After studying this chapter, you would be able to -

- **appreciate** the concept of controlled foreign corporations (CFCs), the need for, and the components of, CFC regulations;

- **appreciate** the concept of Base Erosion and Profit Shifting (BEPS), significance of the various Action Plans of BEPS and the provisions incorporated in Indian tax laws in line with the different Action Plans of BEPS;

- **identify and examine** the various anti-avoidance measures incorporated in the Income-tax Act, 1961 and rules thereunder to prevent tax avoidance in respect of international transactions;

- **appreciate** the concept of GAAR and examine the GAAR provisions incorporated in the Income-tax Act, 1961 and rules thereunder;

- **integrate, analyse and apply** the above concepts, principles, measures and provisions in making computations and addressing relevant issues.
8.1 CONTROLLED FOREIGN CORPORATIONS

(1) INTRODUCTION

CFC Regulations: A significant anti-avoidance measure

Tax avoidance has been accepted as an area of concern in international tax arena, which is the reason why several countries have been legislating anti-avoidance measures in their domestic tax code. Controlled Foreign Company (CFC) Regulations are one such set of anti-avoidance measures. Taxation of foreign passive income is at the heart of CFC Regulations.

Income from a foreign source is usually taxed after it is accrued or received as income in the country of residence of the recipient. Therefore, it is possible to defer or avoid the tax on foreign dividend income until it is repatriated. Many residence states regard this tax deferral as unjustifiable loss of tax revenue. Moreover, it gives the residents who invest overseas a tax advantage over those who invest at home.

Controlled Foreign Corporations: Meaning

Controlled Foreign Corporations (CFCs) are corporate entities incorporated in an overseas low tax jurisdiction and controlled directly or indirectly by residents of a higher tax jurisdiction (Parent State). Since each corporate entity is treated as a separate legal entity, the profits earned by such CFCs are not taxed at the owner level until they are distributed. CFCs tend to earn passive income; such income is not distributed, thereby resulting in tax deferral in the Parent State. It is to curb such tax avoidance that CFC Regulations are legislated by various countries.

CFC Legislation: Protecting domestic tax base from erosion

In order to protect the domestic tax base from erosion through certain tax structuring in CFCs and at the same time not denying the foreign subsidiaries income from their genuine business in the same foreign country, many countries have introduced targeted CFC legislation.

The International Bureau of Fiscal Documentation has explained CFC legislations as under:

“The term is generally used in the context of tax avoidance rules designed to combat the diversion by resident taxpayers of income to companies they control and which are typically resident in countries imposing low-or-no taxation. Under these rules income of the controlled company is typically either deemed to be realized directly by the shareholders or deemed to be distributed to them by way of dividend. Often only part of the controlled company’s income is dealt with in this way, typically passive income such as dividends, interest and royalties (tainted income). Many but not all controlled foreign company regimes apply only to corporate shareholders.”

CFC legislations target the income earned and accumulated in non-resident entities that are under the influence or control of its own tax residents, who are subject to worldwide taxation. It is
generally presumed that, in such situations, they can influence the profit distribution or repatriation policies as shareholders. Different countries, depending upon their fiscal need and tax environment, develop different types of rules and regulations to tax profit earned by their CFCs. The basic mechanism and details may, therefore, vary among jurisdictions. Countries with CFC rules include, but are not limited to, the United States, the United Kingdom, Germany, and Japan.

(2) NEED FOR CFC LEGISLATION

As explained above, under the tax laws of several countries, a shareholder of a corporation is generally 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 low-tax jurisdictions or 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. In some countries, this dividend could be avoided indefinitely by loaning the earnings to the shareholder without actually declaring a dividend.

Many developed countries (where global multi-nationals are generally based) have high tax rates as compared to developing 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.

In the USA, the volume of profits held offshore was so large that a special ‘amnesty’ was introduced in 2004, whereby companies could repatriate dividends for a one year period, and pay tax on these dividends at an effective rate of 5.25% as against the normal 35% tax rate then prevailing. This is an indicator that ‘deferral trap’ is a major issue for companies around the globe.

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 laws are generally referred to as Controlled Foreign Corporation (CFC) laws.

(3) OVERVIEW OF CFC REGIMES

The CFC legislation sets out rules for determining the type of entity which will be viewed as ‘controlled’ for the purposes of its CFC regime, with the starting point generally being the entities which are not tax resident in the parent jurisdiction. One important point here is that, while we refer to the rules as ‘controlled foreign corporation’ rules, they are not necessarily limited to dealing with entities viewed as corporate entities.
Ownership/Control Test

The rules generally have an ownership/control test, so that an entity will be treated as a CFC, only if a certain percentage of ownership/control is in the hands of residents of the parent country. CFC rules may have a threshold for domestic ownership, below which a foreign entity is not considered a CFC. Alternatively, or in addition, domestic members of a foreign entity owning less than a certain portion or class of shares may be excluded from the deemed income regime.

Most CFC rules only apply to those CFCs (entity) over which the domestic shareholder or a number of domestic shareholders have a certain degree of control. Control may be defined as the voting power to influence the business of a CFC, and/or simply having a significant stake in the CFC’s assets, profits or liquidation proceeds (i.e., controlling ownership). Under most CFC regimes, control of more than 50% of resident shareholders is required. If there is more than one shareholder who is treated as an unrelated shareholder, a minimum stake of these unrelated shareholders may or may not be required. CFC rules apply to both direct and indirect subsidiaries of resident shareholder, so that taxpayers do not resort to creating multiple layers of holding companies.

Consequence of being deemed as a CFC: Passive income subject to tax in the hands of the resident parent entity

Once the CFC has been identified, the rules then set out the consequences of being treated as a CFC. The significant consequence is to tax certain income of the CFC ‘currently’ in the hands of the parent, as if it had been remitted to the parent or was the income of the parent, even though there is no actual remittance and the income clearly remains in the legal ownership of the CFC itself.

The methods of taxing CFC income and the type of CFC income taxed will vary, but in general, CFC rules attempt to tax ‘passive’ type income (dividend, certain types of interest and royalties), income received by foreign entities taxed at a lower tax rate than applicable in the parent country or income from related parties. CFC regimes which target income taxed at a lower rate typically do so by either listing countries with low tax rates or by setting a minimum tax rate threshold, or by a combination of both.

The most complicated part of CFC rules are the rules of defining what kind of income is “low taxed”. What is “low” taxation is determined by comparing the taxes levied abroad on such income at the relevant rates, which would have been payable at home country and what has actually been paid abroad.

Components of CFC’s income includible in the hands of the domestic person

The rules vary between countries, and therefore, this paragraph does not specifically describe the tax system of any particular country. However, the features listed are prevalent in many CFC
systems. A domestic person who is a member of a foreign corporation (a CFC) that is controlled by domestic members must include in its income, its share of the CFC's subject income. The includible income (usually determined net of expenses) generally comprises of income received by the CFC from:

1. investment or passive sources, including interest, unrelated party dividends, rents from unrelated parties, and royalties from unrelated parties;
2. purchasing goods from related parties or selling goods to related parties where the goods are both produced and for use outside the CFC's country;
3. performing services outside the CFC's country for related parties;
4. non-operating, insubstantial, or passive businesses.

In addition, many CFC rules treat as a deemed dividend, earnings of the CFC loaned by the CFC to domestic related parties. Further, CFC rules also permit exclusion from taxable income of dividends paid by a CFC from earnings previously taxed to members under the CFC rules.

Participation exemptions & Tax credits: Mechanisms to mitigate the effect of CFC Provisions

Irrespective of how the income is technically attributed/distributed to the domestic shareholder, this nature of mechanism has the inherent danger of taxing the foreign income abroad and the same
income under CFC rules at home and potentially again on distribution back home again. Most countries with CFC rules have in place mechanisms such as participation exemptions or underlying tax credits to mitigate the effect of the CFC provisions. A participation exemption may typically provide that certain types of dividends are not taxed in the hands of shareholders. In addition, some participation exemption regimes may provide that capital gains on shares would not be taxed as long as a specified proportion of the company's share capital is held for a specified period.

Thus, in order to avoid double taxation, a credit is given with respect to the CFC income in the home country as regards foreign taxes paid and on distribution, again, a tax credit is given of the (entire CFC) income distributed from a CFC. Other jurisdictions exempt dividend from a CFC.

Components of a CFC Regulation: In a nutshell

| Defining the types of owners and entities affected | Specifying the types of incomes or investments includible as CFC income |
| Specifying the means of preventing double inclusion of the same income | Specifying the exceptions to inclusion in the computation of CFC income |
(4) APPROACHES IN TAXING CFC INCOME

(i) Categorization of countries based on their tax system, KYC norms and extent of co-operation accorded in sharing of information etc.

All countries have a right to tax their subjects according to their own wisdom and having regard to the economic situation of the country. Some countries, in spite of levying low tax or no tax at all may have sophisticated taxation system, sufficient KYC norms, and co-operative approach at the time of sharing of details of information of assets/investments made by residents/ citizens of the country making the requisition. Such countries must be considered as White listed category jurisdictions. However, there also exist such jurisdictions which must be black listed and CFC rules must be applied by using techniques such as substance over form, look through approach, business purpose rule, etc. Accordingly, it is important to classify countries into various categories. White-listed category jurisdictions which do not assist tax evasion / unacceptable tax avoidance must not be doubted subject to satisfying the substance over form principle, business purpose test and other Anti-Avoidance rules including Transfer pricing regulations.

(ii) Income specific CFC legislation

Under this approach, tax is levied on the specified income of a resident shareholder. The target is to tax certain passive income such as income from investment, income from properties owned by the foreign corporation of which the residents of a jurisdiction are shareholders. Here, on fulfilling certain conditions, CFC legislation presumes that shareholders are acting in a malafide manner by allocating profits to a low taxed jurisdiction and such income is deliberately intended to be parked outside the home country to avoid taxes thereon.

Certain active income may also be subject to taxation on satisfying certain conditions. For example, in some countries, residential status of a corporate entity is dependent upon the place of incorporation or its place of effective management (example – India). Therefore, if the place of effective management of a wholly owned subsidiary, say ABC Ltd. (incorporated in a low tax jurisdiction) of A Ltd (an Indian resident company) is found to be in India, the entire profits of ABC Ltd will be taxable in India. Further, being a resident, ABC Ltd. would be required to file its return of income, deduct tax at source on specified payments, furnish TDS statements, get its books of account audited from an accountant under section 44AB and further, also comply with Indian transfer pricing regulations.

(5) THE INDIAN SCENARIO

Indian resident companies are required to pay taxes on their global income including foreign source income. India is a developing country and it follows United Nations double taxation avoidance treaty model, and accordingly, taxes all the income earned from a foreign source and grants credit for the taxes paid abroad for avoidance of double taxation. A non-resident company is
taxable in India in respect of income accruing or deeming to accrue or arise in India.

Accordingly, income derived by a foreign subsidiary (the holding company being an Indian company) is only taxed abroad, unless it gets distributed back to India. This non-taxation of foreign source income of an Indian company’s foreign subsidiary provides a number of tax planning opportunities to Indian corporate groups enabling them:

- to reduce foreign taxes by choosing a jurisdiction with low / zero tax rates or beneficial regimes for certain types of income; and
- to defer or mitigate taxation in India on these (low) taxed overseas profits until distributed to India.

These strategies seek income being earned in a low tax regime (e.g. tax havens) and not repatriated to India. Such an activity is possible as there are no compulsions on India’s foreign subsidiary under exchange control regime to repatriate such profits into India. Such strategies include but are not limited to setting up either foreign holding company or companies holding global intellectual property (rights) or a global operating company.

In past, the Income-tax Act, 1961 had sections 104 to 109 to levy additional tax on undistributed profits including that of residents. The Finance Act 1987 withdrew these provisions. Circular 495 dated 22 September 1987 explained this withdrawal as follows:

“10.1 Sections 104 to 109 relate to levy of additional tax on certain closely-held companies (other than those in which the public are substantially interested) if they fail to distribute a specified percentage of their distributable profits as dividends. These provisions had lost much of their relevance with the reduction of the maximum marginal rate of personal tax to 50 per cent which is lower than the rate for corporation tax on closely-held companies. Sections 104 to 109 have, therefore, been omitted by the Finance Act, 1987.”

As a substitute, deemed dividend provisions in section 2(22)(e) of the Act were suitably amended to take care of the abuse. Circular 495 dated 22 September 1987 read as follows:

“10.2 With the deletion of sections 104 to 109 there was a likehood of closely-held companies not distributing their profits to shareholders by way of dividends but by way of loans or advances so that these are not taxed in the hands of the shareholders. To forestall his manipulation, sub-clause (e) of clause (22) of section 2 has been suitably amended.”

India is essentially a capital importing country. Hence, earlier, there was not much of outbound investment from India. However, in the last couple of decades, India has witnessed a sharp rise in outbound investments, thereby necessitating regulations around taxation of foreign passive income in its tax legislation.

Taking a leaf out from the Vijay Mathur Committee reforms, the then Union Minister Shri Pranab Mukherjee introduced CFC Regulations in the Revised Direct Taxes Code Bill, 2010 (‘DTC’) for public suggestions. Along with the multiple objectives of eliminating distortions in the tax structure,
rationalization of tax levies, enhanced tax compliance and reduction in tax litigations, the Government had set its sights high on broadcasting the sources from which it could generate revenue. This was evident in the proposals to bring in the regime of CFC regulations in final draft of DTC. The CFC Rules introduced in DTC provided that profits earned by a CFC, located in territory with a lower rate of taxation, would be included in the taxable profits of parent company located in India. As per the Budget Speech 2015-16 of Shri Arun Jaitley, Finance Minister, since most of the provisions of the DTC had already been included in the Income-tax Act, 1961, and the remaining were being addressed in that budget; and also considering that the jurisprudence under the Income-tax Act has been well evolved, there was no great merit in going ahead with the DTC. Therefore, the Income-tax Act, 1961 would continue with amendments being made every year through the Annual Finance Act. Certain significant proposals in the DTC have been incorporated in the Income-tax Act, 1961 in line with the expressed intent, the most important being General Anti Avoidance Rules (GAAR) which became effective from A.Y.2018-19, which is discussed at length later in this chapter. Further, the concept of Place of Effective Management ("POEM") has also been introduced in the Indian taxation regime to determine the residential status of a company, other than an Indian company. Simultaneously, adequate safeguard by way of transition provisions have been put in place to take care of the concerns of those companies becoming resident in India for the first time on account of their place of effective management being in India during the relevant previous year. The provisions relating to POEM have been discussed at length in Chapter 2 – Non-resident Taxation. Further, in order to encourage repatriation of profits, section 115BBD has been inserted in the Income-tax Act, 1961 which 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.

Strengthening CFC Rules is also a BEPS Action Plan (Action Plan 3) which has been detailed in the ensuing part of this chapter containing a discussion on Base Erosion and Profit Shifting.

8.2 BASE EROSION AND PROFIT SHIFTING

(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.

(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.:

(i) Introducing coherence in the domestic rules that affect cross-border activities.

(ii) Reinforcing of ‘substance’ requirements in existing international standards; Alignment of taxation with location of value creation and economic activity; and

(iii) Improving transparency and tax certainty.
A brief classification of the various action plans based on the fundamental pillars is as under:

**BEPS Actions as per objectives**

**Coherence**
- **Action 2** Neutralise the effects of hybrid mismatch arrangements
- **Action 3** Strengthen CFC rules
- **Action 4** Limit interest deductibility

**Substance**
- **Action 5 - 1st component** Preferential tax regimes
- **Action 6** Prevent treaty abuse
- **Action 7** Prevent the artificial avoidance of PE status
- **Action 8-10** Aligning transfer pricing outcomes with value creation: Intangibles; Risk and capital; and Other high-risk transactions

**Transparency**
- **Action 5 - 2nd component** Exchange of information on tax rulings
- **Action 11** Data analysis
- **Action 12** Mandatory disclosure rules
- **Action 13** Re-examine transfer pricing documentation
- **Action 14** Dispute resolution

**Horizontal**
- **Action 1** Digital economy
- **Action 15** Multilateral instrument
The BEPS measures range from new minimum standards to a revision of pre-existing international standards, and to common approaches which will facilitate the convergence of national rules and guidance drawing on best practices.
A brief classification of the various action plans based on the basis of outcomes is as under:

**BEPS Actions as per Outcomes**

<table>
<thead>
<tr>
<th>Minimum standards</th>
<th>Reinforced international standards</th>
<th>Common approaches and best practices</th>
<th>Horizontal work</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Action 5 - 1st component</strong> Preferential tax regimes</td>
<td><strong>Action 7</strong> Prevent the artificial avoidance of PE status</td>
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<td><strong>Action 12</strong> Mandatory disclosure rules</td>
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An unprecedented amount of interest and participation has been witnessed by OECD with more than sixty countries, both OECD members and G-20 countries, being directly involved as a part of technical groups in the development of congruent international tax standards. The Inclusive Framework on BEPS works to ensure that the international tax framework for MNEs remains relevant for today and the future, thereby promoting economic efficiency and global welfare. It will also ensure that governments continue to efficiently raise revenues not only from traditional but also from digital businesses, both for direct tax and indirect tax purposes.

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.

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.

(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:

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

(ii) 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:

- **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.

- **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.

- **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.
The Interim Report, 2018, on Tax Challenges arising from Digitalisation, considers an interim measure in the form of an excise tax on the supply of certain e-services within their jurisdiction that would apply to the gross consideration paid for the supply of such e-services by a registered e-services supplier.

After the delivery of the Interim Report in March 2018, the Inclusive Framework delivered a Policy Note in January 2019 including concrete proposals framed within two complementary pillars.

**Pillar 1 - Re-allocation of profit and revised nexus rules:** This pillar would explore potential solutions for determining where tax should be paid and on what basis ("nexus"), as well as what portion of profits could or should be taxed in the jurisdictions where clients or users are located ("profit allocation").

**Pillar 2 - Global anti-base erosion mechanism:** This pillar would explore the design of a system to ensure that multinational enterprises – in the digital economy and beyond – pay a minimum level of tax. This pillar is intended to address remaining issues identified by the OECD/G20 BEPS initiative by providing countries with new tools to protect their tax base from profit shifting to jurisdictions which tax these profits at below the minimum rate.

### 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.

**“Significant economic presence” to constitute “business connection”**

The scope of provisions of section 9(1)(i), prior to amendment by the Finance Act, 2018, were restrictive as it essentially provided for physical presence based nexus rule for taxation of business income of the non-resident in India. *Explanation 2* to the said section which defines ‘business connection’ was also narrow in its scope since it limited the taxability of certain activities...
or transactions of non-resident to those carried out through a dependent agent. Therefore, emerging business models such as digitized businesses, which do not require physical presence of itself or any agent in India, were not covered within the scope of section 9(1)(i).

In view of the above, the Finance Act, 2018 has amended section 9(1)(i) to provide that ‘significant economic presence’ in India shall also constitute ‘business connection’. For this purpose, “significant economic presence” means-

<table>
<thead>
<tr>
<th>Transaction/activity</th>
<th>Condition</th>
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<tbody>
<tr>
<td>(i) any transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India</td>
<td>the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed</td>
</tr>
<tr>
<td>(ii) systematic and continuous soliciting of its business activities or engaging in interaction with users in India through digital means</td>
<td>The users would be of such number as may be prescribed.</td>
</tr>
</tbody>
</table>

Notes:

(i) Only so much of income as is attributable to such transactions or activities shall be deemed to accrue or arise in India.

(ii) Such transactions or activities shall constitute significant economic presence in India, whether or not the agreement for such transactions or activities is entered in India or whether or not the non-resident has a residence or place of business in India or renders services in India.

(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:

- Part I Recommendations to domestic law
  - The Report sets out some general recommendations for changes to domestic law;
  - Specific recommendations for hybrid mismatch rules designed to neutralise tax effects of arrangements
  - Practical examples for operation of rules

- Part II Recommendations to Tax treaty issues
  - Recommended changes to the OECD Model Tax Convention (OECD MC) to deal with Dual Resident Companies, Transparent Entities, including hybrid entities;
  - Also provides comments on treaty interactions of Part – I recommendations
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.**
**ANTI AVOIDANCE MEASURES**

**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:
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.

(5) ACTION PLAN 3 - STRENGTHEN CONTROLLED FOREIGN COMPANY (CFC) RULES

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 or influence.

- **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.

(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 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 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.

Progress in implementation

As at mid-2019, a number of OECD and Inclusive Framework members have adopted interest limitations rules or are in the process of aligning their domestic legislation with the recommendations of BEPS Action 4. From the commencement of 2019, the EU Member States apply an interest cap that restricts a taxpayer’s deductible borrowing costs to generally 30% of the taxpayer’s earnings before interest, tax, depreciation and amortisation (EBITDA). Various other countries have also taken steps to limit interest deductibility (e.g., Argentina, India, Malaysia, Norway, South Korea) or are in the process of aligning their domestic legislation with the recommendations of Action 4 (e.g., Japan, Peru, Viet Nam).

##### Indian Taxation Regime

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, section 94B has been inserted in the Income-tax Act, 1961 by the Finance Act, 2017 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 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.

**(7) ACTION PLAN 5 – COUNTER HARMFUL TAX PRACTICES**

The Action 5 Report is one of the four BEPS minimum standards. The minimum standard of the Action 5 Report consists of two parts. One part relates to preferential tax regimes, where a peer review is undertaken to identify features of such regimes that can facilitate base erosion and profit shifting, and therefore have the potential to unfairly impact the tax base of other jurisdictions. The second part includes a commitment to transparency through the compulsory spontaneous exchange of relevant information on taxpayer-specific rulings which, in the absence of such information exchange, could give rise to BEPS concerns.

The Forum on Harmful Tax Practice (FHTP) has been conducting reviews of preferential regimes since its creation in 1998 in order to determine if the regimes could be harmful to the tax base of other jurisdictions. The current work of the Forum on Harmful Tax Practices (FHTP) comprises three key areas:

1. the assessment of preferential tax regimes to identify features of such regimes that can facilitate base erosion and profit shifting, and therefore have the potential to unfairly impact the tax base of other jurisdictions.
2. the peer review and monitoring of the Action 5 transparency framework through the compulsory spontaneous exchange of relevant information on taxpayer-specific rulings which, in the absence of such information exchange, could give rise to BEPS concerns.
3. the review of substantial activities requirements in no or only nominal tax jurisdictions to ensure a level playing field.

**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.

**Transparency Framework**

On 1 February 2017, the OECD released the Terms of Reference and Methodology for peer reviews on the Action 5 standard for the exchange of information on tax rulings (the "transparency framework"), approved by the Inclusive Framework on BEPS. The peer review and monitoring process will be conducted by the Forum on Harmful Tax Practices (FHTP) in accordance with the Terms of Reference and Methodology, with all members participating on an equal footing.

The Terms of Reference are broken down into four aspects, which capture the key elements of the transparency framework:

- Information gathering process;
- Exchange of information;
- Confidentiality of information received;
- Statistics.

The methodology sets out the procedural mechanisms by which jurisdictions will complete the peer review, including the process for collecting the relevant data, the preparation and approval of reports, the outputs of the review and the follow up process. The methodology contemplates collecting the data points relevant to the peer review by using standardised questionnaires, sent to the reviewed jurisdiction as well as the peers (i.e. the other members of the Inclusive Framework on BEPS).

**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**
- **Conduit rulings**
- **Rulings giving a downward adjustment to profits**
- **PE rulings**
- **Any other type of ruling which the FHTP apprehends BEPS concerns**

FHTP – Forum on Harmful Tax Practices

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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.

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, section 115BBF of the Income-tax Act, 1961 provides 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 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.

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) 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:

(i) certain dividend transfer transactions intended to lower artificially withholding taxes payable on dividends;
(ii) 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;
(iii) situations where an entity is resident of two Contracting States, and
(iv) 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:
Implementation of Action 6 Minimum Standard

The first peer review on the implementation of the Action 6 minimum standard reveals that a large majority of Inclusive Framework members have begun to translate their commitment on treaty shopping into actions and are now in the process of modifying their treaty network. In total, on 30 June 2018, 82 jurisdictions had some treaties that were already compliant with the minimum standard or that were going to shortly comply.

The first peer review shows the efficiency of the Multilateral Instrument (MLI) [For detailed understanding of MLI, refer to discussion in Action Plan 15] in implementing the minimum standard and the other treaty-related BEPS measures. As per OECD, it is by far the preferred tool of Inclusive Framework members for implementing the minimum standard. The majority of the jurisdictions that have signed the MLI have listed almost all their treaties under the MLI.

As on 1st January, 2019, the provisions of the MLI started to take effect with respect to some treaties. For the treaties for which the MLI is effective, tax administration can now use effective treaty provisions to put an end to treaty-shopping.

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 rupee 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.
(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** – A Commissionnaire 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). Commissionnaire arrangements have been a major cause of concern for tax administrations in many countries.

The 2017 update to OECD and UN MC on Article 5 paragraphs 5 and 7 addresses the artificial avoidance of PE status through commissionaire arrangements and similar strategies.
Article 5(5) of the OECD/UN/US Model refers to what is popularly known as "Agency PE". It contains a deemed inclusion clause and commences with a non-obstante clause overriding Article 5(1)/(2). Accordingly, a foreign enterprise may be treated as having an Agency PE in Source State even though it may not satisfy all the tests in Article 5(1) (such as not having a fixed place of business at its disposal in State of Source within the meaning of Article 5(1) and 5(2), or not satisfying the time threshold of six or twelve months, as the case may be).

As per the 2017 update to OECD and UN MC, for paragraph 5 to apply, all the following conditions must be met: (i) a person acts in a Contracting State on behalf of an enterprise; (ii) in doing so, that person 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, and (iii) these contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.

**Additional Guidance on attribution of profits to PEs under BEPS Action Plan 7**

The March 2018 report contains additional guidance on the attribution of profits to permanent establishments resulting from the changes in the Report on BEPS Action Plan 7 to Article 5 of the OECD Model Tax Convention. This additional guidance sets out high-level general principles for the attribution of profits to permanent establishments arising under Article 5(5), in accordance with applicable treaty provisions, and includes examples of a commissionnaire structure for the sale of goods, an online advertising sales structure, and a procurement structure. It also includes additional guidance related to permanent establishments created as a result of the changes to Article 5(4), and provides an example on the attribution of profits to permanent establishments arising from the anti-fragmentation rule included in Article 5(4.1).

**Progress in implementation of BEPS Action Plan 7**

The changes to the PE definitions were integrated in the 2017 OECD Model Tax Convention and in Part IV of the MLI (Articles 12 to 15). The Multilateral Instrument (MLI) is a flexible instrument that allows jurisdictions to adopt BEPS treaty-related measures to counter BEPS and strengthen their treaty network. The MLI was signed by nearly 90 jurisdictions and about half of the MLI Signatories have so far adopted the MLI articles that implement the permanent establishment changes [For detailed understanding of MLI, refer to discussion under Action 15].

**Indian Taxation Regime**

The OECD, under BEPS Action Plan 7, reviewed the definition of 'PE' with a view to preventing avoidance of payment of tax by circumventing the existing PE definition by way of commissionaire arrangements or fragmentation of business activities. In order to tackle such tax avoidance scheme, the BEPS Action plan 7 recommended modifications to Article 5(5) to provide that an agent would include not only a person who...
habitually concludes contracts on behalf of the non-resident, but also a person who habitually plays a principal role leading to the conclusion of contracts. Similarly Action Plan 7 also recommends the introduction of an anti-fragmentation rule as per paragraph 4.1 of Article 5 of OECD Model tax conventions, 2017 so as to prevent the tax payer from resorting to fragmentation of functions which are otherwise a whole activity in order to avail the benefit of exemption under paragraph 4 of Article 5 of DTAs.

Further, with a view to preventing base erosion and profit shifting, the recommendations under BEPS Action Plan 7 have now been included in Article 12 of Multilateral Convention to implement Tax Treaty Related Measures (MLI¹), to which India is also a signatory. Consequently, these provisions will automatically modify India’s bilateral tax treaties covered by MLI, where treaty partner has also opted for Article 12. As a result, the DAPE provisions in Article 5(5) of India’s tax treaties, as modified by MLI, became wider in scope than the erstwhile provisions in Explanation 2 to section 9(1)(i). Similarly, the anti-fragmentation rule introduced as per paragraph 4.1 of Article 5 of the OECD Model Tax Conventions, 2017 has narrowed the scope of the exception under Article 5(4), thereby expanding the scope of PE in DTAA vis-a-vis domestic provisions contained in Explanation 2 to section 9(1)(i). In effect, the relevant provisions in the DTAs became wider in scope than the domestic law.

However, section 90(2) of the Income-tax Act, 1961 provides that the provisions of the domestic law would prevail over corresponding provisions in the DTAs, to the extent they are beneficial. Since, in the instant situations, the provisions of the domestic law being narrower in scope are more beneficial than the provisions in the DTAs, as modified by MLI, such wider provisions in the DTAs would become ineffective, unless the provisions of domestic law are appropriately amended.

In view of the above, section 9(1)(i) has been amended to align the same with the provisions in the DTAA as modified by MLI so as to make the provisions in the treaty effective. Accordingly, section 9(1)(i) has been amended by the Finance Act, 2018 to provide that “business connection” shall also include any business activities carried through a person who, acting on behalf of the non-resident, habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by the non-resident. Such contracts should be-

(i) in the name of the non-resident; or
(ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that the non-resident has the right to use; or
(iii) for the provision of services by that non-resident.

¹ Refer to discussion on MLI later on in this chapter under BEPS Action 15
(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>
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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. Moreover, Action 9 addresses the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company.</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.

**Significant recommendations in the Final Report (2015)**

- **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.

**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.

(i) **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.

(ii) **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.

(iii) **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.

(iv) **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.

(v) 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.

(vi) 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.

**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.

Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures [March, 2018]

The purpose of these model mandatory disclosure rules is to provide tax administrations with information on CRS Avoidance Arrangements and Opaque Offshore Structures, including the users of those Arrangements and Structures and those involved with their supply. Information disclosed pursuant to the application of these model rules can be used both for compliance purposes and to inform future tax policy design. This information will provide tax administrations both with additional intelligence for their tax compliance activities as well as for designing future tax policy. These rules should also have a deterrent effect against the design, marketing and use of arrangements covered by the rules.

CRS Avoidance Arrangements are arrangements that are designed to circumvent, or are marketed as, or have the effect of, circumventing the Common Reporting Standard, as implemented in relevant domestic laws. An arrangement circumvents the Common Reporting
ANTI AVOIDANCE MEASURES

Standard where it avoids the reporting of CRS information to all jurisdictions of tax residence of the taxpayers in a way that undermines the policy intent of the CRS.

Opaque Offshore Structures are structures that involve the use of a passive entity in a jurisdiction other than the jurisdiction of tax residence of one or more of the beneficial owners and that are designed to, marketed as or have the effect of disguising the identity of the beneficial owner(s). Amongst others, this may include the use of nominee shareholders, the exercise of indirect control over entities or the use of jurisdictions with weak rules for the identification of beneficial owners. In order to minimise reporting in low-risk situations, there is a carve-out from the definition of Offshore Structure for Institutional Investors.

The model rules require an Intermediary or user of a CRS Avoidance Arrangement or Opaque Offshore Structure to disclose certain information to its tax administration. Where such information relates to users that are resident in another jurisdiction, it would be exchanged with the tax administration(s) of that jurisdiction in accordance with the terms of the applicable international legal instrument.

The mandatory disclosure rules provide tax administrations and policy makers with information on schemes, their users and suppliers, for use in compliance activities, exchange with treaty partners and tax policy design.

Progress in implementation

With the adoption of Council Directive (EU) 2018/822 by EU Member States, there has been a significant uptake in jurisdictions that now have mandatory disclosure rules. This directive will result in the reporting of cross-border aggressive tax planning, offshore structures and Common Reporting Standard avoidance schemes to EU tax authorities. The directive incorporates the model rules set out in the 2018 OECD report Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures.

(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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<td>(1) Master File</td>
<td>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.</td>
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<td>(2) Local file</td>
<td>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.</td>
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| (3) Country-by-country report| The BEPS Action 13 report provides a template for multinational enterprises (MNEs) to report annually and for each tax jurisdiction in which they do business the information set out therein. This report is called the Country-by-Country (CbC) Report. To facilitate the implementation of the CbC Reporting standard, the BEPS Action 13 report includes a CbC Reporting Implementation Package which consists of

   (i) model legislation which could be used by countries to require the ultimate parent entity of an MNE group to file the CbC Report in its jurisdiction of residence including backup filing requirements and

   (ii) three model Competent Authority Agreements that could be used to facilitate implementation of the exchange of CbC Reports, respectively based on the:
### Anti-Avoidance Measures

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|   | a) Multilateral Convention on Administrative Assistance in Tax Matters;  
|   | b) Bilateral tax conventions; and  
|   | c) Tax Information Exchange Agreements (TIEAs). |

**Following information are required in the CbC report:**

- 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.

(c) 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.

The BEPS Action 13 report (Transfer Pricing Documentation and Country-by-Country Reporting) provides a template for multinational enterprises (MNEs) to report annually and for each tax jurisdiction in which they do business the information set out therein. This report is called the Country-by-Country (CbC) Report.

Peer Review Process for phased implementation of CbC Reporting

Under the Action 13 Minimum Standard, jurisdictions have committed to foster tax transparency by requesting the largest multinational enterprise groups (MNE Groups) to provide the global allocation of their income, taxes and other indicators of the location of economic activity. This unprecedented information on MNE Groups’ operations across the world will boost tax authorities’ risk-assessment capabilities. The Action 13 Minimum Standard has been translated into specific terms of reference and a methodology for the peer review process. The peer review of the Action 13 Minimum Standard is proceeding in stages with three annual reviews in 2017, 2018 and 2019. The phased review process follows the phased implementation of Country-by-Country (CbC) Reporting. Each annual peer review process will, therefore, focus on different aspects of the three key areas under review: the domestic legal and administrative framework, the exchange of information framework, and the confidentiality and appropriate use of CbC reports. The first annual peer review report (May, 2018) reflects the outcome of the first review which focused on the domestic legal and administrative framework. It contains the review of 95 jurisdictions which provided legislation or information pertaining to the implementation of CbC Reporting.
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 by every person who has entered into an international transaction. **Also, a constituent entity of an international group is required to keep and maintain the prescribed information and document in respect of the international group.**

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 [Section 286]

(a) **Threshold limit for applicability of CbC reporting [Sub-section (7)]:** 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 i.e., ₹ 5,500 crore.

Where the total consolidated group revenue of the international group, as reflected in the consolidated financial statement, is in foreign currency, the rate of exchange for the calculation of the value in rupees of such total consolidated group revenue shall be the telegraphic transfer buying rate (TTBR) of such currency on the last day of the accounting year preceding the accounting year [Rule 10DB(7)].

(b) **Time limit for furnishing CbC report [Sub-section (2)]:** 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 Director General of Income-tax (Risk Assessment) for every reporting accounting year, within a period of twelve months from the end of the said reporting accounting year for which the report is being furnished, in the prescribed form and manner.
(c) **Meaning of “Parent entity”[Clause (h) to sub-section (9)]:** A constituent entity, of an international group holding, directly or indirectly, an interest in one or more of the other constituent entities of the international group, such that,—

(i) it is required to prepare a consolidated financial statement under any law for the time being in force or the accounting standards of the country or territory of which the entity is resident; or

(ii) it would have been required to prepare a consolidated financial statement had the equity shares of any of the enterprises were listed on a stock exchange, and, there is no other constituent entity of such group which, due to ownership of any interest, directly or indirectly, in the first mentioned constituent entity, is required to prepare a consolidated financial statement, under the circumstances referred to in sub clause (i) or sub clause (ii), that includes the separate financial statement of the first mentioned constituent entity.

(d) **Details to be furnished by constituent entity resident in India [Sub-section (1):** Every constituent entity resident in India, of an international group having parent entity that is not resident in India, shall notify the Director General of Income-tax (Risk Assessment) at least two months prior to the due date for furnishing CbC report—

(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 or territory of which the said entities are resident.

The report shall be furnished in prescribed manner and in the prescribed form.

(e) **Details/ information to be included in CbC report [Sub-section (3)]:** 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 incorporation country and residential status, nature and detail of main business activity of each constituent entity 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.

(f) **Furnishing of CbC report by resident constituent entity [Sub-section (4):** A constituent entity of an international group resident in India, other than the parent entity or the alternate
reporting entity, shall be required to furnish CbC report within 12 months from the end of the reporting accounting year to the DGIT (Risk Assessment), if the parent entity of the group is resident -

(1) in a country or territory in which it is not obligated to file report of the nature of CbC report;

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

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

In case the parent entity of the constituent entity is resident of a country or territory, where, there has been a systemic failure of the country or territory and the said failure has been intimated to such constituent entity, the period for submission of the report shall be six months from the end of the month in which said systemic failure has been intimated.

(g) Nomination of one constituent entity for furnishing CbC report [Proviso to sub-section (4)]: If there are more than one such constituent entity of the same group resident in India, other than the parent entity or the alternate reporting entity, 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.

(h) No obligation to furnish CbC report in certain cases [Sub-section (5)]: 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 and such alternate entity has furnished such report on or before the date specified by that country or territory, 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.

(i) Entity to furnish documents and information called for [Sub-section (6)]: The DGIT (Risk Assessment) 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 30 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.
(j) Maintenance and furnishing of Master file: Consequent amendments in the Income-tax Act, 1961

<table>
<thead>
<tr>
<th>Section</th>
<th>Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Section 92D(1)(ii)</td>
<td>A person being constituent of an international group has to keep and maintain the prescribed information and document in respect of the international group. The information and document as mandated for master file under OECD BEPS Action 13 report shall be prescribed by way of Rules.</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>
</tr>
</tbody>
</table>

(k) Threshold limit of consolidated group revenue for applicability of CbC reporting requirement

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 threshold for total consolidated group revenue of the international group prescribed under section 286 of the Income-tax Act, 1961 read with Rule 10DB of the Income-tax Rules, 1962 is ₹ 5,500 crores.

(14) ACTION PLAN 14 – MAKING DISPUTE RESOLUTION MORE EFFECTIVE

Objective of measures developed under Action 14 of BEPS

- Minimize the risks of uncertainty
- Minimize unintended double taxation

through

- Consistent and proper implementation of tax treaties
- Effective and timely resolution of disputes regarding their interpretation or application through MAP
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 final report on Action 14: Making Dispute Resolution Mechanisms More Effective, which contains a BEPS minimum standard, was adopted in October 2015. The Action 14 Minimum Standard consists of 21 elements and 12 best practices, which assess a jurisdiction’s legal and administrative framework in the following key areas:

a) preventing disputes;

b) availability and access to MAP;

c) resolution of MAP cases;

d) implementation of MAP agreements.
The minimum standard will, thus, 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.

Along with the adoption of this minimum standard, the BEPS Inclusive Framework members agreed on:

- a peer review process to evaluate the implementation of this standard and
- to report MAP statistics under a newly developed reporting framework

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.

(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.

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.

Once drafted, the said document was thereafter kept open for signatures from 31 December 2016. 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 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.
MLI’s role in BEPS

Abuse of tax treaties is an important source of BEPS. The MLI helps the fight against BEPS by implementing the tax treaty-related measures developed through the BEPS project in existing bilateral tax treaties in a synchronized and efficient manner. These measures will prevent treaty abuse, improve dispute resolution, prevent the artificial avoidance of permanent establishment status and neutralize the effects of hybrid mismatch arrangements.

Features of MLI

The Multilateral Convention is, thus, 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.

The MLI modifies tax treaties that are “Covered Tax Agreements”. A Covered Tax Agreement is an agreement for the avoidance of double taxation that is in force between Parties to the MLI and for which both Parties have made a notification that they wish to modify the agreement using the MLI.

The MLI is a flexible instrument which will modify tax treaties according to a jurisdiction’s policy preferences with respect to the implementation of the tax treaty-related BEPS measures. The MLI provides for different types of flexibility:

(i) jurisdictions can choose amongst alternative provisions in certain MLI articles;
(ii) jurisdictions can choose to apply optional provisions (for instance, the provisions on mandatory binding arbitration);
(iii) jurisdictions may also choose to reserve the right not to apply MLI provisions (to opt out through a “reservation”) with respect to all of their Covered Tax Agreements or with respect to a subset of their Covered Tax Agreements. Jurisdictions only have the possibility to opt out of provisions that do not reflect a BEPS minimum standard, with the possibility to withdraw their reservation (and opt in) later.

Coverage of the MLI

In the first signing ceremony of the MLI on 7th June, 2017, 67 countries have signed the MLI and 9 countries have expressed their intention to sign the instrument. As on 27th September, 2018, 84 countries have signed the MLI and 6 countries have expressed their intention to sign the instrument. Therefore, the MLI already has a significant impact on the worldwide network of tax treaties.

The provisional MLI position of each Signatory indicates the tax treaties it intends to cover, the options it has chosen and the reservations it has made. Signatories can amend their MLI position until ratification. Even after ratification, parties can choose to opt in with respect to optional provisions or to withdraw reservations.
The Multilateral Convention to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (BEPS) was signed by India at Paris, France on 7th June, 2017. India had ratified the said Convention and had deposited the instrument of ratification along-with the list of Covered Tax Agreements, reservations and notifications (India’s Position under the said Convention) to the Depositary on 25th June, 2019. The date of entry into force of the said Convention for India is 1st October, 2019, being the first day of the month following the expiry of a period of three calendar months beginning on 25th June, 2019, being the date of deposit by India of the instrument of ratification.

The provisions of the said Convention would have effect in India with respect to a Covered Tax Agreement in accordance with the provisions of Article 35 of the said Convention. Accordingly, in exercise of the powers conferred by section 90(1) of the Income-tax Act, 1961, the Central Government has, vide Notification No.57/2019 dated 9.8.2019 (available at https://www.incometaxindia.gov.in/communications/notification/notification57_2019.pdf), notified that the provisions of the said Convention shall be given effect to in the Union of India, in accordance with India’s Position under the said Convention, as set out in the Annexure thereto.

As per Article 35 of the MLI, the provisions of this Convention shall have effect in each Contracting Jurisdiction with respect to a Covered Tax Agreement:

a) with respect to taxes withheld at source on amounts paid or credited to non-residents, where the event giving rise to such taxes occurs on or after the first day of the next calendar year that begins on or after the latest of the dates on which this Convention enters into force for each of the Contracting Jurisdictions to the Covered Tax Agreement; and

b) with respect to all other taxes levied by that Contracting Jurisdiction, for taxes levied with respect to taxable periods beginning on or after the expiration of a period of six calendar months (or a shorter period, if all Contracting Jurisdictions notify the Depositary that they intend to apply such shorter period) from the latest of the dates on which this Convention enters into force for each of the Contracting Jurisdictions to the Covered Tax Agreement.

Therefore, the earliest date when the provisions of this Convention can take effect in India is 1st April, 2020 (six months from 1st October, 2019, the date of entry into force for India)².

Resources: The discussion on BEPS Action Plans contained in this 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/beps-actions.htm

² Since the provisions of this Convention takes effect only from F.Y.2020-21, the same have not been discussed in detail in this Study Material.
8.3 OTHER ANTI AVOIDANCE MEASURES

We have seen that there is a growing concern amongst the revenue in many countries that taxpayers structure transactions to reduce the tax costs. We have also understood that the Base Erosion and Profits Shifting (BEPS) project of the Organization for Economic Cooperation and Development ("OECD") along with G-20 countries sort to tackle this issue. The BEPS Action plans have come out with various recommendations on the issue, both to address it within the international treaty framework (for example, introducing the principle purpose test, limitation of benefits clause, amending the permanent establishment clause, etc.) and in the domestic tax law context (for example, controlled foreign corporation rules, equalization levy, etc.).

Tax avoidance is not defined in taxing statutes. Tax avoidance is, nevertheless, the outcome of actions taken by the assessee, none of which or no combination of which is illegal or forbidden by the law as such. International literature on the subject tends to describe it in the following ways:

- Tax avoidance involves the legal exploitation of tax laws to one's own advantage.
- Every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred, by taking advantage of some provisions or lack of provisions in the law.
- An arrangement entered into solely or primarily for the purpose of obtaining a tax advantage.

Taxpayers consider it their legitimate right to arrange their affairs in a manner as to pay the least tax possible. However, tax authorities internationally consider aggressive tax planning schemes by taxpayers to erode the tax base unnaturally, particularly when effective rates of tax diminish significantly. Several countries have, therefore, legislated to prevent tax avoidance in various ways.

The significant anti-avoidance measures under the Indian tax laws in respect of international transactions are –
The Specific Anti-Avoidance Rules (SAARs) include transfer pricing, thin capitalisation, disincentives for transactions with persons in notified jurisdictional area (discussed in Chapter 1 – Transfer Pricing), Tax Information Exchange Agreements (discussed in Chapter 3 – Double Taxation Relief and Chapter 7 – Tax Treaties – Overview, Features, Application and Interpretation) and Place of Effective Management (discussed in Chapter 2 – Non-resident Taxation). The General Anti-Avoidance Rules (GAAR) are discussed in detail hereunder -

The General Anti-Avoidance Rules (GAAR) provisions aim at combating ‘impermissible tax avoidance’. Many countries, like United Kingdom, China, South Africa, Australia, Canada, Brazil have incorporated General Anti-Avoidance Rules in their domestic tax laws to deal with aggressive tax planning.

The Indian GAAR

In India, the GAAR concept was initially introduced in the Direct Taxes Code Bill, 2009 [DTC Bill, 2009]. Later, a Revised Discussion Paper was released. The Direct Taxes Code Bill, 2010 [DTC Bill, 2010] proposed to introduce GAAR from 1st April 2012 onwards. The GAAR provisions were introduced in the Income-tax Act, 1961 vide the Finance Act, 2012 by insertion of new Chapter X-A. Chapter X-A was substituted by the Finance Act, 2013.

The Government subsequently set up a panel under Parthasarathy Shome to review the proposals. The Committee suggested that the rules be deferred by three years to 2016-17, arguing that more time is needed to create administrative machinery for its implementation and called for intensive training of officials.

The Shome Committee Report explains the need for and rationale of GAAR as under:

(i) GAAR has been enacted as a codification of the proposition that, while interpreting the tax legislation, substance should be selected over a legal form.

(ii) Transactions have to be real and are not to be looked at in isolation.

(iii) The fact that the transactions are legal, does not imply that they are acceptable with reference to the underlying meaning embedded in the fiscal statute.

(iv) Thus, where there is no business purpose except to obtain a tax benefit, the GAAR provisions would not allow such a tax benefit to be availed through the tax statute. These propositions have comprised part of jurisprudence in direct tax laws as reflected in various judicial decisions.

(v) The GAAR provisions codify this ‘substance over form’ basis of the tax law.

The CBDT, vide Press Release dated January 27, 2017, clarified that the GAAR provisions shall be effective from A.Y.2018-19 onwards, i.e., financial year 2017-18 onwards. The provisions of GAAR are contained in Chapter X-A of the Income-tax Act, 1961. The necessary procedures for application of GAAR and conditions under which it shall not apply, have been enumerated in Rules 10U to 10UC of the Income-tax Rules, 1962.
Prior to A.Y. 2018-19, the Act contained only Specific Anti-Avoidance Rules (SAARs) to prevent tax avoidance. SAAR targets known tax planning schemes which are commonly used by taxpayers but are not acceptable owing to misuse or abuse of tax laws, or they result in a consequence unintended in the law. In the Act, the following may, inter alia, be considered specific examples of SAAR -

(i) Section 40A(2) on excessive or unreasonable payments to related parties not deductible
(ii) Section 80-IA(8) on transactions with tax exempt entities to be valued at market value.
(iii) Sections 92 to 92F on transfer pricing regulations applicable to international transactions. These provisions also made applicable to specified domestic transactions by the Finance Act, 2012.
(iv) Section 93 on avoidance of tax by transfer of income to non-residents through transfer of assets, rights or interest.
(v) Section 94 on avoidance of tax by certain transactions in securities.
(vi) Section 94A on transactions with persons located in notified jurisdictions.
(vii) Section 2(22)(e) on deemed dividend.
(viii) Section 40(a)(i) and (ia) on disallowance of expenses for non-deduction of tax at source.
(ix) Section 9 on scope of 'income deemed to accrue or arise in India'. The Finance Act, 2012 had widened its scope to overcome the Supreme Court's ruling in Vodafone and some other cases.
(x) *Explanations 1 to 13 to section 43(1) on determination of actual cost of assets ignoring agreements, etc., in certain cases.*

Tax treaties also provide certain anti-avoidance rules for instance, Limitation of Benefit (LOB) Clause and concept of Beneficial Ownership.

**Applicability of General Anti-Avoidance Rule [Section 95]**

(i) Section 95 of the Act with regard to the applicability of GAAR provides that an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and the consequence in relation to tax arising there from may be determined subject to the provisions of this Chapter.

(ii) The section further clarifies that the provisions of this Chapter may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement.

(iii) The section starts with a non-obstante clause which means, if there is a conflict with provisions in other sections, then this section shall prevail over other conflicting provisions.

(iv) The term arrangement referred to in section 95 of the Act, has been defined in section 102 under clause (1) and means any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not, and includes the
alienation of any property in such transaction, operation, scheme, agreement or understanding;

The term ‘Step’ has been defined in section 102 under clause (9) to include a measure or an action, particularly one of a series taken in order to deal with or achieve a particular thing or object in the arrangement.

Example 1

Facts:
M/s India Chem Ltd. is a company incorporated in India. It sets up a unit in a Special Economic Zone (SEZ) in F.Y. 2016-17 for manufacturing of chemicals. It claims 100% deduction of profits earned from that unit in F.Y. 2020-21 and subsequent years as per section 10AA of the Act. Is GAAR applicable in such a case?

Interpretation:
There is an arrangement of setting up of a unit in SEZ which results in a tax benefit. However, this is a case of tax mitigation where the tax payer is taking advantage of a fiscal incentive offered to him by complying with the conditions imposed and economic consequences of the provisions in the legislation e.g., setting up the business unit in SEZ area. Hence, the Revenue would not invoke GAAR as regards this arrangement.

Example 1A

Facts:
In the above example 1, let us presume M/s India Chem Ltd. has another unit for manufacturing chemicals in a non-SEZ area. It then diverts its production from such manufacturing unit and shows the same as manufactured in the tax exempt SEZ unit, while doing only the process of packaging there. Is GAAR applicable in such a case?

Interpretation:
This is a case of misrepresentation of facts by showing production of non-SEZ unit as production of SEZ unit. Hence, this is an arrangement of tax evasion and not tax avoidance.

Tax evasion, being unlawful, can be dealt with directly by establishing correct facts. GAAR provisions will not be invoked in such a case.

Example 1B

Facts:
In the above example 1A, let us presume that M/s India Chem Ltd. does not show production of non-SEZ unit as a production of SEZ unit but transfers the product of non-SEZ unit at a price lower than the fair market value and does only some insignificant activity in SEZ unit. Thus, it is able to show higher profits in SEZ unit than in non-SEZ unit, and consequently claims higher deduction in computation of income. Can GAAR be invoked to deny the tax benefit?

Interpretation:
As there is no misrepresentation of facts or false submissions, it is not a case of tax evasion. The
company has tried to take advantage of tax provisions by diverting profits from non-SEZ unit to SEZ unit. This is not the intention of the SEZ legislation. However, such tax avoidance is specifically dealt with through transfer pricing regulations that deny tax benefits. Hence, the Revenue need not invoke GAAR in such a case, though GAAR and SAAR can co-exist as per clarification given in the CBDT Circular.

**Example 1C**

**Facts:**

In the above example 1B, let us presume, that both units in SEZ area (say A) and non-SEZ area (say B) work independently. M/s India Chem Ltd. started taking new export orders from existing as well as new clients for unit A and gradually, the export from unit B declined. There has not been any shifting of equipment from unit B to unit A. The company offered lower profits from unit B in computation of income. Can GAAR be invoked on the ground that there has been shifting or reconstruction of business from unit B to unit A for the main purpose of obtaining tax benefit?

**Interpretation:**

The issue of tax avoidance through shifting/reconstruction of existing business from one unit to another has been specifically dealt with in section 10AA of the Act. Hence, the Revenue need not invoke GAAR in such a case, though GAAR and SAAR can co-exist as per clarification given in the CBDT Circular.

**Impermissible Avoidance Agreement [Section 96]**

(1) An impermissible avoidance arrangement (IAA) means an arrangement, the main purpose or one of the main purposes of which is to obtain a tax benefit and also any of the following tests is satisfied:

- creates rights, or obligations, which are not ordinarily created between persons dealing at arm’s length;
- results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act;
- lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part or
- is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bona fide purposes.
The purpose test of obtaining tax benefit and tainted element test as under clauses (a) to (d) above are twin conditions that satisfy an impermissible avoidance arrangement. The purpose test requires that the main purpose or one of the main purposes is to obtain tax benefit. The term “tax benefit” has been defined in section 102 clause (10) as under -

(a) a reduction or avoidance or deferral of tax or other amount payable under this Act; or
(b) an increase in a refund of tax or other amount under this Act; or
(c) a reduction or avoidance or deferral of tax or other amount that would be payable under this Act, as a result of a tax treaty; or
(d) an increase in a refund of tax or other amount under this Act as a result of a tax treaty; or
(e) a reduction in total income or
(f) an increase in loss,

in the relevant previous year or any other previous year.

The first tainted element refers to non-arm’s length dealings where an arrangement creates rights and obligations, which are not normally created between parties dealing at arm’s length. As there are specific transfer pricing regulations (SAAR) applicable to international transactions and certain specified domestic transactions, this tainted element is to be examined only in those transactions which are not covered by Transfer Pricing regulations and where the main purpose of the arrangement is to obtain tax benefit.

Example -2

Facts:

Y Tech Ltd. is a company resident of country C1. It enters into an agreement with Z Energy Ltd., an Indian company for setting up a power plant in India. It is a composite contract for an agreed price of US$ 100 million. The payment has been split in the following parts as per separate agreements

(i) US$ 10 million for design of power plant outside India (payment for which is taxable at 10% on gross basis)

(ii) US$ 70 million for offshore supplies of equipment etc (not taxable as no role is played by any PE in India. These are not subject to import duty)

(iii) US$ 20 million for local supplies and installation charges (taxable on net income basis)

It is found that the fair market value of offshore design is about USD 30 million; therefore, it is under invoiced. On the other hand, offshore supplies were over invoiced. The arrangement resulted in significant tax benefit to the taxpayer. Can GAAR be invoked in such a case? Reviewer
**Interpretation:**

The allocation of price to different parts of the contract has been decided in such a manner as to reduce tax liability of the foreign company in India. Both conditions for declaring an arrangement as impermissible are satisfied. (1) The main purpose of this arrangement is to obtain tax benefit; and (2) the transactions are not at arm's length. Consequently, GAAR may be invoked and prices would be reallocated. However, determination of arm's length price should be based on transfer pricing regulations under the Act.

(4) The second tainted element refers to an arrangement which results in misuse or abuse of the provisions of the Act. It implies cases where the law is followed in letter or form but not in spirit or substance, or where the arrangement results in consequences which are not intended by the legislation, revealing an intent to misuse or abuse the law.

**Example-3**

**Facts:**

Under the provisions of a tax treaty between India and country F4, any capital gains arising from the sale of shares of Indco, an Indian company would be taxable only in F4 if the transferor is a resident of F4 except where the transferor holds more than 10% interest in the capital stock of Indco. A company, A Ltd., being resident in F4, makes an investment in Indco through two wholly owned subsidiaries (K Ltd. and L Ltd.) located in F4. Each subsidiary holds 9.95% shareholding in the Indian Company, the total adding to 19.9% of equity of Indco. The subsidiaries sell the shares of Indco and claim exemption as each is holding less than 10% equity shares in the Indian company. Can GAAR be invoked to deny treaty benefit?

**Interpretation:**

The above arrangement of splitting the investment through two subsidiaries appears to be with the intention of obtaining tax benefit under the treaty. Further, there appears to be no
commercial substance in creating two subsidiaries as they do not change the economic condition of investor A Ltd. in any manner (i.e. on business risks or cash flow), and reveals a tainted element of abuse of tax laws. Hence, the arrangement can be treated as an impermissible avoidance arrangement by invoking GAAR. Consequently, treaty benefit would be denied by ignoring K and L, the two subsidiaries, or by treating K and L as one and the same company for tax computation purposes.

(5) **The third tainted** element refers to an arrangement which lacks commercial substance or is deemed to lack commercial substance. [Dealt with in detail below]

(6) **The fourth element** refers to an arrangement which is entered into, or carried out, by means of, or in a manner which is normally not employed for a bona fide purpose. In other words, it means an arrangement that possesses abnormal features. This is not a purpose test but a manner test.

**Arrangement to lack commercial substance [Section 97]**

Another alternate condition of an impermissible avoidance arrangement is that the arrangement lacks commercial substance or is deemed to lack commercial substance in whole or in part.

(1) Under section 97, certain arrangements have been deemed to lack commercial substance as under—

(a) the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or

(b) it involves or includes—

(i) round trip financing;

(ii) an accommodating party;

(iii) elements that have effect of offsetting or cancelling each other; or

(iv) a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction; or

(c) it involves the location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party.

(d) it does not have a significant effect upon the business risks or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained (but for the provisions of this Chapter)

(2) Clause (a) is the codification of **substance v. form doctrine**. It implies that where substance of an arrangement is different from what is intended to be shown by the form of the arrangement, then tax consequence of a particular arrangement should be assessed
based on the —substance of what took place. In other words, it reflects the inherent ability of the law to remove the corporate veil and look beyond form.

(3) Sub-clause (i) of clause (b) deems an arrangement, which includes round tripping of funds, to lack commercial substance. For this purpose, the phrase round trip financing has been further defined. Round trip financing includes any arrangement in which, through a series of transactions—

(a) funds are transferred among the parties to the arrangement; and

(b) such transactions do not have any substantial commercial purpose other than obtaining the tax benefit (but for the provisions of this Chapter),

without having any regard to—

(A) whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement;

(B) the time, or sequence, in which the funds involved in the round trip financing are transferred or received; or

(C) the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received.

Example-4

Facts:
Indco incorporates a Subco in a NTJ (Low Tax Jurisdiction) with equity of US $100. Subco gives a loan of US $100 to another Indian company (X Ltd.) at the rate of 10% p.a. X Ltd. claims deduction of interest payable to Subco from the profit of business. There is no other activity in Subco. Can GAAR be invoked in such a case?

Interpretation:
The arrangement appears to be to avoid payment of tax on interest income by Indco in case loan is directly provided by Indco to X Ltd. The arrangement involves round tripping of funds even though the funds emanating from Indco are not traced back to Indco in this case. Hence, the arrangement may be deemed to lack commercial substance.

Consequently, in the case of Indco, Subco may be disregarded and the interest income may be taxed in the hands of Indco.
(4) Sub-clause (ii) of clause (b) deems an arrangement which includes an accommodating party to lack commercial substance. For this, the phrase “accommodating party” has been further defined. A party to an arrangement shall be an accommodating party, if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part, is to obtain, directly or indirectly, a tax benefit (but for the provisions of this Chapter) for the assessee whether or not the party is a connected person in relation to any party to the arrangement.

It means that where a party is included in an arrangement mainly for obtaining tax benefit to the taxpayer, then such party may be treated as an accommodating party and consequently the arrangement shall be deemed to lack commercial substance. Also, it is not necessary that such party should be connected to the taxpayer.

(5) Sub-clause (iii) of clause (b) deems an arrangement, which includes elements that have effect of offsetting or cancelling each other to lack commercial substance.

(6) Sub-clause (iv) of clause (b) deems an arrangement, which disguises value, source or location etc. of funds, to lack commercial substance. In other words, such arrangements have an element of deceit as regards funds.

(7) Clause (c) deems an arrangement to lack commercial substance where it involves the location of an asset or of a transaction or of the place of residence of any party and such location is without any substantial commercial purpose. It means if a particular location is selected for an asset or transaction or residence, and such selection has no substantial commercial purpose, then such arrangement shall be deemed to lack commercial substance.

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Example - 5

**Facts:**

(i) Y Ltd. is a company incorporated in country C1. It is a non-resident in India.

(ii) Z Ltd. is a company resident in India.

(iii) A Ltd. is a company incorporated in country F1 and it is a 100% subsidiary of Y Ltd.
A Ltd. and Z Ltd. form a joint venture company X Ltd. in India after the date of commencement of GAAR provisions. There is no other activity in A Ltd.

The India-F1 tax treaty provides for non-taxation of capital gains in the source country and country F1 charges no capital gains tax in its domestic law.

A Ltd. is also designated as a permitted transferee of Y Ltd. Permitted transferee means that though shares are held by A Ltd, all rights of voting, management, right to sell etc., are vested in Y Ltd.

As per the joint venture agreement, 49% of X Ltd’s equity is allotted to A Ltd. and 51% is allotted to Z Ltd.

Thereafter, the shares of X Ltd. held by A Ltd. are sold to C Ltd., a company connected to the Z Ltd. group.

As per the tax treaty with country F1, capital gains arising to A Ltd. are not taxable in India. Can GAAR be invoked to deny the treaty benefit?

**Interpretation:**

The arrangement of routing investment through country F1 results in a tax benefit. Since there is no business purpose in incorporating company A Ltd. in country F1 which is a LTJ, it can be said that the main purpose of the arrangement is to obtain a tax benefit. The alternate course available in this case is direct investment in X Ltd. joint venture by Y Ltd. The tax benefit would be the difference in tax liabilities between the two available courses.

The next question is, does the arrangement have any tainted element? It is evident that there is no commercial substance in incorporating A Ltd. as it does not have any effect on the business risk of Y Ltd. or cash flow of Y Ltd. As the twin conditions of main purpose being tax benefit and existence of a tainted element are satisfied, GAAR may be invoked.

Additionally, as all rights of shareholders of X Ltd. are being exercised by Y Ltd instead of A Ltd, it again shows that A Ltd lacks commercial substance.

Hence, it is possible to invoke GAAR, in this case.

In section 97(4), the following factors are considered relevant but not sufficient for determining whether an arrangement lacks commercial substance or not, namely—

(i) the period or time for which the arrangement (including operations therein) exists;
(ii) the fact of payment of taxes, directly or indirectly, under the arrangement;
(iii) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.
Consequence of impermissible avoidance arrangement [Section 98]

1. If an arrangement is declared to be an impermissible avoidance arrangement, then the consequences may include denial of tax benefit or a benefit under a tax treaty. The consequence may be determined in such manner as is deemed appropriate in the circumstances of the case. Certain illustrations of the manner have been provided, namely:

   a. disregarding, combining or re-characterizing any step in, or a part or whole of, the impermissible avoidance arrangement;
   b. treating the impermissible avoidance arrangement as if it had not been entered into or carried out;
   c. disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;
   d. deeming persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount;
   e. reallocating amongst the parties to the arrangement—
      i. any accrual, or receipt, of a capital or revenue nature; or
      ii. any expenditure, deduction, relief or rebate;
   f. treating—
      i. the place of residence of any party to the arrangement; or
      ii. the situs of an asset or of a transaction, at a place other than the place of residence, location of the asset or location of the transaction as provided under the arrangement; or
   g. considering or looking through any arrangement by disregarding any corporate structure.

2. It has also been provided that—
   i. any equity may be treated as debt or vice versa;
   ii. any accrual, or receipt, of a capital nature may be treated as of revenue nature or vice versa; or
   iii. any expenditure, deduction, relief or rebate may be recharacterised.

Treatment of connected persons and accommodating party [Section 99]

1. As per section 99, for the purposes of Chapter X-A, in determining whether a tax benefit exists—
   i. the parties who are connected persons in relation to each other may be treated as one and the same person;
   ii. any accommodating party may be disregarded;
such accommodating party and any other party may be treated as one and the same person;

(iv) the arrangement may be considered or looked through by disregarding any corporate structure.

(2) The term ‘connected person’ is defined in section 102 clause (4). Connected person means any person who is connected directly or indirectly to another person and includes –

<table>
<thead>
<tr>
<th>If Connected Person is an</th>
<th>A Company/Firm /AOP/BOI/HUF</th>
<th>A Company/Firm /AOP/BOI/HUF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual:</td>
<td>Any director or relative of such director</td>
<td>whose director/partner/member has substantial interest in the business of that other person</td>
</tr>
<tr>
<td>Company:</td>
<td>any director or relative of such director</td>
<td>– being an individual or any relative of such person has substantial interest in the business of that other person</td>
</tr>
<tr>
<td>Firm/ AOP/ BOI:</td>
<td>any partner/member or relative of such partner/member</td>
<td>– being a company/Firm/AOP/BOI/HUF or any director/partner/member or any relative of such director/partner/member</td>
</tr>
<tr>
<td>HUF:</td>
<td>Any member or relative of such member</td>
<td>having substantial interest in the business of the person or any director/partner/member or any relative of such director/partner/member</td>
</tr>
</tbody>
</table>

Framing of guidelines under Income-tax Rules [Section 101]

The provisions of Chapter XA have to be applied in accordance with such guidelines and subject to such conditions as may be prescribed. These guidelines are contained in Rules 10U to 10UC.

(1) As per Rule 10U, the provisions of General Anti Avoidance Rule are not applicable to

(a) an arrangement where the tax benefit in the relevant assessment year arising, in aggregate, to all the parties to the arrangement does not exceed a sum of rupees three crores.

(b) a Foreign Institutional Investor -
(i) who is an assessee under the Act;
(ii) who has not taken benefit of an agreement referred to in section 90 or section 90A as the case may be; and
(iii) who has invested in listed securities, or unlisted securities, with the prior permission of the competent authority, in accordance with the Securities and Exchange Board of India (Foreign Institutional Investor) Regulations, 1995 and such other regulations as may be applicable, in relation to such investments.

(c) a person, being a non-resident, in relation to investment made by him by way of offshore derivative instruments or otherwise, directly or indirectly, in a Foreign Institutional Investor.

(d) any income accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by, any person from transfer of investments made before the 1st day of April, 2017 by such person.

However, the provisions of GAAR shall apply to any arrangement [other than specified in (d) above], irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after the 1st day of April, 2017.

(2) Where a part of an arrangement is declared to be an impermissible avoidance arrangement, the consequences in relation to tax shall be determined with reference to such part only [Rule 10UA].

(3) The Assessing Officer shall, before making a reference to the Commissioner under section 144BA(1), issue a notice in writing to the assessee seeking objections, if any, to the applicability of provisions of GAAR in his case [Rule 10UB(1)].

**Implementation of GAAR Provisions under the Income-tax Act, 1961**

**Clarifications on certain queries about implementation of GAAR [Circular No.7 of 2017 dated 27-1-2017]**

The provisions of Chapter X-A of the Income-tax Act, 1961 relating to General Anti-Avoidance Rule will come into force from 1st April, 2017. Certain queries have been received by the Board about implementation of GAAR provisions. The Board constituted a Working Group in June, 2016 for this purpose. The Board has considered the comments of the Working Group and the following clarifications are issued:

**Question no. 1:** Will GAAR be invoked if SAAR applies?

**Answer:** It is internationally accepted that specific anti avoidance provisions may not address all situations of abuse and there is need for general anti-abuse provisions in the domestic legislation. The provisions of GAAR and SAAR can coexist and are applicable, as may be necessary, in the facts and circumstances of the case.
Question no. 2: Will GAAR be applied to deny treaty eligibility in a case where there is compliance with LOB test of the treaty?

Answer: Adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies and the same are required to be tackled through domestic anti-avoidance rules. If a case of avoidance is sufficiently addressed by LOB in the treaty, there shall not be an occasion to invoke GAAR.

Question no. 3: Will GAAR interplay with the right of the taxpayer to select or choose method of implementing a transaction?

Answer: GAAR will not interplay with the right of the taxpayer to select or choose method of implementing a transaction.

Question no. 4: Will GAAR provisions apply where the jurisdiction of the FPI is finalised based on non-tax commercial considerations and such FPI has issued P-notes referencing Indian securities? Further, will GAAR be invoked with a view to denying treaty eligibility to a Special Purpose Vehicle (SPV), either on the ground that it is located in a tax friendly jurisdiction or on the ground that it does not have its own premises or skilled professional on its own roll as employees.

Answer: For GAAR application, the issue, as may be arising regarding the choice of entity, location etc., has to be resolved on the basis of the main purpose and other conditions provided under section 96 of the Act. GAAR shall not be invoked merely on the ground that the entity is located in a tax efficient jurisdiction. If the jurisdiction of FPI is finalized based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefit, GAAR will not apply.

Question no. 5: Will GAAR provisions apply to (i) any securities issued by way of bonus issuances so long as the original securities are acquired prior to 01 April, 2017 (ii) shares issued post 31 March, 2017, on conversion of Compulsorily Convertible Debentures, Compulsorily Convertible Preference Shares (CCPS), Foreign Currency Convertible Bonds (FCCBs), Global Depository Receipts (GDRs), acquired prior to 01 April, 2017; (iii) shares which are issued consequent to split up or consolidation of such grandfathered shareholding?

Answer: Grandfathering under Rule 10U(1)(d) will be available to investments made before 1st April 2017 in respect of instruments compulsorily convertible from one form to another, at terms finalized at the time of issue of such instruments. Shares brought into existence by way of split or consolidation of holdings, or by bonus issuances in respect of shares acquired prior to 1st April 2017 in the hands of the same investor would also be eligible for grandfathering under Rule 10U(1)(d) of the Income Tax Rules.

Question no. 6: The expression "investments" can cover investment in all forms of instrument - whether in an Indian Company or in a foreign company, so long as the disposal thereof may give rise to income chargeable to tax. Grandfathering should extend to all forms of investments including lease contracts (say, aircraft leases) and loan arrangements, etc.

Answer: Grandfathering is available in respect of income from transfer of investments made before 1st April, 2017. As per Accounting Standards, 'investments' are assets held by an enterprise for earning income by way of dividends, interest, rentals and for capital appreciation.
Lease contracts and loan arrangements are, by themselves, not 'investments' and hence grandfathering is not available.

**Question no. 7:** Will GAAR apply if arrangement held as permissible by Authority for Advance Ruling?

**Answer:** No. The AAR ruling is binding on the PCIT / CIT and the Income Tax Authorities subordinate to him in respect of the applicant.

**Question no. 8:** Will GAAR be invoked if arrangement is sanctioned by an authority such as the Court, National Company Law Tribunal or is in accordance with judicial precedents etc.?

**Answer:** Where the Court has explicitly and adequately considered the tax implication while sanctioning an arrangement, GAAR will not apply to such arrangement.

**Question no. 9:** Will a Fund claiming tax treaty benefits in one year and opting to be governed by the provisions of the Act in another year attract GAAR provisions? An example would be where a Fund claims treaty benefits in respect of gains from derivatives in one year and in another year sets-off losses from derivatives transactions against gains from shares under the Act.

**Answer:** GAAR provisions are applicable to impermissible avoidance arrangements as under section 96. In so far as the admissibility of claim under treaty or domestic law in different years is concerned, it is not a matter to be decided through GAAR provisions.

**Question no. 10:** How will it be ensured that GAAR will be invoked in rare cases to deal with highly aggressive and artificially pre-ordained schemes and based on cogent evidence and not on the basis of interpretation difference?

**Answer:** The proposal to declare an arrangement as an impermissible avoidance arrangement under GAAR will be vetted first by the Principal Commissioner / Commissioner and at the second stage by an Approving Panel, headed by judge of a High Court. Thus, adequate safeguards are in place to ensure that GAAR is invoked only in deserving cases.

**Question no. 11:** Can GAAR lead to assessment of notional income or disallowance of real expenditure? Will GAAR provisions expand the scope of charging provisions or scope of taxable base and/or disallow the expenditure which is actually incurred and which otherwise is admissible having regard to diverse provisions of the Act?

**Answer:** If the arrangement is covered under section 96, then the arrangement will be disregarded by application of GAAR and necessary consequences will follow.

**Question no. 12:** A definite timeline may be provided such as 5 to 10 years of existence of the arrangement where GAAR provisions will not apply in terms of the provisions in this regard in section 97(4) of the IT Act.

**Answer:** Period of time for which an arrangement exists is only a relevant factor and not a sufficient factor under section 97(4) to determine whether an arrangement lacks commercial substance.

**Question no. 13:** It may be ensured that in practice, the consequences of a transaction being treated as an 'impermissible avoidance arrangement' are determined in a uniform, fair and rational basis. Compensating adjustments under section 98 of the Act should be done in a consistent and
Adequate procedural safeguards are in place to ensure that GAAR is invoked in a uniform, fair and rational manner. In the event of a particular consequence being applied in the hands of one of the participants as a result of GAAR, corresponding adjustment in the hands of another participant will not be made. GAAR is an anti-avoidance provision with deterrent consequences and corresponding tax adjustments across different taxpayers could militate against deterrence.

**Question no. 14:** Tax benefit of INR 3 crores as defined in section 102(10) may be calculated in respect of each arrangement and each taxpayer and for each relevant assessment year separately. For evaluating the main purpose to be obtaining of tax benefit, the review should extend to tax consequences across territories. The tax impact of INR 3 crores should be considered after taking into account impact to all the parties to the arrangement i.e. on a net basis and not on a gross basis (i.e. impact in the hands of one or few parties selectively).

**Answer:** The application of the tax laws is jurisdiction specific and hence what can be seen and examined is the Tax Benefit' enjoyed in Indian jurisdiction due to the 'arrangement or part of the arrangement'. Further, such benefit is assessment year specific. Further, GAAR is with respect to an arrangement or part of the arrangement and therefore limit of Rs. 3 crores cannot be read in respect of a single taxpayer only.

**Question no. 15:** Will a contrary view be taken in subsequent years if arrangement held to be permissible in an earlier year?

**Answer:** If the PCIT/Approving Panel has held the arrangement to be permissible in one year and facts and circumstances remain the same, as per the principle of consistency, GAAR will not be invoked for that arrangement in a subsequent year.

**Question no. 16:** No penalty proceedings should be initiated pursuant to additions made under GAAR at least for the initial 5 years.

**Answer:** Levy of penalty depends on facts and circumstances of the case and is not automatic. No blanket exemption for a period of five years from penalty provisions is available under law. The assessee, may at his option, apply for benefit u/s 273A if he satisfies conditions prescribed therein.
### SUMMARY

**BEPS Action Plan 1: Addressing the challenges of the digital economy**

<table>
<thead>
<tr>
<th>OECD Recommendation</th>
<th>Provision incorporated in Indian Tax Laws</th>
</tr>
</thead>
<tbody>
<tr>
<td>i Modifying existing Permanent Establishment (PE) rule to provide whether an enterprise engaged in fully de-materialized digital activities would constitute a PE if it maintained significant digital presence in another country’s economy</td>
<td>“Significant economic presence” (SEP) to constitute “business connection”</td>
</tr>
</tbody>
</table>
| ii A virtual fixed place of business PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction & carries on business through that website. | **Upto A.Y.2018-19**  
As per sec 9(1)(i) of the Income-tax Act, 1961, as it stood prior to amendment by the Finance Act, 2018, physical presence in India was necessary to fall within the scope of “business connection” to attract deemed accrual provisions for income of Non-resident to be subject to tax in India. |
| iii Imposition of a final withholding tax on certain payments for digital goods or services provided by a foreign e-commerce provider | **From A.Y.2019-20**  
The Finance Act, 2018 has amended section 9(1)(i) to provide that significant economic presence would also constitute business connection from A.Y.2019-20. * |
| iv Imposition of a Equalisation Levy on consideration for certain digital transactions received by a Non-resident from a resident or Non-resident having PE in the other contracting state | Equalisation Levy  
Chapter VIII of the Finance Act, 2016 provides for Equalisation levy@6% of the amount of consideration for specified services received or receivable by a Non-resident not having PE in India or providing services not effectively connected with PE in India, from:  
- a resident in India who carries on business or profession or  
- from a Non-resident having PE in India.  
The Resident or Non-resident having PE in India has to deduct Equalisation Levy@6% from consideration for specified services paid to Non-resident and remit the same to the Central Government within the prescribed time. |

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* Rules in this regard are yet to be notified
### BEPS Action Plan 3: Strengthen CFC rules

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>CFCs are foreign subsidiaries in tax havens in which the taxpayer has controlling interest. Since tax is generally levied on distributed dividend, tax in parent country could be avoided until the tax haven country actually paid dividend to the shareholders. The OECD regards CFC Rules as important in tackling BEPS and has made a series of best practice recommendations in relation to the building blocks of an effective CFC regime.</td>
<td>There are no CFC Rules in the Income-tax Act, 1961. However, section 115BBD has been inserted in Income-tax Act, 1961 to encourage repatriation of profits by Indian companies which have significant voting power in foreign Companies.</td>
</tr>
</tbody>
</table>

**Building Blocks**

- Definition of a CFC & Control
- CFC Exemptions & Threshold requirement
- Rules to prevent or eliminate Double Taxation
- Rules for attributing CFC Income
- Rules for computing CFC Income

#### Tax on dividend (Divd) received by an Indian Co. (IndCo) from a Foreign Co.

1. **Does the IndCo hold 26% or more in the nominal value of Share Capital of the Foreign Co.?**
   - Yes
   - No

   **Divd received is taxable @15% u/s 115BBD**
   - No deduction is allowable in computing divd income
   - Any reasonable commission or remuneration for realization of divd allowable as deduction

2. **Is the foreign Co. a subsidiary of IndCo.?**
   - Yes
   - No

   **Divid received from foreign Co. can be reduced from divd distributed by IndCo, for payment of DDT**
   - Divid received from foreign Co. cannot be reduced from divd distributed by IndCo., for payment of DDT
BEPS Action Plan 4: Interest deductions and other financial payments

<table>
<thead>
<tr>
<th>Common Approach in 2015 Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>The common approach which directly links an entity’s net interest deductions to its level of economic activity, based on taxable EBITDA includes three elements:</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rule</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>i</td>
<td>Fixed Ratio Rule based on benchmark net interest/EBITDA Ratio</td>
</tr>
<tr>
<td>ii</td>
<td>Group Ratio Rule allows an entity to deduct more interest expense based on the position of its worldwide group</td>
</tr>
<tr>
<td>iii</td>
<td>Targeted Rules address specific risks</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Provisions incorporated in the Income-tax Act, 1961</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sec 94B – Limitation of interest deduction [based on Fixed Ratio Rule]</td>
</tr>
</tbody>
</table>

Is the borrower an IndCo or a PE of a Foreign Co?

- Yes
- No

Is the borrower a bank or Ins. Co.?

- Yes
- No

Sec 94B would not apply

Does the interest paid to NR AE exceed Rs.1 crore?

- Yes
- No

Excess interest: Total interest paid or payable in excess of 30% of EBITDA or interest paid or payable to AE for that P.Y., whichever is less

Disallowed interest can be c/f for 8 A.Y.s for deduction against PGBP income to the extent of maximum allowable interest expense

* Total interest paid or payable may also be interpreted to mean interest paid or payable to NR AE.
### BEPS Action Plan 5: Counter harmful tax practices

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Action 5 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. For instance, in case of R&amp;D activities, the nexus approach recommended by the OECD under BEPS Action 5 requires attribution and taxation of income arising from exploitation of IP in the jurisdiction where substantial R &amp; D activities are undertaken instead of the jurisdiction of legal ownership.</td>
<td><strong>Sec 115BBF of the Income-tax Act, 1961 – Tax on income from patent</strong> Where the Total Income of the eligible assessee includes any income by way of royalty in respect of a patent developed &amp; registered in India, then, such royalty is taxable@ 10% (plus applicable surcharge &amp; cess).</td>
</tr>
<tr>
<td><strong>Applicability of concessional rate of 10% u/s 115BBF</strong></td>
<td></td>
</tr>
<tr>
<td>Assessee should be a person resident in India, who is a patentee</td>
<td>Income must be from a patent developed &amp; registered in India</td>
</tr>
<tr>
<td><strong>Meaning of developed</strong></td>
<td></td>
</tr>
<tr>
<td>The invention should be one for which patent is granted under the Patents Act, 1970</td>
<td>At least 75% of the expenditure for such invention must be incurred in India</td>
</tr>
</tbody>
</table>
## BEPS Action Plan 6: Preventing treaty abuse

<table>
<thead>
<tr>
<th>OECD Minimum Standard</th>
<th>LoB clause incorporated in Indian Tax Treaties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Given the risk to revenues posed by treaty shopping, countries have committed to</td>
<td>LoB clause in India-Mauritius Tax Treaty</td>
</tr>
<tr>
<td>ensure a minimum level of protection against treaty shopping by including in their</td>
<td>• On 10.5.2016, the India-Mauritius tax treaty was amended and for the first time, it has been provided that</td>
</tr>
<tr>
<td>treaties:</td>
<td>gains from the alienation of shares acquired on or after 1.4.2017 in a company which is a resident of India</td>
</tr>
<tr>
<td>(i) the combined approach of Limitation of Benefits (LOB) and Principal Purpose Test</td>
<td>• The tax rate on such capital gains arising from 1.4.2017-31.3.2019 should, however, not exceed 50% of</td>
</tr>
<tr>
<td>(PPT) rule,</td>
<td>the applicable tax rate on capital gains in India.</td>
</tr>
<tr>
<td>(ii) the PPT rule alone, or</td>
<td>• LOB Clause provides that a resident of a Contracting State shall not be entitled to the benefits of 50% of</td>
</tr>
<tr>
<td>(iii) the LOB rule supplemented by a mechanism that would deal with conduit financing</td>
<td>the tax rate applicable in transition period if its affairs are arranged with the primary purpose of taking</td>
</tr>
<tr>
<td>arrangements not already dealt with in tax treaties</td>
<td>advantage of concessional rate of tax.</td>
</tr>
<tr>
<td></td>
<td>• A shell or a conduit Co. claiming to be a resident of a Contracting State shall not be entitled to this</td>
</tr>
<tr>
<td></td>
<td>benefit.</td>
</tr>
<tr>
<td></td>
<td>• A shell or conduit Co. is any legal entity falling within the meaning of resident with negligible or nil</td>
</tr>
<tr>
<td></td>
<td>business operations or with no real and continuous business activities carried out in that Contracting</td>
</tr>
<tr>
<td></td>
<td>State.</td>
</tr>
<tr>
<td>LoB clause in India-Singapore Tax Treaty</td>
<td></td>
</tr>
<tr>
<td>• The India-Singapore tax treaty has been amended to provide that capital gains on</td>
<td></td>
</tr>
<tr>
<td>alienation of shares would be taxable in a similar manner as laid out in India-</td>
<td>• The transition period benefit is also similar to that contained in India-Mauritius Tax Treaty.</td>
</tr>
<tr>
<td>Mauritius tax treaty, subject to LoB clause.</td>
<td></td>
</tr>
<tr>
<td>• The transition period benefit is also similar to that contained in India-Mauritius</td>
<td></td>
</tr>
</tbody>
</table>
## BEPS Action Plan 7: Prevent the Artificial Avoidance of PE Status

<table>
<thead>
<tr>
<th>OECD Recommendation</th>
<th>Provision incorporated in the Income-tax Act, 1961</th>
</tr>
</thead>
<tbody>
<tr>
<td>Review of definition of PE</td>
<td>Expanding the scope of business connection (BC) u/s 9(1)(i) of Income-tax Act, 1961</td>
</tr>
<tr>
<td>To prevent tax avoidance</td>
<td></td>
</tr>
<tr>
<td><strong>By way of Commissionaire Arrangements</strong></td>
<td><strong>Upto A.Y.2018-19</strong></td>
</tr>
<tr>
<td>Modification of Article 5(5) to <strong>include a person who habitually plays a principal role leading to conclusion of contracts</strong> in the definition of agent</td>
<td>BC is established, inter alia, where a person acting on behalf of NR has and habitually exercises the authority to conclude contracts on behalf of the NR.</td>
</tr>
<tr>
<td><strong>By way of Fragmentation of business activities</strong></td>
<td><strong>From A.Y.2019-20</strong></td>
</tr>
<tr>
<td>Introduction of anti-fragmentation Rule to <strong>prevent fragmentation of functions</strong> which are otherwise a whole activity to avail benefit of exemption</td>
<td>BC also include any business activities carried through a person who, acting on behalf of the NR, habitually concludes contracts or <strong>habitually plays the principal role leading to conclusion of contracts</strong> by the NR. Such contracts should be-</td>
</tr>
<tr>
<td><strong>Upto A.Y.2018-19</strong></td>
<td>(i) in the name of the NR; or</td>
</tr>
<tr>
<td><strong>From A.Y.2019-20</strong></td>
<td>(ii) for transfer of ownership of, or for the granting of right to use, property owned by that NR or that the NR has the right to use; or</td>
</tr>
<tr>
<td></td>
<td>(iii) for provision of services by that NR</td>
</tr>
</tbody>
</table>

Upto A.Y.2018-19: BC is established, inter alia, where a person acting on behalf of NR has and habitually exercises the authority to conclude contracts on behalf of the NR.

From A.Y.2019-20: BC also include any business activities carried through a person who, acting on behalf of the NR, habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by the NR. Such contracts should be-
BEPS Action Plan 13: Re-examine transfer pricing (TP) documentation

**OECD Minimum Standard**

- **Provisions incorporated in the Income-tax Act, 1961**
  - Section 92D
  - Section 286

- **Maintenance & Furnishing of Master File**
  - Requires aggregate information, relevant for all MNE group members, regarding global business operations & TP policies.
  - To be delivered by MNEs directly to local tax administrations.

- **Master File**
  - Standardised information for all MNE group members.
  - To be filed in the tax residence jurisdiction of ultimate parent entity.

- **Local File**
  - Transactional info specific to each country, in detail, covering related party transactions.
  - To be delivered by MNEs directly to local tax administrations.

- **CBC Report**
  - Information relating to global allocation of MNE’s income & taxes, paid, & indicators of location of eco. activity within the MNE group.
  - Requires aggregate information w.r.t. amount of revenue, P&L before income-tax, amount of income-tax paid, no. of employees, nature of each constituent entity etc.

**ANTI AVOIDANCE MEASURES**

8.7

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**BEPS Action Plan 15 Developing a Multilateral Instrument (MLI)**

<table>
<thead>
<tr>
<th>BEPS Report</th>
<th>Entry into Force of MLI</th>
</tr>
</thead>
<tbody>
<tr>
<td>The MLI helps fight against BEPS by implementing tax treaty-related measures developed through the BEPS Project in existing bilateral treaties in a synchronized and efficient manner to –</td>
<td>➢ The Multilateral Convention to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (BEPS) was signed by India at Paris, France on 7th June, 2017.</td>
</tr>
<tr>
<td>• prevent treaty abuse,</td>
<td>➢ India had ratified the said Convention and had deposited the instrument of ratification along-with the list of Covered Tax Agreements, reservations and notifications (India’s Position under the said Convention) to the Depositary on 25th June, 2019.</td>
</tr>
<tr>
<td>• improve dispute resolution</td>
<td>➢ The date of entry into force of the said Convention for India is 1st October, 2019, being the first day of the month following the expiry of a period of three calendar months beginning on 25th June, 2019, being the date of deposit by India of the instrument of ratification.</td>
</tr>
<tr>
<td>• prevent the artificial avoidance of PE status</td>
<td>➢ The earliest date when the provisions of this Convention can take effect in India is 1st April, 2020 (six months from 1st October, 2019, the date of entry into force for India).</td>
</tr>
<tr>
<td>• neutralize the effects of hybrid mismatch arrangements.</td>
<td></td>
</tr>
</tbody>
</table>

The MLI is flexible instrument which modifies tax treaties that are “Covered Tax Agreements”. A Covered Tax Agreement is an agreement for the avoidance of double taxation that is in force between Parties to the MLI and for which both Parties have made a notification that they wish to modify the agreement using the MLI.