Base Erosion and Profit Shifting (BEPS) Analysis of Provisions & Updates

Seminar on Anti-Avoidance Measures

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OUTLINE

- BEPS Meaning
- Need for BEPS
- What's in the BEPS Package?
- BEPS Action Plans 1 to 15 – A Macro Insight

BEPS MEANING

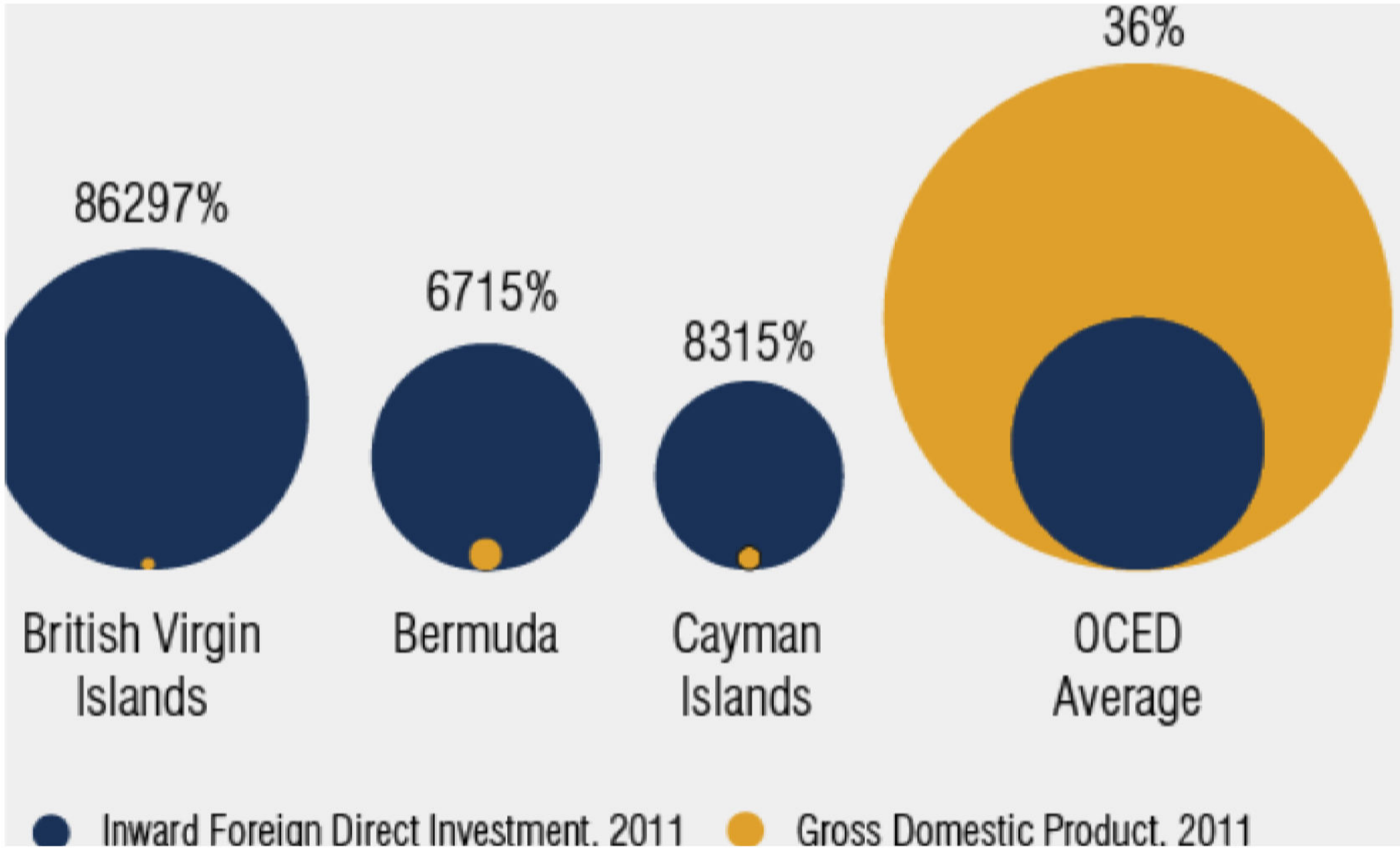
- "Base Erosion and Profit Shifting ('BEPS') refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits "disappear" for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid" – OECD FAQs

- Base Erosion refers to the reduction of companies that can be taxed and the amount of profits that a country can tax
  - Achieved by means of shifting residence to different country or causing profits to arise in different country (by transfer of intellectual property, etc.)

- Profit Shifting refers to aggressive tax planning strategies focused on shifting profits out of high tax country to lower tax country

BEPS strategies may not necessarily be illegal
Increased globalisation enables companies to exploit gaps arising on interaction of domestic tax systems and treaty rules within the boundary of acceptable planning

NEED FOR BEPS



"The empirical evidence suggests that income-shifting by multinational corporations is a significant concern that should be addressed through tax reform."

- US President Obama in The President's Framework for Business Tax Reform

What's In The BEPS Package?

Minimum standards

Reinforced international standards on tax treaties and transfer pricing

Common approaches and **best practices** for domestic law measures

Analytical reports with recommendations (digital economy and multilateral instrument)

Detailed **report on measuring BEPS**

BEPS Action Plans

Coherence

- Hybrid Mismatch Arrangements (2)
- Interest Deductions (4)
- CFC Rules (3)
- Harmful Tax Practices (5)

Substance

- Preventing Tax Treaty Abuse (6)
- Avoidance of PE Status (7)
- TP Aspects of Intangibles (8)
- TP/Risk and Capital (9)
- TP/High Risk Transactions (10)

Transparency

- Methodologies and Data Analysis (11)
- Disclosure Rules (12)
- TP Documentation (13)
- Dispute Resolution (14)

Digital Economy (1)

Multilateral Instrument (15)

Impact Of BEPS Action Plans

Immediate impact

- Action 8 – Transfer pricing for intangibles
- Action 9 – Transfer pricing for risks and capital
- Action 10 – Transfer pricing for other high-risk transactions
- Action 13 – Transfer pricing documentation and country-by-country reporting

Treaty-based action

- Action 2– Hybrid mismatch arrangements
- Action 6 – Treaty abuse
- Action 7 – Permanent establishment status
- Action 14 – Dispute resolution
- Action 15 - Multilateral instrument

Legislative action

- Action 2 – Hybrid mismatch arrangements
- Action 3 – CFC rules
- Action 4 – Interest deductions and other financial payments
- Action 5 – Harmful tax practices

BEPS Action Plan 1 – Addressing The Challenges Of The Digital Economy

Key Features

- Reliance on Data
- Mobility of Business Functions
- Mobility of Users
- Excessive Reliance on intangible
- Multi-sided business model
- Networks effect – impact of one user's decision on other users
- Volatility – low barrier to entry and fast growth

BEPS Recommendation

- Key tax challenges of the digital economy to be addressed as a part of other OECD/ BEPS initiatives including Artificial Avoidance of PE, CFC Rules, Transfer Pricing and VAT

- Action Plan 7 (Artificial Avoidance of PE) to consider whether activities hitherto considered as preparatory or auxiliary activities may result in core activities in digital economy

- Explore possibility of taxation based on concept of "Significant Digital Presence"

- Explore possibility of introducing withholding tax on sale of digital goods/ services (Equalization Levy)

BEPS Action Plan 2 – Neutralising The Effects Of Hybrid Mismatch Arrangements

BACKGROUND

- Hybrid Arrangements – Involve use of cross-border differences in characterisation of entities and instruments to produce mismatched tax outcomes.

- Objective of the BEPS Action Plan is to develop model treaty provisions and design domestic rules to neutralise the effect of hybrid instruments/ entities by not permitting:

  - Multiple deductions for a single expense
  - Deduction in one country without corresponding taxation in another
  - Generation of multiple foreign tax credits for one amount of foreign tax paid

PROBLEM

Core aspect of BEPS as hybrid mismatch arrangements create non-taxed/ stateless income

- Erode tax base of affected countries
- Undermine fairness
- Distort competition
- Inefficient
- Non-transparent

SOLUTION

Comprehensive

- Rules apply to all types of arrangements (including instruments and entities) and whether all countries participate or not

Stop hybrids

- Eliminates the mismatch benefit without affecting any other tax or regulatory outcomes

Targeted and workable

- Related parties and structured transactions

Avoid double taxation

- Agreed rule order with detailed commentary explaining effect and interaction of the rules

BEPS Action Plan 3 – Designing Effective Controlled Foreign Company (CFC) Rules

Key Points

- Definition of a CFC
  - Includes transparent entities and PE's where they raise BEPS concerns
  - Final report includes a form of anti-hybrid rule to prevent avoidance of CFC rules

- CFC Exemptions and threshold requirements
  - Final report is clear on tax rate exemptions and use of lists such as the white list

- Definition of a CFC Income
  - Recognising different policy objectives there is more flexibility and options

- Elimination of double taxation
  - Emphasis on ensuring that rules do not lead to double taxation

Six Building Blocks For Design Of Effective CFC Rules

Definition of a CFC	CFC exemptions and threshold requirements	Definition of Income	Computation of Income	Attribution of Income	Prevention and elimination of double taxation
Recommendation on how to determine when shareholders have sufficient influence over a foreign company	CFC rules apply only to controlled foreign companies that are subject to effective tax rates that are meaningfully lower than those applied for in the parent jurisdiction	Non-exhaustive list of approaches or combination of approaches that CFC rules could use for such a definition	Use the rules of parent jurisdiction to compute the CFC income to be attributed to shareholders	Attribution threshold to be tied to the control threshold	Jurisdiction with CFC rules allow a credit for foreign taxes actually paid, including any tax assessed on intermediate parent companies under CFC regime
Recommendation on how non-corporate entities and their income should be brought within CFC rules			CFC losses should be offset against the profits of the same CFC or other CFC's in the same jurisdiction	Amount of income attributed should be calculated by reference to the proportionate ownership or influence	Countries consider relief from double taxation on dividends on, and gains arising from the disposal of, CFC shares where the income of the CFC has previously been subject to taxation under a CFC regime

BEPS Action Plan 4 – Limiting Base Erosion Involving Interest Deductions And Other Financial Payments

PROBLEM

"No or low taxation associated with practices that artificially segregate taxable income from the activities that generate it"

- BEPS Action Plan, chapter 3

Location of third party interest in high tax countries

Quantity of related party interest, in excess of group's actual interest cost

Use of interest expense to fund tax exempt income

The Key Building Blocks

Fixed Ratio Rule

- Allows net interest deduction up to a fixed percentage of EBITDA (ranging from 10% to 30%)
- Applies to interest paid to third parties and intra-group

Group Ratio Rule

- Allows interest deductions up to net interest/ EBITDA ratio of group
- Countries may instead apply a different group ratio rule (e.g. equity escape) or no group ratio rule

Targeted Rules

- Protect fixed ratio rule and group ratio rule from planning
- Address specific BEPS risks

Additional Optional Elements

- *De minimis* threshold
- Disallowed interest expenses/ unused interest capacity of earlier years to be carry forward
- Exclusion for 3rd party interest funding certain public-benefit assets

India has recently introduced thin capitalisation rules under section 94B of the Income Tax Act, 1961 applicable from AY 2018-19 vide Finance Act 2017

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BEPS Action Plan 5 – Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency And Substance

BEPS Recommendation

- "**Nexus Approach**" to be adopted to assess preferential regimes with respect to substantial activity requirement.
- Expenditure incurred to be used as proxy for activity for Nexus Approach
- Eligible IP Income = Qualifying R&D Expense * Income from IP Asset/ Total R&D Expense for IP Asset
- Framework for exchanging information covering rules relevant from BEPS perspective agreed

BEPS Action Plan 6 – Preventing The Granting Of Treaty Benefits In Inappropriate Circumstances

BEPS Recommendation

Treaty Shopping

Treaty shopping generally refers to a situation where a person, who is resident in one country (home country) and who earns income or capital gains from another country (source country), is able to benefit from a tax treaty between the source country and yet another country (third country)

e.g. Use of a letterbox company in a treaty state

Action

Each contracting state has agreed to include a minimum standard in new treaties, and protocols to existing treaties, choosing from one of three options:

a) Limitation of Benefit (LOB) article, combined with anti-conduit rules (either incorporated in the treaty or under domestic law)

b) Principle of Purpose Test (PPT)

c) LOB in combination with a PPT

India has introduced GAAR which is applicable from FY 2017-18, i.e., AY 2018-19. This results in a double whammy for Indian taxpayers

BEPS Action Plan 7 – Preventing The Article Avoidance Of PE Status

The following changes address techniques used to inappropriately avoid being taxed in a State, including

Replacing a distributor with a "commissionaire arrangement" through which a local member of a multinational group sells products belonging to foreign members of that group	Taking advantage of exceptions that were initially adopted to prevent the taxation of mere preparatory or auxiliary activities carried on by foreign enterprises, in particular by artificially fragmenting business activities between parts of a multinational enterprise	Splitting-up construction contracts in order to qualify for an exception based on the time during which an enterprise is active on the construction site

BEPS Recommendation

- **Activities by an intermediary** leading to regular conclusion of contracts to be performed by foreign enterprise to constitute PE (except in case of activities in course of independent business)
- **Exceptions to the definition of PE** to be modified to ensure that core activities (hitherto considered auxiliary) are taxed in source state
- **Anti-fragmentation rule** to ensure that PE status not avoided by fragmentation of cohesive operating business into smaller operations
- **Splitting up of contract** between related parties not to avoid PE status

New Anti – Fragmentation Rule

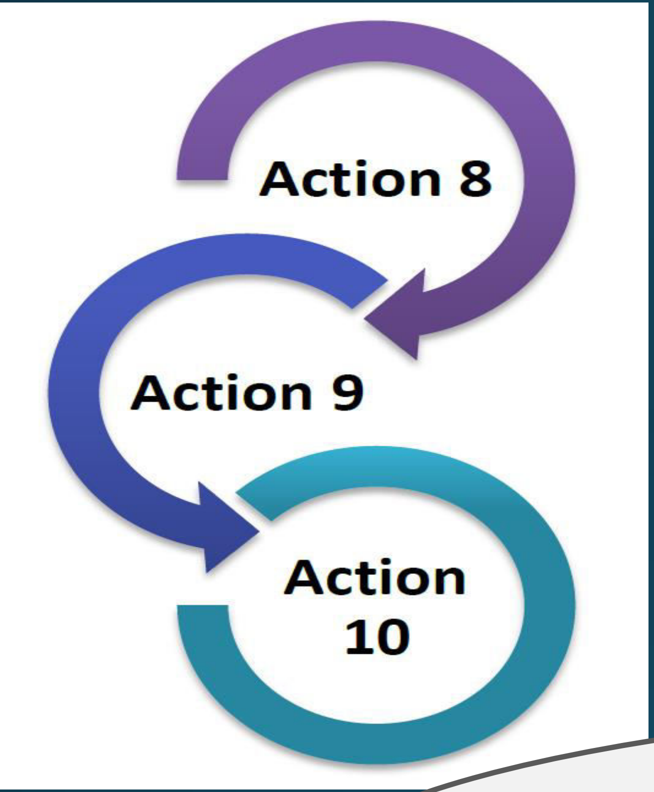
- Included to prevent an enterprise or a group of "closely related enterprises" from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

- The concept of "closely related enterprise" is illustrated as follows:

  Rco, a bank, resident of State R, has a number of branches in State S which constitutes a PE. Further. RCo. also has a separate office in state S with few employees for verification of information provided by clients at these different branches. The results of the above verification is forwarded to headquarters of RCo. where they again analyse the information and provide reports to the branches where the final decision are taken. In such cases, the separate office in state S shall also constitute a PE of RCo., since the business activities carried on by RCo. at the office and at the branch constitute complementary functions that are part of cohesive business operation.

BEPS Action Plan 8 – 10 Aligning Transfer Pricing Outcomes With Value Creation

BEPS Action Plans 8 To 10



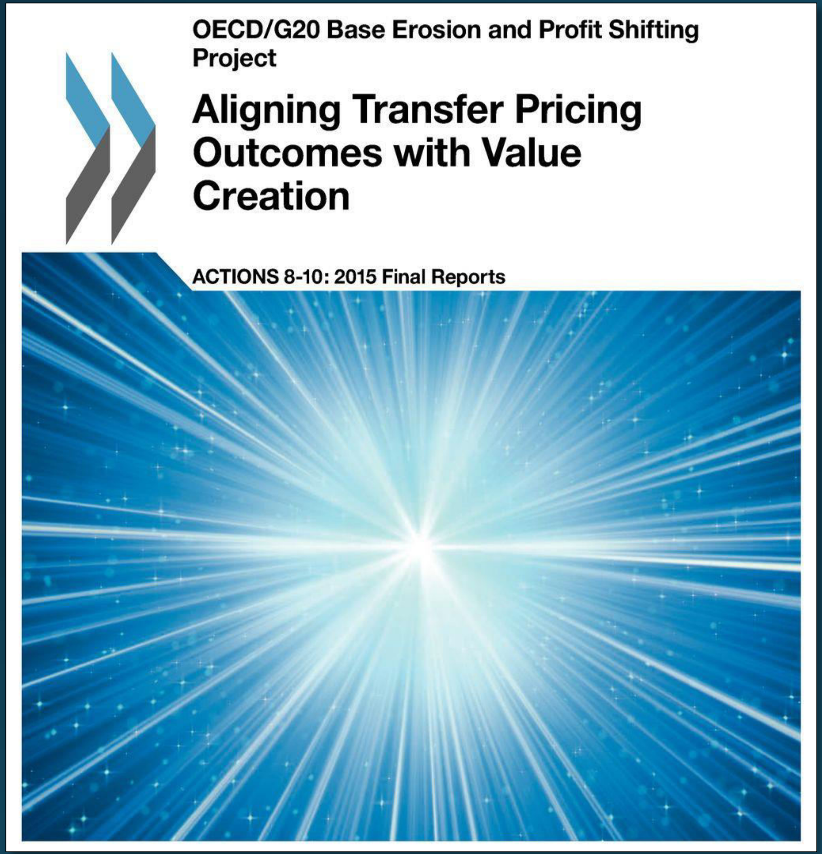
Action Plan 8	Intangibles
Action Plan 9	Risk and Capital
Action Plan 10	Other High Risk Transactions

The OECD has released a consolidated report on all the above 3 action plans under the title **"Aligning Transfer Pricing Outcomes with Value Creation"**

The potential for misalignment of profits and value creation may arise from misalignment of form and substance, and in particular exclusive reliance on:

1)mere contractual ownership;
2)mere contractual assumption of risk; and
3)provision of capital

BEPS Action Plan 8 – 10 [Aligning Transfer Pricing Outcomes With Value Creation]



The Action Plan mandates development of "*rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that* ***inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation.***"

BEPS - Principle Of Value Creation

- Substantial activity requirement to get tax preferential regime

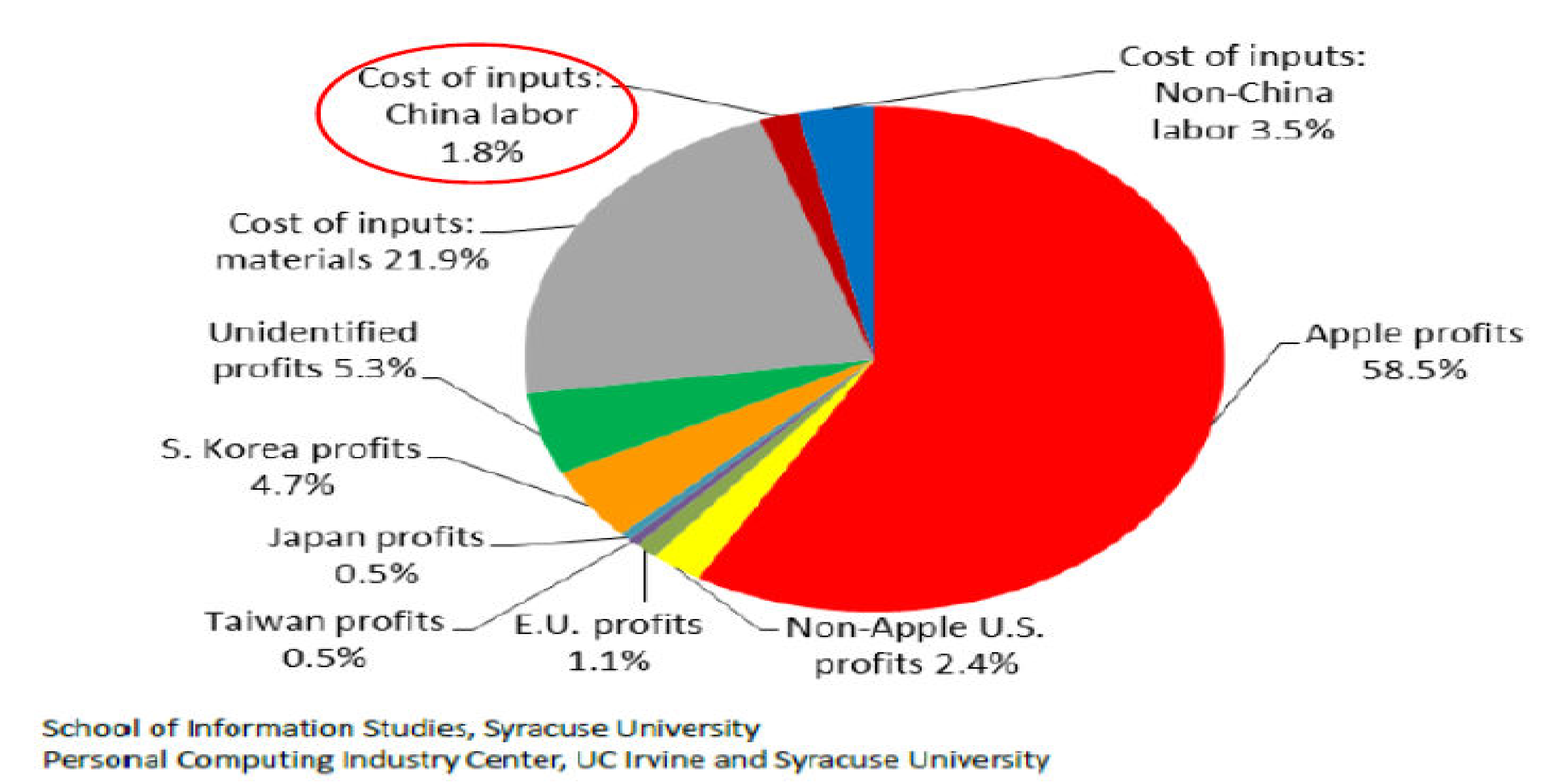
- Align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created.

- **Modified Nexus approach:** a link between IP income and qualifying R&D spend.
- **Proportional approach:** preferential rate for IP-related income to the extent it was generated by qualifying expenditures

Value Creation

When an intangible is completely designed and perfected in one country but is solely exploited in a second country, where is value created in the first or the second? If in both countries – how to split the value creation between the two jurisdiction?

WHERE IS THE VALUE CREATED?



BEPS Action Plan 8 – Transfer Pricing Of Intangibles

Definition of 'Intangible'- within India

Intangible

- **Customer-** Customers lists, open purchase order
- **Marketing-** Trade mark, Brand names, logos
- **Engineering-** Industrial design, trade secrets
- **Technology-** Patents, technical Know-how
- **Data processing-** software copyright, automated databases
- **Artistic-** Copyrights, Literary work

Contract	License agreements , Franchise agreements, non-compete agreements
Human Capital	Trained & Organised work force, Union Contracts
Location	Leasehold interest, Air rights, Water rights
Goodwill	Institutional / Professional Practice / Celebrity goodwill , General business going concern value
Others	Methods, Systems, Procedures, Campaigns, Surveys, Forecasts

Overview Of Final Report

- Wider and clearer definition of "intangibles"
- Introduction of a six step framework to analyse transfer pricing aspects of intangibles
- Legal ownership alone does not generate a right to the return generated by the exploitation of an intangible
- Focus on Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions
- Hard-to-Value Intangibles (HTVIs)
- Cost-Contribution Arrangements (CCAs)

BEPS Recommendation

Develop rules to prevent BEPS by moving intangibles among group members. This will involve:

- adopting a broad and clearly delineated definition of intangibles;
- ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;
- developing transfer pricing rules in relation to hard-to-value intangibles;
- updating the guidance on cost contribution arrangements.

BEPS Action Plan 9 – Transfer Pricing: Risk And Capital

Points TO Consider In Conducting A Transfer Pricing Analysis

- The importance of accurately delineating the actual transactions between associated enterprises through analysing the contractual relations between the parties together with evidence of the actual conduct of the parties.

- Detailed guidance on analyzing risks as part of a functional analysis, including a six-step analytical framework. This framework considers the identification of the economically significant risks with specificity, the determination of contractual allocation of these risks and the functions relating to these risks. For transfer pricing purposes, the associated enterprise assuming a risk should control the risk and have the financial capacity to assume the risk.

- A capital-rich MNE group member without any other relevant economic activities (a "cash box") that provides funding, but cannot control financial risks in relation to the funding, will attain no more than a risk-free return, or less if the transaction is commercially irrational.

- In exceptional circumstances of commercial irrationality, a tax administration may disregard the actual transaction. The main question is whether the actual transaction has the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances.

BEPS Action Plan 10 – Transfer Pricing: High Risk Transactions

OVERVIEW

- "Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to:

  - clarify the circumstances in which transactions will not be recognised;
  - clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and
  - provide protection against common types of base eroding payments, such as low value-add services."

Key Features

- A standard definition of low value-adding intra-group services as being supportive in nature, not being part of the MNE's core business, not requiring or creating valuable intangibles and not involving significant risks.
- A list of services that would typically meet the definition. In essence the services listed are back-office services.
- An elective simplified approach to determine arm's length charges for low value-adding services:
  - A process for determining the costs associated with low value adding services
  - Allowing general allocation keys
  - A simplified benefits test
  - A standard 5% mark-up
- Prescriptive guidance on documentation and reporting that should be prepared for the MNE to be able to apply the simplified approach
- The ability for tax administrations to include a threshold above which the simplified approach may be denied. Further work on the threshold will be performed as part of step two mentioned below.

BEPS Action Plan 11 – Measuring And Monitoring BEPS

Key Features

- Different from other Action Plans because it is concerned with measuring BEPS activity rather than addressing it
- This Action Plan is intended to estimate the size of BEPS, identify indicators of BEPS and providing recommendations for improving the measurement of BEPS
- The final report estimates that global corporate income tax revenue is reduced by 4% to 10% (i.e., US$ 100 billion to US$ 240 billion annually)
- Recommendation of greater cooperation between the OECD and taxing authorities in the collection and sharing of data
- Identification of several measures of BEPS that will become possible using the data collected under Actions 5, 12 and 13

Six Indicators Of BEPS

- the concentration of foreign direct investment in low tax countries
- the profit rates of MNE affiliates in low tax countries compared to those in high tax countries
- the profit rates of MNE affiliates in low tax countries compared with the profit rate of their own global groups
- the effective tax rates of MNEs compared to those of domestic-only enterprises
- the separation of intangible assets from the location of their production
- the concentration of debt in MNE affiliates located in higher-tax rate countries.

BEPS Action Plan 12 – Mandatory Disclosure Rules

Objective

- increase transparency through providing early information to tax authorities
- deter the implementation of potentially aggressive schemes
- early identification of promoters and taxpayers associated with abusive schemes which are considered to pose BEPS-related tax risks

Aim of Mandatory Disclosure Rules is to reduce the time delay between the emergence of an aggressive tax planning scheme and the point at which tax authorities recognize them

KEY DESIGN FEATURES

Impose a disclosure obligation on both, promoter and taxpayer

Include a mixture of both, generic and specific hallmarks, the existence of each of them triggering a requirement for disclosure

Establish a mechanism to track disclosures and link disclosures made by promoters and clients as identifying scheme users is also an essential part of any MDR

Link the timeframe for disclosures to the scheme being made available to taxpayers when the obligation to disclosure is imposed on the promoter

Introduce penalties (including non-monetary) to ensure compliance

Coverage Of International Tax Schemes - Issues

- Lot of differences between domestic and cross-border schemes
- Cross-border schemes are more difficult to target with mandatory disclosure regimes
- International schemes are specifically designed for a particular taxpayer or transaction and may involve multiple parties and tax benefits in different jurisdictions

Coverage Of International Tax Schemes - Recommendation

- Countries develop hallmarks that focus on the type of cross-border BEPS outcomes that cause them concern

- Only be required to be disclosed if arrangement includes a transaction with domestic taxpayer that has material tax consequences in the reporting country and domestic taxpayer was aware or ought to be aware of the cross-border outcome

- Taxpayers that enter into intra-group transactions with material tax consequences are obliged to make reasonable enquiries as to whether the transaction forms part of the arrangement that includes a cross border outcome that is specifically identified as reportable under their home disclosures' mandatory disclosure regime

BEPS Action Plan 13 – TP Documentation And Country-by-Country Reporting

Three Tiered Standardized Approach

Master File

- Provides tax administrations with high level information regarding a MNE's global business operations and transfer pricing policies

Local File

- Provides a local tax administration with information regarding material related party transactions, the amounts involved, and the company's analysis of the transfer pricing determinations they have made with regard to those transaction

CbC Reporting Template

- Requires large MNEs to report the amount of revenue (related and unrelated party), profits, income tax paid and taxes accrued, employees, stated capital and retained earnings, and tangible assets annually for each tax jurisdiction in which they do business. In addition, MNEs are required to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity conducts

TEMPLATES

Masterfile

- Org Structure
- Description of MNEs Business(es)
- MNEs Intangibles
- MNEs Intercompany financial activities
- MNEs financials and tax positions

Business Line | ***Business Line*** | ***Business Line*** | ***Business Line***

Local File

Local entity

- Management structure
- Local Org Chart
- Business restructurings
- Local reporting lines
- Key competitors

Controlled transactions

- Description and context
- Payments / receipts
- Inter-Co. agreements
- TP analysis
- APAs

Financial information

- Financial accounts
- Reconciliation
- Comparable data

CbCR Template

Tax Jurisdiction	**Revenues**			**Profit (loss) before Income Tax**	**Income Tax Paid (on cash basis)**	**Income Tax Accrued – Current Year**	**Stated Capital**	**Accumulated Earnings**	**Number of Employees**	**Tangible Assets (other than Cash and Cash equivalents)**
	Unrelated party	**Related party**	**Total**							

Key Features

- Applicable to all MNE Groups with revenue > Euro 750M or equivalent local currency.
- Implemented from fiscal year beginning on or after 1st January 2016
- CbCR, Master file and Local file to be submitted annually
- CbCR to be filed with ultimate parent's home tax authority
- Master file and Local file to be filed directly with relevant tax jurisdictions
- Search for comparables to be updated every three years rather than annually
  - Financial data for comparables to be updated every year
- Mandated that countries participating in the BEPS project carefully monitor the implementation of these new standards and reassess no later than the end of 2020 compliance and effectiveness of the new three-tier approach.

BEPS Action Plan 14 – Making Dispute Resolution Mechanisms More Effective

Key Features

- Reflects the commitment of participating countries to implement substantial changes in their approach to dispute resolution

- Final report contains measures aimed at strengthening the effectiveness and efficiency of the mutual agreement procedure (MAP) mechanism, such as:
  - specific actions to be taken by countries,
  - suggested changes to legislation and administrative practices, and
  - changes to the OECD Model Tax Convention and its Commentary

- Compliance with this standard will be subject to peer based monitoring that will be executed through the Forum on Tax Administration's MAP Forum

KEY FEATURES (CONTD..)

- Minimum standard is complemented with additional measures designated as best practices to which only some of the OECD BEPS and G20 countries were willing to commit

- Report lists 20 countries that have agreed to implement mandatory binding MAP arbitration in their bilateral tax treaties

- According to the OECD, the countries that have made that commitment were involved in more than 90% of the outstanding MAP cases at the end of 2013

India does not agree with mandatory arbitration and therefore, has expressed a reservation

Objectives

To allow taxpayers access to the MAP process when the requirements for taxpayers to access the MAP process are met

To ensure that domestic administrative procedures don't block access to the MAP process

To ensure that countries implement Article 25 of the OECD Model Tax Convention in good faith

BEPS Action Plan 15 – Multilateral Convention To Implement Tax Treaty Related Measures To Prevent BEPS

Key Features

- A multilateral instrument to serve as alternative mechanism for modification of tax treaties in line with BEPS Action
- Analysis of the legal issues related to the development of a multilateral instrument to enable countries to streamline the implementation of the BEPS treaty measures
- On 7th June 2017, 76 Ministers and other high-level representatives participated in the signing ceremony of the Multilateral Instrument
- The MLI modifies the application of thousands of bilateral tax treaties concluded to eliminate double taxation
- Also implements agreed minimum standards to **counter treaty abuse** and to **improve dispute resolution** mechanisms while providing flexibility to accommodate specific tax treaty policies

Minimum Standards

- Model provisions to prevent treaty abuse (including treaty shopping)
- Standardised Country-by-Country (CbC) Reporting
- A revitalised peer review process to address harmful tax practices
- An agreement to secure progress on dispute resolution (MAP)


ANY
QUESTIONS
?

THANK YOU