Base Erosion and Profit Shifting: Literature Review, India Perspective and OECD's focus on Action Plans

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Base Erosion and Profit Shifting (BEPS) Action Plan: Introduction

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

The OECD's Action Plan on BEPS was published in July 2013 with a view to addressing perceived flaws in international tax rules. The 40-page Action Plan, which was negotiated and drafted with the active participation of its member states, contained 15 separate action points or work streams, some of which were further split into specific actions or outputs. The Plan was squarely focused on addressing these issues in a coordinated, comprehensive manner, and was endorsed by G20 leaders and finance ministers at their summit in St. Petersburg in September 2013.

The BEPS Project had been initiated by the G20 countries but it effectively also encompassed the other OECD Member States from the outset. As the project progressed, engagement in the discussions was extended to other large non-OECD states and representatives of developing countries. The OECD published over 1600 pages in the 'final' reports in relation to all 15 BEPS Action items in October 2015. The UN, IMF, World Bank and OECD are developing toolkits to assist "lowest income countries" in implementing the outcomes of the BEPS Project, so far as they are relevant to those countries or to address related issues. A framework has been agreed for all countries to participate in further BEPS work on an equal footing, , broadly if they commit to implementing the minimum standards

Need for Base Erosion Profit Shifting Action plan- 'BEPS'

One of Fortune 500 US based company

With 4% employees and 1% customers- Ireland contributes to 64% to US based Company's Profit

	Pre-tax Income ($b)	Pre-tax contribution %	Employee Nos. %	Customers %	Effective Tax Rate
US	10.20	30%	67%	39%	46%
Ireland	***22.00***	***64%***	***4%***	***1%***	***0.06%***
Others	2.00	6%	29%	60%	29%

Four key factors to define a "tax haven":
a) No or nominal tax on relevant income
b) Lack of effective exchange of information
c) Lack of transparency
d) No substantial activities

"BEPS arises because under the existing rules MNEs are often able to artificially separate the allocation of their taxable profits from the jurisdictions in which these profits arise.

This can result in income going untaxed anywhere, and significantly reduces the corporate income tax paid by MNEs in the jurisdictions where they operate, thus affecting competition, distorting investment decisions and reducing overall trust in the tax system" – OECD Webinar

OECD BEPS Action Plan – In a nutshell

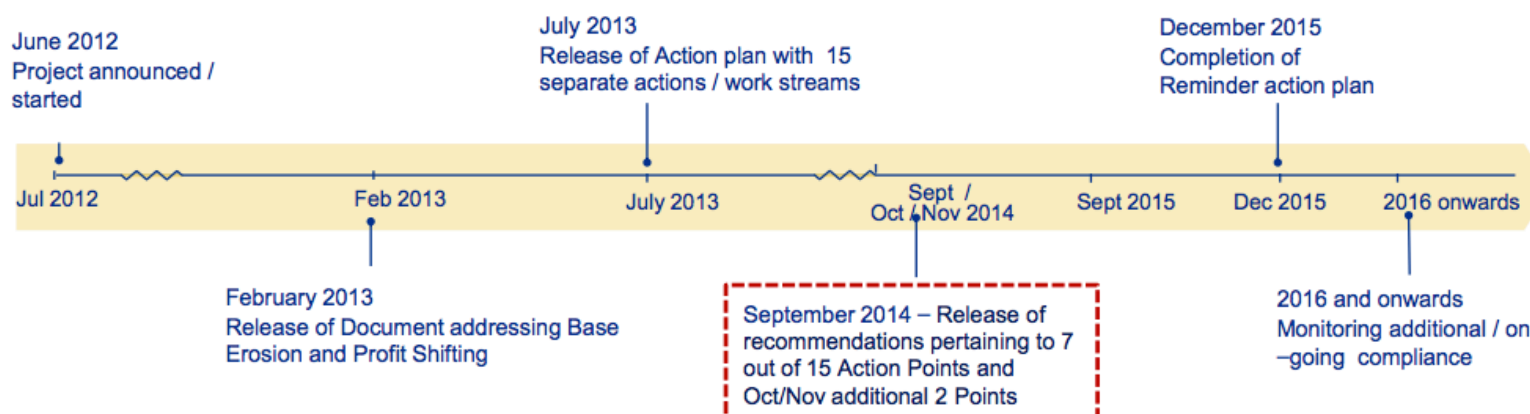
A group of twenty- 'G20' countries realized the need of preventing BESP and approached OECD to address the issue related to BEPS.

- On 19 July 2013, the OECD released an Action Plan on Base Erosion and Profit Shifting (BEPS) which was presented to the meeting of G20 Finance Ministers in Moscow.
- The purpose of the Action Plan is "to prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from activities that generate it."

The report indicates that "no or low taxation is not per se a cause for concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it."

The Action Plan covers 15 specific Actions which are broadly to be achieved within a two-year time frame (i.e. by the end of 2015). September / October / November 2014, OECD released various recommendations for 9 out of 15 Action Points.

OECD BEPS Action Plan – Timeline



Key highlights

The 15 BEPS Actions is intended to equip governments with consistent domestic and international instruments to address tax avoidance and ensure that profits are taxed where economic activities generating the profits are performed and where value is created. Highlights of some of the key action points are as follows:

• **Digital economy:** the concept of permanent establishment is proposed to be widened by modifying the exceptions to permanent establishment to ensure that they are available only for activities that are preparatory or auxiliary in nature. Coverage of income from digital sales under CFC is also expected and the collection of VAT/ GST on cross-border B2C transactions will be on a destination principle basis.

• **Hybrid mismatch arrangements**: where differences in the tax treatment of an entity/ instrument under the tax laws of two or more jurisdictions to achieve double non-taxation are intended, the basic approach recommended is to disallow the expense, with a secondary rule to tax the income, where the payer country does not counter the deduction. These recommendations will neutralize hybrid mismatches, by putting an end to multiple deductions for a single expense, deductions without corresponding taxation or the generation of multiple foreign tax credits for one amount of foreign tax paid.

• **Interest deductions and financial payments**: recommends that countries should limit interest deductions to a fixed percentage of earnings before interest, tax and depreciation (EBITDA). The cap should be in the range 10-30%. Countries may optionally offer a fallback to a group-wide ratio of third party net interest expense, should this be higher.

• **Treaty Abuse**: recommends countries to include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping. It has also recognized that some flexibility in the implementation of the minimum standard is required as these provisions need to

be adapted to each country's specificities and to the circumstances of the negotiation of bilateral conventions. A specific anti-abuse rule, the limitation-on-benefits (LOB) rule that limits the availability of treaty benefits to entities that meet certain conditions will be included in the OECD Model Tax Convention. In other cases which would not be covered by the LOB rule described above, a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or "PPT" rule) will be included.

• **Permanent Establishment**: the proposal redefines the term 'permanent establishment' and includes recommendations to address commissionaire arrangements With change in the definition of permanent establishment, arguments previously taken by taxpayers in not having a taxable presence within a commissionaire arrangement will be disregarded unless it is proved that activities are performed in the course of independent business. Moreover, in conclusion of contracts, the PE definition has been widened.

• **Transfer pricing on value creation**: The final reports provide guidance to ensure that transfer pricing outcomes are in line with value creation in relation to intangibles, including hard-to-value ones, to risks and capital, and to other high-risk transactions. The aim is to evaluate whether "transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them." For intangibles, the guidance clarifies that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. This implies that entities must be able to control the risks that give rise to potential rewards and the group companies performing important functions, controlling economically significant risks and contributing assets, will be entitled to an appropriate return reflecting the value of their contributions. The report also adds that "capital-rich entities without any other relevant economic activities ("cash boxes") will not be entitled to any excess profits", which includes interest. Further, as part of the Report, a mandate is included for follow-up work to be done on the transactional profit split method, which will be carried out during 2016 and finalized in the first half of 2017.

• **Transfer pricing documentation**: a significant development is reorganizing transfer pricing documentation across participating countries to enhance transparency while taking into consideration compliance costs. The final deliverable contains guidance on the transfer pricing documentation (master file and local file) and Country-by-Country (CbC) report. The deliverable provides a fixed CbC template with very clear guidance on its use. Authorities are intended to receive the benefit of additional information for risk assessment, provided they have a double tax treaty or a tax information exchange agreement with the parent company country – or both have signed the multilateral Convention on Mutual Administrative Assistance in Tax Matters.

Coherence

Harmful or inappropriate use of international tax legislation to obtain unintended tax benefits

Action 2
Hybrids

Action 3
CFC rules

Action 4
Interest deductions

Action 5
Harmful tax practices

Substance

Mismatches where profits are being taxed vs. where people responsible for generating these profits are located

Action 6
Treaty abuse

Action 7
Permanent establishment status

Actions 8-10
Transfer pricing

Transparency

Provide tax authorities information to carry out audits better and determine if "fair share" of taxes are being paid

Action 11
BEPS data analysis

Action 12
Disclosure of aggressive tax planning

Action 13
Transfer pricing documentation

Action 14
Dispute resolution

Horizontal actions

Action 1
Digital economy

Action 15
Multilateral instrument

India perspective and area of impact

As a member of the G20 and an active participant in the BEPS project, India is committed to its outcome. Indian authorities believe that structural changes and mechanisms may need to be adopted as the BEPS project outcome will result in an increased flow of information and exchange of information under treaties. While confidentiality is important, an objective from the Indian perspective is to ensure that relevant information is shared under the exchange of information mechanism. India also believes that mandatory and binding arbitration in tax disputes is not acceptable and should remain as an option. For the BEPS actions to be implemented consistently, the multinational Instrument is a practical way to address treaty related measures.

In relation to the actions itself, some key transactions that may be affected from an Indian perspective include digital transactions, holding structures, permanent establishment (taxable presence) and funding transactions/ structures amongst others.

As regards the prevention of treaty abuse, India has already introduced in its domestic law the consolidated rules in the form of General Anti Avoidance Rule (GAAR) as a measure to address treaty shopping and other forms of treaty abuse by shell companies which is likely to be implemented from 2017. Also, with the proposed change in the definition of PE under BEPS, Indian taxation norms are going to be impacted and existing treaties may have to be renegotiated accordingly. It would be essential to provide greater certainty regarding the constitution of the PE and determining the profits attributable to a PE.

The Indian view on marketing intangibles has largely developed on the basis of judicial precedents. Reviewing and aligning with BEPS guidance may pose challenges. Further, the BEPS proposals on the treatment of assigning profits where value creating activities are undertaken, will have to be aligned with India specific guidance on this matter.

The Indian transfer pricing regulations presently do not provide for maintenance of information contained in the master file and CbC template. Rules may need to be framed to accommodate these and avoid duplicity with domestic compliance norms. To collate the required information, taxpayers, particularly outbound businesses would need to put in place a robust information tracking and collection system, leading to an increase in their transfer pricing compliance efforts. As a consequence, the larger companies may be required to consider technology solutions to collect, store, analyse, and prepare the CbC template and master file. Further, while the timelines of this guidance being implemented in India is still awaited, considering the OECD proposed timelines on CbC reporting, companies may need to take this on priority.

India Focus on BEPS – Base Erosion & Profit Shifting

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

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

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

OECD's Focus on Action Plans

Addressing the tax challenges of the digital economy

The focus of Action 1 is on identifying the main difficulties in applying the current international tax rules to the digital economy and to develop detailed options to address these difficulties. The action involves examination of the following:

1. The potential for a digital presence in a country without creation of taxable nexus
2. The attribution of value created from the generation of marketable location-relevant data through the use of digital products and services
3. The characterization and sourcing of income from new business models
4. How to ensure the effective collection of VAT/GST with respect to cross-border digital delivery

Neutralizing the effects of hybrid mismatch arrangements

The focus of Action 2 is on developing model treaty provisions and recommendations on the design of domestic rules to neutralize the effect of hybrid instruments and entities. This includes:

1. Changes to the OECD Model Tax Convention to ensure that such hybrids are not used to obtain treaty benefits inappropriately
2. Domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer
3. Domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient
4. Domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction

5. Guidance on coordination or tie-breaker rules

Designing effective controlled foreign company (CFC) rules

The focus of Action 3 is on developing recommendations regarding the design of controlled foreign company (CFC) rules, coordinated with the work on other Actions.

The OECD BEPS Action Plan states that CFC rules can address BEPS by addressing the routing of income of a resident enterprise through a non-resident affiliate. It further states that CFC rules also have a positive spillover effect in source countries by lessening any incentive to shift profits into a third, low-tax jurisdiction.

Limiting base erosion involving interest deductions and other financial payments

The focus of Action 4 is on developing recommendations regarding best practices in the design of rules to prevent BEPS through the use of interest expense and other economically-equivalent financial payments.

Transfer pricing guidance also is to be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives, and captive and other insurance arrangements.

Countering harmful tax practices more effectively, taking into account transparency and substance

The focus of Action 5 is on refocusing the OECD's work on harmful tax practices, with a priority on improving transparency and on requiring substantial activity for any preferential regime. This work is also to include a focus on compulsory spontaneous exchange of information on rulings related to preferential regimes.

Preventing the artificial avoidance of permanent establishment status

The focus of Action 6 is on developing changes to the OECD Model Tax Convention and recommendations for domestic law measures to counter the granting of treaty benefits in 'inappropriate circumstances' and other potential treaty abuse situations, and identifying the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. Action 6 report includes a number of changes to the OECD Model Convention and its Commentary, as well as the introduction of a minimum level of protection against treaty abuse.

Preventing the artificial avoidance of permanent establishment status

The focus of Action 7 is on developing changes to the OECD Model Tax Convention on the definition of permanent establishment (PE) to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and under the exceptions for preparatory or auxiliary activities.

Aligning transfer pricing outcomes with value creation

Action 8 (Intangibles)

Action 9 (Risks and capital)

Action 10 (Other high-risk transactions)

The focus of Action 8 is on developing changes to the OECD Transfer Pricing Guidelines to prevent BEPS by moving intangibles among group members. This is to involve:

1. Adopting a broad, clear definition of intangibles
2. Ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in line with value creation
3. Developing rules for transfers of hard-to-value intangibles
4. Updating guidance on cost contribution arrangements

The focus of Action 9 is on developing changes to the OECD Transfer Pricing Guidelines to prevent BEPS by transferring risks among, or allocation of excessive capital to, group members. The changes are to ensure that "inappropriate returns" will not accrue to an entity solely because it has contractually assumed risks or has provided capital and will require the alignment of returns with "value creation."

The focus of Action 10 is on developing changes to the OECD Transfer Pricing Guidelines to prevent BEPS involving transactions which would not (or would only very rarely) occur between third parties. This is to involve:

1. Adopting rules to clarify the circumstances in which transactions can be recharacterized
2. Clarifying the application of transfer pricing methods (profit splits in particular) in the global value chain context
3. Providing protection against common types of base-eroding payments such as management fees and head office expenses

Measuring and monitoring BEPS

The focus of Action 11 is on developing recommendations on indicators of the scale and economic impact of BEPS and to ensure that tools are available to evaluate the effectiveness and economic impact of actions taken to address BEPS on an ongoing basis. This work is to take into consideration the need to respect taxpayer confidentiality and the cost for both tax administrations and businesses.

Mandatory disclosure rules

The focus of Action 12 is on developing recommendations on the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into account the costs for tax administrations and businesses and drawing on experiences of countries that have such rules in place. The work is to use a "modular design" allowing for consistency and for country-specific needs and risks. In addition, the work is to be coordinated with work on cooperative compliance and will involve the design and implementation of enhanced information sharing models for tax administrations.

Transfer pricing documentation and country-by-country reporting

The focus of Action 13 is on developing rules on transfer pricing documentation to enhance transparency for tax administrations, taking into account the compliance costs for business. The

work is to include a template for MNCs to report information on their global allocation of income economic activity and taxes paid among countries.

Making dispute resolution mechanisms more effective

The focus of Action 14 is on developing changes to the OECD Model Tax Convention to address obstacles that prevent countries from solving treaty-related disputes under the mutual agreement procedure (MAP), including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.

Developing a multilateral instrument to modify bilateral tax treaties

The focus of Action 15 is on analyzing the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions to implement measures developed in the OECD's work on BEPS and to amend bilateral tax treaties.

Conclusion

For successful implementation of the BEPS project, simultaneous actions and coherence amongst countries is vital. Inaction on their part could lead to the emergence of competing sets of international rules, which could result in “global chaos’’ marked by massive unrelieved double taxation. ‘Consensus’ has been and continues to be one of the significant concerns relating to implementation of the BEPS outcomes.

However, steadily, a larger number of countries are seeing the need for implementing the BEPS outcomes, and are demonstrating their willingness to adopt them. Of late, more and more countries have been seen to be implementing at least the minimum standards and particularly Action 13 (TP documentation, including CbCR).

Where required, OECD as well as regional and international organizations are also lending a strong helping hand in implementation of these measures. As far as India in concerned, apart from announcements in its upcoming Budget 2016, subordinate legislation by way of administrative circulars, notifications, and rules is also anticipated. It is hoped that in bringing in these amendments, the Government will take (as it has in the recent past) a consultative approach with stakeholders, and also be sensitive to a general grievance of many stakeholders that BEPS counter measures are currently lop sided in favor of the Revenue.

For an emerging economy such as India, it is extremely important to balance implementation of BEPS measures while continuing to be an alluring investment destination, as well as attract the much-needed foreign capital, and ensure ease of doing business. A cautious and calibrated implementation approach will help the country to remain competitive.

On the one hand, while the Government will face the challenge of striking the right balance, MNCs, on the other hand, may need to rethink their tax strategies. They will also have to evaluate their state of preparedness and make alterations, if required, in their tax policies and corresponding processes to ensure that they are BEPS-compliant. These are undoubtedly exciting times, as countries stand at the brink of a new world tax order, with several changes, modifications and amendments on the cards. It will be interesting to see how the next few months span out!

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