

# B.E.P.S.

## Base Erosion Profit Shifting



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## **1. INTRODUCTION**

Base erosion and profit shifting (BEPS) is a tax avoidance strategy used by multinational companies, wherein profits are shifted from jurisdictions those are highly taxed to jurisdictions that have low (or no) taxes (including tax havens).

## **2. BACKGROUND**

In 2013, OECD and G20 Countries governments' embarked on the most significant re-write of the international tax rules in the century.

The BEPS Project ambitiously launched during the severest financial and economic crisis of our lifetime will:

- revise the rules to align them to developments in the world economy;
- ensure that profits are taxed where economic activities are carried out by creating value.

## **3. WHAT WILL BEPS DO?**

BEPS will ensure that profits are taxed where economic activities generating the profits are performed and where value is created by setting out 15 Action Plans with domestic and international instruments to address tax avoidance.

## **4. ACTION PLANS IN BRIEF**

The Action Plans on Base Erosion and Profit Shifting identified 15 specific actions to ensure international tax rules are fit for an increasingly globalized & digitalized business world and to deter international taxpayers from unfairly organizing their business arrangements in order to minimize their tax bills.

The Action Plans call for fundamental changes to the current mechanisms of the existing Tax treaties and the adoption of consensus-based approach, in order to prevent and counter base erosion and profit shifting.

## Action 1:- Address the tax challenges of the digital economy

### Framework

To identify the difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties. This will be done by taking a holistic approach and considering both direct and indirect taxation.

The Task Force on the Digital Economy (“*TFDE*” subsidiary body of the OECD Committee on Fiscal Affairs) determined that the digital economy is increasingly becoming an economy by itself. Also an attempt to ring-fence the digital economy from the rest of the economy for tax purposes would not be practical.

### Recommendation

The *TFDE* discussed and analyzed a number of potential options to address challenges of digital economy and thus concluded by introducing:-

- A new nexus in the form of a significant economic presence,
- A withholding tax on certain types of digital transactions, and
- An equalization levy.

### Indian Taxation Regime

In order to address the challenges of the digital economy, Chapter VIII of the Finance Act, 2016 (India) title “Equalization Levy” provides for an equalisation levy of 6% of the amount of consideration for “specified services” received or receivable by non-resident not having permanent establishment in India from a resident in India subject to certain threshold.

## Action 2:- Neutralising the Effects of Hybrid Mismatch Arrangements

### Framework

Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or an instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long term deferral. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness.

### Recommendation

The aim is to prevent double non-taxation through interaction of domestic and treaty rules by eliminating tax benefits of mismatches and multiple deductions. This is done by not giving effect to corresponding taxation and multiple tax credits.

## Action 3:- Controlled foreign company rules (CFC)

### Framework

CFC rules generally apply to foreign companies that are controlled by shareholders in the parent jurisdictions.

The goal is of CFC regulation is to avoid the loss of tax revenue because of domestic companies allocating their profits to companies resident in low tax countries or tax havens.

### Recommendation

The recommendation made in the OECD report deals with effective implementation of CFC rules to prevent taxpayers from shifting profits to foreign subsidiaries. While implementing CFC rules, income from intellectual property, services and digital transactions will be specially treated. It recommends substantive reporting requirement for entities having CFCs.

## Action 4:- Interest deduction and other Financial Payments

### Framework

Multinational groups may achieve favorable tax results by adjusting the amount of debt in a group entity. The deductibility of interest expense can give rise to double non-taxation.

### Recommendation

To develop recommendations regarding best practices to design rules those prevent base erosion through the use of interest expense. For example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the exempt or deferred income, and other financial payments that are economically equivalent to interest payments.

### Indian Taxation Regime

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

## Action 5:- Countering Harmful Tax Practices

### Framework

The OECD produced a report in 1998 on “harmful tax practices” that has largely gathered dust since then. This revamped the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, including it's substantial activity by taking holistic approach. It will engage with non-

OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

## **Recommendation**

The report identifies factors for determining a potential harmful tax practice that results in low or no effective tax rate, lack of transparency, negotiable tax rate or base etc.

## **Indian Taxation Regime**

*Section 115BBF of the Income Tax Act, 1961 introduced Finance Act, 2016 (India) – In line with nexus approach of BEPS Action .*

If 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 10% (plus applicable surcharge and cess).

## **Action 6:- Preventing Treaty Abuse**

### **Framework**

Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created.

### **Recommendation**

Work will be undertaken :-

- to clarify that tax treaties, which will not be used to generate double non-taxation,
- to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

## **Indian Taxation Regime**

### **LoB clause introduced in India –Mauritius Tax Treaty**

On 10<sup>th</sup> May, 2016 India and Mauritius has signed a protocol amending the India-Mauritius tax treaty at Mauritius.

- Article 13 was amended to give India the right to charge tax on Capital Gain on transfer of Indian Share acquired on or after 1<sup>st</sup> April 2017.
- A Two year transition period upto 31<sup>st</sup> March 2019 is provided during which the Tax rate will be 50% of the prevailing tax rates, subject to an Limitation Of Benefits (LOB) Clauses.
- After 31<sup>st</sup> March 2019 Tax will be charged at full domestic tax rates.
- The shares acquired before 1<sup>st</sup> April 2017 are exempt from above amendment.
- Capital gain on derivates and fixed income securities will continued to be exempted
- The above amendment effectively nullifies the benefit earlier taken by other countries of taking Mauritius route for making investment in India
- Reason for amendment was, major investment was done from Mauritius in India because of this treaty.
- Interest on Debt Instrument: Article 11 was amended such that the interest arising in India and paid to a Mauritius resident will be taxed at 7.5% in India and Fees for Technical Service (FTS) paid from India would be taxed at 10% in India if the beneficial owner of FTS is a resident of Mauritius
- LOB requires the Mauritius resident to meet two test i.e.-
  - a. Main purpose test
  - b. Bonafide business test to avail 50% reduction in Tax rate
- As per Sec 56 of the Income Tax Act, if the Shares are transferred free of cost without any consideration the person receiving the shares is liable to pay tax. Earlier before the amendment the it was not taxable in India. But as per amendment in Article 22 it will be taxed under Other Income in the country of Source

### **LoB clause in India –Singapore Tax Treaty**

On similar lines, India and Singapore has signed a protocol amending the India- Singapore tax treaty.

- Amendment gives India the right to charge tax on Capital Gain on transfer of Indian Share acquired on or after 1st April 2017

- A Two year transition period upto 31st March 2019 is provided during which the Tax rate will be 50% of the prevailing tax rates, subject to an Limitation Of Benefits (LOB) Clauses
- After 31st March 2019 Tax will be charged at full domestic tax rates
- The shares acquired before 1st April 2017 are exempt from above amendment

## **Action 7:- Preventing the Artificial Avoidance of Permanent Establishment**

### **Framework**

Develop changes to the definition of PE to prevent the artificial avoidance of PE status, including through the use of commissionaire arrangements and the specific activity exemptions. Through such 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.

### **Recommendation**

The changes recommended in this report will restore taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates as result of the provisions of tax treaties.

## **Action 8, 9 and 10:- Assure that transfer pricing outcomes are in line with value creation**

### **Action 8:- Intangibles**

The Action plan focuses on transfer pricing issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting.

To develop rules to prevent BEPS by moving intangibles among group members.

## **Action 9 – Risks and capital**

The Action plan addresses 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. To develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members.

## **Action 10 – Other high-risk transactions**

The Action plan focuses on other high-risk areas including:-

- The scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises.
- 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 types 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 value creation.

To develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties.

## **Indian Taxation Regime**

The CBDT has notified a new safe harbour regime based on the report of the Committee set up in this regard which has come into effect from 01<sup>st</sup> April, 2017 (A.Y.2017-18) and shall continue to remain in force upto A.Y.19-20.

In these Rules, a new category of transactions being “Receipt of Low-Value – Adding Intra-Group Services” has been introduced and the mark upto 5% recommended by OECD has been adopted in safe harbor rules.

## Action 11:- Measuring and Monitoring BEPS

Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis.

## Action 12:- Disclosure of Aggressive Tax Planning Arrangements

### Framework

The lack of timely, comprehensive and relevant information on aggressive tax planning strategies is one of the main challenges faced by tax authorities worldwide.

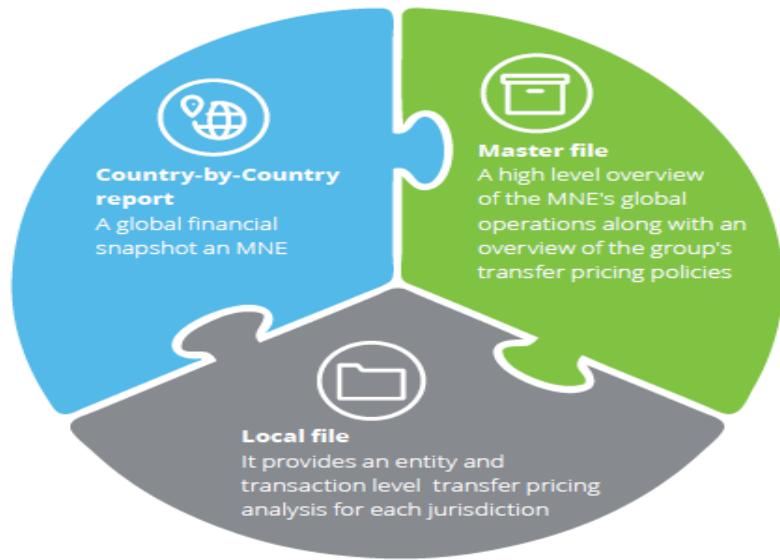
### Recommendation

Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses. It will also draw on experiences of the increasing number of countries that have such rules.

## Action 13:- Re-examine Transfer Pricing Documentation

### Framework

Action 13 of the Action Plan on Base Erosion and Profit Shifting requires the development of “rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business.



## **Recommendation**

The rules to be developed will include a requirement that Multi national enterprises provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.

## **Indian Taxation Regime**

For the purpose of implementing the international consensus , a specific reporting regime in respect of CbCr(Country by Country) reporting and also the Master File has been incorporated in the Income-tax Act,1961.The essential elements relating to CbCr(Country by Country) reporting requirements and related matters have been incorporated in the Income-tax Act,1961 (**New Section 286**)

## **Action 14:- Dispute Resolution**

## **Framework**

Eliminating opportunities for cross-border tax avoidance, tax evasion and the effective and efficient prevention of double taxation are critical to building an international tax system. This should support economic growth and a resilient global economy. Improving dispute resolution mechanisms is therefore an integral component of the work on BEPS issues.

## **Recommendation**

Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP (Mutual agreement procedure), including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.

### **Action 15:- Multilateral Instrument**

#### **Framework**

Quick implementation of tax treaty-related BEPS measures has been recognized. Amendment of thousands of bilateral tax treaties may be time-consuming and may not result in consistent implementation of BEPS measures which may result in the failure of the BEPS project.

#### **Recommendation**

Analyze the tax and public international law issues related to the development of a multilateral instrument by enabling co-operative jurisdictions in order to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.

## **5. HOW WILL BEPS AFFECT YOU AND YOUR BUSINESS?**

### **Areas Affected by BEPS Actions**

- **Impact on Consumer Business:** MNEs in consumer business sector especially companies engaged in FMCG, retail, ecommerce, travel, hospitality and leisure products are highly driven from client perceptions of their brands and products. MNEs engaged in consumer businesses need to review their business model viz. their investment holding structures, funding and operating arrangements from BEPS viewpoint.
- **Impact on Manufacturing:** The key potential impact of BEPS Actions for Indian MNEs in the manufacturing sector having global operations as well as to MNEs operating in India.

- **Impact on infrastructure funding structures:** Like many sectors, even infrastructure industry is anticipating millions or billions of additional tax due to BEPS action items. While most of the BEPS Action Plan is likely to impact infrastructure sector.
- **Impact on Technology, Media and Telecommunication:** Action Plan 1 talks about challenges in digital economy. India is the first country to introduce equalization levy under its domestic tax legislation based on the recommendations of the committee formed by the apex tax body. The move is targeted at foreign internet companies who earn substantial revenues from digital advertisement.
  - Foreign Internet companies like social media companies, internet search engines, media websites, e-commerce companies, apps and games developers who do not have any presence in India
  - Foreign broadcasting network companies who derive revenue from Indian companies for advertisement in television and radio.

## 6. EXPECTED IMPACT OF BEPS

The impact of BEPS is not confined to the tax department. As we move further into the implementation phase, the broader effect on the business will become apparent in the cost of financing, on the supply chain and on the increase in publically available information on the activities of multinational groups amongst other things.

## 7. SOME FAQ's AND WHAT WE CAN DO

### (i)FAQ's

#### 1) Has the BEPS Project delivered on its promise to put an end to double non-taxation?

Ans) The expectation is that once implemented, the measures restore taxation in a number of instances where income would otherwise go untaxed.

Depending on the planning structure used income will be taxed only once.

## **2) How will the BEPS measures be implemented?**

Ans) Some of the measures may be immediately applicable such as the revised guidance on transfer pricing. Other measures require changes to bilateral tax treaties, something that can be done via the multilateral instrument under Action 15. Finally, other measures require domestic law implementation.

## **3) What is the nature of the BEPS outputs? Are they legally binding?**

Ans) They are soft law legal instruments. They are not legally binding but there is an expectation that they will be implemented accordingly by countries that are part of the consensus.

## **4) Do the BEPS measures increase the risk of double taxation?**

Ans) The aim of the measures is to realign taxation with economic substance and value creation, while preventing double taxation. The BEPS package represents the first substantial renovation of the international tax rules in almost a century. As new rules always raise interpretation issues, Action 14 on improving dispute resolution is a key part of the BEPS Project.

## **5) Will MNEs have to restructure their business in light of the BEPS outputs?**

Ans) This should not be the case for groups whose legal and tax structures reflect the underlying economic reality.

## **6) Will SMEs be impacted by the BEPS measures?**

Ans) A number of measures have been crafted in a way that minimizes the impact on SMEs with negligible BEPS risks, e.g. the measures on interest deductibility can exclude companies with interest below a certain *de minimis* threshold, and the new Country-by-Country Reporting template does not apply to groups with annual consolidated

revenue in the immediately preceding fiscal year of less than EUR 750 million.

### **7) Will BEPS implementation be monitored?**

Ans) Yes. Monitoring will focus on what countries have done to implement the BEPS recommendations and the measurement of the impact of BEPS and the countermeasures thereof.

### **8) How will the success (or otherwise) of the BEPS Project be judged?**

Ans) There are many ways to define the success (or otherwise). The BEPS Project will also be a success if businesses do not have to comply with hundreds of different disclosure requirements or anti-avoidance measures and can therefore benefit from lower compliance costs.

#### **(ii) What we can do:-**

- a. *Familiarize with transactions with the new reporting requirements, and information required for compliance.*
- b. *Analyzing the transaction while you undertake specified services for the purpose of equalization levy.*
- c. *Filing the necessary forms for Country by Country Reporting and Master File*
- d. *Computing Taxes with regards to Royalty payments for Patent registered in India.*
- e. *Calculation of allowable interest expenditure on the loan provided to you by your associated enterprise*
- f. *Impact of amendments in the treaties on your transactions.*
- g. *Analyze whether current transfer pricing documentation meets the demands of the new two-tier structure.*
- h. *Advice and Opinion on BEPS Action plans on your business in the recent regime. Evaluate whether or not current transfer pricing policies are relevant and reflect the operational and economic realities of your business today – given that the enhanced transfer pricing reporting requirements associated with the OECD's proposals will likely give*

*individual tax administrations more information about a company's international structure and profit allocation.*

**Important Note:**

This communication is intended to provide a general introduction and guidance on the subject matter and should not be regarded as a basis for taking decisions on specific matters. In such instances, separate advice should be taken.

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