BEPS

Impact on Manufacturing

Base Erosion and Profit Shifting

India has emerged as the seventh largest economy. Favorable demographics, a burgeoning domestic market and an annual growth rate in excess of 7% in recent years has led severalmultinational enterprises (MNEs) to establishtheir manufacturing facilities in India. The Indian economy is now getting integrated with the global market and any change at a global level is increasing impacting entities operating in India. Cross border transactions including those between MNE groups have increased manifold inviting attention of tax authorities to safeguard the tax base.

The Organisation for Economic Co-operation and Development [OECD] commenced work on the Base Erosion and Profit Shifting [BEPS] project to address concerns that existing principles of domestic and international taxation were failing to keep pace with the global nature of modern business models.

Thefinal BEPS reports were released on 5 October 2015 and ratified by the G-20 Finance Ministers at their meeting in Lima, Peru on 8 October 2015. As a member of the G20 and an active participant in the BEPS project, India has started implementing some of the BEPS action plan by making amendment in its domestic tax laws.

This paper seeks to capture some of the key potential impact of BEPS Actions for Indian MNEs in the manufacturing sector having global operations as well as to MNEs operating in India.

What is BEPS?
Base erosion and Profit Shifting refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profit 'disappear' for tax purpose or to shift profits to locations where there is little or no real activity but taxes are low, resulting in little or no overall corporate tax being paid

Final BEPS Action Plans were released on October 5, 2015

Local countries have started enacting / amending laws and tax treaties to implement BEPS action plans

Overview of action plans
The BEPS action plans are structured around three fundamental pillars of Coherence, Substance and transparency. The action plans can be classified as follows:

Establishing coherence in corporate taxation

- Action plan 2 # Hybrid mismatch
- Action plan 3 # CFC rules
- Action plan 4# Limit base erosion involving interest deduction and other financial payments
- 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

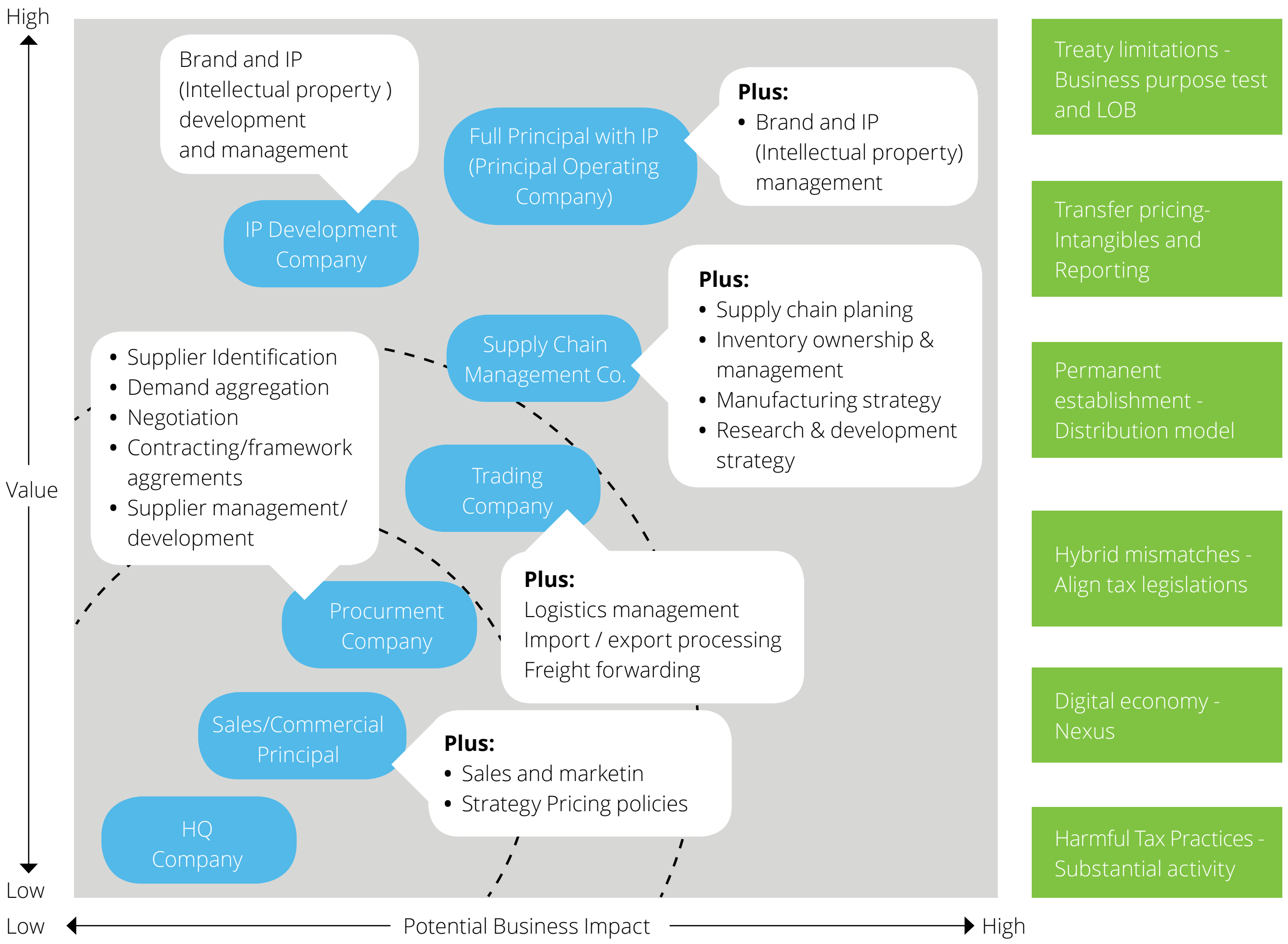
- Action plan 11# Data collection and analysis
- Action plan 12# Disclosure of aggressive tax planning
- Action plan 13# TP documentation and CbC reporting
- Action plan 14# Dispute resolution mechanisms

Turning tax polices in to tax rules

- Action plan 15# Develop multilateral instruments

BEPS impact on Manufacturing Sector

BEPS action plans shall impact the overall business model of the MNEs in manufacturing sector. The below diagrammatic representation highlights the business models and the actions plans that are likely to impact MNEs in manufacturing sector:

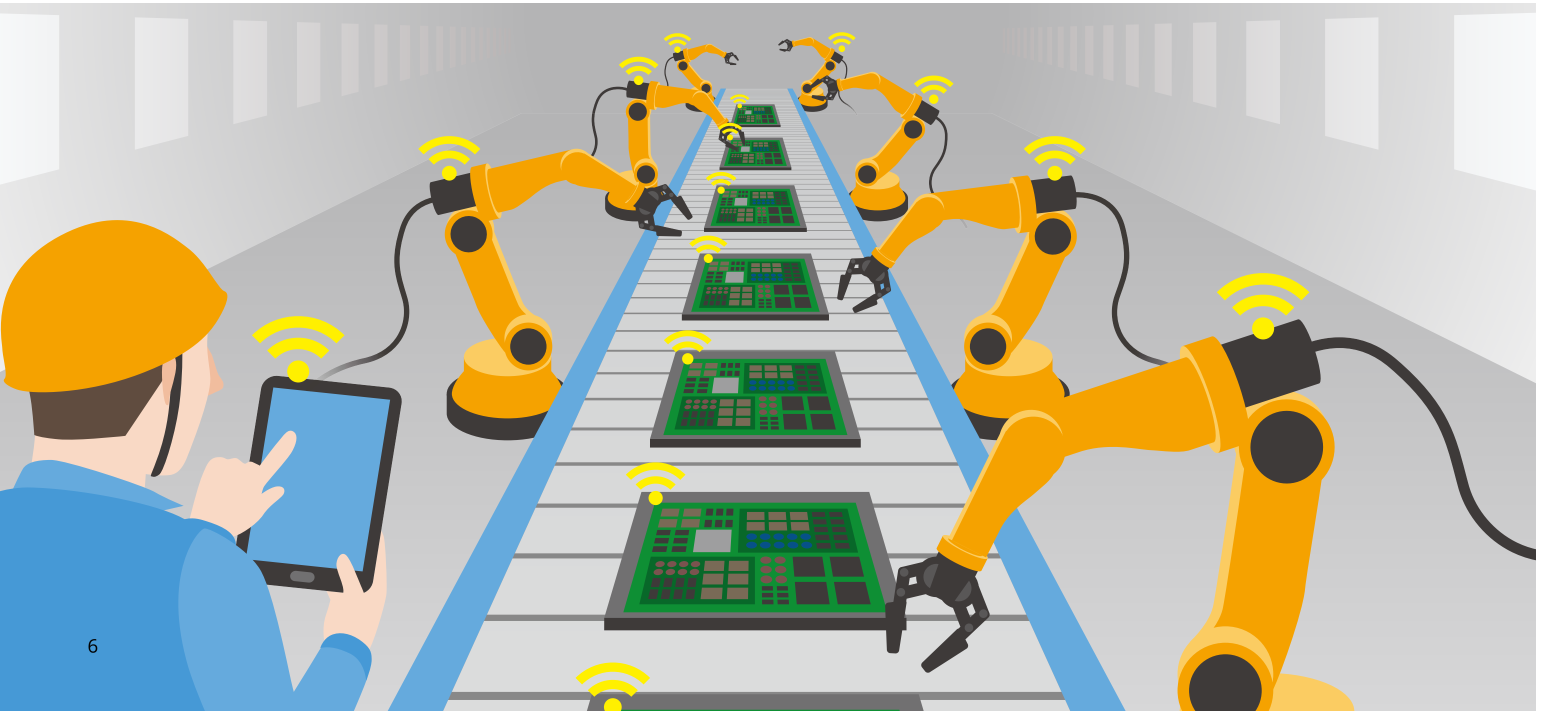


Impact on Investment holding structure

Intermediate holding structure

A significant amount of investment flows into India from companies incorporated within intermediary jurisdictions, which have favourable tax treaties with India. 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.

The general anti-avoidance rule [GAAR] has been introduced in the Indian tax law, and is to be implemented from 1 April 2017. The Indian GAAR overrides tax treaties, which is consistent with the OECD commentary on anti-avoidance rules. Interestingly, such a treaty override provision has been specifically included in certain recent bilateral tax treaties that India has entered into (e.g. Indian-Luxembourg tax treaty and India-Malaysia tax treaty).The PPT rule as recommended under Action 6 of BEPS is akin to the main purpose test as proposed under the Indian GAAR. The GAAR would allow the revenue authorities to analyse and go deeper into the transactions and / or arrangements (e.g. judging their ownership structures, beneficial ownerships, voting rights, etc.) and would permit them to draw inference as to whether a particular entity is a conduit entity without any real economic substance / activity and the main purpose of setting up the entity is to obtain preferential tax benefit.



Substance based approach

The GAAR and LOB / PPT rule may impact intermediate holding structure put in place by MNEs in manufacturing sector, which lack substance and have been interposed only to avail tax treaty benefits. Foreign investors need to review their group structures and investment modes including documentation to consider whether they are sufficiently robust to withstand a potential challenge under the LOB / PPT rule.

India has always been an advocator of the substantial activity test and does not have a harmful IP or other regime. Action Plan 8 of the BEPS report emphasizes that the group companies performing important functions, controlling economically significant risks and contributing assets in development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangible, as determined through the accurate delineation of the actual transaction, shall also be entitled to an appropriate return reflecting the value of their contributions. Indian MNEs that may have opted for some of the 'harmful' IP regime to house patents and copyrights in overseas jurisdictions need to relook at their IP holding structure and align the value creation activities with the economic activities undertaken in India.

India has also introduced patent box regime which provides for 10% (plus surcharge and cess) concessional tax rate on gross basis for worldwide royalty income arising from the exploitation of patents developed and registered in India

by Indian residents. Considering the BEPS recommendation on nexus approach, India has restricted the benefit to only those patents for which at least 75% of the expenditure is incurred in India.

Impact on Operation and contracting arrangements

Supply chain model

Many multinational enterprises operate in India through a subsidiary to marketing support – typically the Indian subsidiary receives a fee or commission that is taxable in India, whereas the overseas group entity is not taxable in India on the profit of the sales, in the absence of a PE in India. The proposed expansion of the definition of agency PE in the context of conclusion of contracts discussed above and the inability of the Indian subsidiary to be regarded as an 'independent agent' could expose a part of the overseas group entity's profit on sale of products to be taxed in India, depending on the facts of the case.

One of the recommendations in Action 7 dealing with preventing the artificial avoidance of PE status is that the PE exceptions will be modified to ensure that all activities that qualify for exemption are purely in the nature of preparatory and auxiliary activities. In the light of the recommendations under action plan 7, exceptions from creating a PE for specific activities (such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing or collection of information) will only apply where the activity in question is of preparatory or auxiliary character. This is to reflect modern ways of doing business, where such activities may represent a key part of the value chain of a business (particularly relevant for supply chain involving digital sales).

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

Impact on funding structure

Hybrid mismatch

A large number of foreign companies invest in India by subscribing to Compulsory Convertible Debentures [CCDs] issued by their Indian subsidiaries. Till the time of conversion to equity, India would generally regard the CCDs as debt and grant a tax deduction for interest on such CCDs. With the proposed linking rules in relation to hybrid instruments contemplated under BEPS, if the home country of the CCD-holder regards the instrument as equity and does not tax the dividend, India may deny a deduction for such interest.

Another related rule in relation to hybrid instruments is imported hybrid mismatches – pursuant to this proposal, the Indian Revenue authorities may investigate overseas borrowing transactions.

Interest deduction

India is typically regarded as a high tax jurisdiction from the corporate tax perspective. The BEPS proposal to limit interest deductions by following a fixed ratio rule may impact the interest deductibility of manufacturing MNEs in India.

Digital economy

Online advertisement

BEPS Action plan 1 on "Addressing Tax Challenges in Digital Economy" is aimed at addressing tax issues in the digital economy which include artificial shifting of income, avoidance of direct tax nexus and avoidance of Value Added Tax. The report discusses measures to address these tax challenge, however, these measures are not recommended as an international standard in the report and could be imposed through domestic legislation.

Through Finance Act 2016, India introduced equalisation levy on specified services which include online advertisement, provision of digital advertising space and other facilities/ services for the purpose of online advertisement. Any payment made to a non-resident, who does have a permanent establishment in India, for specified services is subject to an equalisation levy of 6%. Payment for such services would however not be considered as income for income tax purposes.

Transfer pricing considerations

Non-recognition: The Indian tax authorities have historically resorted to re-characterising transactions challenging the substance of the transaction, in the pre-BEPS period as well. Indian authorities have usually re-characterised transactions such as: (i) domestic

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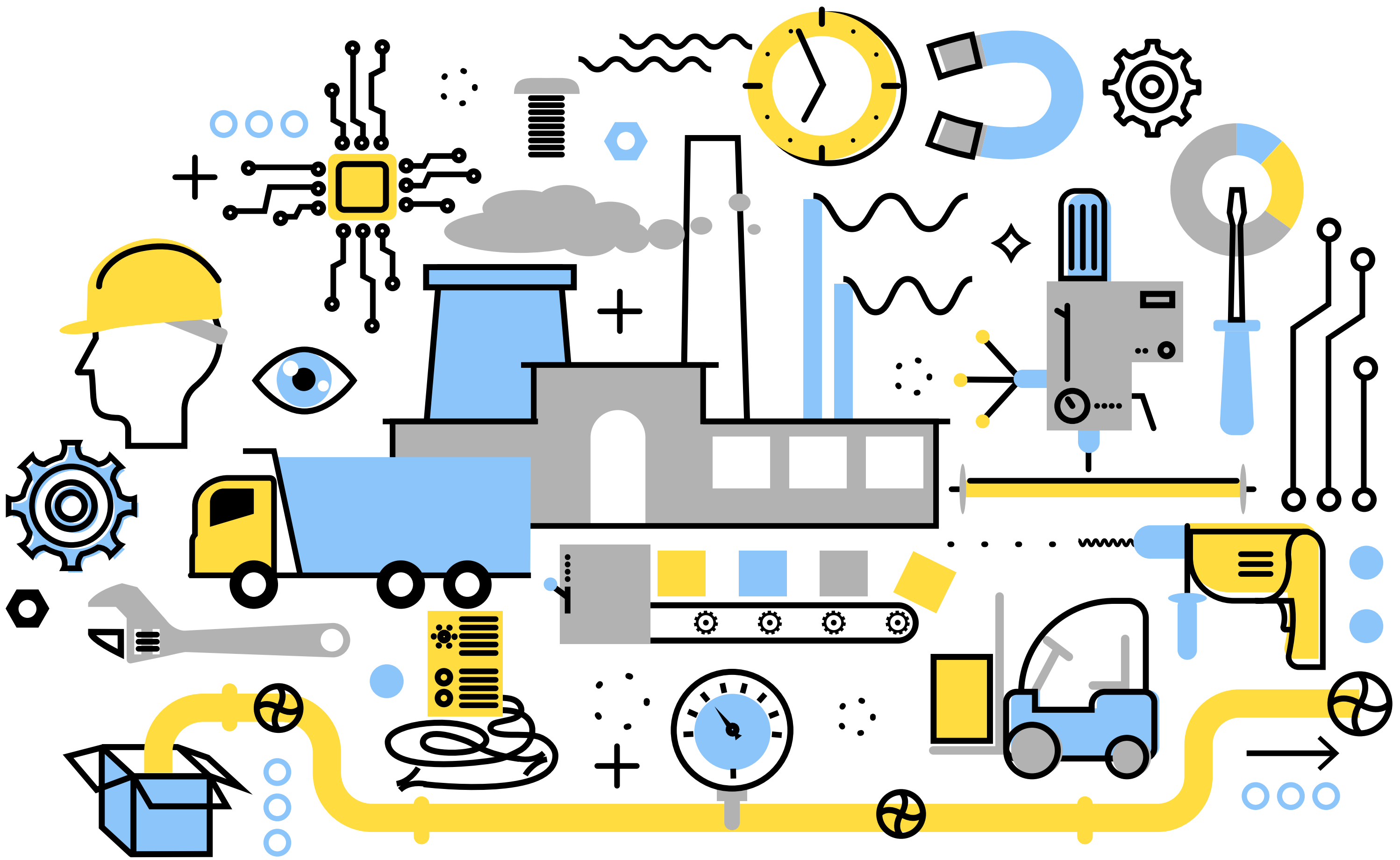


advertising and marketing expenses as provision of brand building services; (ii) Management fees. Given that the new guidance focuses on commercial rationality rather than substance, MNEs need to factor in and evaluate the impact of the new guidance on the positions adopted by them.

Indian MNEs, vis-à-vis their global operations need to evaluate their positions in the backdrop of this guidance which goes to the root of the transfer pricing analysis and reinforces the 'substance over form' principle. 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.

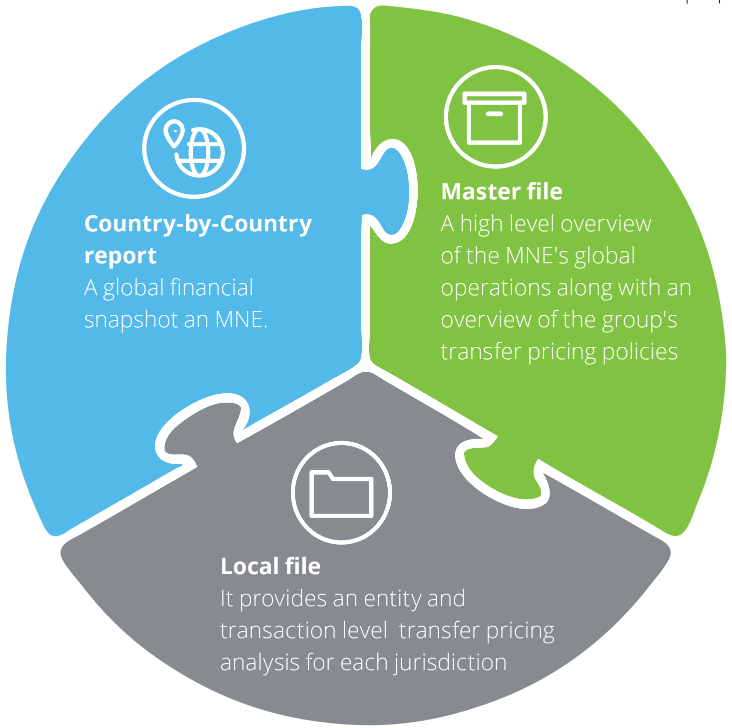
Intangibles and risk: India has emerged as an important location for research and development (R&D) centres for MNEs. These centres function as in-house resource centres where all investments are done by the global affiliates. The Indian tax authorities have, in the past, in some cases contended that the Indian R&D centre is the economic owner of the intangible and is entitled to receive a portion of the non-routine returns derived from the intangibles developed by the Indian R&D centre. In such cases, the Indian authorities have argued that application of the profit split method is more appropriate than expecting a routine cost-plus return. With a view to establishing a degree of certainty and uniformity in the audits of development centres engaged in R&D activities, guidance was provided vide Circular No. 6. Circular indicates that contracts could be the starting point of the analysis, although the conduct of the parties is the ultimate determinant when focusing on functions, risks and costs.

The revised BEPS guidance also emphasises supplementing the contractual arrangement through examination of the actual conduct of the parties and also emphasises on value created by the group companies through functions performed, assets used and risk assumed in DEMPE of the intangible.

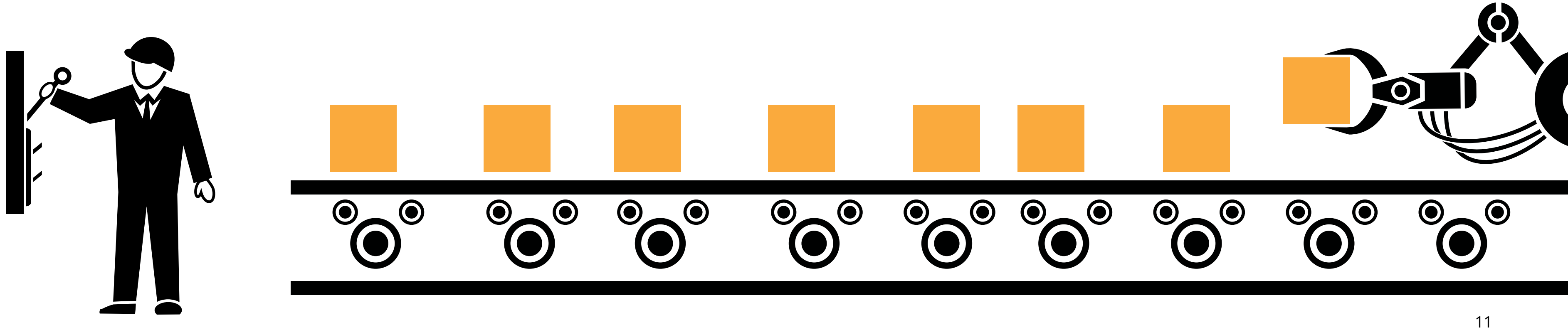
Location savings: Various MNCs work on contract manufacturing business model in India where entire output is exported to associated enterprises outside India. Indian tax authorities at lower level have been of the view that the part of the benefit of location savings (referred to the cost savings attributable to operating in particular low cost jurisdictions, such as India), should be retained by the Indian group entity. However, such an approach has not been favoured by the Indian judiciary in several judicial precedents. The divergent Indian view would need to be aligned to the BEPS guidance which provides a step wise approach to determine the allocation of location savings.

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:



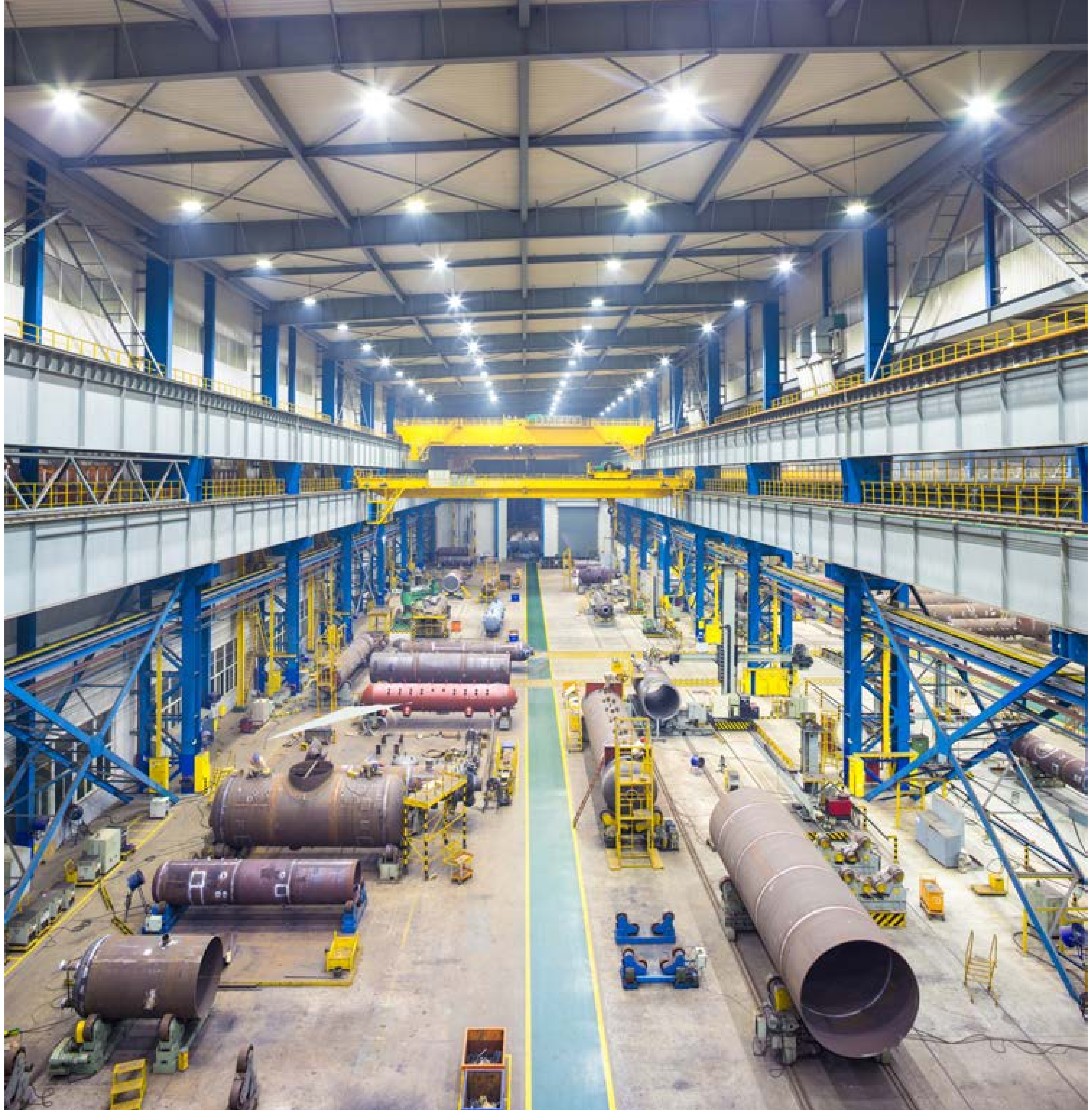
As an active member in the BEPS initiative, for implementing the international consensus on Action 13 of the BEPS project, India has introduced the Country by Country (CbC) reporting requirement and the concept of master file in the Indian Income Tax Act, 1961 (through the Finance Act 2016).



Country-by-Country (CbC) report
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 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 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.



BEPS | Impact on Manufacturing

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
CbC template as provided in the Guidelines is intended to be used only for risk assessment purposes, CbC report is not a conclusive evidence on whether transfer prices are appropriate or not. It will be imperative for MNEs to evaluate the existing data, data gaps, economic inconsistencies and non-compliance with transfer pricing policies. MNEs would need 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. The new documentation requirements should drive MNEs to revisit the overall supply chain models of their businesses. A thorough analyses of the organizational and operating structure could help mitigate exposure through valid corrective measures.

Multilateral Agreements
Recently more than 100 jurisdictions including India concluded negotiations on a multilateral instrument, which is envisaged to implement the results from BEPS project in several thousand tax treaties worldwide and hence

would diminish tax avoidance by MNEs. This development will facilitate rapid amendment of worldwide network of treaties rather than implementing the amendments on a treaty by treaty basis. This will ensure consistency in implementation of the BEPS project and provide more certainty to business.

A Step wise plan

Way forward for manufacturing business

1. Stay updated and keeping proper information on the OECD developments on BEPS
2. Assess roadmap for addressing immediate tax and transfer pricing challenges
3. Identify contractual structure which need to be revisited from a substance perspective
4. Align substance and legal form of transactions
5. Evaluate intra-group transactions & actual substance and look at profitability per country, to identify any potential risk
6. Review of 'tax haven' jurisdictions, given the focus of attention in the future

As a member of the G20 and an active participant in the BEPS project, India is committed to the BEPS project outcome and implementation as seen from the changes introduced in the Finance Act, 2016. Therefore companies operating in India and Indian MNEs need to be aware of and constantly monitor the changes that India and other countries are bringing about in their domestic laws and tax treaties, including positions on the multilateral instrument, in order to evaluate the BEPS impact in relation to their operations.