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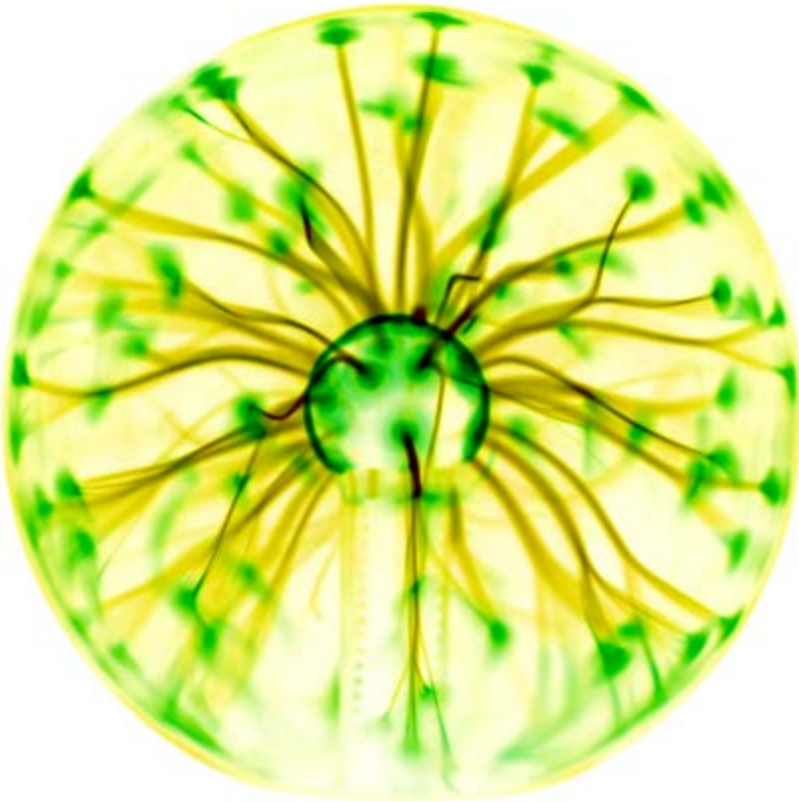


BEPS

Impact on Technology, Media and Telecommunication

BEPS – Impact on TMT Business

"Let's be crystal clear: What is at stake is to restore the confidence of your people in the fairness of our tax systems."

- Angel Gurría, OECD Secretary-General, speaking at G20 Ankara Meeting of Finance Ministers and Central Bank Governors on 5 September 2015

The growth of international businesses has been accompanied by the development of strategies and structures designed to minimize taxes across the jurisdictions in which they operate. These actions have been countered by the tax authorities attempts to control what they consider to be abuses of the tax system through exploitation of the differences and asymmetries in the domestic and international tax rules. Multinational Companies have been under fire for not payingtheir "fair share" of taxes. Yet they have all emphasized that they are following the tax laws to the letter, and havebeen planning their affairs in a legally permissible manner. The negative media coverage and the public ire towards these multinational companies have put political parties under pressure to look at this matter. In September 2013, G20 Leaders endorsed the ambitious and comprehensive Action Plan on BEPS. 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.

"The international tax system is outdated, we are bringing it up to date."

- Pascal Saint-Amans Director, Centre of Tax Policy and Administration, OECD

The Organization for Economic Co-operation and Development (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. The 15 final reports[1] released by OECD on 5 October 2015 under the BEPS project have the following broad objectives -

Establishing coherence in corporate taxation

- action #2 hybrid mismatches
- action#3 CFC rules
- action #4 limit base erosion
- action #5 harmful practices

Restoring effects of international standards

- action #6 prevent treaty abuses
- action #7 artificial avoidance of PE
- action #8, 9, 10 value creation intangibles, risks and capital, high risks transactions

Turning tax policies into tax rules

- #15 develop multilateral instrument

Ensuring transparency while promoting predictability

- action #11 data collection and analysis
- action #12 disclosure aggressive tax planning
- action #13 TP documentation & CbC reporting
- action #14 dispute resolution mechanisms

Action #1 address challenge of digital economy

[1]On 8 October 2015, the G-20 Finance Ministers at their meeting in Lima, Peru endorsed these reports.

Under the BEPS action plan, a comprehensive package of measures has been agreed upon and the participating countries have committed to its implementation. The countries have agreed to a minimum standard (preventing treaty shopping, country by country reporting, harmful tax practices, and dispute resolution) to tackle issues where no action by some countries would have created negative impact on other countries. Existing standards have been updated and will be implemented despite the fact that not all BEPS participating countries have endorsed the standards on tax treaties and transfer pricing. In other areas viz., hybrid mismatch arrangements and interest deductibility countries have agreed a general tax policy and are expected to come together over a period of time. BEPS outcomes prescribed although not legally binding, but there is an expectation that they will be implemented accordingly by countries that are part of the consensus.

Further, as a part of the implementation process, 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.

BEPS and Companies in Technology, Media and Telecom (TMT) space

India, being a member of the G20 nations, has actively participated in the OECD BEPS project and is committed to its outcome. The BEPS project is extremely relevant for India especially Action 1 on the Digital economy as it has revolutionized traditional ways of conducting business around the world including India and a digital revolution is taking place. The digital economy is based on conventional production of goods and servicessuch assoftware development, IT services, telecommunications, advertising, or content creation. The global companies serving millions of users are changing the rules of the game and bringing far-reaching

changes in various sectors of the economy through - intense reliance on digital technologies and innovative business models. India is on the brink of internet revolution with the latest figures indicating that India has more internet users than the population of the US and has become the country with the second largest population of internet usersafter China. With new Government initiatives, like Digital India, there will be an increased usage of various services and so will be the complexity in business models that are likely to evolve over time.

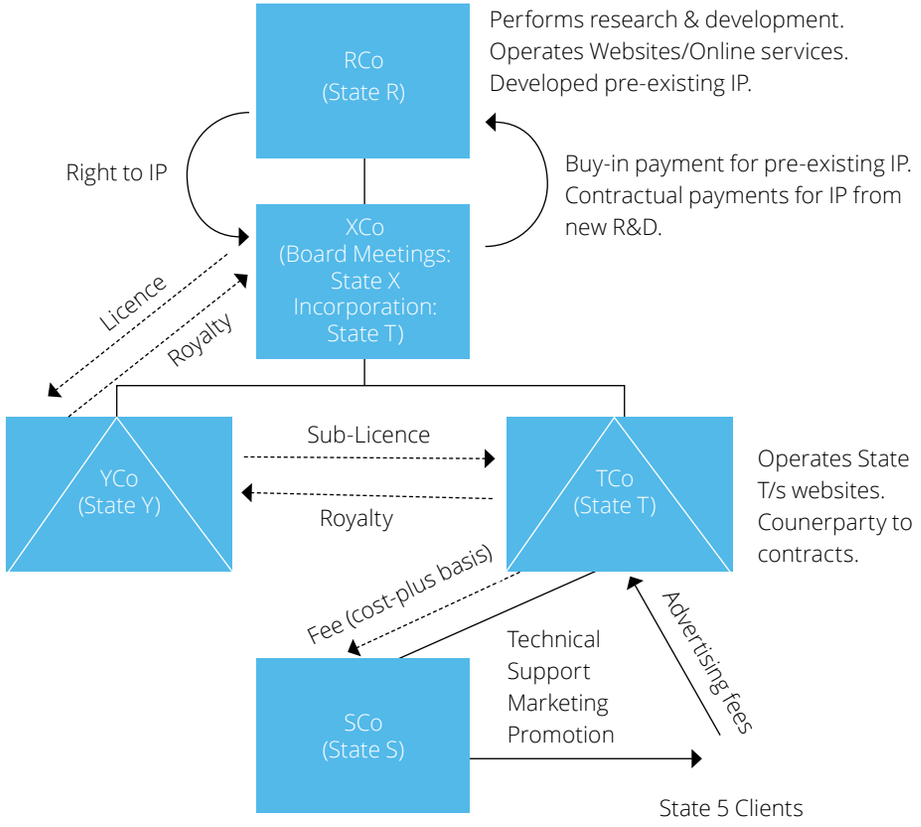
Challenges in Digital Economy – India illustration

The digital economy is increasingly pervading all aspects of the traditional economy. Action Item 1 observes that "it is increasingly becoming the economy itself".

While there is a view that the digital and the traditional economy ought to be viewed through the same lens and be evaluated on the same traditional standards, there are several aspects of the digital economy that significantly exacerbate the BEPS risks.

One of the key characteristics of many digital economy business structures is the ease by which the traditional business roles can be disaggregated. Another key characteristic is the heavy dependence on intangibles in creating value and producing income. Both these characteristics can deliver either minimal or zero taxation in the market country. Many BEPS structures also involve the transfer of intangibles to a tax advantaged location.

The example below illustrates this:



In the pre BEPS scenario, questions arise whether T Co, located outside India could, in the absence of a permanent establishment, be taxed for advertising revenues earned from various advertisers in India. The attempts by Indian tax authorities to tax such transactions in the past have not yielded much success and matters are pending before the higher courts for resolution.

BEPS Package and Digital economy

The digital economy and its business models present however some key features which are potentially relevant from a tax perspective. These features include mobility, reliance on data, network effects, the spread of multi-sided business models, a tendency toward monopoly or oligopoly and volatility. The Report identifies four main broader tax challenges raised by the digital economy:

Nexus - The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence to carry on business raises questions as to whether the current rules are appropriate.

Data - The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, and of how to characterise for tax purposes a person's or entity's supply of data in a transaction, for example, as a free supply of a good, as a barter transaction or some other way.

Characterisation -The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models, particularly in relation to cloud computing.

VAT Collection - Cross-border trade in both goods and services creates challenges for VAT systems, particularly where such goods and services are acquired by private consumers from suppliers abroad.

The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services.

The BEPS package provides a detailed analysis of the digital economy, including its business models and key features. While the Digital Economy does not create unique BEPS issues, some of its features exacerbate the existing ones and these have been addressed via the modifications to the definitionof permanent establishment, the new transfer pricing rules, in particular regard to hard-to-value intangibles and recommendations on how to strengthen so-called "Controlled Foreign Corporation" rules. Building on the OECD International VAT/GST Guidelines, the BEPS package also recommends that VAT on digital transactions be collected in the country where the customer is located and provides agreed mechanisms to do so in an efficient manner. Accordingly, it indicates that work on certain other actions like–

i. Modifying the list of exceptions to the definition of Permanent Establishment (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 Transfer Pricing Guidelines on intangibles; and
iv. Changes to the controlled foreign company (CFC) rules.

It is expected that the implementation of these measures, as well as the other measures developed in the BEPS Project (e.g. minimum standard to address treaty shopping arrangements, best practices in the design of domestic rules on interest and other deductible financial payments, application to IP regimes of a substantial activity requirement with a "nexus approach"), will substantially address the BEPS issues exacerbated by the digital economy at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so-called stateless income.

Potential options evaluated but not recommended

The following options analysed namely –

i. a new nexus in the form of a significant economic presence – purposeful and sustained interaction of an enterprise with the economy of a country via technology and other automated tools to

create taxable presence;

ii. a withholding tax on certain types of digital transactions (digital goods and services) ; and

iii. an equalisation levy – an alternative for profit attribution under the new nexus based on 'significant economic presence'

These measures were not recommended at this stage because it is expected that the other measures developed in the BEPS Project will have a substantial impact on issues identified in the digital economy and that certain BEPS measures will mitigate some aspects of the tax challenges with digital economy. However, it has been left open for the countries to introduce any of these three options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties.

Impact of other BEPS action on TMT Companies

Background - Digital Advertising

The issue of taxing digital economy has been considered in the Base Erosion and Profit Shifting (BEPS) project and taxation of digital economy is the first action plan under the BEPS project. One of measures suggested in the report was equalization levy. Though, OECD did not agree for imposition of such a levy at this stage, it did mention that individual countries could impose such a levy provided they respect their existing tax treaty obligations.

India is the first country to introduce equalization levy under its domestic tax legislation based on the recommendations of the committee formed by the apex tax body. The panel in its report has mentioned that the purpose of the levy is to equalize the income tax disadvantage faced by Indian digital companies and facilitate an environment, where Indian digital companies can compete with foreign players without having to locate outside India.

Equalization Levy, 2016

The Finance Act, 2016 has introduced equalization levy of 6% on specified digital services and is currently applicable only for specified payments made for online advertisements on or after June 1, 2016. The Government has left the window open to include other digital services as may be notified by it. The levy is applicable only on payments made in excess of INR 1 lakh (USD 1,500) in a financial year to a particular foreign enterprise which does have any permanent establishment in India. The payer is required to withhold the equalization levy from the consideration payable to the non-resident. The non-resident is not liable to income tax if the payment received by it is subject to equalization levy.

The Government has notified the Equalization Rules, 2016 which provides the mechanism for remitting equalization levy, form of annual return filing which needs to be uploaded on or before June 30 immediately following the financial year and the forms for filing appeal with the Commissioner and Tribunal in case of dispute.

Impact on the TMT sector

The move is targeted at foreign internet companies who earn substantial revenues from digital advertisement. The following are the key players who are impacted because of equalization levy:

- Foreign Internet companies like social media companies, internet search engines, media websites, e-commerce companies, apps and games developers who do not have any presence in India
- Foreign broadcasting network companies who derive revenue from Indian companies for advertisement in television and radio
- Digital advertisement intermediaries which render digital ad related services like ad management, website management, uploading of ads, ad trading agencies etc., as it may also get covered under the residuary clause "any other facility or service for the purpose of online advertisement".
- Small Indian companies, startups and e-commerce entities may be impacted as the foreign digital media companies hold the market and they may dictate that the Indian companies has to absorb tax costs which eventually leads to grossing up of the payments

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Currently the scope of levy is only on digital advertisements but based on the Government appointed Panel report ("Panel"), the levy could be extended to other services and accordingly the following business may also have to take a cut of 6% in future:

- Web developers, server management companies
- Service providers engaged in the field of uploading, storing or distribution of digital content
- Online data processing & collection companies
- Payment gateways
- Apps market place selling music, online games, online books, online software etc.,
- Online software applications

Accordingly, one may have to wait to see what categories of services would get notified by the Government. However, the question that remains unanswered is some of these services are B2C type and therefore such services may not fall within the coverage of equalization levy. However, suggestion of the panel for foreign recipients earning more than INR 100 million to file returns may plug this loophole.

Open Issues

- **Is the equalization levy in the nature of income tax?**
  The amendment is enacted videFinance Act, 2016 under a separate chapter and therefore whether the levy is in the nature of an additional income tax or an indirect tax as it is tax received on consideration for services or altogether a new tax is a debatable issue. However, the Panel in its report has clearly mentioned that the levy should be kept outside the scope of Income tax.

- **Is this levy applicable on payments made by Indian company to non-residents which are consumed outside India like its branch etc.?**
  The levy is applicable on any payment made by Indian payer to a Non-resident towards online advertisement. Let's say an Indian company has a branch outside India (USA) and Indian company pays a certain amount to a USA based Internet Company for online advertisement for increasing its USA branch sales. In this scenario, the service provider, recipient and source of income are all located outside India. However, as no exemption is provided, therefore levy is applicable on services consumed by the foreign branch of the Indian company.

- **Is tax credit available to foreign company?**
  The term income tax is defined in tax treaties to mean 'Indian income tax' or surtax (which was applicable in the past). As the levy is not in the nature of income tax, therefore tax credit may not be allowed in home country. However, the home country may allow deduction as the levy is based on OECD proposal under BEPS project. Alternatively, the recipient foreign company can explore the option of claiming tax deduction as an expense under their domestic tax laws.

  In this regard, the Panel in its report has mentioned that the levy is currently imposed under domestic tax laws and

hence no credit is available under tax treaties. However, the Government is examining the possibility of entering into reciprocal agreements for credit with countries which have similar levy.

- **Foreign companies earning income which is subject to equalization levy is required to file income tax returns in India?**
  The Income tax Act provides that a return of income needs to be filed in India in case non-resident receives income in India irrespective of the fact whether such income is taxable in India or tax is already remitted through withholding tax by the payer.

  The equalization levy legislation provides that a payment which is subject to equalization levy is tax exempt and there is further no tax liability for the foreign company in India but there is no clarity whether a foreign company is still required to file income tax returns or any other returns in India.

  However, the Panel has proposed that in case the payments received by the foreign enterprise exceeds INR 100 million then it has to file equalization levy returns in India. Where no deduction is made by Indian payers,the foreign company has to remit such sum. In such a scenario, large players who derive significant online advertisement revenues from India may need to pay 6% of their gross earnings as equalization levy.

- **Can the foreign company apply for an advance ruling?**
  Though the administration of the levy falls under the Income tax Act but there is no provision for seeking advance ruling on equalization levy.

- **Impact on Service tax liability?**
  Per the existing definition of Online Database Access and Retrieval (OIDAR) services, online advertising services were outside its scope. It is important to note that the place of Supply of OIDAR services is determined by Rule 9 of Place of provision of services Rules, 2012(PoPS) which is the location of service provider.

  As the online advertising services are not covered under OIDAR services till now, Indian companies pay service tax at the rate of 15% under reverse charge mechanism for such services under default Rule 3 of in terms of which place of supply is where the service recipient is based.

Therefore, both service tax and equalization levy are applicable.

Online Information and Database Access Retrieval (OIDAR) services

In the report released by OECD onthe first action plan addressing tax challenges of digital economy incross border transactions, it has emphasized on a requirement fornon-resident supplier, particularly for B2C supplies, to register, collectand remit tax in the jurisdiction of the consumer.

Recently, Central Board of Excise & Customs, vide the recent Notifications and clarifications issued, w.e.f 1 December 2016, has amended taxability of receipt of OIDAR services from outside India. The amendment seems to be in line with the recommendations on BEPS.

OIDAR services have been defined to mean services whose delivery is mediated by information technology over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and impossible to ensure in the absence of information technology and includes electronic services such as-

i. advertising on the internet;
ii. providing cloud services;
iii. provision of e-books, movie, music, software and other intangibles via telecommunication networks or internet;
iv. providing data or information, retrievable or otherwise, to any person, in electronic form through a computer network;
v. online supplies of digital content (movies, television shows, music, etc.);
vi. digital data storage; and
vii. online gaming;

At present, the place of provision of service with respect to OIDAR services is the location of the service provider (Rule 9(b) of Place of Provision of Services Rules, 2012). Post amendment, the place of provision of OIDAR service shall be the location of the service recipient. Also, exception to the general rule that the location of service provider will be the place of provision of service in the instances where location of service receiver is not available in the ordinary course of business, shall not apply to OIDAR services.

Presently, services received by Government, a local authority, a governmental authority or an individual in relation to any purpose

other than commerce, industry or any other business or profession from overseas service provider are exempt from service tax (cross border B2C transactions). The aforesaid exemption has been withdrawn in respect of OIDAR services. Hence, service tax will be applicable on OIDAR services provided by a service provider located outside India and received by Government, a local authority, a governmental authority or an individual (in relation to any purpose other than commerce, industry or any other business or profession) located within India (collectively defined or referred to as "non-assessee online recipient" [generally B2C customers]). Factors to be considered to determine the location of service recipient are also prescribed.

Person liable to pay service tax:
Where OIDAR services are received by non-assessee online recipient, the person liable to discharge service tax will be such service provider. Further, it is provided that a person located within India can represent the OIDAR service provider located outside India and such person located in India will be the person liable to pay service tax. In other cases (i.e. OIDAR services received from outside India by persons other than non-assessee online recipient), the service recipient within India shall be liable to discharge service tax under reverse charge mechanism.

Interplay between Equalization Levy & OIDAR services
The Finance Minister in his budget speech stated that the equalization levy is aimed at taxing B2B e-commerce transactions. By the amendment to OIDAR services it would cover not only B2B but also B2C transactions of those services indicated above which are mediated by Information Technology.

The taxability is summarized as below:

Service recipient	Service	Taxability	Person liable to pay service tax
Non-assessee online recipient	OIDAR	Taxable	Service provider
Non-assessee online recipient	Other than OIDAR	Exempt	-
Others (B2B customers)	All services including OIDAR (subject to exceptions)	Taxable	Service recipient (under reverse charge mechanism)

Unlike the threshold limit under equalization levy, there is no such minimum limit for applicability of service tax. However, the general threshold limit of INR 1,000,000 for liability to pay service tax(other than services provided under a brand name) remains unchanged.

Transfer Pricing Implications

Aligning Transfer Pricing Outcomes with Value Creation

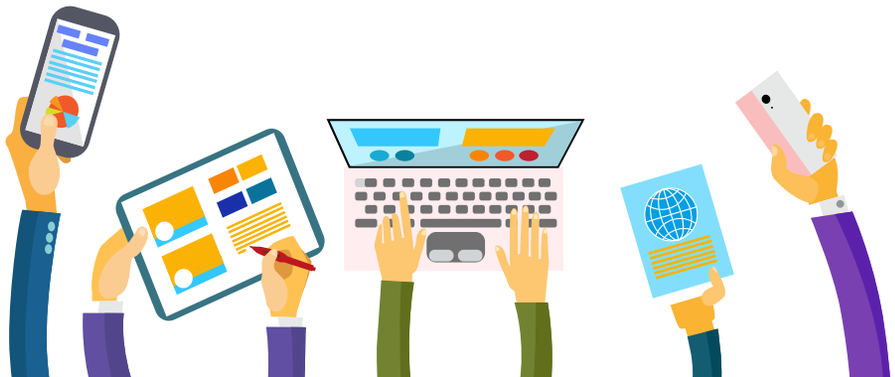
With the establishment of numerous research and development [R&D] centres in India, abundant availability of talent pool, discussions on transfer pricing aspects of intangibles have dominated the Indian Transfer Pricing landscape in the past few years. In respect of such R&D centres, there has been debate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

The BEPS actions intend to align transfer pricing outcomes with value creation, by requiring that the attribution of value for tax purposes is consistent with economic activity generating that value.

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 thearising 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, shouldbe 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.

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

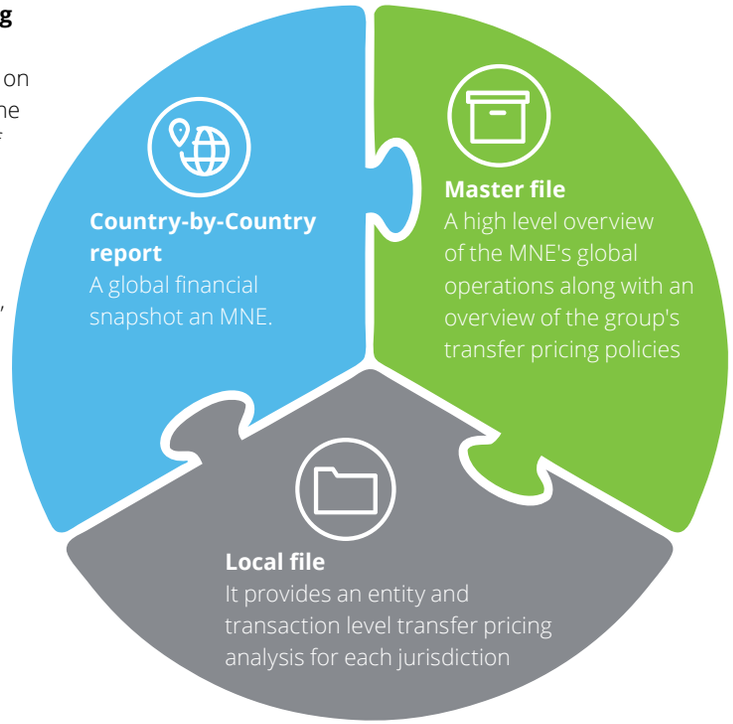


of functional contributions and financial investment with legal rights is seen in the circular as well. The exercise of important functions by the foreign principal and control over service providers are factors that are in line with the OECD Guidelines and accordingly, on this aspect the view of Indian 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.

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).

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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 (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.

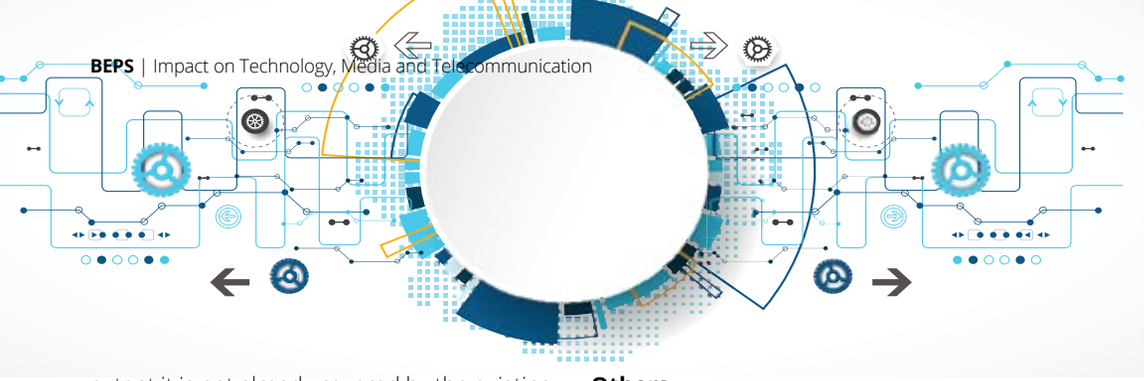
As per existing Indian regulations, the information requirements of the CbC report are similar to those prescribed by the OCED BEPS Action Plan 13. The CbC report is required to set out for each jurisdiction, specified data pertaining to revenue, income, taxes, number of employees, capital and tangible 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 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

The submission of details of the MNE's income, profit and number of employees along with other details relating to business operationsin the CbC Report and Master File would provide an insight into the value chain of the multinational group to the tax authorities.

Though, tax authorities may not conclude a transfer pricing audit based on the information available in the CbC reporting, tax authorities can ask for additional information based on the CbC reporting details submitted.

Treaty Shopping

Additionally, multinational enterprises in TMT space in India would also need to analyse their group investment holding structure in terms of Action Plan 6 which provides for prevention of treaty abuse. The Action recommends either adopting a moregeneral anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or "PPT" rule) or Limitation of Benefit (LOB) rule that limits benefit to treaty entitlement to entities that meet certain criteria or a combination of the two. Given the risk to revenues posed by treaty shopping, the countries have committed to ensure a minimum level of protection against treaty shopping - the minimum standard.

Others

Evaluate 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 and Compliance and reporting requirement in light of the global transfer pricing documentation requirement and country by country reporting requirement.

Way forward

BEPS measures seeks to improve the coherence of international tax rules, reinforce their focus on economic substance and ensure a more transparent tax environment. Having regard to the BEPS recommendations, business models are likely to be subjected to increased scrutiny in India specially- assertion of permanent establishment on accessibility of websites from India, presence of marketing or sales personnel in India or for presence of some equipment. It is likely that the revenue authorities may attempt to tax on account of 'significant digital presence' in India. Further, there is a likelihood of increased focus on withholding tax implications on digital products and services to non- residents. It is imperative that MNEs in this space need to align their tax models in line with the OECD BEPS action plans and also need to track tax policy changes as regards assertion of PE and taxation of digital products

Deloitte.