CROSS BORDER TAXATION BASE EROSION AND PROFIT SHIFTING (BEPS) – INDIA IS MOVING TOWARDS THE BIGGEST EVER INTERNATIONAL TAX REFORMS

CMA Mrityunjay Acharjee
Associate Vice President, Tax and Chief Internal Auditor, Balmer Lawrie Limited

Spreading business across the universe and availing the maximum possible fiscal advantage by routing the flow of capital and repartition of the return thereon reported to curve out the tax liability to the maximum permissible extent and through that process of availing cross border tax advantage and double taxation avoidance agreement advantage shelter, the effective tax rates of some leading Multinational Corporations (MNCs) are lower than 1% of their revenues. This came out as an big impact on the tax to GDP ratio as well as on the revenue collection situation of all the reported countries and specially Country like India. These reports sparked-off public protests and led to a surge of anger within the taxpayer community, who compared their own effective tax rates with those paid by the supposedly highly-profitable MNCs. It also made the common man wonder how this was achieved.

All the multinational originations (MNCs) used to adopt the sophisticated tax planning practices of MNCs, of reducing their tax base by shifting profits to other countries especially tax havens (i.e. Base Erosion and Profit Shifting (BEPS)). This was being done within the existing legal framework by taking advantage of loopholes/gaps/mismatches in the tax rules of different countries. Action plan has been initiated to curb and restrict these process on a pan world basis and India is not out of the fray.

Origin of the BEPS Project

In order to curb such malafide practices, the Organisation for Economic Cooperation and Development (OECD) along with G20 countries formulated the BEPS Action Project. This project aims at providing a mechanism to plug such loopholes/gaps/mismatches in international tax laws, thereby providing every country an opportunity to earn their fair share of tax revenues.

The BEPS Project has 15 Action Plans covering the taxability of digital economy, hybrid entities, prevention of treaty abuse, artificial avoidance of Permanent Establishment (PE), linking transfer pricing requirements to value creation, dispute resolution mechanisms, to name a few.

Base erosion and profit shifting (BEPS) refers to tax planning strategies used by multinational companies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity. The project headed by the OECD was initiated by the G20 in 2012.

The international tax system is changing rapidly as a result of coordinated actions by governments and of unilateral measures designed by individual countries, both intended to tackle concerns over base erosion and profit shifting (BEPS) and perceived international tax avoidance techniques of high-profile multinationals. The recommendations of the BEPS Project led by the Organisation for Economic Cooperation and Development (OECD) and published in October 2015 are at the root of much of the coordinated activity, although the timing and methods of implementation vary. At the completion of this scheduled programme, it started to be recognised as the end of phase one of the project and the start of phase two, dealing with outstanding or additional work, implementation and monitoring.

BEPS concerns strategies which aim to move profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates. The result is a tendency to associate more profit with legal constructs and intangible rights and obligations, and reduce the share of profits associated with substantive operations involving the interaction of people with one another. "While these corporate tax planning strategies may be technically legal and rely on carefully planned interactions of a variety of tax rules and principles, the overall effect of this type of tax planning is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy."

BEPS Project

The 2012 G20 Los-Cabos summit referred to "the need to prevent base erosion and profit shifting" in their final declaration and tasked the OECD to develop an Action Plan. The G20 Leaders endorsed the BEPS Action Plan at the 2013 G-20 St. Petersburg summit. The BEPS Project had been initiated by the G20 countries but it effectively also encompassed the other OECD Member States from the outset. As the project progressed, engagement in the discussions was extended to other large non-OECD states and representatives of developing countries.

Underlying principles of the BEPS Project

The underlying principle of the BEPS Project is that tax should be paid in the country in which the economic substance and value-addition functions of a transaction are carried out and the tax treaty benefits should not be given to dummy/shell entities set up primarily to take unfair advantage of tax treaties and mis-match in tax rules.

Implementation of the BEPS Project

Implementing the BEPS Action Plan would require amending more than 3,000 bilateral tax treaties. Therefore, to save the participating countries the need to approach each of its treaty partners for the amendment of their bilateral tax treaty, Action Plan 15 of the BEPS Project provides for the signing of a Multi-Lateral Instrument (MLI) to modify various tax treaties simultaneously. Once signed, the MLI would have to be read along with the various bilateral tax treaties. The MLI was issued in November 2016 and a signing ceremony is proposed to be held in June 2017 in Paris.

Minimum standards – a measure towards acceptance of BEPS principles

The MLI provides for certain minimum standards (binding clauses) i.e. clauses to be compulsory adopted by countries signing the MLI. These clauses are binding on all participating countries and cannot be deviated from. In addition, there are certain recommendatory (optional) clauses with alternative options regarding the text and coverage of optional clauses. Participating countries have the freedom to reject the optional clauses or to accept the alternative options as per their requirement. The MLI also contains provisions to deal with mismatches between decisions/options chosen by the participating countries.

The OECD published over 1600 pages in the 'final' reports in relation to all 15 BEPS Action items in October 2015. The UN, IMF, World Bank and OECD are developing toolkits to assist "lowest income countries" in implementing the outcomes of the BEPS Project, so far as they are relevant to those countries or to address related issues. A framework has been agreed for all countries to participate in further BEPS work on an equal footing, broadly if they commit to implementing the minimum standards The BEPS Package consisting of reports on 15 actions designed to be implemented domestically and through tax treaty provisions was agreed at their 2015 G20 Antalya summit. The Action plans for Cross Border taxation are as follows:

- Action 1: Addressing the Tax Challenges of the Digital Economy
- Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements
- Action 3: Designing Effective Controlled Foreign Company Rules
- Action 4: 2 Limiting Base Erosion Involving Interest Deductions and Other Financial Payments
- Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
- Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
- Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status
- Actions 8–10: Aligning Transfer Pricing Outcomes with Value Creation
- Action 11: Measuring and Monitoring BEPS
- Action 12: Mandatory Disclosure Rules
- Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting
- Action 14: Making Dispute Resolution Mechanisms More Effective
- Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

There are 4 minimum standards on BEPS relating to Countering Harmful Tax Practices (Action 5) Treaty Shopping (Action 6), Transfer Pricing Documentation and Country-by-Country Reporting (Action 13) and Dispute Resolution (Action 14). Each of the four BEPS minimum standards is subject to peer review.

In November 2016, the main text on the Multi-Lateral Instrument (MLI)) was agreed – this is a single instrument by which countries will be able to amend up to 3,000 bilateral treaties. It includes clauses which relate to the BEPS minimum standards on treaty abuse and dispute resolution, as well as other opt-in/opt-out provisions and options where there are multiple ways to address BEPS.

- In India, the Government has so far released draft Rules in respect of the "Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting" and a host of other rules are expected shortly.
- The idea is simple. Firms make profits in one jurisdiction, and shift them across borders by exploiting gaps and mismatches in tax rules, to take advantage of lower tax rates and, thus, not paying taxes to in the country where the profit is made.
- There have been concerns across the globe about companies making profits in a particular country but not paying taxes to the local government. The Organization for Economic Cooperation and Development (OECD) states that BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises. It also states that estimates since 2013 conservatively indicate annual losses of anywhere from 4 to10 per cent of global corporate income tax revenues, or $100-$240 billion annually.
- The OECD, under the authority of the Group of 20 countries, has considered ways to revise tax treaties, tighten rules, and to share more government tax information under the BEPS project, and has issued action plans last year. One of the areas discussed was on addressing tax challenges in the digital economy.
- The term sprang into the public consciousness last month, because the 2016 Union Budget announced an 'equalisation levy' of 6 per cent on payments exceeding over ₹1 lakh to online ad services from non-resident entities. Prominent among the companies affected would be new economy multinationals with Indian subsidiaries, like Facebook and Google.
- India is the first country to impose such a levy, post the OECD action plan. A tax panel has recommended expanding the ambit of this levy to cover a wide gamut of transactions including online marketing, cloud computing,

website designing, hosting and maintenance, platforms for sale of goods and services, and online use of or download of software and applications.

Inclusive Framework

The BEPS Package was developed mainly by G20 and OECD countries, but international tax issues effect other countries. At the 2015 G20 Antalya summit, it was agreed to open the process to all interested countries and jurisdictions including developing countries by developing an 'Inclusive Framework'. To join the framework countries and jurisdictions are required to commit to the comprehensive BEPS package and its consistent implementation and to pay an annual BEPS Member fee (reduced when applied to developing countries). All members of the Inclusive Framework on BEPS commit to implementing the minimum standards and participating in the peer reviews.

As of April 2017 96 countries had joined the Inclusive Framework. There could be controversy too. Causes for controversy around this issue can be found in "gaps and inadequacies of domestic laws, insufficient controlled foreign company rules, transfer mispricing, tax treaty abuses or problems arising from hybrid mismatch arrangements".[10] The effect on countries hosting investment from multinational companies is laid out in, for example, comments made by Oxfam South Africa to the UN: "The negative impact of base erosion and profit shifting (BEPS) on South Africa is evident in the escalating rates of poverty, inequality and unemployment. This continues despite some impressive developmental strides taken by the government. The reason for this is that only 1.6 out of 2 million registered companies in South Africa are active and pay their tax revenue.

India Focus on BEPS – Base Erosion & Profit Shifting

The view of governments across the world is that the current international tax standards have not kept pace with the changes in global business practices. Many countries have perceived the relevance of adopting BEPS as these reports include recommendations for significant changes in key elements of the international tax architecture.

India's support towards the BEPS Project

Since the BEPS Project aims to link tax with value creation, developing countries stand to gain from it. India has been one of the front-runners in the BEPS initiative. It is said that the Indian tax authorities' position on certain tax matters, for which they were criticised in the past (for being narrow-minded and revenue-focused), now find place under the BEPS Action Plans.

The effect of BEPS on the Indian tax environment

At the outset, India has already introduced certain provisions in its domestic tax law to deal with concerns highlighted under the BEPS Action Plan. The imposition of Equalisation Levy, Country-by-Country reporting and Master File requirements under the transfer pricing provisions have their origins in the BEPS Project.

The Finance Bill 2017 proposes special provisions to restrict deduction of interest paid by an Indian company to its associated enterprises where the interest pay-out exceeds INR 10 million in a year. The interest deduction in such cases will be restricted to 30% of the EBITDA of the borrower. A significant impact of the MLI could be felt in the areas of tax treaty abuse and artificial avoidance of Permanent Establishment (PE) status.

Even before the MLI is signed, India has already amended its tax treaties with Mauritius, Cyprus and Singapore to deal with the artificial avoidance of tax liabilities in India. Once the MLI is signed, a substantial number of the treaties signed by India would be covered under the principles of the BEPS Project. Any aggressive tax planning by using loopholes/gaps in the existing tax treaty provisions could be thwarted by the Indian tax authorities. This would significantly affect intermediate/holding company structures and cash-box companies.

Foreign entities operating in India under 'Commissionaire' models could also witness a significant impact. A commissionaire model involves an Indian entity securing orders in India for a foreign entity such that the ultimate contract of sale is concluded outside India between the foreign entity and the Indian customer. In such cases, under the existing regulations, the Indian entity pays tax on a small margin attributable to the marketing/sales function, commonly on a cost plus margin basis, even though virtually all efforts for securing the contract were carried out in India. The MLI now provides, as an optional clause, that where the Indian entity plays a principal role in securing the contract, it can be considered as a PE of the foreign entity in India. This would require a higher attribution of profits to the Indian entity and increase the tax liability in India. The tax exposure here would also be linked to the transfer pricing policies of the Indian enterprise.

The MLI also contains provisions to deal with situations of artificially splitting contracts between different entities to avoid a PE status in India. The MLI provides for the aggregation of the contracts in such cases to examine the constitution of the PE. This will significantly affect enterprises undertaking Engineering Procurement and Commissioning (EPC) contracts or dealing with specialised installations/works.

Preparing for life under BEPS

Adherence to BEPS requirements would necessitate the evaluation of the functions performed by the Indian enterprise, the value added by it and its comparison to the overall functions performed by the group entities. Based on this evaluation, the PE exposure could be evaluated and the profit to be attributed to Indian operations could be determined based on transfer pricing principles. This activity could also involve amending the business model of the Indian entity to ensure tax optimisation and risk mitigation.

India is actively following the BEPS recommendations and has been bringing amendments in the domestic law to be in line with BEPS regulations. A number of proposals in Indian Finance Act, 2016, are influenced from the recommendations emanating from the final reports of the OECD under its Action Plan on BEPS. These include implementation of Master File and Country-by-Country (CbC) Reporting (in compliance with Action 13), introduction of equalization levy which requires withholding on gross basis for all payments in relation to certain specified digital services (Action 1) and a “Patent Box” tax regime for royalty income (Action 5).

Response to BEPS will have to be managed in a phased manner and will require proactive and timely planning. Companies will have to build consideration of potential BEPS impact into current tax planning and prepare different scenarios for its application.