BEPS
Impact on Private Equity

BEPS impact on private equityspace – An Indian perspective

In this age of increasing focus on bottomlines, it is indeed tempting for a global tax director of a multinational ('MNC') to explore leveraging on arbitrage amongst tax rates of various countries and to park profits in low tax jurisdictions. While such investment/ transfer pricing structures are generally within the four corners of law, not unsurprisingly, they create a disconnect between countries where MNCs carry out substantial activities and countries where they report profits.

With the advent of 'fair share of tax' discussions and more global approach by the Governments to a taxpayer's tax profile, it is only natural that these structures are increasingly being viewed as resulting in 'base erosion and profit shifting' ('BEPS'), thereby depleting tax revenues for the Governments globally.

In order to address the concerns created by BEPS, G20 countries and Organisation for Economic Co-operation and Development (OECD) have introduced the BEPS project, for which the final plans were released on 5 October 2015. These plans have been designed to ensure that both developed and developing worlds levy and collect their 'fair share' of tax. More specifically, each action plan intends to scrutinize and correct a certain tax evasion mechanism.

While India is not a member of OECD, it is an active participant in the BEPS project, and is committed to its implementation. With growing Private Equity ('PE') activity in India, these actions are likely to have far reaching impact on PE investments and related structures. We have summarized below some of the key areas -

Time to have a re look at Mauritius, Singapore holding structures

Private equity investors in the past have been making investments in India from holding jurisdictions like Mauritius, Singapore, Netherlands etc. In many cases, these companies have no real substance and are established primarily to take advantage of tax treaty benefits.

Action Plan 6 (which intends to curtail treaty shopping and other methods that deprive countries of tax revenues) aims to prevent 'treaty abuse' through several economic and political considerations. The plan lays out the following approach to deal with treaty shopping:

- Inclusion of Limitation of Benefit Clause in treaties; and / or
- Inclusion of general anti-abuse rule (Principle Purpose Test) in treaties.

The plan is presently in draft stage as it requires collaboration and consensus amongst several countries.

The recent amendments in India-Mauritius (and consequently India-Singapore) and India-Cyprus treaties to provide for source based taxation of capital gains, going forward, is a move towards aligning with Action Plan 6.

The CBDT has on 10 May 2016 issued a Protocol to amend the India – Mauritius tax treaty as follows:

- Shares acquired prior to 31 March 2017 would be grandfathered and would continue to be tax exempt;
- If the shares are acquired on or after 01 April 2017 are sold before 31 March 2019, then the tax payable in India in respect of capital gains would be 50% of the applicable rate.
- If the shares are sold post 31 March 2019, then the gains would be taxed at the full domestic tax rate.

As a result of the amendment to the India – Mauritius treaty, the taxation of capital gains under the India – Singapore treaty would also be impacted since the capital gains provisions in the India – Singapore treaty are linked to the capital gains provisions in the India – Mauritius treaty.

India has signed a new Double Taxation Avoidance Agreement (DTAA) with Cyprus on 18 November 2016 provides for taxation of capital gains from alienation of shares of an Indian company acquired on or after 1 April 2017 in India.

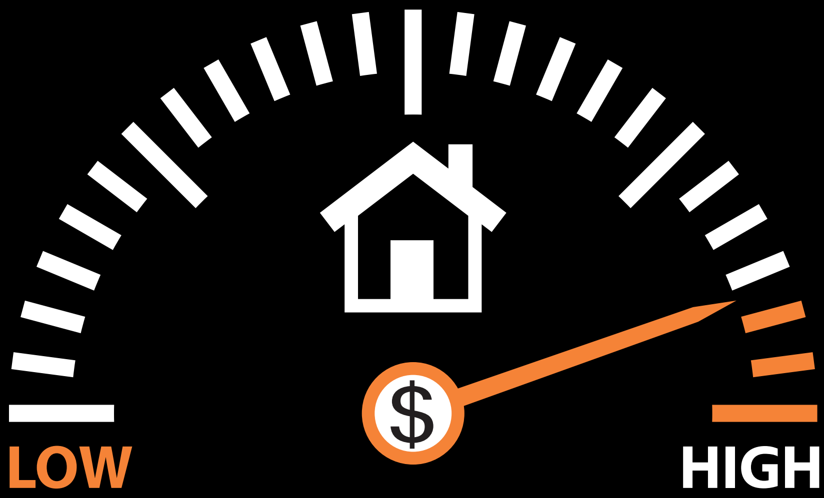
According to news reports, there are ongoing discussions between the Governments of India and Singapore which are expected to incorporate similar amendments in India Singapore DTAA.

Further, here are key considerations from the perspective of various modes of investments that PEs have historically adopted for investing in India -

FDI investments
Currently, a majority of the PE funds investing across Asia, have established holding vehicles in Mauritius / Singapore / Netherlands. The BEPS scrutiny aims to curb the shell-companies/ letter-box companies existing merely for tax avoidance. Therefore, structures that entail creating layers of intermediary subsidiaries, without commercial substance, are likely to be impacted.

FPI investments
Additionally, collective investment vehicles (CIVs) will be adjudged on their residential status based on the residential status of its investors / stakeholders and taxed accordingly. Apart from resulting in denial of treaty benefits to CIVs, this might be a difficult provision to comply with for the CIVs that have frequent changes in the ownership patterns.

From a transfer pricing perspective, another challenge that the proposed plan may pose for a multi-layered investment structure is the need to justify profits allocation to each entity basis its functional and risk profile, resulting in effective denial of the commonly adopted argument that profits from investment activity belong to the registered shareholder vehicle. In a scenario where, in a chain of investment vehicles, certain vehicles (especially those claiming treaty benefits), are unable to demonstrate the value they add to the underlying investment, the action plan may result in re-allocation of profits and consequent tax issues. More specifically, the BEPS guidance emphasizes that the entity only providing capital without bearing any funding risk or performing key functions (such as final investment decision), would be entitled to no more than a risk free return.



The Indian Government is mindful of the tax evasions through international transactions involving treaty shopping and has been proactive in introducing and announcing measures such as
a) anti-abuse rules ('GAAR') which can override the tax treaty benefits
b) taxation of indirect transfer,
c) focus on tax residency through introduction of the concept of place of effective management and substance test etc.

All in all, need of the hour for PE industry is to build, document and demonstrate adequate substance in the holding jurisdictions to address the risk of treaty denial.

Financing Indian companies – Hybrid mismatch
Hybrid mismatch may arise on account of royalties, payment for

BEPS | Impact on Private Equity

goods, bonds or debentures where a company claims tax deduction in one jurisdiction (for example, in India), while the recipient entity does not offer the corresponding income to tax in its home jurisdiction. Action Plan 2 entails neutralizing the effects of hybrid mismatch arrangements through:

- Primary linking rule – If income is non-taxable, deny deduction in the payer's jurisdiction; and
- Defensive rule – If primary rule fails, include income for taxation in the recipient's jurisdiction.

PE investors often make investments in India by subscribing to debt/ quasi-equity instruments that seek to achieve commercially agreed waterfall mechanism is a tax efficient manner.

Payment of interest by an Indian entity on Compulsorily Convertible Debentures (CCDs) / Non-convertible debentures (NCDs) is often tax deductible for Indian income tax purposes. However, the same may be considered as dividend in overseas jurisdiction and be exempt from taxation due to participation exemption clause. This effectively results in a 'double dip' for investors.

Although India doesnot have thin capitalization rules, the GAAR provisions, once in force from 1 April 2017, will allow recharacterizationof debt into equity in abusive cases. This may impact typical debt structures including hybrid convertible debt, bonds or convertible debentures. Considering this, MNCs need to review their existing funding structures and ascertain whether their structures lead to a deduction cum non-income inclusion outcome which has potential tax risks.

Interest deduction on debt instruments

Companies structure their holding pattern in a manner to transfer their debt or generate tax deductible interest payments at multiple levels of holding structure in order to increase their interest deductions. Action Plan 4 restricts double non-taxation via interest deductions and other financial payments.

The plan outlines several best practices and suggests a range bound ratio for an entity's interest deduction vis-à-vis the EBITDA. This approach will avoid any inflated interest deductions availed by

group entities. It also has a dual benefit of allowing companies to carry forward their unused interest deduction which can be claimed at a future date when a company is profitable.

Limiting interest deduction and its consequent impact thereon may require amendments in local law. Issues may arise in case of disallowance of interest without a corresponding adjustment in the hands of the recipient leading to some double taxation. Application of common benchmark fixed ratio could impact debt geared companies like real estate and infrastructure. Interest limitation based on a fixed ratio may lead to disallowance of legitimate interest deductions. MNCs would need to review their existing financing structures to avoid any major disallowances later which may impact their businesses. To get more certainty, MNCs may evaluate adopting the MAP route.

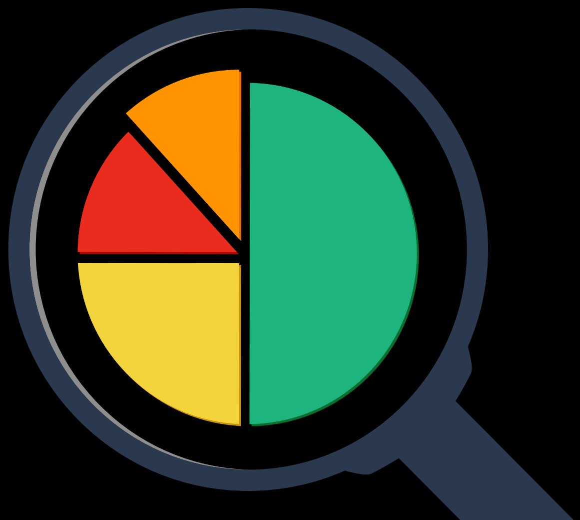
Creation of Permanent Establishment in a typical fund structure

Typically in an overseas fund structure, Indian advisory company provides non-binding non-exclusive services to the overseas management company vide an advisory agreement. The local team in India sources the deal, evaluates opportunities and presents their findings to the overseas manager.

The widening of Permanent Establishment ambit could have repercussions on Funds operating from abroad and soliciting advice from Indian advisory companies. Action Plan 7 focuses on the artificial avoidance of Permanent Establishment. It proposes

amendment of the Permanent Establishment definition to include the commissionaire arrangements and exclude certain exceptions for the preparatory and ancillary activities.

If the Indian advisory company plays a principal role (such as making the investment decision) leading to the conclusion of contracts that are routinely concluded by the foreign principal without material modification, it could create a Permanent Establishment of the foreign principal in India. If an FPI has a related party broker/ custodian in India that habitually plays a principal role in concluding contracts on behalf of the FPI, a dependent agency Permanent Establishment may be created. Under this action plan, such structures may be viewed as the Fund having a presence in India in the form of a Permanent Establishment.



Creation of a Permanent Establishment could result in taxation of a part of the overseas group entity's profit in India. 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 income of the foreign principal would be of critical importance.

Advisory entities are typically compensated on cost + basis, but whether their compensation is at arm's length is a burning TP issue in PE industry.

The BEPS guidance emphasizes that transfer pricing outcomes should be aligned with value creation. As per industry framework, the Indian advisory company typically identifies and analyses investment opportunities for the Fund's investments, while the overseas manager reviews the analysis and makes its recommendations to the Fund. The Fund is to assess the opportunity and make the final decision to approve or reject the investment opportunity. In this

BEPS | Impact on Private Equity

context, BEPS focuses on where the critical functions (such as final decision to make or not to make the investment) are performed and which entity controls and manages the risk related to the investment. Therefore, it would be critical to ensure that each entity (Indian advisory company, the overseas manager and the Fund) is allocated its fair share of income based on its functional and risk profile. To enable the Fund to claim a significant part of the income from investments, in addition to funding, it would need to perform the key value generating functions (such as final investment decision) and have control over risk and demonstrate the same with documentary evidence. Therefore, going forward, a robust functional and risk analysis would be required to determine allocation of income from investments.

Re-examine 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 major change being related to country-by-country (CbC) reporting which provides a global financial snapshot.

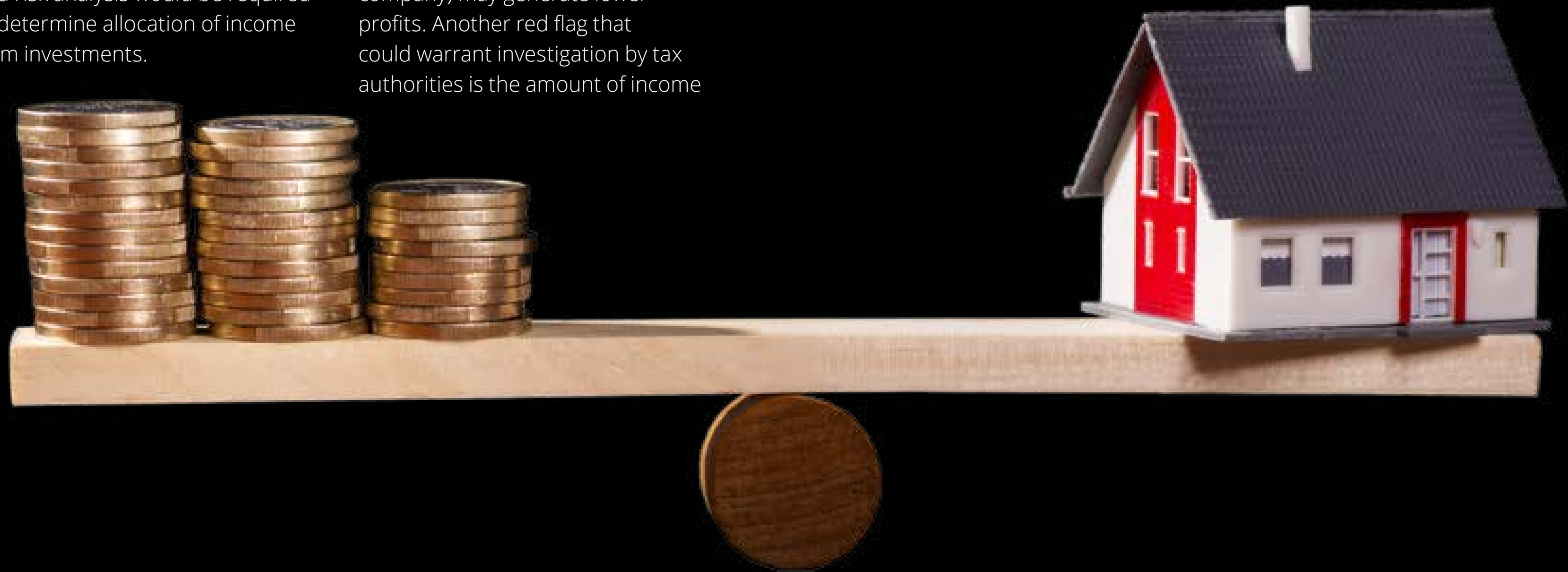
In the PE context, it will be imperative for PE players that their CbC report is interpreted in an appropriate manner. It is characteristic of the PE space to have large amounts of value and profit being generated by highly qualified senior employees while the larger team (at the advisory company) may generate lower profits. Another red flag that could warrant investigation by tax authorities is the amount of income tax paid relative to revenues, such as higher revenues being earned in low tax jurisdictions. Thus any focus by tax authorities on specific variables such as number of employees, taxes in specific locations can lead to detailed investigations.

Applicability of CbC reporting rules to PE

The Indian regulations do not provide any clarification on the said aspect. In this regard, reference may be drawn on recently realized "Guidance on the Implementation of Country-by-Country Reporting" relating to BEPS Action 13, which states that as per paragraph 55 of the Action 13 Report, there is no general exemption for investment funds. The relevant extracts of para 55 is mentioned below:

"55. It is considered that no exemptions from filing the Country-by-Country Report should be adopted apart from the exemptions outlined in this section. In particular, no special industry exemptions should be provided, no general exemption for investment funds should be provided, and no exemption for non-corporate entities or non-public corporate entities should be provided……"

Therefore the governing principle is to follow the accounting consolidation rules. For example,



if the accounting rules instruct investment entities not to be consolidated with investee companies (e.g. because the consolidated accounts for the investment entity should instead report fair value of the investment through profit and loss), then the investee companies should not form part of a Group. This principle applies even where the investment entity has a controlling interest in the investee company.

On the other hand, if the accounting rules require an investment entity to consolidate with a subsidiary, such as where that subsidiary provides services that relate to the investment entity's investment activities, then the subsidiary should be part of a Group.

It is still possible for a company, which is owned by a PE, to control other entities such that, in combination with these other entities, it forms a Group. In this case, and if the Group exceeds the revenue threshold, it would need to comply with the requirement to file a CbC report.

Thus, the governing principles to determine whether a PE is part of a group or must include investees in its compliance with the CbC requirements are the accounting consolidation rules.

Conclusion

In summary, the BEPS guidance presents considerable changes in the way PE investors structure and report their transactions. They will need to review the use of holding company structures, manner of funding Indian companies, investment advisory arrangements, etc. It is imperative for them to accurately delineate the transactions / decision making process to establish a coherent transfer pricing policy that aligns the allocation of income with value creation (that is supported by documentary evidence).