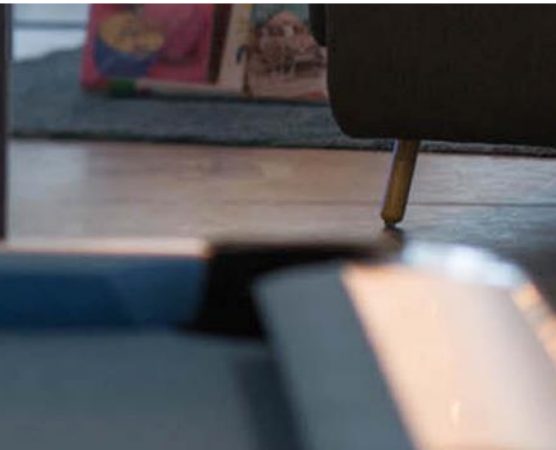


# *BEPS: The New Transfer Pricing Landscape*

*Refresher Course on International Tax & Transfer Pricing*

*Arun Saripalli*

July, 2020





# EVOLVING LANDSCAPES: BUSINESS AND TAX

# Evolving Business Landscapes

## Key trends



**Nexus**

*Reduced need for physical presence*



**Characterization**

- *New types of products and deliveries*
- *Digitized deliverables*



**Data**

- *Vast sources of data*
- *Increasing importance of data in creating value for a business*

## New age business models

Business	Product/ Service/ Offering	Distinct factor vis-à-vis traditional business model
<b>Airbnb</b>	Accommodations	No ownership of places offered on rent
<b>Alibaba/ Amazon/ eBay/ Flipkart</b>	Retailing	No inventory holding
<b>Paytm/ MobiKwik</b>	Payment gateways/ digital wallets	No physical bank
<b>Zomato/ Swiggy</b>	Food delivery	No ownership of restaurants
<b>Uber/ Ola</b>	Car rentals/ rides	No ownership of cars

# ACTION PLANS: OVERVIEW



# 15 Action Plans: 3 Pillars



**1**

## *Coherence*

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

Digital Economy (AP 1)

**2**

## *Substance*

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

Multilateral Instrument (AP 15)

**3**

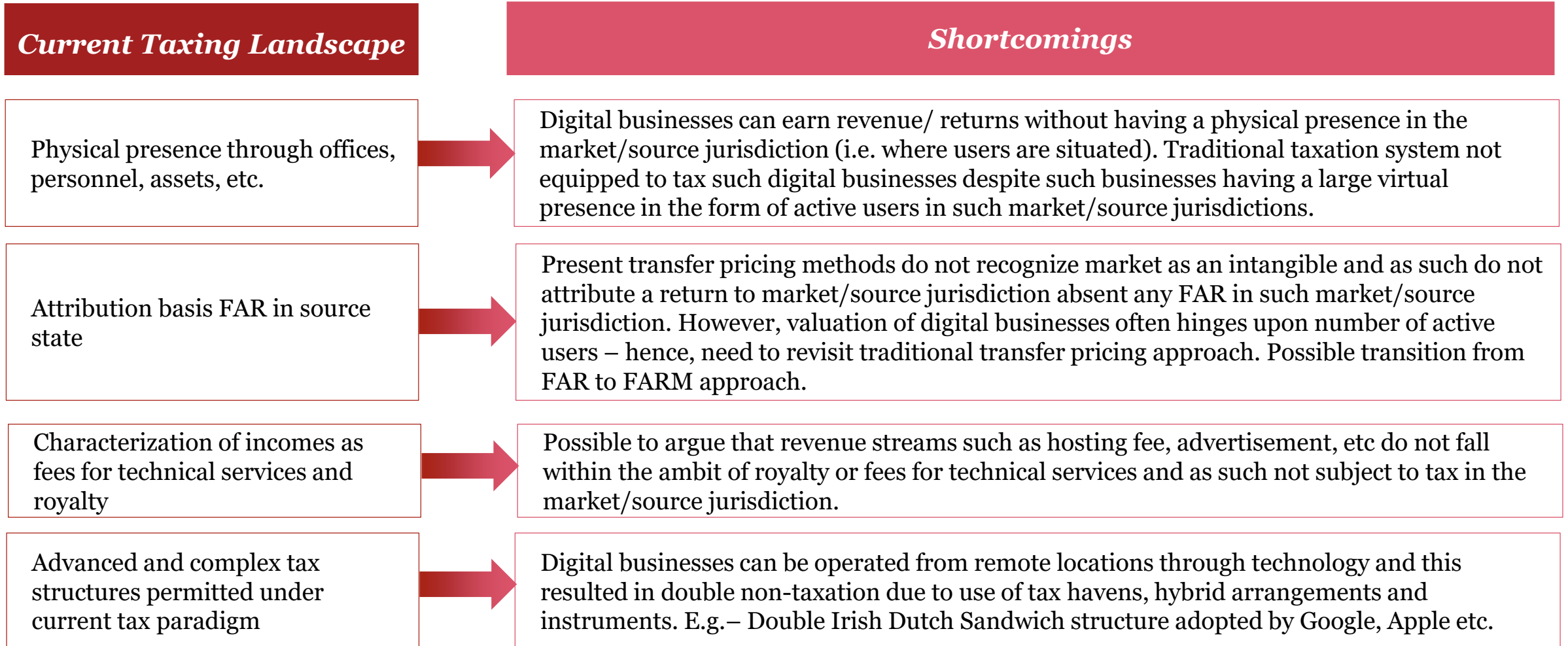
## *Transparency*

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

A person in a dark suit and striped tie is sitting at a desk, writing in a notebook with a black pen. The notebook is open, and the person's hands are visible. In the foreground, a large white arrow points from the bottom left towards the right. The background is blurred, showing what appears to be a bookshelf or a wall with some decorative elements. The overall lighting is warm and professional.

# **ACTION PLAN 1: TAX CHALLENGES ARISING FROM DIGITALIZATION**

# Digital Tax Landscape and its Shortcomings



# Global Measures

## BEPS

- AP 1 discusses various measures to curb tax evasion viz. modification of PE thresholds, withholding tax on digital transactions, bandwidth tax or 'bit tax'
- Pillar 1: Unified approach – Proposal for reallocation of taxing rights: Creation of a new taxing right - seeks to attribute a portion of profits to the market/source jurisdictions absent physical presence
- Pillar 2: Global anti-base erosion (GloBE): Proposal to prevent profit shifting to low or no tax jurisdictions and ensuring a minimum level of tax paid by MNEs using new technologies

## Alternate PE thresholds

- Significant Economic Presence – Israel and India
- PE Attribution Rules - India
- Digital PE – European commission proposing thresholds w.r.t. users, revenue and business contracts

## Turnover taxes

- Equalization levy – India
- Levy on digital transactions – Italy
- Sectoral taxes for advertising – Hungary
- Digital services tax – European commission proposing taxation code for sale of ads, intermediary activities and sale of data

## Specific regime for MNEs

- Diverted profit taxes – UK and Australia
- Base erosion and anti abuse (BEAT) - USA



# Indian Measures

## Equalization Levy

- The Finance Act 2016 introduced 6% Equalization Levy effective 1st June, 2016. This Equalization Levy is to be deducted from amounts paid to a non-resident, not having any PE in India, for online advertisement, provision of digital advertisement space, etc.
- In the Finance Act 2020, the scope of Equalization Levy was widened to cover the consideration received or receivable for e-commerce supply or services made or facilitated by an ecommerce operator. The rate of this Equalization Levy is 2% effective from 1st April, 2021.

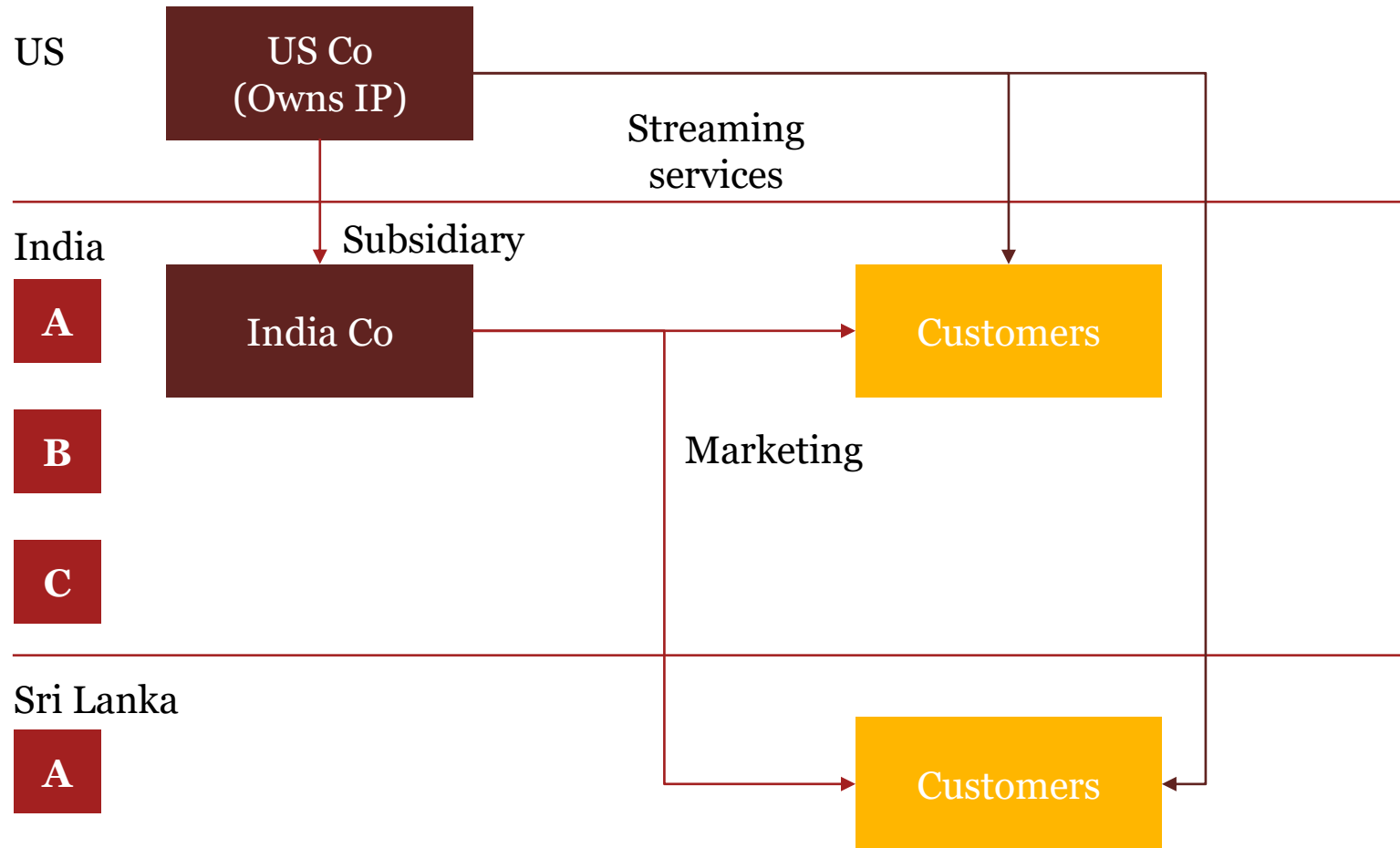
## Significant Economic Presence (SEP)

- In its Union Budget 2018, the Government of India had introduced a concept SEP for non-residents by expanding the definition of “business connection” under Section 9 of the Income Tax Act, 1961. This was done with the motive to tax business income based on its nexus.
- SEP is to be determined through a combination of factors such as transaction amount, number of users, etc.
- It covers within its ambit services like provision of download of data or software in India and interaction with users in India through digital means (subject to thresholds).

## Profit Attribution Rules (Draft)

- Committee formed to assess profit attribution which recommended a formulary approach that allocates profits between the jurisdiction where sales take place and the jurisdiction where supply is undertaken.
- The report lays down emphasis on factors such as sales, employees, assets (SEA) , and **users** for attribution of profits.

# Case Study – OECD’s Unified Approach: Pillar 1



## Key industry attributes – Content Streaming

- High user engagement
- Physical presence – not critical for generating value
- Generating value through user data

Pillar 1 seeks to attribute a new taxing right to source/market jurisdictions absent any physical presence. This rights are attributed on the basis of market/user presence.

In this case study, Sri Lanka will be entitled to a return despite no physical presence of the Group



**ACTION PLAN 4: LIMITING BASE  
EROSION VIA INTEREST  
DEDUCTIONS AND OTHER  
FINANCIAL PAYMENTS**

# *Current Issues on use of Interest and Financial Payments*

- Use of interest (related and third party interest) is perceived to be one of the most simple profit-shifting techniques used in international tax planning.
- Adjusting the mix of debt and equity in a multinational group/ individual group entities leads to base erosion and profit shifting illustratively due to:
  - ✓ Location of third party interest in high tax countries
  - ✓ Use of third party or intragroup financing to fund the generation of tax exempt income
  - ✓ Use of structures/ hybrid entities to claim multiple interest deductions
  - ✓ Highly leveraged entity in a high tax jurisdiction in excess of group's actual third party interest cost



# AP 4 Recommendations at a glance

## **Fixed Ratio Rule**

- Links the level of interest expense to a measure of an entity's economic activity.
- Limiting net interest deduction claimed by an entity (or group of entities operating in same country) to a fixed percentage of earnings (EBIDTA).
- Ratio should be between 10% and 30% of the applicable EBIDTA.

## **Group Ratio Rule**

- Compares level of interest expense or debt in an entity to that of its group's overall interest expense/ earnings or debt/equity ratio position.
- Countries may adopt a 'group ratio rule' to supplement (but not replace) the fixed ratio rule, to provide additional flexibility for highly leveraged groups or industry sectors.
- Group ratio rule is applied by using following steps –
  - Determine the group's net third party interest/EBIDTA ratio;
  - Applying the above ratio to local company's EBIDTA.

## **Targeted Anti-Avoidance Rules**

- Anti-avoidance rules which disallow interest expense on specific transactions.
- In addition to general limitation rules (i.e. FRR and GRR), existing targeted rules like thin capitalization rules/ transfer pricing applicability may continue to apply, to address specific risks. E.g. section 14A of the Income tax Act, 1961.

# Global Measures

## EBITDA based cap

- Interest deduction in excess of certain percentage of borrower's EBITDA is disallowed:
  - India – 30% of EBITDA (details covered in next slide)
  - South Africa – 30% (applicable to related and third party debt);
  - Germany – 30% of taxable EBITDA;
  - Greece – Phased reduction from 60% in 2014 to 30% in 2017;
  - Norway – 30% of taxable EBITDA.

## Threshold limits for Thin Capitalization Rules

- Interest deduction on debt in excess of a specified debt-equity ratio is disallowed:
  - Australia – specified debt-equity ratio of 1.5:1;
  - Brazil - specified debt-equity ratio of 2:1 (or 3:1 in case of low tax or privileged tax jurisdictions);
  - Canada - specified debt-equity ratio of 1.5:1; disallowed interest is deemed as dividend and subject to withholding;
  - Indonesia - specified debt-equity ratio of 4:1.

## Other targeted measures

- Black listed jurisdictions – interest paid/ payable to entities in black listed jurisdictions is disallowed. E.g. in Canada, France;
- Transfer pricing regulations requiring interest to be benchmarked at arm's length.

# Indian Measures

## Interest limitation under section 94B of the Income tax Act, 1961

- The Finance Act 2017 introduced a new section 94B to restrict the deduction of interest paid by an entity in respect of any debt from a non-resident being its AE. The section became effective from 1<sup>st</sup> April 2017 on specified interest amounts exceeding INR 1 crore;
- Section 94B applies to:
  - Indian company or PE of foreign company in India;
  - Debt is borrowed from a non-resident which is the AE of the company/ PE;
  - Interest expense on debt is deductible while computing income from business and profession for the company/ PE.
- Deduction of interest paid or payable to AE is restricted to a maximum of 30% of EBITDA;
- Interest disallowed can be carried forward for set off against future taxable profit and gain from business and profession for up to 8 assessment years (subject to 30% of EBITDA).

## Other measures

- Section 14A: Disallowance of interest expense in relation to exempt income;
- Section 43B: Deduction of interest payable to financial institutions only on actual payment;
- Section 94A: Disallowance of expenses paid/ payable to persons located in notified jurisdictions (Cyprus was recently denotified); etc.



**ACTION PLANS 8-10: TRANSFER PRICING  
OUTCOMES IN LINE WITH VALUE CREATION  
– INTANGIBLES, RISKS AND CAPITAL, AND  
HIGH RISK TRANSACTIONS**



# AP 8 at a glance

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**Intangible defined** – not physical / financial, capable of being owned / controlled, use or transfer would be compensated between third parties

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Arm's length return for development, enhancement, maintenance, protection and exploitation (**DEMPE**) of intangibles

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**Legal ownership** and **funding** not determinative of residual returns

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**Control over functions** important rather than contractual obligations

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Intangibles to be distinguished from **market conditions** which cannot be owned / controlled

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Introduction of **six step framework** to analyze transfer pricing aspects of intangibles

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## Hard to Value Intangibles

Partially developed intangibles

Intangibles not exploitable soon

Intangibles integral to HTVI

Intangibles expected to be exploited in novel manner

Intangibles developed under Cost Contribution Arrangements

# AP 9 at a glance

## Risk Assessment

### Control over risk

- Capability to make decisions to take on, lay off, or decline risk bearing opportunity
- Capability to make decisions on responding to risk associated with opportunity
- Actual decision making. Assumption of risk without 'control' over that risk may create issues

### Financial capacity to assume risk

- Capability to access funding when managing risks
- Absorbing consequences of risk

## Six step analytical framework to identify risks specifically

Determine contractual allocation of risk

Identify control over risk

Identify financial capacity to absorb risk

Check conduct with contractual terms

Re-characterize risks if appropriate

Pricing based on risk assumption & management

# AP 10 at a glance

## Low value adding intra-group services

- Supportive in nature
- Not a part of the core business of MNE group
- No use/ creation of unique and valuable intangibles
- No assumption/ control/ creation of significant risk by or for service provider

## Simplified Approach

Simplified benefit test

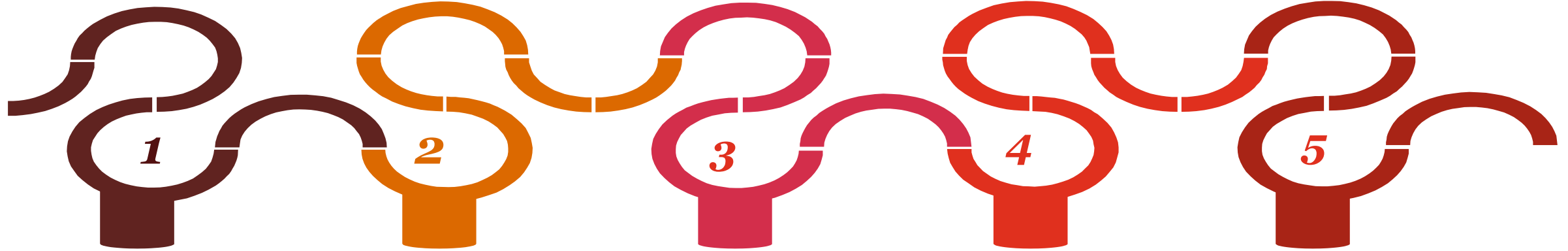
Determination of cost pool

Allocation of costs from the pool

Profit mark-up (5% safe harbour)

Clarify the application of transfer pricing methods, in particular **profit splits**, which should be applied in the context of global value chains

# AP 8 – 10: Key Takeaways



***Substance***

***Control over risks & financial capability***

***Intangibles and their valuation***

***Discouraging cash boxes***

***Low value adding intra-group services***



# Indian Measures – Circular 6

## 3 types of R&D centres

- Entrepreneurial in nature
- Based on cost-sharing arrangements
- Undertaking contract R&D

Distinguish based on  
**F A R**

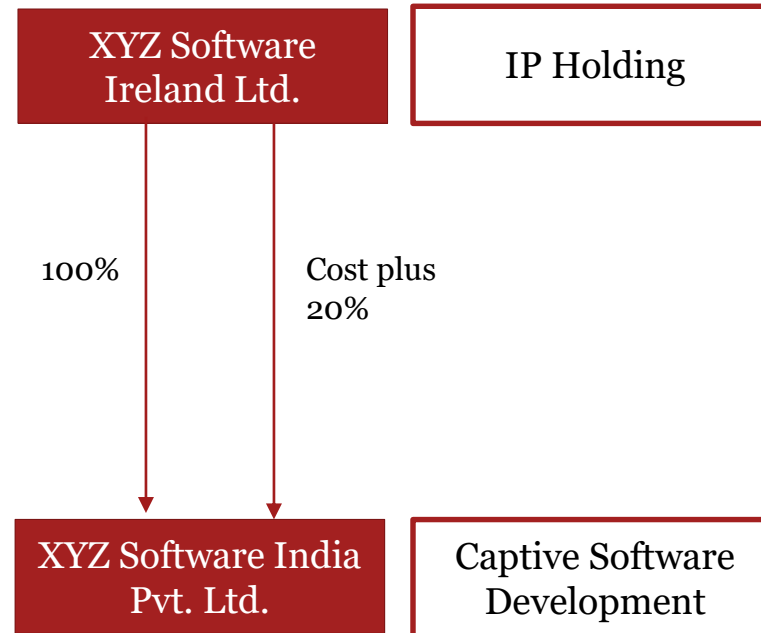
## Guidelines for identification of contract R&D service provider with insignificant risk

- **Functions:** Principal or AEs should perform economically significant functions. Guidance provided on what is economically significant;
- **Assets:** Principal or AEs provides funds/capital and economically significant assets (including significant intangibles);
- **Control and supervision:** Centre works under the direct supervision of principal or AEs;
- **Risks:** Centre does not bear any significant risk;
- **Ownership right:** Centre has no ownership right on the outcome of the research.

# Case Study – Captive Service Providers

## Current focus areas

- India's functions
- Contractual risks
- Comparables – is 20% enough?
- Operating vs non-operating
- Pass-through costs
- Comparability adjustments



## Focus areas, going forward

- AE's functions including risk management
- Whether AE mere cash box?
- Who is entitled to residual profits?

# *STA's ruling in case of Puma: Marrying Contractual Terms with Actual Conduct- The BEPS World!*

## **A. Facts of the case:**

**Background:** Puma group is engaged in designing, developing and selling marketed shoes, clothing and accessories under the Puma brand for over 65 years and is considered to be one of the world's leading sports brand.

The majority of Puma's **production** is handled by **external contract manufacturers**. The group's employees are mainly engaged into marketing, design and product development.

**PUMA SE is the parent company** of the Puma Group, headquartered in Germany and the Group also includes the German company, **PUMA International Trading GmbH (PIT)- a central procurement company** which is responsible for liaising with external contract manufacturers.

**Puma in Sweden:** Puma Nordic AB is an indirect wholly-owned subsidiary of the German parent company Puma SE. Puma Sweden acts as a distributor with its main functions being marketing and selling Puma products in the Swedish market.

## **B. The Dispute:**

Puma Sweden- a routine distributor not exposed to key risks has been incurring losses for several continuous years.

## **C. Related party transactions & Inter-company Pricing:**

<b>Nature of the transaction</b>	<b>Name of the contracting AE</b>	<b>Pricing Policy</b>	<b>MAM</b>
<b>Purchase of goods</b>	PIT	8.5% on the manufacturing cost (+) 2.5% - 4% on manufacturing cost for product development & design (transferred by PIT to Puma SE)	CUP
<b>Payment of Royalty for marketing license</b>	Puma SE	9% on all sales to external customers	CUP

# *STA's ruling in case of Puma: Marrying Contractual Terms with Actual Conduct- The BEPS World!*

## ***D. Critical analysis by the Swedish Tax Agency ('STA'):***

The STA undertook a detailed study, analyzing the various functions performed by the group entities, identifying the economically significant risks, the owner of such risks, etc. by adopting the six step plan laid down in the OECD guidelines.

<b>Function</b>	<b>Performed by and Observations by STA</b>	<b>Controlled by</b>
<b>Design and product development</b>	Puma SE (parent company) Puma SE has employees with requisite experience and knowledge who can take strategic decisions regarding design and development	Puma SE
<b>Manufacturing &amp; procurement</b>	External contract manufacturers PIT negotiates purchase prices and other contract terms with external manufacturers and is responsible for resolving quality issues with them	PIT with support from Puma SE
<b>Marketing and brand strategy</b>	Puma SE Puma SE is the legal and economic owner of the brand & IP of Puma group	Puma SE
<b>Sales &amp; Distribution</b>	Puma Sweden Puma Sweden has its own customer relationships and it sells products to external retailers in Sweden	Puma Sweden subject to a Framework Purchase Agreement and an International Marketing Agreement with PIT



# *STA's ruling in case of Puma: Marrying Contractual Terms with Actual Conduct- The BEPS World!*

**Risk analysis:** The six step plan is as detailed below:

Step No	Particulars	Findings of the STA
1	Identification of economically significant risks	a. Brand Risk: Creating a strong and a well perceived international brand is instrumental to success; a. Product design & development risk: Innovative designing and development of high quality products is vital to remain competitive and create value for customers.
2	Contractual obligations	Puma Sweden was contractually obligated to compensate Puma SE and PIT for the functions performed by them and retain the residual. Thus, bearing the implicit risks.
3	Actual conduct of the parties	It was clear that Puma SE had the actual control over such significant risks and also the appetite to actually bear such risks.
4	Alignment of contractual terms with actual conduct	The STA concluded that since Puma Sweden was actually bearing the key risks though the control over such risks remained with Puma SE, contractual terms did not marry with actual conduct of the parties.
5	Re-allocating the risks, if contractual terms are not in alignment with actual conduct	Since Puma Sweden did not have the actual control of such key risks nor did it have the financial ability to bear such risks, these significant risks should be re-allocated to Puma SE.
6	Correct pricing based on the re-aligned risks	Basis the above, the STA concluded that Puma Sweden is a LRD and in an independent scenario, no third party would have continued with operating losses for several years and would have definitely re-negotiated the pricing or switched to alternate suppliers or brands.

The STA concluded that **both the intercompany transactions are intrinsically linked** to one another and hence must be tested on an aggregate basis. Thus, they selected **TNMM as the MAM** for benchmarking the same. They performed a comparable search on **Amadeus database to find independent distribution companies and accordingly made an adjustment.**

# ACTION PLAN 13: RE-EXAMINE TRANSFER PRICING DOCUMENTATION



# AP 13 at a glance

## OECD's approach and objective on Documentation

*Master File*

*Local File*

*CbCR*

**Master file:** 'blueprint' of multinational enterprise ('MNE') business

Provide a high-level overview of MNE group's TP practices

**Local file:** detailed information on specific intercompany transactions

Provide assurance that local TP compliances are achieved

**CbCR:** aggregated information on revenues, profits, taxes and indicators of economic activity

Support high level transfer pricing risk assessment

# Global Updates

## AP 13 – implementation and review

- AP 13 is a **minimum standard**. This means that all members of the Inclusive Framework must comply with its requirements.
- AP 13 recommends having a 3 tiered documentation system. Exchange of information is also critical to this standard. Countries across the world are becoming signatories to the **Multilateral Competent Authority Agreement (MCAA)** to facilitate exchange of information. There are 85 signatories to the MCAA presently.
- To ensure timely and consistent implementation of the standard across the world, members of the Inclusive Framework are peer reviewed and monitored. The CbCR **Peer Review** is a phased review focusing on:
  - Phase 1: Domestic legal and administrative framework;
  - Phase 2: Exchange of Information framework;
  - Phase 3: Confidentiality and appropriate use conditions.

So far there have been 2 completed peer reviews.

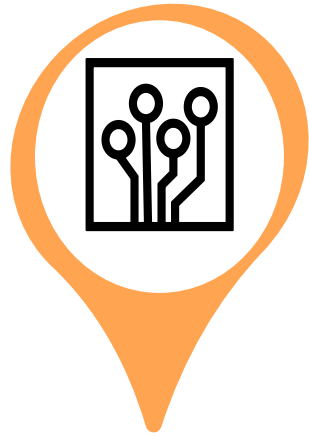
## Results up to the second peer review

- 116 jurisdictions covered now under peer review;
- Over 80 jurisdictions have introduced legislations to impose a filing obligation on MNE groups (this includes India);
- Post the start of CbCR in June 2018, there are more than 2,200 bilateral relationships for CbC exchanges in place now;

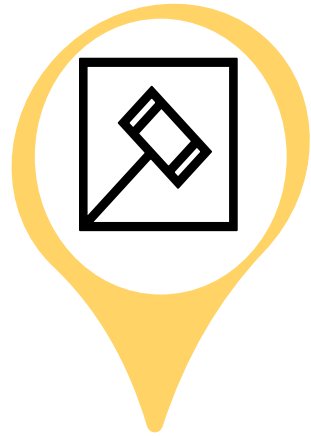
# Indian Updates



**Forms** for Master File and CbCR have been notified



**E-filing** functionality adopted



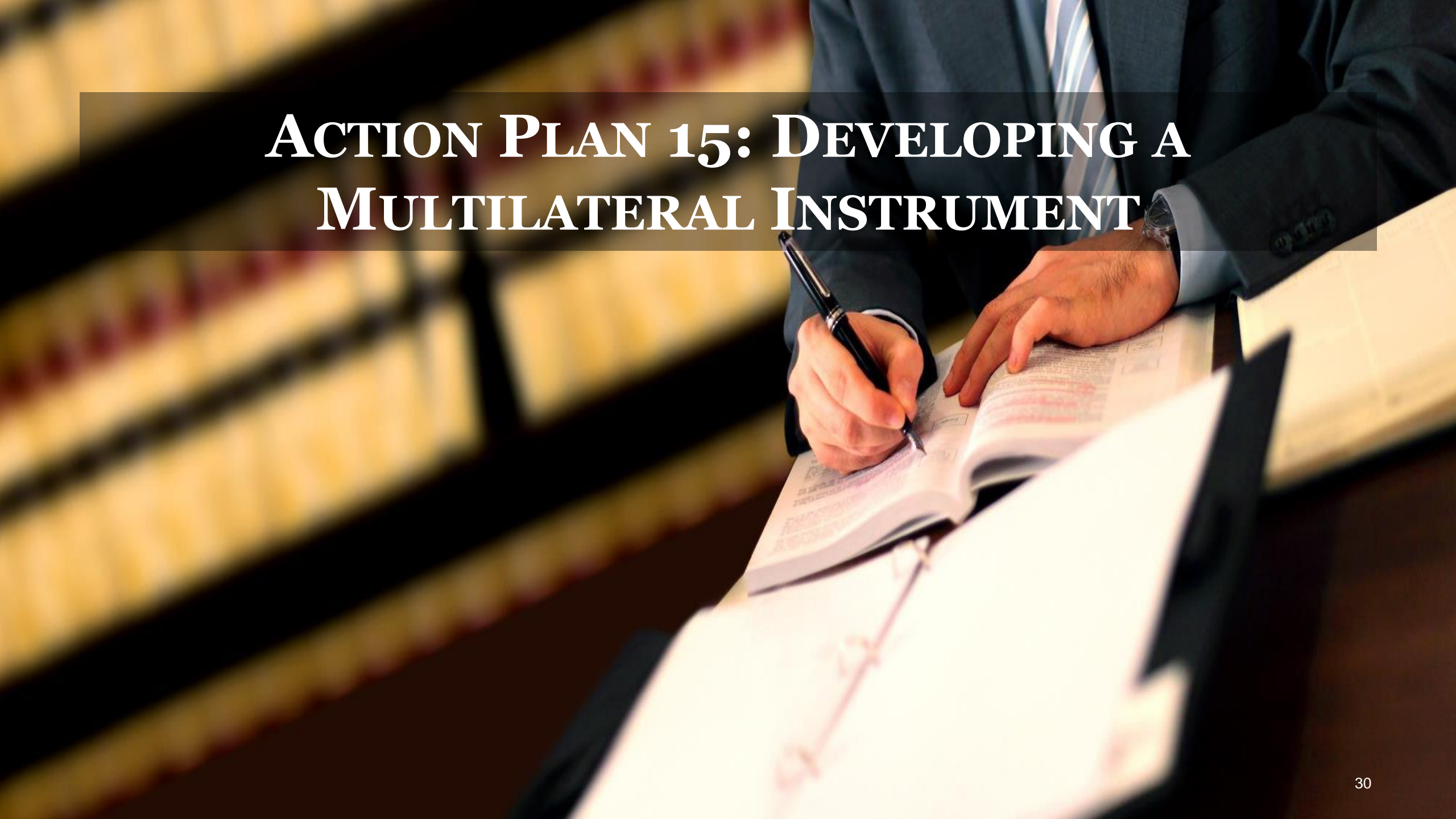
The Prescribed Authority – **Joint Director of Income-tax (Risk Assessment)**

*4 additional requirements in India's Master File vs. AP 13:*

- *FAR analysis of the constituent entities > 10% of the revenues or assets or profits of the group;*
- *List of all the entities with addresses;*
- *Financing arrangements including names and addresses of the top ten unrelated lenders;*
- *All entities engaged in development of intangibles and in management of intangibles with address.*

*Instruction issued for access to and appropriate use of CbCR:*

- *Indian Competent Authority and Joint Director of Income-tax (Risk Assessment) to have primary access*
- *The Transfer Pricing Officer to have access to CbCR only where the Constituent Entity has been selected for scrutiny based risk assessment.*

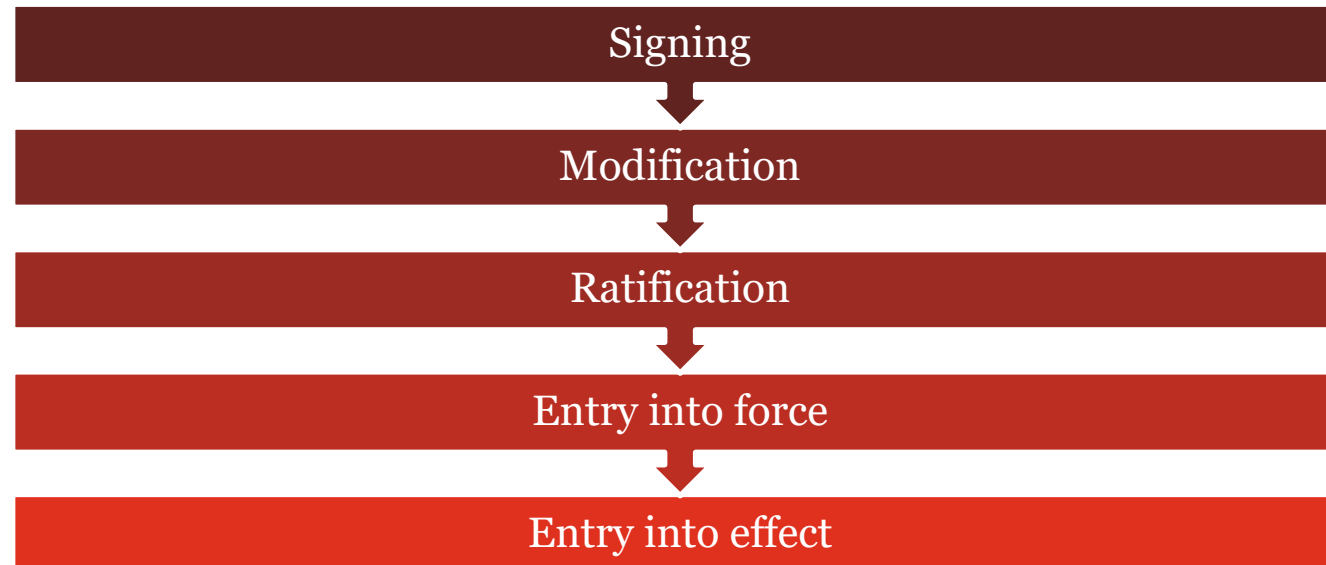
A person in a dark suit and striped tie is seated at a desk, writing in a notebook with a black pen. The notebook is open, and the person's hands are visible. In the foreground, a large white document with a red line is partially visible. The background is blurred, showing what appears to be a conference room with yellow and red patterned chairs.

# **ACTION PLAN 15: DEVELOPING A MULTILATERAL INSTRUMENT**

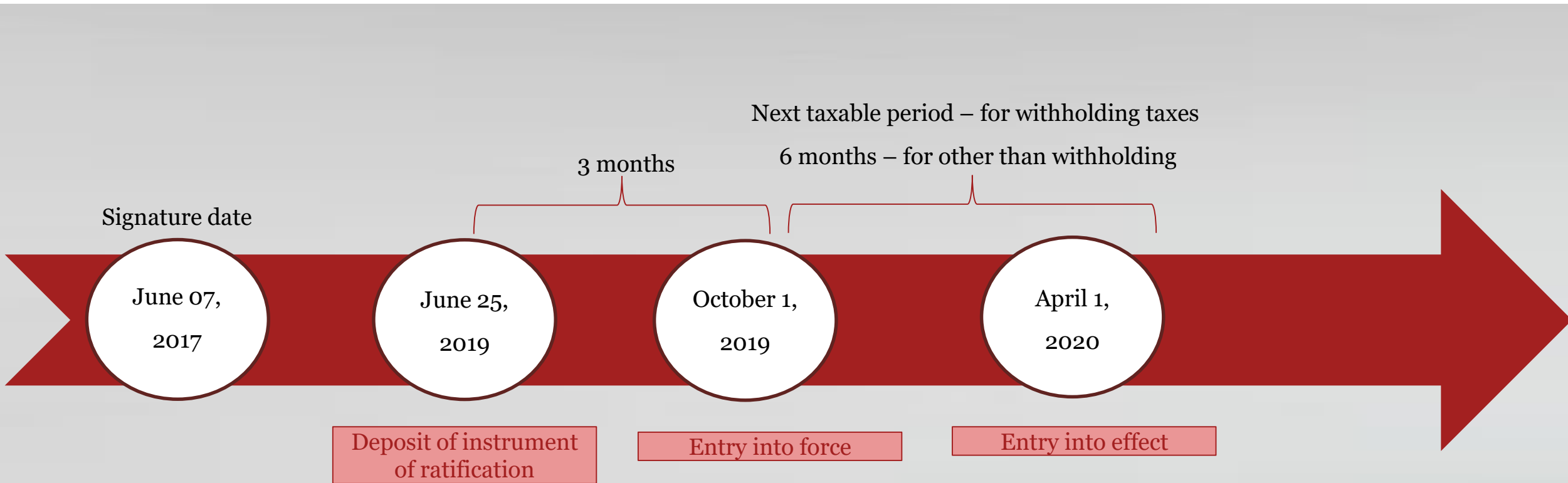
# AP 15 at a glance

- Multilateral Instrument (MLI) involves changes to the existing network of over 3,000 bilateral tax treaties.
- It offers concrete solutions for governments to close loopholes in international tax treaties by transposing results from the BEPS Project in a synchronized and efficient manner into bilateral tax treaties worldwide.
- The MLI entered into force on 1<sup>st</sup> July, 2018 and its provisions entered into effect for the first provisions on 1<sup>st</sup> January, 2019.
- Presently there are 94 signatories to MLI. 4 more nations have expressed their intent to sign the MLI.

## Step by step process



# Timeline for India





# *MLI Impact on Select Indian Tax Treaties*

## India – France treaty

- Only PPT to be added since France has not opted for SLOB
- Broader agency PE rule applicable since France has notified India tax treaty
- Avoidance of PE status through specific activity exemptions related provision not applicable since France has not chosen same option
- Splitting up of contracts related provision not applicable since France has made a reservation

## India – UK treaty

- Only PPT to apply since UK has not opted for SLOB
- Broader agency PE rule not applicable since UK has made a reservation
- Avoidance of PE status through specific activity exemptions related provision not applicable since UK has not chosen any option
- Splitting up of contracts related provision not applicable since UK has made a reservation

## India – Netherlands treaty

- Only PPT to be added since Netherlands has not opted for SLOB
- Broader agency PE rule not applicable since Netherlands has made a reservation
- Avoidance of PE status through specific activity exemptions related provision applicable since Netherlands has chosen same option
- Splitting up of contracts related provision applicable

## India – Singapore treaty

- Only PPT to apply since Singapore has not opted for SLOB
- Broader agency PE rule not applicable since Singapore has made a reservation
- Avoidance of PE status through specific activity exemptions related provision not applicable since Singapore has not chosen same option
- Splitting up of contracts related provision not applicable since Singapore has made a reservation

# WAY FORWARD... EMBRACE THE CHANGE

A person in a dark blue suit and striped tie is sitting at a desk, writing in a notebook with a black pen. The notebook is open, and the person's left hand is resting on the pages. In the foreground, a large white arrow points to the right, partially overlapping the notebook. The background is blurred, showing what appears to be a library or office setting with bookshelves.

# Embrace the Change...

*Transfer pricing so far..  
Reactive approach to date*



*Compliance focused*



*Protracted litigation*



*Invest in..*



Value chain analysis



Defense against PSM



Variable royalty models



Understand and establish data value chain



*Time to turn Pro-active*



Upfront planning and price setting



Global alignment



Assume potential dispute, prepare litigation strategy



Upfront engage with tax authorities – BAPA / MAP

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***Thank you***