After studying this chapter, you would be able to -

- **gain** a broad understanding of the concept of BEPS
- **appreciate** the significance of the Action Plans of BEPS
- **comprehend and appreciate** the provisions incorporated in Indian tax laws in line with the different Action Plans of BEPS
8.1 BACKGROUND

Impact of Globalisation

Globalisation has benefited our domestic economies, boosted trade and increased foreign direct investments in many countries. The unrestricted movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers, technological and telecommunication developments, and the ever-increasing importance of managing risks and of developing, protecting and exploiting intellectual property, have had an important impact on the way cross-border activities take place. In this way, it accelerated growth, created jobs and fostered innovation. Globalisation is not new, but the pace of integration of national economies and markets has increased substantially in recent years. It has a significant impact on a country’s corporate income tax regimes.

Growth of E-Commerce and consequent aggressive tax planning

Way back in 1920s, the League of Nations recognised that the interaction of domestic tax systems can lead to double taxation with adverse effects on growth and global prosperity. Globally, countries concur on the need to eliminate double taxation and the need to achieve this on the basis of accepted international laws that are clear and predictable, giving certainty to both governments and businesses. International tax law is, therefore, a pillar in facilitating the development of the global economy. With the economy, the enterprises also became more globally integrated. Multi-national enterprises (MNE) now represent a significant proportion of global GDP. Further, intra-firm trade comprises of a growing proportion of overall trade. Also, the increasing significance of the service component of the economy, and of digital products which are deliverable over the Internet, has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers. These developments have been accompanied by the increasing sophistication of tax planners in identifying and exploiting the legal arbitrage opportunities and the boundaries of acceptable tax planning, thus, encouraging MNEs to minimise their tax burden by resorting to aggressive tax planning.

Adverse Effects of BEPS

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. This has become a critical issue since governments have to cope with less revenue and a higher cost to ensure compliance. Moreover, BEPS undermines the integrity of the tax system, as reporting of low corporate taxes is considered to be unfair. In developing countries, the lack of tax revenue leads to significant under-funding of public investment that could help foster economic growth. Further, when tax laws permit businesses to reduce their tax burden by shifting their income away from jurisdictions where income producing activities are conducted, other taxpayers, especially individual taxpayers in that jurisdiction bear a greater share of the burden. This gives rise to tax
fairness issues on account of individuals having to bear a higher tax burden. Also, enterprises that operate only in domestic markets, including family-owned businesses or new innovative businesses, may have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax. Fair competition is harmed by the distortions induced by BEPS.

Need for international collaboration to protect tax sovereignty of its countries

Taxation is at the core of countries’ sovereignty, but the interaction of domestic tax laws in certain cases leads to gaps and frictions. While developing their domestic tax laws, sovereign states may not adequately take into consideration the effect of other countries’ laws. The interaction of separate sets of laws enforced by sovereign countries causes frictions, including potential double taxation for corporations operating in many countries. It also causes gaps, in cases where corporate income is untaxed, both in the country of source and in the country of residence, or is taxed only at nominal rates. In the domestic context, coherence is generally achieved through a principle of matching – a payment that is deductible by the payer is usually taxable in the hands of the recipient, unless explicitly exempted. There is no similar principle of coherence at the international level, which leaves considerable scope for arbitrage by taxpayers, though sovereign states have united to ensure coherence in a narrow field, namely to prevent double taxation. BEPS relates primarily to instances where the interaction of different tax rules leads to double non-taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. International standards have tried to reduce these frictions in a manner that respects tax sovereignty; however, gaps still remain. Therefore, there is a need for countries to collaborate on tax matters so that they are able to get their due share of taxes.

8.2 OVERVIEW OF BEPS

In the background of the above repercussions, in February 2013, the OECD published a report on “Addressing Base Erosion and Profit Shifting” iterating the need for analyzing the issue of tax base erosion and profit shifting by global corporations. The OECD followed it up with publishing draft Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan) in July 2013 which came to final fruition in October 2015. The BEPS action plan identifies fifteen actions to address BEPS in a comprehensive manner and sets a deadline to implement those actions.

The Action Plans were structured around three fundamental pillars viz.:

1. Reinforcing of ‘substance’ requirements in existing international standards;
2. Alignment of taxation with location of value creation and economic activity; and
3. Improving transparency and tax certainty.
A brief classification of the various action plans based on the fundamental pillars is as under:

**Action 1:** Address the tax challenges of the digital economy

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**Action 15:** Develop a multilateral instrument
An unprecedented amount of interest and participation has been witnessed by OECD with more than sixty countries, both OECD members and G20 countries, being directly involved as a part of technical groups in the development of congruent international tax standards.

The summary explanatory statement indicates the level of political commitment by OECD, G20 and other States involved in the 2015 work to the various reports. The OECD has iterated the following terms to indicate the commitment by various participant countries:

**New minimum standard** - New minimum standard implies application of a new rule to be implemented by all states, since non-implementation may result in negative spill overs (including adverse impact of competitiveness) on other countries. Each of the four BEPS minimum standards [namely, Actions 5, 6, 13 and 14] is subject to peer review in order to ensure timely and accurate implementation and thus safeguard the level playing field. All members of the Inclusive Framework on BEPS commit to implementing the minimum standards, and commit to participating in the peer review.

**Greater transparency and improved data** - Pre-requisites to evaluate the impact and magnitude of BEPS.

Taxpayers to report their aggressive tax planning arrangements and rules about transfer pricing documentation, breaking down the information on a country-by-country basis: Assist governments identify risk areas and focus their audit strategies.

Making dispute resolution mechanisms more effective: To provide businesses with greater certainty and predictability.

### Coherence

**Domestic tax systems are coherent** – tax deductible payments by one person results in income inclusions by the recipient.

**International coherence in corporate income taxation** - A prerequisite to complement the standards that prevent double taxation with a new set of standards designed to avoid double non-taxation.

### Substance

**Present tax laws must be modified** - To align tax with substance.

Domestic and international tax laws should ideally relate to both income and the economic activity that generates it. Since at times, tax treaty and transfer pricing facilitate the separation of taxable profits from value-creating activities, such as through shell companies that have little or no economic substance.

**Concerns in the area of transfer pricing should be addressed within the prevalent system** - These areas include returns related to over-capitalisation, risk and intangible assets. Specific rules, either within or beyond the arm’s length principle, may be required for this purpose.

### Transparency

Greater transparency and improved data: Pre-requisites to evaluate the impact and magnitude of BEPS.

Taxpayers to report their aggressive tax planning arrangements and rules about transfer pricing documentation, breaking down the information on a country-by-country basis: Assist governments identify risk areas and focus their audit strategies.

Making dispute resolution mechanisms more effective: To provide businesses with greater certainty and predictability.

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Domestic tax systems are coherent – tax deductible payments by one person results in income inclusions by the recipient.

International coherence in corporate income taxation - A prerequisite to complement the standards that prevent double taxation with a new set of standards designed to avoid double non-taxation.
Revision of a standard which already exists – Existing standards have been updated and will be implemented but with the caveat that all BEPS participants have not endorsed the underlying standards on tax treaties or transfer pricing; and

Best practice – A best practice is not a standard but optional recommendation for states to follow. Guidance based on best practices will support those countries proposing to act in the areas of mandatory disclosure initiatives or controlled foreign company (CFC) legislation.

8.3 ACTION PLAN 1 – ADDRESSING THE CHALLENGES OF THE DIGITAL ECONOMY

Digital economy: Dissolving link between income-producing activity and physical location

At present, in the digital domain, business may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. Hence, business in digital domain doesn’t actually occur in any physical location but instead takes place in “cyberspace.” Persons carrying business in digital domain could be located anywhere in the world. Entrepreneurs across the world have been quick to evolve their business to take advantage of these changes. It has also made it possible for the businesses to conduct themselves in ways that did not exist earlier, and given rise to new business models that rely more on digital and telecommunication network, do not require physical presence, and derives substantial value from data collected and transmitted from such networks.

Given the rise of e-commerce, an entire digital economy has emerged in the last decade. Since there is a concept of ‘intangibility’ attached to the digital model of business, tax authorities often faced challenges rightly bringing to tax the profits earned from a digital business. To address the same, the first action plan of the BEPS project was developed by the OECD which outlines the methods and principles based on which physical and digital economies can be taxed at par. Before the same, physical locations of the servers of such digital businesses were considered to establish the tax jurisdiction in which the profits of digital businesses could be taxed. However, it was observed that servers were therefore placed in tax efficient jurisdictions, even though the main income generation and customers were from other jurisdictions.

Taxation issues in E-Commerce

These new business models have created new tax challenges. The typical taxation issues relating to e-commerce are:

(1) the difficulty in characterizing the nature of payment and establishing a nexus or link between a taxable transaction, activity and a taxing jurisdiction,

(2) the difficulty of locating the transaction, activity and identifying the taxpayer for income tax purposes.

The digital business, thus, challenges physical presence-based permanent establishment rules. If
permanent establishment (PE) principles are to remain effective in the new economy, the fundamental PE components developed for the old economy i.e., place of business, location, and permanency must be reconciled with the new digital reality.

**OECD Recommendations under Action Plan 1 of the BEPS project**

The OECD has recommended several options to tackle the direct tax challenges which include:

1. **Modifying the existing Permanent Establishment (PE) rule** to provide whether an enterprise engaged in fully de-materialized digital activities would constitute a PE, if it maintained a significant digital presence in another country’s economy.

2. **A virtual fixed place of business PE in the concept of PE** i.e., creation of a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website.

3. **Imposition of a final withholding tax** on certain payments for digital goods or services provided by a foreign e-commerce provider or **imposition of a equalisation levy** on consideration for certain digital transactions received by a non-resident from a resident or from a non-resident having PE in other contracting state.

Taking into consideration the potential of new digital economy and the rapidly evolving nature of business operations, it becomes necessary to address the challenges in terms of taxation of such digital transactions.

**Indian Taxation Regime**

**Insertion of Chapter VIII in the Finance Act, 2016 on Equalisation Levy to address this challenge**

In order to address the challenges of the digital economy, Chapter VIII of the Finance Act, 2016, titled "Equalisation Levy", provides for an equalisation levy of 6% of the amount of consideration for specified services received or receivable by a non-resident not having permanent establishment in India, from a resident in India who carries out business or profession, or from a non-resident having...
permanent establishment in India.

**Meaning of “Specified Service”**

1. Online advertisement;
2. Any provision for digital advertising space or any other facility or service for the purpose of online advertisement;

Specified Service also includes any other service as may be notified by the Central Government.

Further, in order to reduce burden of small players in the digital domain, it is also provided that no such levy shall be made if the aggregate amount of consideration for specified services received or receivable by a non-resident from a person resident in India or from a non-resident having a permanent establishment in India does not exceed ₹1 lakh in any previous year.

### 8.4 ACTION PLAN 2 - NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

Before understanding what Action Plan 2 recommends, we must understand what a hybrid mismatch is.

**Hybrid Mismatch Arrangement: Meaning**

A hybrid mismatch is an arrangement that:

- Exploits a difference in the tax treatment
- Of an entity or an instrument
- Under the laws of two or more tax jurisdictions
- To achieve double non-taxation

Hybrid mismatch arrangements are sometimes used to achieve unintended double non-taxation or long-term tax deferral in one or more of the following ways -
Specific country laws that allow taxpayers to opt for the tax treatment of certain domestic and foreign entities may aid hybrid mismatches. It may not be easy to find out which country has in fact lost tax revenue, since the laws of each country involved have been complied with; however, there is a reduction of the overall tax paid by all parties involved as a whole, which ultimately has an adverse effect on competition, economic efficiency, transparency and fairness.

The Final Report on Action Plan 2 is detailed providing examples on operational practicality of various proposals for amendments to domestic law. The Report provides recommendations for both general changes to domestic law followed by a set of dedicated anti-hybrid rules. Treaty changes are also recommended. A snap shot of the Action Plan 2 is as below:
Recommended general amendments are as follows:

- **A rule denying transparency to entities where the non-resident investors’ resident country treats the entity as opaque;**

**Example**

Let us say, X Co., a parent company in country X indirectly holds Y Co., an operating company in country Y. Between X Co. and Y Co. is a hybrid entity that is treated as transparent or disregarded for country X tax purposes and as non-transparent for country Y tax purposes. X Co. holds all or almost all equity interest in the hybrid entity which in turn holds all or almost all equity interests in Y Co. The hybrid entity borrows money from a third party and the loan is used to invest equity into Y Co (or to buy the shares in Y Co from either another company of the same group or from an unrelated third party). The hybrid entity pays interest on the loan. Except for the interest, the hybrid entity does not claim any other significant deduction and does not have any significant income.

With respect to Country Y, for tax purposes, Hybrid Entity is subject to corporate income tax. Its interest expenses can be used to offset other country Y group companies’ income under...
the country Y group tax relief regime. On the other hand, country X treats the hybrid entity as transparent or disregarded, with the result that its interest expenses are allocated to X Co, which deducts the interest expense to offset unrelated income. The net effect is that there are two deductions for the same contractual obligation in two different countries. Therefore, by virtue of rule denying transparency to an entity which is treated as opaque in the subsidiary company’s country, the double deduction can be avoided.

- A rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer;

**Example**

N Co, a company resident in country N is funded by M Co., a company resident in country M with an instrument that qualifies as equity in country M but as debt in country N. A payment made under the instrument would be deductible as interest expense for N Co under country N tax law. The corresponding receipts are treated as exempt dividends under the tax laws of country M. Consequently, deduction is available under the tax laws of country N without a corresponding income inclusion in country M.

Therefore, by virtue of rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer, exemption of such income in country M would not be possible.

- A rule denying a foreign tax credit for withholding tax where that tax is also credited to some other entity; and

- Amendments to CFC and similar regimes attributing local shareholders the income of foreign entities that are treated as transparent under their local law.

**Treaty changes** - Action Plan 2 recommends a new provision in the case of income earned by a transparent entity. As per the new provision, treaty benefits will only be afforded to so much of the income of the entity as the income of a resident of that State. A specific or general saving rule is proposed so that a State can tax a resident entity generally unrestricted by treaty.

**Anti-hybrid rules** - The report further issued a series of dedicated domestic anti-hybrid rules which would work in two stages. The primary rules would deny deductions to payers in situations where either

(i) Those payments will not be included in the recipient’s ordinary income, or

(ii) The same amount is being simultaneously deducted by another entity.

The examples in the 2015 Final Report demonstrate these outcomes (deduction and non-inclusion, or double deduction) arising from various hybrid financial instruments, financing transactions and under entity recognition and de-recognition rules.

The report also addresses banks and insurance companies wherein it recommends that there should be targeted rules addressing base erosion and profit shifting in such sectors. The basic rules might not work for them because they will typically have net interest income.
Treatment of Branch mismatches : 2017 Report

While the 2015 Report addresses mismatches that are a result of differences in the tax treatment or characterisation of hybrid entities, it did not directly consider similar issues that can arise through the use of branch structures. These branch mismatches occur where two jurisdictions take a different view as to the existence of, or the allocation of income or expenditure between, the branch in head office of the same taxpayer.

Branch mismatches arise where the ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping the charge to taxation in both the branch and residence jurisdiction. Unlike hybrid mismatches, which result from conflicts in the legal treatment of entities or instruments, branch mismatches are the result of differences in the way the branch and head office account for a payment made by or to the branch. The 2017 report identifies five basic types of branch mismatch arrangements that give rise to one of three types of mismatches:

- deduction / no inclusion outcomes
- indirect deduction / no inclusion outcomes
- double deduction outcomes

The 2017 report includes specific recommendations for improvements to domestic law intended to reduce the frequency of branch mismatches as well as targeted branch mismatch rules which adjust the tax consequences in either the residence or branch jurisdiction in order to neutralise the hybrid mismatch without disturbing any of the other tax, commercial or regulatory outcomes.
Shifting investment income and passive income to subsidiaries in low tax or no tax jurisdictions: Deferral of home country taxation

Under the tax laws of several countries, a shareholder of a corporation is not taxed on the corporation's income until the income is distributed as a dividend. Therefore, it was common for publicly traded companies to form foreign subsidiaries in tax havens and shift "portable" income to those subsidiaries. Generally, income shifted were mainly investment income (interest and dividends) and passive income (rents and royalties), as well as sales and services income involving related parties. Tax in parent country on this income was avoided until the tax haven country paid a dividend to the shareholding company. This dividend could be avoided indefinitely by loaning the earnings to the shareholder without actually declaring a dividend.

Many countries (where global multi-nationals are based) have high tax rates as compared to certain other countries, which used their low tax rates as a means of attracting inward investment. As a result, when dividends were repatriated from these lower tax countries, the recipient generally suffered additional tax on those profits. Therefore, many companies have a tendency to leave the profits from these low-taxed subsidiaries offshore, with the objective of deferring home country taxation.

Obviously, Governments were disturbed that multinationals based in their countries kept large amounts of profits offshore. In order to address this issue, governments in various countries have introduced legislation aimed at eliminating the benefits of deferral, by currently taxing income in the parent country even when the income has not been repatriated or remitted to that country. These rules are generally referred to as Controlled Foreign Corporation (CFC) rules.

CFC Rules : Addressing BEPS

Controlled foreign company (CFC) rules respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries by shifting income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation.

The OECD Final Report does not propose a minimum standard for controlled foreign company (CFC) regimes. However, OECD regards CFC rules as being important in tackling BEPS and has made a series of best practice recommendations in relation to the ‘building blocks’ of an effective CFC regime. The major reason why the OECD was unable to provide more than best practice was fundamental disagreement over the policy of CFC regimes, in particular whether states should use the regime to protect other states’ tax bases from earnings stripping.
Building Blocks

The OECD recommended ‘building blocks’ are as follows.

- **Computation and attribution of CFC income** - CFC income should be calculated under a notional application of the parent jurisdiction’s tax laws and attribution should be subject to a control threshold and based on proportionate ownership.

- **Prevention and elimination of double taxes** - CFC rules should not result in double taxation. The specific measures suggested are to provide a credit for foreign tax paid on CFC income, provide relief where a dividend is paid out of attributed income or where taxpayers dispose of their interest in a CFC where there has been attribution.

- **CFC definition** - CFC rules apply to foreign subsidiaries controlled by shareholders in the parent jurisdiction. OECD recommends application of CFC rules to non-corporate entities, if those entities earn income that raises BEPS concerns and such concerns are not addressed.

- **CFC exemptions and threshold requirements** - Companies should be exempted from CFC rules where they are subject to an effective tax rate that is not below the applicable tax rate in the parent jurisdiction.

- **Definition of CFC income** - CFC rules should have a definition of income that ensures that BEPS concerns are addressed, but countries are free to choose their own definition.
Indian Taxation Regime

- At present, there are no CFC rules in the Income-tax Act, 1961;
- CFC rules formed part of the proposed Direct Tax Code.
- CFC regime has been debated over last many years in India and is one of the last remaining concepts from the DTC to be incorporated in the Income-tax Act, 1961.
- In order to encourage repatriation of profits, section 115BBD provides a concessional tax rate of 15% (gross basis) on dividends received from a specified foreign company i.e., a foreign company in which the Indian company holds 26% or more in the nominal value of the equity share capital of the company.

8.6 ACTION PLAN 4 – INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

The OECD is concerned that multinational groups are able to erode their tax base (i.e., reduce their taxable profits) with interest expense, for example by:
- Locating third party debt in high tax countries;
- Using intra-group loans to achieve interest deductions in excess of the group’s actual third party interest expense;
- Using related party or third party debt to finance the production of exempt or deferred income.

BEPS Action Plan 4 calls for the development of recommendations for the design of domestic rules to prevent tax base erosion through the use of interest expense and other financial payments that are economically equivalent to interest.

Common Approach: Linking an entity’s net interest deduction to its level of economic activity

The mobility and fungibility of money enables multinational groups to achieve favourable tax results by adjusting the amount of debt in a group entity. The 2015 Report established a common approach which directly links an entity’s net interest deductions to its level of economic activity, based on taxable earnings before interest income and expense, depreciation and amortisation (EBITDA). This approach includes three elements:
Updation of BEPS Action 4 Report: Guidance on the design and operation of the group ratio rule and approaches to deal with risks posed by the banking and insurance sectors

In December 2016, the OECD released an updated version of the BEPS Action 4 Report (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments), which includes further guidance on two areas: the design and operation of the group ratio rule, and approaches to deal with risks posed by the banking and insurance sectors.

- **The design and operation of the group ratio rule** - The 2015 Action 4 Report set out a common approach to address BEPS involving interest and payments economically equivalent to interest. This included a 'fixed ratio rule' which limits an entity's net interest deductions to a set percentage of its tax-EBITDA and a 'group ratio rule' to allow an entity to claim higher net interest deductions, based on a relevant financial ratio of its worldwide group. The report included a detailed outline of a rule based on the net third party interest/EBITDA ratio of a consolidated financial reporting group, and provided that further work would be conducted in 2016 on elements of the design and operation of the rule. The updated report does not change any of the conclusions agreed in 2015, but provides a further layer of technical detail to assist countries in implementing the group ratio rule in line with the common approach. This emphasises the importance of a consistent approach in providing protection for countries and reducing compliance costs for groups, while including some flexibility for a country to take into account particular features of its tax law and policy.

- **Banking and insurance sectors** - The 2015 report also identified factors which suggest that the common approach may not be suitable to deal with risks posed by entities in the banking and insurance sectors. The updated report examines regulatory and commercial requirements which constrain the ability of groups to use interest for BEPS purposes, and limits on these constraints. Overall, a number of features reduce the risk of BEPS involving interest posed by banking and insurance groups, but differences exist between

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countries and sectors and in some countries risks remain. Each country should identify the risks it faces, distinguishing between those posed by banking groups and those posed by insurance groups. Where no material risks are identified, a country may reasonably exempt banking and/or insurance groups from the fixed ratio rule and group ratio rule without the need for additional tax rules. Where BEPS risks are identified, a country should introduce rules appropriate to address these risks, taking into account the regulatory regime and tax system in that country. The updated report considers how these rules may be designed, and includes a summary of selected rules currently applied by countries.

**Indian Taxation Regime**

**New section 94B of the Income-tax Act, 1961: Addressing Thin Capitalization**

Debt financing of cross-border transactions is often favorable than equity financing for taxpayer. In view of the above, in line with the recommendations of OECD BEPS Action Plan 4, new section 94B has been inserted in the Income-tax Act, 1961 to provide a cap on the interest expense that can be claimed by an entity to its associated enterprise. The total interest paid in excess of 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise for that previous year, whichever is less, shall not be deductible.

**Applicability**

The provision is applicable to an Indian company, or a permanent establishment of a foreign company, being the borrower, who pays interest in respect of any form of debt issued by a non-resident who is an 'associated enterprise' of the borrower. Further, the debt is deemed to be treated as issued by an associated enterprise where it provides an implicit or explicit guarantee to the lender, being a non-associated enterprise, or deposits a corresponding and matching amount of funds with such lender.

**Carry forward of disallowed interest expenditure**

The provision allows for carry forward of disallowed interest expense for 8 assessment years immediately succeeding the assessment year for which the disallowance is first made and deduction against the income computed under the head "Profits and gains of business or profession" to the extent of maximum allowable interest expenditure.

**Threshold limit**

In order to target only large interest payments, it provides for a threshold of interest expenditure of ₹1 crore in respect of any debt issued by a non-resident exceeding which the provision would be applicable. Banks and Insurance business are excluded from the ambit of the said provisions keeping in view of special nature of these businesses.
8.7 ACTION PLAN 5 – COUNTER HARMFUL TAX PRACTICES

Substantial activity in preferential regime: Basis for tax concession

The report identifies factors for determining a potential harmful tax practice that results in low or no effective tax rate, lack of transparency, negotiable tax rate or base etc. A minimum standard has been set up based on an agreed methodology to assess whether there is substantial activity in a preferential regime, such as IP regime. For instance, in case of R&D activities, a minimum standard has been advocated that establishes nexus test as the means of identifying the R&D activities which provide the substance justifying the tax concession including tracking of expense and income on a particular products/product line.

Consensus on Framework: Six categories of rulings

As a key outcome of the work on BEPS Action 5, a framework covering all rulings that could give rise to BEPS concerns in the absence of compulsory spontaneous exchange has been agreed, which covers six categories of rulings:

- Rulings related to preferential regimes
- Cross border unilateral APAs/unilateral TP rulings
- Rulings giving a downward adjustment to profits
- PE rulings
- Conduit rulings
- Any other type of ruling with the FHTP apprehends BEPS concerns

FHTP – Forum on Harmful Tax Practices

Indian Taxation Regime

In India, the Finance Act, 2016 has introduced a concessional taxation regime for royalty income from patents for the purpose of promoting indigenous research and development and making India
a global hub for research and development. The purpose of the concessional taxation regime is to encourage entities to retain and commercialise existing patents and for developing new innovative patented products. Further, this beneficial taxation regime will incentivise entities to locate the high-value jobs associated with the development, manufacture and exploitation of patents in India.

New section 115BBF of the Income-tax Act, 1961: In line with nexus approach of BEPS Action 5

The nexus approach has been recommended by the OECD under BEPS Action Plan 5. This approach requires attribution and taxation of income arising from exploitation of Intellectual property (IP) in the jurisdiction where substantial research and development (R & D) activities are undertaken instead of the jurisdiction of legal ownership. Accordingly, new section 115BBF has been inserted in the Income-tax Act, 1961 to provide that where the total income of the eligible assessee includes any income by way of royalty in respect of a patent developed and registered in India, then such royalty shall be taxable at the rate of 10% (plus applicable surcharge and cess). For this purpose, developed means least 75% of the expenditure should be incurred in India by the eligible assessee for any invention in respect of which patent is granted under the Patents Act, 1970.

**Meaning of Eligible Assessee**

Eligible assessee includes

- every such person, being the true and first inventor of the invention, where more than one person is registered as patentee under Patents Act, 1970 in respect of that patent.

### 8.8 ACTION PLAN 6 – PREVENTING TREATY ABUSE

**Protection against treaty shopping: Minimum Standard**

Given the risk to revenues posed by treaty shopping, countries have committed to ensure a minimum level of protection against treaty shopping (the minimum standard). That commitment will require countries to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.
Countries will implement this common intention by including in their treaties:

(i) the combined approach of Limitation of Benefits (LOB) and Principal Purpose Test (PPT) rule,
(ii) the PPT rule alone, or
(iii) the LOB rule supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties.

Section A: Treaty Anti-abuse Rules

Section A of this report includes new treaty anti-abuse rules that provide safeguards against the abuse of treaty provisions and offer a certain degree of flexibility regarding how to do so. These new treaty anti-abuse rules first address treaty shopping, which involves strategies through which a person who is not a resident of a State attempts to obtain benefits that a tax treaty concluded by that State grants to residents of that State, for example by establishing a letterbox company in that State.

Section A also includes new rules to be included in tax treaties in order to address other forms of treaty abuse. These rules address:

(1) certain dividend transfer transactions intended to lower artificially withholding taxes payable on dividends;
(2) transactions that circumvent the application of the treaty rule that allows source taxation of shares of companies that derive their value primarily from immovable property;
(3) situations where an entity is resident of two Contracting States, and
(4) situations where the State of residence exempts the income of permanent establishments situated in third States and where shares, debt-claims, rights or property are transferred to permanent establishments set up in countries that do not tax such income or offer preferential treatment to that income.

The report recognises that the adoption of anti-abuse rules in tax treaties is not adequate to address tax avoidance strategies that seek to circumvent provisions of domestic tax laws; these must be addressed through domestic anti-abuse rules, including through rules that will result from the work on other parts of the Action Plan.

The report also addresses two specific issues related to the interaction between treaties and domestic anti-abuse rules. The first issue relates to the application of tax treaties to restrict a Contracting State’s right to tax its own residents. A new rule will codify the principle that treaties do not restrict a State’s right to tax its own residents (subject to certain exceptions). The second issue deals with so-called “departure” or “exit” taxes, under which liability to tax on some types of income that has accrued for the benefit of a resident (whether an individual or a legal person) is triggered in the event that the resident ceases to be a resident of that State.
Section B: Clarity of intent to eliminate double taxation without creating opportunities for tax evasion and avoidance

Section B of the report addresses the part of Action seeking clarification “that tax treaties are not intended to be used to generate double non-taxation”. This clarification is provided through a reformulation of the title and preamble of the Model Tax Convention that will clearly state that the joint intention of the parties to a tax treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance, in particular, through treaty shopping arrangements.

Section C: Identifying tax policy considerations before entering into a treaty

Section C of the report addresses the third part of the work mandated by Action 6, which was “to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country”. The policy considerations described in that section should help countries explain their decisions not to enter into tax treaties with certain low or no-tax jurisdictions; these policy considerations will also be relevant for countries that need to consider whether they should modify (or, ultimately, terminate) a treaty previously concluded in the event that a change of circumstances (such as changes to the domestic law of a treaty partner) raises BEPS concerns related to that treaty.

The three-pronged approach to address anti-treaty abuse is illustrated as under:
Indian Tax Regime

**LoB clause introduced in India-Mauritius Tax Treaty** - On 10th May, 2016, India and Mauritius has signed a protocol amending the India-Mauritius tax treaty at Mauritius. In the said treaty, for the first time, it has been provided that gains from the alienation of shares acquired on or after 1.4.2017 in a company which is a resident of India may be taxed in India. The tax rate on such capital gains arising during the period from 1.4.2017-31.3.2019 should, however, not exceed 50% of the tax rate applicable on such capital gains in India. A Limitation of Benefit (LOB) Clause has been introduced which provides that a resident of a Contracting State shall not be entitled to the benefits of 50% of the tax rate applicable in transition period if its affairs are arranged with the primary purpose of taking advantage of concessional rate of tax. Further, a shell or a conduit company claiming to be a resident of a Contracting State shall not be entitled to this benefit. A shell or conduit company has been defined as any legal entity falling within the meaning of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State. A resident of a Contracting State is deemed to be a shell/conduit company if its expenditure on operations in that Contracting State is less than Mauritian `15,00,000 or Indian `7,00,000 in the respective Contracting State as the case may be, in the immediately preceding period of 12 months from the date the gains arise.

**LoB clause in India-Singapore Tax Treaty** - On similar lines, India and Singapore has signed a protocol amending the India-Singapore tax treaty. Capital gains on alienation of shares would be taxable in a similar manner as laid out in India-Mauritius tax treaty, subject to LoB clause. The transition period benefit is also similar to that contained in India-Mauritius Tax Treaty. In respect of shares acquired after 1.4.2017 and sold before 1.4.2019, the expenditure test needs to be met for the 12 month period immediately preceding the date of transfer.

8.9 **ACTION PLAN 7 – PREVENT THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT (PE) STATUS**

This report includes changes to the definition of permanent establishment (PE) in the OECD Model Tax Convention that will address strategies used to avoid having a taxable presence in a country under tax treaties.

These changes will ensure that where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise will be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business. The changes will also restrict the application of a number of exceptions to the definition of permanent establishment to activities that are preparatory or auxiliary nature and will ensure that it is not possible to take advantage of these exceptions by the fragmentation of a cohesive operating business into several small
operations; they will also address situations where the exception applicable to construction sites is circumvented through the splitting-up contracts between closely related enterprises.

Thus, the following steps have been advocated:

- **Reworking exceptions to PE definition** – An anti-fragmentation rule to be adopted to aggregate all activities carried by an enterprise in a state, along with activities undertaken by its closely related entities undertaking business operation that create tax mismatch and are cohesive in nature. The above test can also be applied to understand whether the activities undertaken by an enterprise in a state are ‘preparatory or auxiliary’.

- **Analyzing arrangements entered through contractual agreements** – OECD proposes to include Commissionaire business model under the definition of PE. The emphasis is not on the taxable presence for a commissionaire arrangement unless it is performed as an independent business activity.

A Commissionaire arrangement may be broadly defined as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). Since Article 5(5) of the OECD Model Tax Convention relies on the formal conclusion of contracts in the name of the foreign enterprise, it is possible to avoid the application of that rule by changing the terms of contracts without material changes in the functions performed in a State. Commissionaire arrangements have been a major cause of concern for tax administrations in many countries.

As per the revised agency PE rule, a person who “habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise”, leading to a contract in the name of the foreign enterprise or provision of goods or services by that enterprise (even if it is not a party to the contract), it is covered under the definition of agency PE.
8.24 INTERNATIONAL TAXATION

**Before**
Warehouse facilities used for storage or delivery of goods: no PE risk

**After**
Warehouse facilities used for storage or delivery of goods would be exempted only if the activity of the fixed place of business is of a preparatory or auxiliary character, otherwise there is a PE risk

**Before**
A purchasing office solely performing purchasing functions: no PE risk

**After**
A purchasing office merely performing purchasing functions would constitute a PE where that purchasing function forms an essential and significant part of the enterprise's overall activity

**Before**
Existing anti-fragmentation rule covers only activities undertaken by one enterprise in several locations

**After**
A PE may exist if the enterprise or a connected enterprise carries on business activities at the same location, or different locations in the same country, and such activities constitute complementary functions that are part of a cohesive business operation, and such activities when combined, exceed what is preparatory or auxiliary

### 8.10 ACTION PLAN 8-10 - TRANSFER PRICING OUTCOMES IN LINE WITH VALUE CREATION/INTANGIBLES/ RISK AND CAPITAL AND OTHER HIGH-RISK TRANSACTIONS

The aforesaid Action plans represent the OECD's work on transfer pricing which has been a core focus of the BEPS Action Plans. The specific Actions focus on Intangibles, Risks and capital and other high-risk transactions. These are the hard areas of transfer pricing and are summarized together in the Final Report 'Aligning Transfer Pricing Outcomes with Value Creation'.

**Clarification and Strengthening of existing standards on transfer pricing**

Transfer pricing rules, which are set out in Article 9 of tax treaties based on the OECD and UN Model Tax Conventions and the Transfer Pricing Guidelines, are used to determine on the basis of the ALP...
the conditions, including the price, for transactions within an MNE group. The existing standards in this area have been clarified and strengthened, including the guidance on the arm’s length principle and an approach to ensure the appropriate pricing of hard-to-value-intangibles has been agreed upon within the arm’s length principle. The work has focused on three key areas.

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<th>Action Plan</th>
<th>Details</th>
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<td>8</td>
<td>Addresses transfer pricing issues relating to controlled transactions involving intangibles, since intangibles are by definition mobile and they are generally difficult-to-value. Misallocation of the profits generated by valuable intangibles is a significant cause of BEPS.</td>
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<td>9</td>
<td>Contractual allocations of risk are respected only when they are supported by actual decision-making and thus exercising control over these risks.</td>
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| 10          | This action focuses on other high-risk areas, which include:  
- the scope for addressing profit allocations resulting from controlled transactions which are not commercially rational,  
- the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and  
- the use of certain type of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with the value-creation. |

The combined 2015 report on these action plans contains revised guidance which responds to these issues and ensures that transfer pricing rules secure outcomes that better align operational profits with the economic activities which generate them. The report also contains guidance on transactions involving cross-border commodity transactions as well as on low value-adding intra-group services. As those two areas were identified as of critical importance by developing countries, the guidance will be supplemented with further work mandated by the G20 Development Working Group.

**OECD Transfer Pricing Guidelines**

In addition, the OECD Transfer Pricing Guidelines released in 2017 provide guidance on the application of the “arm’s length principle”, which represents the international consensus on the valuation, for income tax purposes, of cross-border transactions between associated enterprises. In today’s economy where multinational enterprises play an increasingly prominent role, transfer pricing continues to be high on the agenda of tax administrations and taxpayers alike. Governments need to ensure that the taxable profits of MNEs are not artificially shifted out of their jurisdiction and that the tax base reported by MNEs in their country reflects the economic activity undertaken therein and taxpayers need clear guidance on the proper application of the arm’s length principle.

- **Analysis of contractual relations between parties in combination with the conduct of the parties** - The OECD’s view is that contractual allocation of functions, assets and risks between associated enterprises leaves the arm’s length principle vulnerable to manipulation leading to outcomes which do not correspond to the value created through underlying economic activity. In order to deal with this, the revised transfer pricing guideline requires careful delineation of the actual transaction between the associated enterprises by analysing the contractual relations between the parties in combination with the conduct of the parties. The conduct will supplement or replace the contractual arrangements if the contracts are incomplete or are not supported by the conduct.

- **Risks and returns to be allocated to the party exercising control and having financial capacity to assume the risks** - The Report determines that a party that cannot exercise meaningful and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will not be allocated those risks and consequential returns. Rather, those risks and returns will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks.

- **Allocation of returns to MNE group members controlling economically significant risks and contributing assets** - The Report does not allocate the returns to the party which merely owns the assets rather, those returns are allocated to the MNE group members which perform important functions, control economically significant risks and contribute assets, as determined through the accurate delineation of the actual transaction. Similar considerations should apply to MNE group members who provide funding but perform few activities. Accordingly, the passive funder may only be entitled to a risk-free return, or less.

- **Actual nature of transaction to be determined for pricing, in a case where economic substance differs from form** - The OECD advocates that effort should be made to determine the actual nature of a transaction and then to price it, where the economic substance differs from form, or arrangements viewed in totality differ from those that would be made by independent enterprises.

- **Pricing methods to ensure that the profits are allocated to the most important economic activities** - Transactional profit split method is being analysed in order to provide additional guidance on the ways in which this method can be applied to align transfer pricing outcomes with value creation, including in the circumstances of integrated global value chains. Similarly, further guidance is expected on transfer pricing for financial transactions including identifying the economically relevant characteristics for determining arm’s length conditions. On low value adding intra group services, the guidance provides for an elective approach covering a wide category of services which command a very limited mark up on costs and which provide a consistent allocation key for all recipients for such services.
OECD’s guidance on transfer pricing for low value-adding intra-group services under BEPS Actions 8-10

The guidance is intended to achieve a balance between appropriate charges for low value adding services and head office expenses and the need to protect the tax base of payer countries.

**Key features:**

A standard definition of low value-adding intra-group services as being supportive in nature, not being part of the Multinational Enterprise’s (MNE) core business, not requiring or creating valuable intangibles and not involving significant risks.

- A list of services that would typically meet the definition. The services listed generally are back-office services.
- An elective simplified approach to determine arm’s length charges for low value adding services, including:

  - A process for determining costs associated with low value adding services
  - Elective simplified approach
  - Ability to use general allocation keys
  - Standard 5% mark up
  - Simplified benefits test
- 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.

The Action Plan, thus, advocates a simplified approach to determination of arm’s length price which would reduce the compliance effort of meeting the benefit test, provide greater certainty for MNEs that price charged would be accepted by tax authorities, provide tax authorities with targeted documentation enabling effective review of compliance risks.

### Indian Taxation Regime

In order to reduce transfer pricing disputes, to provide certainty to taxpayers, to align safe harbour margins with industry standards and to enlarge the scope of safe harbour transactions, the CBDT has notified a new safe harbour regime based on the report of the Committee set up in this regard. It has come into effect from 1st April, 2017, i.e., A.Y. 2017-18 and shall continue to remain in force for two immediately succeeding years thereafter, i.e. up to A.Y.2019-20. In these Rules, a new category of transactions being “Receipt of Low Value-Adding Intra-Group Services” has been introduced and the mark up of upto 5% recommended by OECD has been adopted in safe harbour rules.

### 8.11 ACTION PLAN 11 – MEASURING AND MONITORING BEPS

The adverse fiscal and economic impacts of BEPS have been the focus of the OECD/G20 BEPS Project since its inception. While anecdotal evidence has shown that tax planning activities of some multinational enterprises (MNEs) take advantage of the mismatches and gaps in the international tax rules, separating taxable profits from the underlying value-creating activity, The Addressing Base Erosion and Profit Shifting report (OECD, 2013) recognised that the scale of the negative global impacts on economic activity and government revenues have been uncertain.

Although measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, the fiscal effects of BEPS are significant. BEPS causes other adverse economic effects, including tilting the playing field in favour of tax-aggressive MNEs, exacerbating the corporate debt bias, misdirecting foreign direct investment, and reducing the financing of needed public infrastructure.

#### Indicators of BEPS activity

Six indicators of BEPS activity highlight BEPS behaviour using different sources of data, employing different metrics, and examining different BEPS channels. When combined and presented as a dashboard of indicators, they confirm the existence of BEPS, and its continued increase in scale in recent years.
The profit rates of MNE affiliates located in lower-tax countries are higher than their group’s average worldwide profit rate. For example, the profit rates reported by MNE affiliates located in lower-tax countries are twice as high as their group’s worldwide profit rate on average.

The effective tax rates paid by large MNE entities are estimated to be lower than similar enterprises with only domestic operations - This tilts the playing-field against local businesses and non-tax aggressive MNEs, although some of this may be due to MNEs’ greater utilisation of available country tax preferences.

Foreign direct investment (FDI) is increasingly concentrated - FDI in countries with net FDI to GDP ratios of more than 200% increased from 38 times higher than all other countries in 2005 to 99 times higher in 2012.

The separation of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomenon has grown rapidly - For example, the ratio of the value of royalties received to spending on research and development in a group of low-tax countries was six times higher than the average ratio for all other countries, and has increased three-fold between 2009 and 2012.

Royalties received by entities located in these low-tax countries accounted for 3% of total royalties - This provides evidence of the existence of BEPS, though not a direct measurement of the scale of BEPS.

Debt from both related and third-parties is more concentrated in MNE affiliates in higher statutory tax-rate countries. The interest-to-income ratio for affiliates of the largest global MNEs in higher-tax rate countries is almost three times higher than their MNE’s worldwide third-party interest-to-income ratio.

Empirical Analysis: Confirming existence of BEPS and its adverse effects

The new empirical analysis of the fiscal and economic effects of BEPS along with the existing empirical studies that prove the existence of profit shifting through transfer mispricing, strategic location of intangibles and debt, as well as treaty abuse, these BEPS indicators confirm that profit shifting is occurring, is significant in scale and likely to be increasing, and creates adverse economic distortions. Also, empirical analysis indicates that BEPS adversely affects competition between businesses, levels and location of debt, the location of intangible investments, and causes fiscal spillovers between countries and wasteful and inefficient expenditure of resources on tax engineering. The empirical analysis in this report, along with several academic studies, confirms that strong anti-avoidance rules reduce profit shifting in countries that have implemented them.
Limitations

These indicators and all analyses of BEPS are severely constrained by the limitations of the currently available data. The available data is not comprehensive across countries or companies, and often does not include actual taxes paid. In addition to this, the analyses of profit shifting to date have found it difficult to separate the effects of BEPS from real economic factors and the effects of deliberate government tax policy choices. Improving the tools and data available to measure BEPS will be critical for measuring and monitoring BEPS in the future, as well as evaluating the impact of the countermeasures developed under the BEPS Action Plan.

While recognising the need to maintain appropriate safeguards to protect the confidentiality of taxpayer information, this report makes a number of recommendations that will improve the analysis of available data. Some of the information needed to improve the measurement and monitoring of BEPS is already collected by tax administrations, but not analysed or made available for analysis. The focus of the report’s recommendations in this area is on improved access to and enhanced analysis of existing data, and new data proposed to be collected under Actions 5, 13 and, where implemented, Action 12 of the BEPS Project. The report recommends that the OECD work with governments to report and analyse more corporate tax statistics and to present them in an internationally consistent way. For example, statistical analyses based upon Country-by-Country Reporting data have the potential to significantly enhance the economic analysis of BEPS. These improvements in the availability of data will ensure that governments and researchers will, in the future, be better able to measure and monitor BEPS and the actions taken to address BEPS.

8.12 ACTION PLAN 12 – DISCLOSURE OF AGGRESSIVE TAX PLANNING ARRANGEMENTS

A significant challenge faced by tax authorities worldwide is the lack of timely, comprehensive and relevant information on aggressive tax planning strategies. Timely access to such information would facilitate quick response to tax risks through informed risk assessment, audits, or changes to legislation or regulations. BEPS Action Plan 12 recognises the advantages of tools designed to facilitate the information flow on tax risks to tax administrations and tax policy makers. The Report provides a modular framework for guidance drawn from best practices for use by countries without mandatory disclosure rules to design a regime that suits their requirement to get early information on potentially aggressive or abusive tax planning schemes and their users. The recommendations in this Report do not represent a minimum standard and countries can decide whether or not to introduce mandatory disclosure regimes. Where a country opts for mandatory disclosure rules, the recommendations provide the necessary flexibility to balance a country’s need for better and more timely information with the compliance burdens for taxpayers. It also sets out specific best practice recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations.
Design principles and significant objectives of a mandatory disclosure regime:

- Clarity and comprehensibility
- Ability to balance additional compliance costs to taxpayers with the benefits obtained by the tax administration
- Flexibility and dynamism: to allow the tax administration to adjust the system to respond to new risks (or carve-out obsolete risks)
- Accurate identification of the schemes to be disclosed
- Effective achievement of objectives
- Ensuring effective use of information collected

The primary object of mandatory disclosure regimes is to increase transparency by providing the tax administration with early information regarding potentially aggressive or abusive tax planning schemes and to identify the promoters and users of those schemes. Another objective of mandatory disclosure regimes is deterrence: taxpayers may rethink about entering into a scheme if it has to be disclosed.

Key design features for an effective mandatory disclosure regime:
The final report suggests the use of different hallmarks to identify cross-border schemes, given that the tax benefit of a cross-border scheme may arise in a different country. Such hallmarks include use of hybrids arrangements that separate legal and tax ownership of depreciable assets and cross-border transfers of assets at other than market value.

### 8.13 ACTION PLAN 13 – RE-EXAMINE TRANSFER PRICING DOCUMENTATION

This report contains revised standards for transfer pricing documentation incorporating a master file, local file, and a template for country-by-country reporting of revenues, profits, taxes paid and certain measures of economic activity. The revised standardised approach requires taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing and other BEPS risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries. Country-by-country reports will be disseminated through an automatic government-to-government exchange mechanism. The implementation package included in this report sets out guidance to ensure that the reports are provided in a timely manner, that confidentiality is preserved and that the information is used appropriately, by incorporating model legislation and model Competent Authority Agreements forming the basis for government-to-government exchanges of the reports.

#### Requirements as per OECD report on Action 13 of BEPS Action Plan

The OECD report provides for:

(a) revised standards for transfer pricing documentation; and

(b) a template for country-by-country reporting of income, earnings, taxes paid and certain measure of economic activity.

#### Three-tier structure mandated by BEPS

The BEPS report recommends that countries adopt a standardised approach to transfer pricing documentation; it mandates the following three-tier structure:-

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| (1) Master File| Standardised information relevant for all multinational enterprises (MNE) group members.  
|                | Master file requires MNEs to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies. The master file is to be delivered by MNEs directly to local tax administrations. |
Local file requires maintaining of transactional information specific to each country in detail covering related-party transactions and the amounts involved in those transactions. In addition, relevant financial information regarding specific transactions, a comparability analysis and analysis of the selection and application of the most appropriate transfer pricing method should also be captured. The local file is to be delivered by MNEs directly to local tax administrations.

Information relating to the global allocation of the MNE’s income and taxes paid; and indicators of the location of economic activity within the MNE group. CBC report requires MNEs to provide an annual report of economic indicators viz. the amount of revenue, profit before income tax, income tax paid and accrued in relation to the tax jurisdiction in which they do business. CBC reports are required to be filed in the jurisdiction of tax residence of the ultimate parent entity, being subsequently shared between other jurisdictions through automatic exchange of information mechanism.

Advantages of the three-tier structure [as per BEPS Report]:

(a) Taxpayers will be required to articulate consistent transfer pricing positions;
(b) Tax administrations would get useful information to assess transfer pricing risks;
(c) Tax administrations would be able to make determinations about where their resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.

Country-by-country Report: Reporting Requirements of MNEs

The Country-by-Country (CbC) report has to be submitted by parent entity of an international group to the prescribed authority in its country of residence. This report is to be based on consolidated financial statement of the group.

(a) MNEs have to report annually and for each tax jurisdiction in which they do business:
   (1) the amount of revenue;
   (2) profit before income tax; and
   (3) income tax paid and accrued.

(b) MNEs have to report their total employment, capital, accumulated earnings and tangible assets in each tax jurisdiction.
MNEs have to identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities each entity engages in.

**Master File: Objective & Features**

(a) The master file would provide an overview of the MNE groups business, including:

1. the nature of its global business operations,
2. its overall transfer pricing policies, and
3. its global allocation of income and economic activity

in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.

(b) The master file is intended to provide a high-level overview in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context.

(c) The master file shall contain information which may not be restricted to transaction undertaken by a particular entity situated in particular country.

(d) Thus, information in master file would be more comprehensive than the existing regular transfer pricing documentation.

(e) The master file shall be furnished by each entity to the tax authority of the country in which it operates.

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**Indian Taxation Regime**

**Transfer Pricing provisions under the Income-tax Act, 1961**

Chapter X of the Income-tax Act, 1961 comprising sections 92 to 92F contain provisions relating to transfer pricing regime.

Section 92D requires maintenance of prescribed information and document relating to the international transaction and specified domestic transaction.

**Implementation of international consensus in India**

India is one of the active members of BEPS initiative and part of international consensus. For the purpose of implementing the international consensus, a specific reporting regime in respect of CbC reporting and also the master file has been incorporated in the Income-tax Act, 1961. The essential elements have been incorporated in the Income-tax Act, 1961 while remaining aspects would be dealt with in detail in the Income-tax Rules, 1962.

**Elements relating to CbC reporting requirement and related matters which have been incorporated in the Income-tax Act, 1961 [New Section 286]**

(a) the reporting provision shall apply in respect of an international group for an accounting year, if the total consolidated group revenue as reflected in the consolidated financial statement
(CFS) for the accounting year preceding such accounting year is above a threshold to be prescribed.

(b) the parent entity of an international group or the alternate reporting entity, if it is resident in India shall be required to furnish the report in respect of the group to the prescribed authority for every reporting accounting year, on or before the due date of furnishing of return of income under section 139(1) for the relevant accounting year for which the report is being furnished, in the prescribed form and manner;

(c) the parent entity shall be an entity which is required to prepare consolidated financial statement under the applicable laws or would have been required to prepare such a statement, had equity share of any entity of the group been listed on a recognized stock exchange in India;

(d) every constituent entity resident in India, of an international group having parent entity that is not resident in India, shall notify the prescribed income-tax authority on or before the prescribed date –

(1) whether it is the alternate reporting entity of the international group; or

(2) the details of the parent entity or the alternate reporting entity, if any of the international group, and the country of territory of which the said entities are resident.

(e) the report shall be furnished in prescribed manner and in the prescribed form.

(f) It should contain aggregate information in respect of:

(1) the amount of revenue,

(2) profit and loss before income-tax,

(3) amount of income-tax paid and accrued,

(4) details of stated capital, accumulated earnings, number of employees, tangible assets other than cash or cash equivalent in respect of each country or territory along with details of each constituent’s residential status, nature and detail of main business activity and any other information as may be prescribed.

This shall be based on the template provided in the OECD BEPS report on Action Plan 13;

(g) A constituent entity of an international group resident in India, shall be required to furnish CbC report to the prescribed authority if the parent entity of the group is resident ;-

(1) in a country with which India does not have an arrangement for exchange of the CbC report; or

(2) there has been a systemic failure of the country or territory i.e., such country is not exchanging information with India even though there is an agreement; and

(3) this fact has been intimated to the entity by the prescribed authority.

(h) If there are more than one such constituent entity of the same group in India, then the group can nominate (under intimation in writing on behalf of the group to the prescribed authority),
then, one constituent entity that shall furnish the report on behalf of the group. This entity would then furnish the report;

(i) If an international group, having parent entity which is not resident in India, had designated an alternate entity for filing its report with the tax jurisdiction in which the alternate entity is resident, then the entities of such group operating in India would not be obliged to furnish report if the report can be obtained under the agreement of exchange of such reports by Indian tax authorities;

(j) The prescribed authority may call for such document and information from the entity furnishing the report as it may specify in notice for the purpose of verifying the accuracy. The entity shall be required to make submission within thirty days of receipt of notice or further period if extended by the prescribed authority, but extension shall not be beyond a further period of 30 days.

**Maintenance and furnishing of Master file: Consequent amendments in the Income-tax Act, 1961**

<table>
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<th>Section</th>
<th>Provision</th>
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<tr>
<td>(1) Proviso to section 92D(1)</td>
<td>A person being constituent of an international group shall, in addition to the information related to the international transaction required under section 92D(1), also keep and maintain such information and document in respect of the international group to be prescribed by way of rules. The rules shall, thereafter, prescribe the information and document as mandated for master file under OECD BEPS Action 13 report;</td>
</tr>
<tr>
<td>(2) 92D(4)</td>
<td>The information and document shall also be furnished to the prescribed authority u/s 286(1) within such period as may be prescribed and the manner of furnishing may also be provided for in the rules</td>
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**Threshold limit of consolidated group revenue for applicability of CbC reporting requirement**

As indicated above, the CbC reporting requirement for a reporting year does not apply unless the consolidated revenues of the preceding accounting year of the group, based on consolidated financial statement, exceeds a threshold to be prescribed. The current international consensus is for a threshold of € 750 million equivalent in local currency. This threshold in Indian currency would be equivalent to ₹ 5395 crores (at current rates). Therefore, CbC reporting for an international group having Indian parent, for the previous year 2016-17, shall apply only if the consolidated revenue of the international group in previous year 2015-16 exceeds ₹ 5395 crore (the equivalent would be determinable based on exchange rate as on the last day of previous year 2015-16).
8.14 ACTION PLAN 14 – MAKING DISPUTE RESOLUTION MORE EFFECTIVE

Eliminating opportunities for cross-border tax avoidance and evasion and the effective and efficient prevention of double taxation are significant to developing an international tax system that facilitates economic growth and a buoyant global economy. Countries concur that the measures introduced to address BEPS pursuant to the BEPS Action Plans should not result in unnecessary uncertainty for compliant taxpayers and in unintended double taxation. Improving dispute resolution mechanisms is, therefore, a critical component of the work on BEPS issues.

**MAP: Key to proper application and interpretation of tax treaties**

Article 25 of the OECD Model Tax Convention provides a mechanism, distinct from the general legal remedies available under domestic law, through which the competent authorities of the Contracting States may resolve differences or difficulties relating to interpretation or application of the Convention on a mutually-agreed basis. This mechanism, the mutual agreement procedure (MAP), is the key to the proper application and interpretation of tax treaties, particularly to ensure that taxpayers entitled to the benefits of the treaty are not subject to taxation by either of the Contracting States which is not in accordance with the terms of the treaty. Through the adoption of the Final Report of BEPS, countries have agreed to important changes in their approach to dispute resolution, in particular, by having developed a minimum standard with respect to the resolution of treaty-related disputes, committed to its rapid implementation and agreed to ensure its effective implementation through the establishment of a robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20.
Minimum Standard: Ensure effective implementation of MAP

The minimum standard will ensure:

- that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner.
- the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes.
- that taxpayers can access the MAP when eligible.

Setting up FTA: Enabling Effective Monitoring of MAP Performance

The final report advocates setting up a Forum on Tax Administration (FTA), a subset of MAP Forum to deal with practical issues, as a minimum standard. The minimum standard is complemented by a set of best practices. States have agreed to join the FTA MAP Forum, report MAP statistics and agree to have their MAP performance monitored. In this way, a peer review mechanism has been set in place to ensure transparency in the area of exchange of information. The monitoring of the implementation of the minimum standard will be carried out pursuant to detailed terms of reference and an assessment methodology.

8.15 ACTION PLAN 15 – DEVELOPING A MULTILATERAL INSTRUMENT

Analysis of tax and public international law issues relating to development of multilateral instrument

Action 15 of the BEPS Action Plan provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable countries that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.

Pursuant to this analysis, interested countries have to develop a multilateral instrument designed to provide an innovative approach to international tax matters, which reflect the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution. The aim of Action 15 is to
streamline the implementation of the tax treaty-related BEPS measures. This is an innovative approach with no exact precedent in the tax world, but precedents for modifying bilateral treaties with a multilateral instrument exist in various other areas of public international law. Based on the public international law and the expertise of tax professionals, the 2014 Report, analysed the technical feasibility of a multilateral hard law approach and its consequences on the prevalent tax treaty system. The issues arising from the development of such an instrument were identified. The Report also provided an analysis of the international tax, public international law, and political issues arising from such an approach. The 2014 Report also concluded that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly.

**Formation of Adhoc Group to develop a multilateral instrument on tax treaty measures to tackle BEPS**

Based on this analysis, a mandate for the formation of an ad hoc Group to develop a multilateral instrument on tax treaty measures to tackle BEPS, was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015.

In line with Action 15 report, an ad-hoc group was formed with a pre-defined purpose of development of such Multilateral Instrument (MLI) and that adopted the text of the Convention and accompanying Explanatory Statement in November 2016.

Once drafted, the said document was thereafter kept open for signatures from 31 December 2016. On 7th June 2017, 68 countries and jurisdictions, signed the BEPS MLI at the first joint signing ceremony held in Paris. At the time of signature, signatories submitted a list of their tax treaties in force that they would like to designate as Covered Tax Agreements (CTAs), i.e. to be amended through the MLI.

The Multilateral Convention is an outcome of the OECD / G20 Project to tackle Base Erosion and Profit Shifting (the "BEPS Project") i.e., tax planning strategies 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, resulting in little or no overall corporate tax being paid.

India was part of the Ad Hoc Group of more than 100 countries and jurisdictions from G20, OECD, BEPS associates and other interested countries, which worked on an equal footing on the finalization of the text of the Multilateral Convention, starting May 2015. The text of the Convention and the accompanying Explanatory Statement was adopted by the Ad hoc Group on 24th November 2016.

The Convention enables all signatories, *inter alia*, to meet treaty-related minimum standards that were agreed as part of the Final BEPS package, including the minimum standard for the prevention of treaty abuse under Action 6.

The Convention will operate to modify tax treaties between two or more Parties to the Convention. It will not function in the same way as an amending protocol to a single existing treaty, which would directly amend the text of the Covered Tax Agreement. Instead, it will be applied alongside existing tax treaties, modifying their application in order to implement the BEPS measures.
The Convention will modify India's treaties in order to curb revenue loss through treaty abuse and base erosion and profit shifting strategies by ensuring that profits are taxed where substantive economic activities generating the profits are carried out and where value is created.

### 8.16 CHALLENGES AHEAD

The Final reports have generated good response with about 90 countries having joined the Group as members, and 5 regional tax organizations having joined as observers. However, there are certain challenges that lie ahead on the journey of BEPS viz. inclusiveness, consistent implementation and monitoring impact. After widespread agreement among countries on the measures for tackling BEPS, implementation becomes key. There is a need for increased inclusiveness, a new framework for monitoring BEPS will be conceived and put in place, with all interested participating on an equal footing. Monitoring the impact of the BEPS measures will include assessing the implementation of the minimum standards agreed in the areas of treaty abuse, dispute resolution, country-by-country reporting and harmful tax practices, as well as of the other BEPS measures, together with the monitoring of their overall impact and effectiveness. Some of the measures may be immediately applicable, such as the revised guidance on transfer pricing, while others require changes in domestic laws and in bilateral tax treaties, and hence may take time for implementation.

**Resources:** The discussion on BEPS Action Plans in the above chapter is essentially based on the Action Plans developed in the context of the OECD/G20 BEPS Project and available at the website [http://www.oecd.org/tax/beps/](http://www.oecd.org/tax/beps/)
Question 1

What do you understand by base erosion and profit shifting? Describe briefly its adverse effects.

Answer

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.

Adverse Effects of BEPS:

1. Governments have to cope with less revenue and a higher cost to ensure compliance.

2. In developing countries, the lack of tax revenue leads to significant under-funding of public investment that could help foster economic growth.

3. BEPS undermines the integrity of the tax system, as reporting of low corporate taxes is considered to be unfair. When tax laws permit businesses to reduce their tax burden by shifting their income away from jurisdictions where income producing activities are conducted, other taxpayers, especially individual taxpayers in that jurisdiction bear a greater share of the burden. This gives rise to tax fairness issues on account of individuals having to bear a higher tax burden.

4. Enterprises that operate only in domestic markets, including family-owned businesses or new innovative businesses, may have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax. Fair competition is harmed by the distortions induced by BEPS.

Question 2

What are the significant OECD Recommendations under Action Plan 1 of BEPS? Which recommendation has been adopted in Indian tax laws?

Answer

The OECD has recommended several options to tackle the direct tax challenges which include:

1. Modifying the existing Permanent Establishment (PE) rule to provide that whether an enterprise engaged in fully de-materialized digital activities would constitute a PE, if it maintained a significant digital presence in another country’s economy.

2. A virtual fixed place of business PE in the concept of PE i.e., creation of a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website.
(3) Imposition of a final withholding tax on certain payments for digital goods or services provided by a foreign e-commerce provider or imposition of an equalisation levy on consideration for certain digital transactions received by a non-resident from a resident or from a non-resident having permanent establishment in other contracting state.

Taking into consideration the potential of new digital economy and the rapidly evolving nature of business operations, it becomes necessary to address the challenges in terms of taxation of such digital transactions.

In order to address these challenges, Chapter VIII of the Finance Act, 2016, titled "Equalisation Levy", provides for an equalisation levy of 6% of the amount of consideration for specified services received or receivable by a non-resident not having permanent establishment in India, from a resident in India who carries out business or profession, or from a non-resident having permanent establishment in India.

**Meaning of “Specified Service”:**

(1) Online advertisement;

(2) Any provision for digital advertising space or any other facility or service for the purpose of online advertisement;

Specified Service also includes any other service as may be notified by the Central Government.

Further, in order to reduce burden of small players in the digital domain, it is also provided that no such levy shall be made if the aggregate amount of consideration for specified services received or receivable by a non-resident from a person resident in India or from a non-resident having a permanent establishment in India does not exceed ₹ 1 lakh in any previous year.

**Question 3**

*Discuss the provision incorporated in the Income-tax Act, 1961 in line with the OECD recommendations under Action Plan 4 of BEPS.*

**Answer**

In line with the recommendations of OECD BEPS Action Plan 4, new section 94B has been inserted in the Income-tax Act, 1961, to provide a cap on the interest expense that can be claimed by an entity to its associated enterprise. The total interest paid in excess of 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise for that previous year, whichever is less, shall not be deductible.

The provision is applicable to an Indian company, or a permanent establishment of a foreign company, being the borrower, who pays interest in respect of any form of debt issued by a non-resident who is an 'associated enterprise' of the borrower. Further, the debt is deemed to be treated as issued by an associated enterprise where it provides an implicit or explicit guarantee to the lender, being a non-associated enterprise, or deposits a corresponding and matching amount of funds with such lender.
The provision allows for carry forward of disallowed interest expense for 8 assessment years immediately succeeding the assessment year for which the disallowance is first made and deduction against the income computed under the head "Profits and gains of business or profession" to the extent of maximum allowable interest expenditure.

In order to target only large interest payments, it provides for a threshold of interest expenditure of ₹1 crore in respect of any debt issued by a non-resident, being an associated enterprise, exceeding which the provision would be applicable. Banks and Insurance business are excluded from the ambit of the said provisions keeping in view of special nature of these businesses.

**Question 4**

*Describe the three tier structure for transfer pricing documentation mandated by BEPS Action Plan 13.*

**Answer**

Action 13 contains a three-tiered standardized approach to transfer pricing documentation which consists of:

(a) **Master file:** Master file requires MNEs to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies. The master file is to be delivered by MNEs directly to local tax administrations.

(b) **Local file:** Local file requires maintaining of transactional information specific to each country in detail covering related-party transactions and the amounts involved in those transactions. In addition, relevant financial information regarding specific transactions, a comparability analysis and analysis of the selection and application of the most appropriate transfer pricing method should also be captured. The local file is to be delivered by MNEs directly to local tax administrations.

(c) **Country-by-country (CBC) report:** CBC report requires MNEs to provide an annual report of economic indicators viz. the amount of revenue, profit before income tax, income tax paid and accrued in relation to the tax jurisdiction in which they do business. CBC reports are required to be filed in the jurisdiction of tax residence of the ultimate parent entity, being subsequently shared between other jurisdictions through automatic exchange of information mechanism.

**Question 5**

*Explain the nexus approach recommended by OECD in BEPS Action Plan 5 which has been adopted in the Income-tax Act, 1961.*

**Answer**

In India, the Finance Act, 2016 has introduced a concessional taxation regime for royalty income from patents for the purpose of promoting indigenous research and development and making India a global hub for research and development. The purpose of the concessional taxation regime is to encourage entities to retain and commercialise existing patents and for developing new innovative
patented products. Further, this beneficial taxation regime will incentivise entities to locate the high-value jobs associated with the development, manufacture and exploitation of patents in India.

The nexus approach has been recommended by the OECD under BEPS Action Plan 5. This approach requires attribution and taxation of income arising from exploitation of Intellectual property (IP) in the jurisdiction where substantial research and development (R & D) activities are undertaken instead of the jurisdiction of legal ownership. Accordingly, new section 115BBF has been inserted in the Income-tax Act, 1961 to provide that where the total income of the eligible assessee (being a person resident in India who is the true and first inventor of the invention and whose name is entered in the patent register as the patentee in accordance with the Patents Act, 1970 and includes every such person, being the true and the first inventor of the invention, where more than one person is registered as patentee under Patents Act, 1970 in respect of that patent) includes any income by way of royalty in respect of a patent developed and registered in India, then such royalty shall be taxable at the rate of 10% (plus applicable surcharge and cess). For this purpose, developed means at least 75% of the expenditure should be incurred in India by the eligible assessee for any invention in respect of which patent is granted under the Patents Act, 1970.

**Question 6**

*What are the ways in which hybrid mismatch arrangements are used to achieve unintended double non-taxation or long-term tax deferral?*

**Answer**

Hybrid mismatch arrangements are sometimes used to achieve unintended double non-taxation or long-term tax deferral in one or more of the following ways -

1. Creation of two deductions for a single borrowal;
2. Generation of deductions without corresponding income inclusions;
3. Misuse of foreign tax credit; and
4. Participation exemption regimes.