Impact on International Tax : The effect of BEPS

WIRC - ICAI

Refresher Course on International Tax & Transfer Pricing

CA Hitesh D. Gajaria

25 June 2020

The effect of BEPS on International Tax

1. Introduction
2. BEPS Country Implementation - MLI and beyond
3. Interplay between GAAR and BEPS in India
4. Tax Dispute Resolution in a post BEPS World
5. Cross-Border Structures in a Post-BEPS Environment
6. Key Takeaways

Introduction

Introduction

- **Base Erosion and Profit Shifting (BEPS)** - refers to tax planning strategies used by MNCs that exploit gaps and mismatches in tax rules to avoid payment of tax, by artificially shifting profits to low or no-tax jurisdictions, where there is little or no economic activity

- **OECD's BEPS Action Plans** - a project developed by OECD / G20 Member Countries - Recommends measures to counter base erosion under domestic law & to nullify tax treaty abuses. Combats tax avoidance to realign taxation with economic substance & value creation

- **Multilateral Instrument (MLI)** - signed by developed and developing economies around the world to implement tax treaty related measures to prevent BEPS

- **MLI** - Includes measures against hybrid mismatch arrangements (Action 2) and treaty abuse (Action 6), strengthened definition of permanent establishment (Action 7) and measures to make mutual agreement procedure (MAP) more effective (Action 14), including provisions on MAP arbitration

BEPS Country Implementation – MLI and beyond

The MLI Journey

Oct 2015, Release of BEPS reports (15 AP)

OECD's initiative to tackle tax avoidance through BASE EROSION AND PROFIT SHIFTING ('BEPS')

Nov 2016, over 100 jurisdictions (including India) concluded negotiations and adopted MLI (BEPS15)

MLI and its explanatory statement finalised to implement BEPS measures

June 2017, signatures on MLI (BEPS AP15)

MLI signed by 67 countries including India (followed by subsequent signatories)

1 July 2018, MLI Entry into Force (*After first five ratifications*)

By Austria, the Isle of Man, Jersey, Poland and Slovenia

25 June 2019 MLI Ratification by India

MLI Ratification and deposit by India (after Cabinet approval on 12 June 2019)

9 August 2019 MLI Notification by India

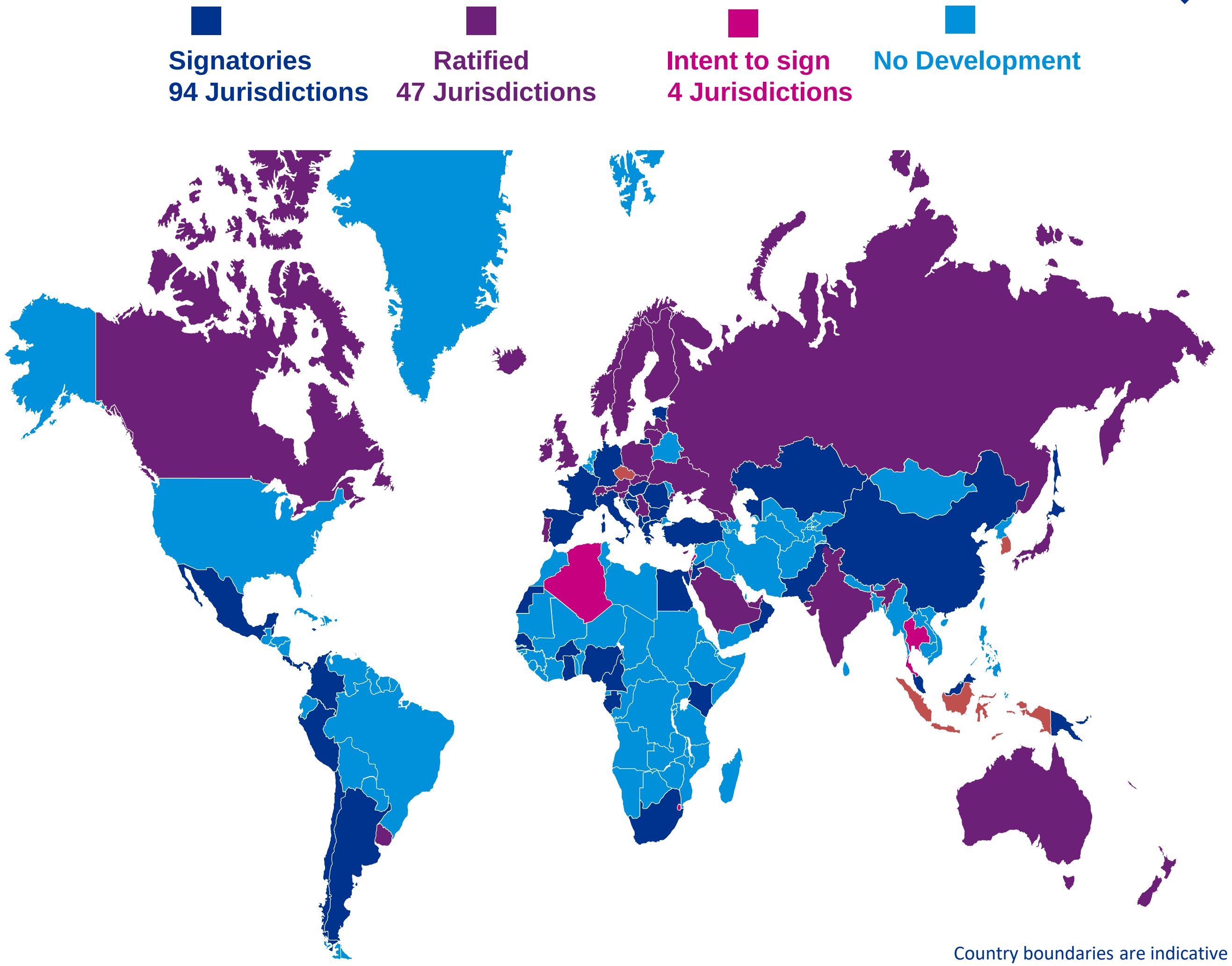
MLI Notified by Ministry of Finance

MLI Status of Adoption

- Albania
- Andorra
- Argentina
- Armenia
- Australia
- Austria
- Barbados
- Belgium
- Belize
- Bosnia & Herzegovina
- Bulgaria
- Burkina Faso
- Cameroon
- Canada
- Chile
- China
- Colombia
- Costa Rica
- Cote d'Ivoire
- Croatia
- Curacao
- Cyprus
- Czech Republic
- Denmark
- Egypt
- Estonia
- Fiji
- Finland
- France
- Gabon
- Georgia
- Germany
- Greece
- Guernsey
- Hong Kong
- Hungary
- Iceland
- India
- Indonesia
- Ireland
- Isle of Man
- Israel
- Italy
- Jamaica
- Japan
- Jersey
- Jordan
- Kazakhstan
- Kenya
- Korea
- Kuwait
- Latvia
- Liechtenstein
- Lithuania
- Luxembourg
- Malaysia
- Malta
- Mauritius
- Mexico
- Monaco
- Morocco
- Netherlands
- New Zealand
- Nigeria
- North Macedonia
- Norway
- Oman
- Pakistan
- Panama
- Papua New Guinea
- Peru
- Poland
- Portugal
- Qatar
- Romania
- Russia
- San Marino
- Saudi Arabia
- Senegal
- Serbia
- Seychelles
- Singapore
- Slovakia
- Slovenia
- South Africa
- Spain
- Sweden
- Switzerland
- Tunisia
- Turkey
- Ukraine
- United Arab Emirates
- United Kingdom
- Uruguay

Intent to sign:

- *Algeria*
- *Eswatini*
- *Lebanon*
- *Thailand*



Country boundaries are indicative only

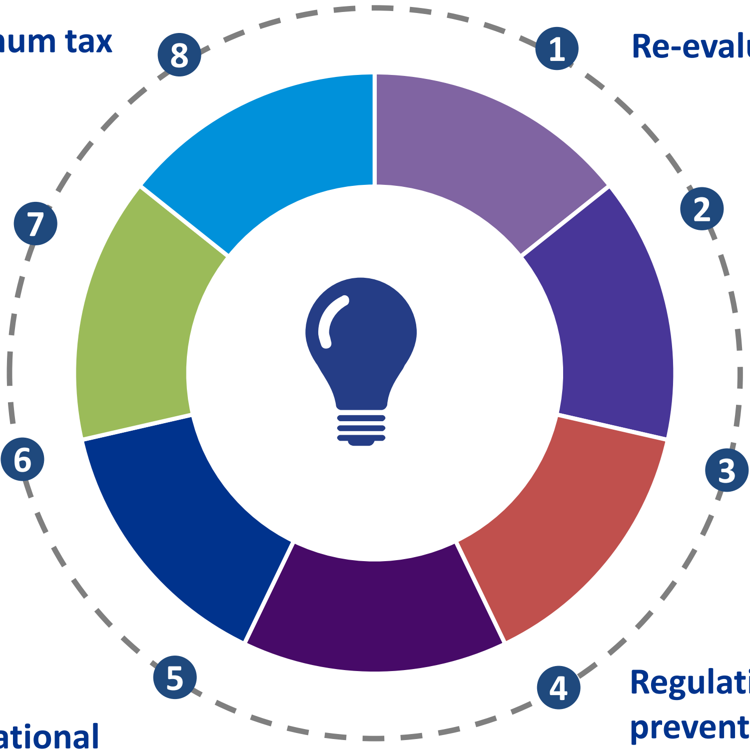
Source: http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf

BEPS Implementation – Other developments

- **Digital Economy**
  - Pillar One focuses on allocation of taxing rights
    - ✓ Seeks to undertake review of profit allocation & nexus rules
    - ✓ Discussion on user participation, marketing intangibles and SEP proposals
  - Pillar Two envisages a GloBE proposal comprising of:
    - ✓ Income inclusion rule
    - ✓ Tax on base eroding payments
  - Inclusive Framework adopted PoW in May 2019
  - Negotiations underway, but future of US participation in doubt
- **Many countries have implemented domestic measures to give effect to BEPS recommendations e.g. Interest Limitation (e.g. India's Sec. 94B), hybrid mismatch arrangements (in Australia / NZ etc.)**
- **Peer reviews of treaty abuse, MAP efficacy and preferential regimes undertaken**

Interplay between GAAR and BEPS

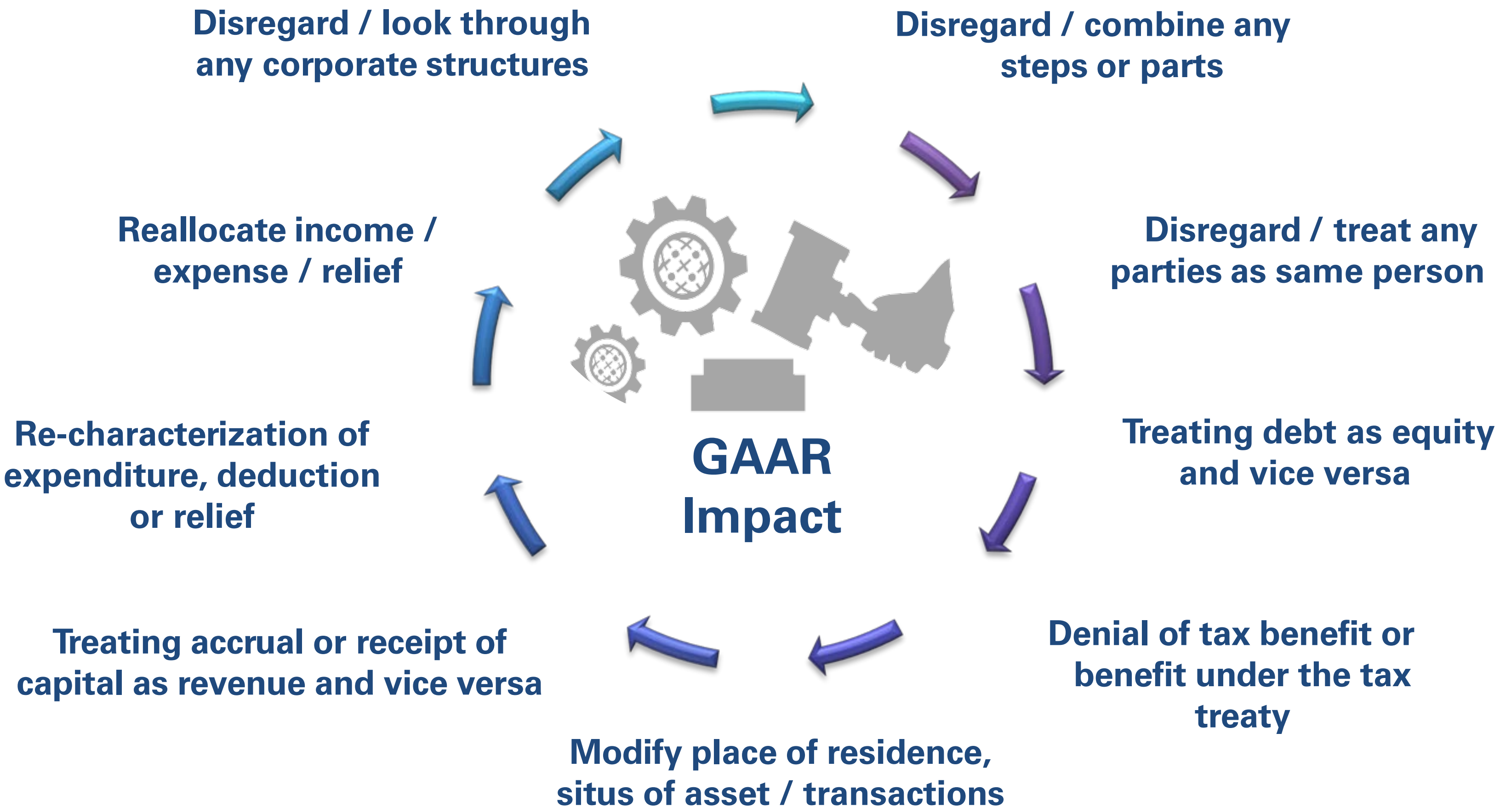
Objectives of the BEPS / MLI initiative



1. Re-evaluation of source country taxing rights
2. Overhauling of rules for digital businesses
3. Aligning TP outcomes to value creation
4. Regulating access to treaties (to prevent treaty abuse)
5. Increased reporting requirements on multinational groups
6. Automatic exchange of information between countries
7. Shift towards formula based apportionment of taxing rights
8. A global minimum tax

Objectives of GAAR

- Targets abusive arrangements entered into with the main purpose of obtaining a tax benefit



Interplay between GAAR and BEPS

- Overlap largely confined to application of the Principal Purpose Test under the MLI

Particulars	GAAR	PPT
Applicability	• Main purpose is tax benefit; and • One of the tainted element tests is present	• One of the principal purposes is tax benefit • Not in accordance with object and purpose of treaty
Consequences	Re-characterization / disregarding of transaction, re-allocation of income (includes denial of treaty benefit)	Denial of treaty benefit
Onus	Primary onus on tax authority	Primary onus on tax authority and rebuttal assumption for carve out
Administrative safeguards	Approving Panel	To be determined by respective states. OECD and UN Model Commentaries recommend safeguards
Grandfathering	Yes	No
De-minimis threshold	Yes	No

Dispute Resolution

Dispute Resolution in a post BEPS era

- Disputes likely to increase. Factors pointing to this trend include:
  - Increased information flows between countries (exchange of information framework)
  - Greater disclosure norms (e.g. CbCR, reporting of aggressive transactions)
  - Divergent approaches in adoption of BEPS measures in domestic law (e.g. India’s thin capitalization)
  - Risk of inconsistency in interpretation and enforcement across countries
- Some measures envisaged as part of the BEPS project to strengthen dispute resolution structures:
  - Expanding and strengthening the MAP framework
  - Mandatory binding arbitration (not accepted by India)
  - Evolution of a new / different dispute resolution mechanism by the Inclusive Framework?
- Insufficient focus on providing certainty in advance:
- Delays in the Advance ruling framework in India
- Need for dispute ‘settlement’ mechanism more pronounced

Impact of BEPS / MLI on cross-border structures

Traditional areas of Cross-border Planning

IP and Supply Chain

- IP and R&D planning (contract R&D, cost sharing arrangements etc.)
- Tax-efficient manufacturing arrangements (e.g. contract and toll manufacturing)
- Sales and distribution arrangements (dependent and independent agents, marketing support, limited risk and full distributors, commissionaire structures etc.)

Holding & Financing Structures

- Accessing treaty benefits through use of holding companies in favourable jurisdictions
- Funding structures, including through use of inter-company debt
- Use of group financing entities and branches
- Hybrid instruments

Incentive regimes

- Headquarter regimes
- IP and other R&D incentive regimes (including patent box, IP box regimes)
- Deemed foreign tax credit regimes
- Participation exemption etc.

Impact of BEPS / MLI on Tax Planning

Supply Chain (R&D / Manufacturing)

- Increased focus on aligning taxation with value creation (especially w.r.t. intangibles):
  - Intended to prevent companies with no significant employees or minimal operational activity from earning significant risk-related or intangible-related returns
  - Contractual arrangements or funding to not by themselves entitle an entity to returns from intangibles or risk assumption
  - The entity must have "substance" in the form of actual controlling of risk by employees or by performing of important DEMPE functions

Impact on planning

- Pure 'cash box' entities may no longer work
- Need to shift IP / intangibles to entities with employees and operations (i.e. substance)
- Need to shift employees and operations to entities with IP / intangibles
- Increased availability of information with the tax authorities under CbCR

Impact of BEPS / MLI on Tax Planning

Supply Chain (Marketing / Distribution)

- Scope of PE expanded to include agent playing principal role, leading to routine conclusion of contracts, without material modification
- Agent acting exclusively or almost exclusively on behalf of one or more closely related enterprises not to be considered independent
- Restricted exemptions for preparatory and auxiliary activities under some treaties
- Restriction on splitting up of contracts for installation PE

Impact on planning

- Increased focus on actual conduct in the source state
- Planning involving use of structures where final signing / approval authority is retained outside the source country could be affected
- Artificial splitting up of contracts to be disregarded for computing installation PE thresholds

Impact of BEPS / MLI on Tax Planning

Holding and Financing Structures

- Several measures intended to curb ‘treaty shopping’
  - Changes to the treaty preamble
  - Introduction of a Simplified Limitation on Benefits Article (and a detailed LOB with anti-conduit rules)
  - Use of a ‘Principal Purpose Test’ to access treaty benefits
- Proposals to neutralize hybrid mismatch arrangements
- Thin-capitalization provisions

Impact on planning

- Treaty access for holding / financing SPVs at risk – several existing structures could be affected
- ‘Purpose’ behind structures will be critical going forward
- Domestic law provisions could be introduced to deny deductions if corresponding income is exempt
- Thin capitalisation provisions will affect debt financing structures in high tax jurisdictions

Impact of BEPS / MLI on Tax Planning

Incentive Regimes

- Harmful tax practices – incentive regimes under scrutiny at the OECD
- State-aid cases under EU Anti-Trust rules
- Pillar Two Proposals – move towards a global minimum tax

Impact on planning

- Continued availability of incentives (headquarter regimes, private rulings, deemed credit etc.) under a scanner
- Tax benefits could face challenges under anti-trust norms as well (especially in the EU)
- GloBE proposals – multiple consequences could potentially ensue if income is not subject to tax at a minimum effective rate (Including income-pick up in parent jurisdiction, denial of deduction and treaty benefits, and levy of withholding tax at source)

Other factors affecting tax planning

- **Enactment of General and Special Anti-abuse rules by most countries, including India**
- **Emergence of tax morality – purpose and acceptability of tax outcomes are increasingly relevant**
- **Tax matters routinely make the headlines – tax planning will need to survive the spotlight**
- **Increased data leaks- confidentiality and secrecy no longer assured**
- **Debate over MNCs tax strategies plays out in social media**
- **Increased interest on the part of media, NGOs and even consumers in tax matters**

Key Takeaways

Key Takeaways - impact on professionals

- Role of professionals will see a transformation
- Changed expectations from clients - need to manage significantly increased tax risks without overpaying taxes
- Mere compliance with rules insufficient – acceptability and morality are increasingly relevant
- All planning must be geared up to face rigorous (and possibly public) scrutiny
- Mandatory Disclosure Requirements for BOTH – Intermediaries and Taxpayers ?

Thank You!

CA Hitesh D. Gajaria