. Indian headquartered MNEs having consolidated group revenues above approx INR 5395 crore (equivalent to Euro 750 million) will be required to file the CbC report in India for Assessment Year 2017-18 (financial year 2016-17) onwards.





MNEs not headquartered in India, having group companies resident in India will be required to notify Indian authorities of the details of their parent entity/alternate reporting entity and its jurisdiction. In certain scenarios, such companies will also be required to file their CbC report in India (such as when India does not have an exchange of information agreement with their parent entity jurisdiction or where there has been a systemic failure in exchange of such reports).

As per existing Indian regulations, the information requirements of the CbC report are similar to those prescribed by the OCED BEPS Action Plan 13. The CbC report is required to set out for each jurisdiction, specified data pertaining to revenue, income, taxes, number of employees, capital and tangible assets. The CbC report is required to be filed in India 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 (April to March) in March. Stringent penalty provisions have also been prescribed for non-furnishing and/or furnishing inaccurate particulars. The core provisions are included in the Act and the balance detailed provisions in the Income Tax Rules.

**Master File**

The memorandum to the Finance Bill 2016 introduced the concept of Master File, whereby entities being constituent of an international group shall be required to maintain and furnish the Master File. The Memorandum provided that the rules prescribing the information and document as mandated for master file under OECD BEPS Action 13 report shall be prescribed in the rules. The Master File is intended to provide a high-level overview of the MNE groups' business, including the nature of its global business operations, value drivers, supply chain analysis, intangibles employed, financial arrangements, overall transfer pricing policies, and financial and tax positions. The Memorandum also provides for the penalty leviable for non-furnishing of the information and document to the prescribed authority.

**Local File**

The Indian transfer pricing regulations under Section 92D read with Rule 10D of the Income Tax Rules 1962 require every person who has entered into an international transaction to maintain prescribed information /documents for substantiating the arm's length price

of its transactions with the related parties. It is possible that the Local File guidelines in the OECD BEPS Action 13 Report may also be incorporated in the expected rules to the extent it is not already covered by the existing Rule 10D documentation requirements.

**Impact**

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.

**Impact on MNEs in consumer business sector in India:** 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, 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. Taxpayers will need to be more meticulous in preparing documentation as tax authorities globally (including India) will have access to the information. This would significantly raise the benchmark for the quality of information reported to Indian authorities.

Indian authorities in trying to protect their revenue base, may take a greater interest in the MNEs 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, MNEs will be required to substantiate that they have delineated the transaction accurately as reflected in the documentation.

Tax authorities are also 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 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.
In addition to the above action plans, MNEs in consumer business should also consider evaluation of the impact on deduction of interest cost in light of funding through hybrid instruments like compulsory convertible debentures and limitation of interest deduction under the fixed ratio rule under Action plan 4.

**Conclusion**

Considering the consumer centric business model of consumer business sector entities, MNEs in this sector need to align their tax models in line with the OECD BEPS Actions. From both inbound and outbound investment perspective, the MNEs in consumer business need to track tax policy changes as regards management of intangiblesparticularly brands, remodel their supply chain models, review the group holding structure along with inter-company transactions,evaluate the tax aspect of digital transactions in order to meet the level of compliance requirements and undertake risk assessment of the transfer pricing policy and documentation along with the reporting requirements.

All in all the MNEs in consumer business need to align their business models with regards to the actual 'value generation' to 'economic activity' in countries which they operate.

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