After studying this chapter, you would be able to -

- gain a broad understanding of the concept of Base Erosion and Profit Shifting (BEPS);
- appreciate the significance of action plans of BEPS;
- comprehend and appreciate the provisions incorporated in the Indian tax laws in line with the different Action Plans of BEPS.
7.1 BACKGROUND

Impact of Globalisation

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

Growth of E-Commerce and consequent aggressive tax planning

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

Adverse Effects of BEPS

Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits ‘disappear’ for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid. This has become a critical issue since governments have to cope with less revenue and a higher cost to ensure compliance. Moreover, BEPS undermines the integrity of the tax system, as reporting of low corporate taxes is considered to be unfair. In developing countries, the lack of tax revenue leads to significant under-funding of public investment that could help foster economic growth. Further, when tax laws permit businesses to reduce their tax burden by shifting their income away from jurisdictions where income producing activities are conducted,
other taxpayers, especially individual taxpayers in that jurisdiction bear a greater share of the burden. This gives rise to tax fairness issues on account of individuals having to bear a higher tax burden. Also, enterprises that operate only in domestic markets, including family-owned businesses or new innovative businesses, may have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax. Fair competition is harmed by the distortions induced by BEPS.

Need for international collaboration to protect tax sovereignty of its countries

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

8.2 OVERVIEW OF BEPS

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

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

(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

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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>Action 5 - 1st component</td>
<td>Action 7</td>
<td>Action 2</td>
<td>Action 11</td>
</tr>
<tr>
<td>Preferential tax regimes</td>
<td>Prevent the artificial avoidance of PE status</td>
<td>Neutralise the effects of hybrid mismatch arrangements</td>
<td>Data analysis</td>
</tr>
<tr>
<td>Action 5 - 2nd component</td>
<td>Action 8-10</td>
<td>Action 3</td>
<td>Action 15</td>
</tr>
<tr>
<td>Exchange of information on tax rulings</td>
<td>Aligning transfer pricing outcomes with value creation: Intangibles; Risk and capital; and Other high-risk transactions</td>
<td>Strengthen CFC rules</td>
<td>Multilateral instrument</td>
</tr>
<tr>
<td>Action 6</td>
<td>Action 12</td>
<td>Action 4</td>
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<tr>
<td>Prevent treaty abuse</td>
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<td>Action 13</td>
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<td>Re-examine transfer pricing documentation</td>
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<td>Action 14</td>
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<tr>
<td>Dispute resolution</td>
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</tbody>
</table>

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.

(1) **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." 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.

**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>
</tr>
</thead>
<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.
(2) 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 -

- Creation of two deductions for a single borrowal
- Generation of deductions without corresponding income inclusions
- Misuse of foreign tax credit
- Participation exemption regimes

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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.

Recommended general amendments are as follows:

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

  **Example**
  Let us say, X Co., a parent company in country X indirectly holds Y Co., an operating company in country Y. Between X Co. and Y Co. is a hybrid entity that is treated as transparent or disregarded for country X tax purposes and as non-transparent for country Y tax purposes. X Co. holds all or almost all equity interest in the hybrid entity which in turn holds all or almost all equity interests in Y Co. The hybrid entity borrows money from a third party and the loan is used to invest equity into Y Co (or to buy the shares in Y Co from either another company of the same group or from an unrelated third party). The hybrid entity pays interest on the loan. Except for the interest, the hybrid entity does not claim any other significant deduction and does not have any significant income.
  
  With respect to Country Y, for tax purposes, Hybrid Entity is subject to corporate income tax. Its interest expenses can be used to offset other country Y group companies’ income under the country Y group tax relief regime. On the other hand, country X treats the hybrid entity as transparent or disregarded, with the result that its interest expenses are allocated to X Co, which deducts the interest expense to offset unrelated income. The net effect is that there are two deductions for the same contractual obligation in two different countries. Therefore, by virtue of rule denying transparency to an entity which is treated as opaque in the subsidiary company’s country, the double deduction can be avoided.

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

  **Example**
  N Co, a company resident in country N is funded by M Co., a company resident in country M with an instrument that qualifies as equity in country M but as debt in country N. A payment made under the instrument would be deductible as interest expense for N Co under country N tax law. The corresponding receipts are treated as exempt dividends under the tax laws of country M. Consequently, deduction is available under the tax laws of country N without a corresponding income inclusion in country M.
  
  Therefore, by virtue of rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer, exemption of such income in country M would not be possible.
• A rule denying a foreign tax credit for withholding tax where that tax is also credited to some other entity; and

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

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

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

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

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

*Treatment of Branch mismatches: 2017 Report*

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. 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.

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.

(3) 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.
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.

(4) 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:

- **A Fixed Ratio Rule**: Based on a benchmark net interest/EBITDA ratio
- **A Group Ratio Rule**: This rule allows an entity to deduct more interest expense based on the position of its worldwide group.
- **Targeted Rules**: These Rules address specific risks
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.

(5) 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.
Indian Taxation Regime

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

**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.

(6) **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.

**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.

### (7) 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.

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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.

**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].
(8) 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.

<table>
<thead>
<tr>
<th>Action Plan</th>
<th>Details</th>
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<tbody>
<tr>
<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>
</tr>
<tr>
<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>
</tr>
<tr>
<td>10</td>
<td>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.</td>
</tr>
</tbody>
</table>

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.

(9) 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.
Royalties received by entities located in these low-tax countries accounted for 3% of total royalties. This provides evidence of the existence of BEPS, though not a direct measurement of the scale of BEPS.

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

(10) 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.

(11) 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:

<table>
<thead>
<tr>
<th>Document</th>
<th>Information</th>
</tr>
</thead>
<tbody>
<tr>
<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>
</tr>
<tr>
<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>
</tr>
<tr>
<td>(3) Country-by-country report</td>
<td>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: a) Multilateral Convention on Administrative Assistance in Tax Matters; b) Bilateral tax conventions; and c) Tax Information Exchange Agreements (TIEAs).</td>
</tr>
</tbody>
</table>
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.

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.

Note – Refer to Chapter 1 Transfer Pricing, wherein the following have been discussed at length -

(i) Elements relating to CbC reporting requirement and related matters which have been incorporated in section 286 of the Income-tax Act, 1961
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 current international consensus is for a threshold of € 750 million equivalent in local currency. This 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.

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

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

(13) ACTION PLAN 15 – DEVELOPING A MULTILATERAL INSTRUMENT

MLI’s role in tackling 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.

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.

**Formation of ad hoc Group to develop MLI**

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.

**Signatories to the MLI**

Once drafted, the said document was thereafter kept open for signatures from 31 December 2016. 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.

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.

**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.

**Amendment of MLI position**

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.

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**Indian Taxation Regime**

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](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)\(^1\).

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\(^1\) 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.

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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](http://www.oecd.org/tax/beps/beps-actions.htm)
## 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</td>
<td>“Significant economic presence” (SEP) to constitute “business connection”</td>
</tr>
<tr>
<td>ii</td>
<td>“Significant economic presence” (SEP) to constitute “business connection”</td>
</tr>
<tr>
<td>iii</td>
<td>“Significant economic presence” (SEP) to constitute “business connection”</td>
</tr>
<tr>
<td>iv</td>
<td>“Significant economic presence” (SEP) to constitute “business connection”</td>
</tr>
</tbody>
</table>

#### 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.

#### 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.

### 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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2 Rules in this regard are yet to be notified.

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### BEPS Action Plan 3: Strengthen CFC rules

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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.**

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

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>
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<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>
<td>Sec 94B – Limitation of interest deduction [based on Fixed Ratio Rule]</td>
</tr>
</tbody>
</table>

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

**Sec 94B – Limitation of interest deduction [based on Fixed Ratio Rule]**

- Is the borrower an IndCo or a PE of a Foreign Co?
  - Yes
  - Sec 94B would not apply
  - No

- Is the borrower a bank or Ins. Co.?
  - Yes
  - No

- Does the interest paid to NR AE exceed Rs.1 crore?
  - Yes
  - Excess Interest not allowable as deduction
  - 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

*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

|---------------------------|----------------------------------------------------|
| 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&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 & D activities are undertaken instead of the jurisdiction of legal ownership. | Sec 115BBF of the Income-tax Act, 1961 – Tax on income from patent  
Where the Total Income of the eligible assessee includes any income by way of royalty in respect of a patent developed & registered in India, then, such royalty is taxable@ 10% (plus applicable surcharge & cess). |

#### Applicability of concessional rate of 10% u/s 115BBF

- **Assessee should be a person resident in India, who is a patentee**
- **Income must be from a patent developed & registered in India**
- **Option for taxation of income u/s 115BBF to be exercised by assessee on or before due date u/s 139(1) for filing ROI**

#### Meaning of developed

- **The invention should be one for which patent is granted under the Patents Act, 1970**
- **At least 75% of the expenditure for such invention must be incurred in India**
Given the risk to revenues posed by treaty shopping, countries have committed to ensure a minimum level of protection against treaty shopping 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

<table>
<thead>
<tr>
<th>OECD Minimum Standard</th>
<th>LoB clause incorporated in Indian Tax Treaties</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>LoB clause in India-Mauritius Tax Treaty</strong></td>
<td>• On 10.5.2016, the India-Mauritius tax treaty was amended and 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.</td>
</tr>
<tr>
<td>• The tax rate on such capital gains arising from 1.4.2017-31.3.2019 should, however, not exceed 50% of the applicable tax rate on capital gains in India.</td>
<td></td>
</tr>
<tr>
<td>• LOB Clause 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.</td>
<td></td>
</tr>
<tr>
<td>• A shell or a conduit Co. claiming to be a resident of a Contracting State shall not be entitled to this benefit.</td>
<td></td>
</tr>
<tr>
<td>• A shell or conduit Co. is 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.</td>
<td></td>
</tr>
</tbody>
</table>

**LoB clause in India-Singapore Tax Treaty**

• The India-Singapore tax treaty has been amended to provide that 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.
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>By way of Commissionaire Arrangements</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>By way of Fragmentation of business activities</td>
<td>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-</td>
</tr>
<tr>
<td>Modification of Article 5(5) to include a person who habitually plays a principal role leading to conclusion of contracts in the definition of agent</td>
<td>(i) in the name of the NR; or (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 (iii) for provision of services by that NR</td>
</tr>
<tr>
<td>Introduction of anti-fragmentation Rule to prevent fragmentation of functions which are otherwise a whole activity to avail benefit of exemption</td>
<td></td>
</tr>
</tbody>
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Upto A.Y.2018-19 From A.Y.2019-20
### BEPS Action Plan 13  Re-examine transfer pricing (TP) documentation

#### OECD Minimum Standard

- **Standardised approach to TP documentation**
  - **Master File**: Standardised information relevant for all MNE group members regarding global business operations & TP policies; To be delivered by MNEs directly to local tax administrations.
  - **Local File**: Transactional info specific to each country in detail covering related party transactions; To be filed in the tax residence jurisdiction of ultimate parent entity.
  - **CBC Report**: Information relating to global allocation of MNE’s income & taxes paid; & indicators of the location of the eco. activity within the MNE group.

#### Provisions incorporated in the Income-tax Act, 1961

- **Provisions in the IT, Act, 1961**
  - **Section 92D**: Maintenance & Furnishing of Master File; requires aggregate information w.r.t. amount of revenue, P&L before income-tax, amount of income-tax paid and accrued, stated capital, no. of employees, nature and detail of main business activity of each constituent entity etc.
  - **Section 286**: CBC Reporting requirement and related matters; maintenance of prescribed information and documents.

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<table>
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<tr>
<th>BEPS Report</th>
<th>Entry into Force of MLI</th>
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</table>
| 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 –  
  - prevent treaty abuse,  
  - improve dispute resolution  
  - prevent the artificial avoidance of PE status  
  - neutralize the effects of hybrid mismatch arrangements.  
  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. | ➢ 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 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) |
EXERCISE

Question 1

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

Answer

Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits ‘disappear’ for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid.

Adverse Effects of BEPS:

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

Question 2

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

Answer

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

1. Modifying the existing Permanent Establishment (PE) rule to provide that whether an enterprise engaged in fully de-materialized digital activities would constitute a PE, if it maintained a significant digital presence in another country’s economy.
2. A virtual fixed place of business PE in the concept of PE i.e., creation of a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website.
(3) Imposition of a final withholding tax on certain payments for digital goods or services provided by a foreign e-commerce provider or imposition of an equalisation levy on consideration for certain digital transactions received by a non-resident from a resident or from a non-resident having permanent establishment in other contracting state.

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

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

**Meaning of “Specified Service”:**

(1) Online advertisement;

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

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

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

**Note:** 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. However, Rules in this regard are yet to be notified

**Question 3**

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

**Answer**

In line with the recommendations of OECD BEPS Action Plan 4, 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.

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

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

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

**Question 4**

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

**Answer**

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

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

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

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

**Question 5**

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

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

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

Question 6

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

Answer

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

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