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The Chamber's Journal

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YOUR MONTHLY COMPANION ON TAX & ALLIED SUBJECTS

February - 2016 Vol . IV | No. 5

BEPS

Direct Taxes
Other Laws
International Taxation

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INDIRECT TAXES COMMITTEE

4th Residential Refresher Course on Service Tax held on 29th to 31st January, 2016 at Aamby Valley City.

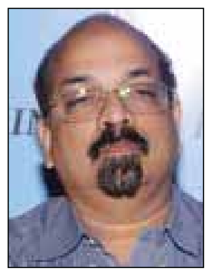
CA Avinash Lalwani, President delivering the opening remarks. Seen from L to R : S/Shri CA Atul Mehta, Convenor, CA A. R. Krishnan, Advisor, CA Rajiv Luthia, Chairman and CA Ashit Shah, Member.

CA Rajiv Luthia, Chairman welcoming the faculties and delegates. Seen from L to R : S/Shri CA Atul Mehta, Convenor, CA A. R. Krishnan, Advisor, CA Avinash Lalwani, President and CA Ashit Shah, Member.

CA Avinash Lalwani, President inaugurating the RRC by lighting the lamp. Seen from L to R: S/Shri CA Manish Gadia, Member, CA Rajiv Luthia, Chairman and CA Ashit Shah, Member.

Faculties

Mr. V. Raghuraman, Advocate



Mr. K. Vaitheesvaran, Advocate

CA Prashant Deshpande

Mr. L. Badrinarayan, Advocate

Group Photo

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Editorial

Richard Edmund Neal an American Democrat Politician representative for Massachuset's 1st congressional district said "It is easy to talk about tax simplification, and we all know it is very difficult to accomplish – but for the last 3 congresses, I have offered a tax simplification bill that would include a plea for repeal of alternative minimum tax". The Modi Government which is committed to improve 'ease for doing business' has appointed a committee to simplify the provisions of Income-tax Act, 1961 on 27th October, 2015. The terms of reference of the same are -

i. To study and identify the provisions/phrases in the Act which are leading to litigation due to different interpretations;

ii. To study and identify the provisions which are impacting the ease of doing business;

iii. To study and identify the areas and provisions of the Act for simplification in the light of existing jurisprudence;

iv. To suggest alternatives and modifications to the existing provisions and areas so identified to bring about predictability and certainty in tax laws without substantial impact on the tax base and revenue collection.

The committee headed by Justice R. V. Easwar former High Court Judge has long experience in the field of taxation as professional, being part of the judiciary as member of ITAT and judge of the Delhi High Court. The committee, in a very swift manner, within two months on 18th January, 2016 has made its report public in which it has made many constructive suggestions. We hope that on 29th February, 2016, the Finance Minister will consider the same while presenting the Finance Bill for the year 2016-17.

The Special Story of the present issue of the Chamber's Journal is 'Base Erosion on Profit Shifting'. In short, it is referred to as BEPS. Many senior professionals have contributed on various topics under this special story which is a futuristic topic. I hope this will help our members to equip themselves by the time BEPS becomes a reality.

I thank all the authors who have contributed to the Chamber's Journal, February 2016 issue for sparing their valuable time.

K. GOPAL
Editor

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The Chamber's Journal

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From the President

Dear Readers

I would like to begin by sharing a quote *"By asking questions intelligently you might be developing the wisdom of your team members"*. I was reading the speech of Dr. Raghuram Rajan, Governor – October 31, 2015 – Indian Institute of Technology, Delhi –Tolerance and Respect for Economic Progress, I would like to share one para from there. "Richard Feynman, a Nobel prize-winning physicist writes in his autobiography about how he found the atmosphere stultifying at the Institute of Advanced Studies at Princeton. Now, as you know, the Institute of Advanced Studies brings together some of the finest scholars in the world to ponder problems in a multi-disciplinary environment. ***Richard found the atmosphere sterile because there were no students to ask him questions, questions that would force him to rethink his beliefs and perhaps discover new theories. Ideas start with questioning and alternative viewpoints, sometimes seemingly silly ones. After all, Einstein built his theory of relativity pondering the somewhat wacky question of what someone travelling in a train at the speed of light would experience. So nothing should be excluded but everything should be subject to debate and constant testing. No one should be allowed to offer unquestioned pronouncements. Without this competition for ideas, we have stagnation."***

Current Issue is on BEPS. I must compliment CA Hinesh Doshi for creating a synopsis to provide excellent coverage to the Current subject of BEPS....................I am sure it will be very useful to our members as a reference material while dealing with matters related to International Taxation.

Committee updates

During the month, The ***Membership and Public Relations Committee*** under the chairmanship of CA Hemant Parab organised a Half Day Joint seminar with Vapi Industrial Association and Vapi Branch of ICAI at Valsad on Labour Law and Digital Smart use of Technology. It is the first ever seminar held By CTC with any Industrial Association. CTC must explore in future to do the joint seminars with other associations. Second meeting was organised under SAS "Eat Healthy, Live Healthy". It was attended by a good number of members.

The ***Student and IT Connect Committee*** under the chairmanship of CA Parimal Parikh had organized a Half Day Visit to National Stock Exchange. CTC got an amazing response and it was attended by 171 students and members. CA Kishore Pishori from Ulhasnagar had bought two buses full of students from CHM College to attend this programme. The Power of youth is hidden. The programme structured for students should reach to them so CTC brand name can spread among the future generations. The Second programme held was "Understanding Start up Investment". Prime Minister Shri Narendra Modi has announced "START UP INDIA" Scheme on 15-1-2016. In my view CTC was the first association to organize a START UP Workshop. I must appreciate the vision of Vice Chairman CA Dinesh Tejwani. This programme got house full response from delegates. In my view the visibility of Chamber is increasing by holding this type of events.

The ***Study Circle & Study Group Committee*** under the Chairmanship of CA Ashok Sharma is organising fantastic meetings. During the month, he had organized one SG on Recent Judgments under Direct tax by CA Yogesh Thar and one SC meeting – Issues in Reassessment by CA Mahendra Sanghvi.

Direct Taxes Committee under the Chairmanship of CA Ketan Vajani organised a Seminar on Capital Gain. It was attended by 104 delegates. Contents of Seminar contained all live and relevant issues on Capital Gain Taxation and it was appreciated by all. Second Meeting organised was a Lecture meeting on Section 14 – The Unending and Unpredictable Journey by CA Yogesh Thar. It was attended by approx. 150 persons. The theme of the meeting was excellent. The third meeting was under ISG.

International Taxation Committee under the Chairmanship of CA Naresh Tejwani organised a Two day seminar on Taxation of Foreign Remittance. It was attended by 80 delegates (The content was relevant & current and the Speakers were superb. It was appreciated by all the delegates. Second Meeting was Study Circle on FEMA and Third meeting was ISG – International Tax. Both the meetings went very well.

Allied Laws Committee under the Chairmanship of CA Kamal Danuka had organized one Study Circle meeting on Industrial subsidy. The speaker CA G. B. Modi came from Dhule to address CTC Members. I must appreciate the efforts taken by the outstation speaker. Subsidy liaising is a big practice area for professionals. Most of the delegates benefitted from his talk. Due to lesser enrollment, Labour law seminar is postponed to April 2016.

Indirect Taxes Committee under Chairmanship of CA Rajiv Luthia had organized the 4th Service Tax RRC at Aamby Valley. It was attended by 148 delegates including delegates from 9 States of India and extended stay was availed by 64 persons (members and their family members). All the three Papers presented were classic. The delegates were enjoying studying fellowship in a relaxed environment. The laser show and aqua bus in Aamby valley were too good. Over all this RRC got the higher enrollment as compared to last year. Advisor CA A. R. Krishnan, Conference Director and Past Chairman CA Ashit Shah, Vice Chairman CA Vikram Mehta, Convener CA Atul Metha, Mr. Akhil Kedia, Mr. Narendra Soni, Committee Member CA Naresh Sheth and other committee members have put in a lot of efforts for this RRC. Delegates have given AAA(R) rating to this RRC. The Second event was 2 Sessions of a Joint workshop with STPAM and other associations.

CTC Delhi Chapter on 16-1-2016 under the Chairmanship of Mr. R. P. Garg, Advocate had organised a Felicitation function of CTC Past President Mr. V. P. Verma, Advocate. Vermaji was president of CTC in the year 1999-2000 as well as founder member and Chairman of CTC Delhi Chapter in 2007-08. The function went very well. It was attended by members, friends and well wishers of Vermaji. Great leaders are born to serve the society at large and Vermaji is one of them. We wish in future also he continues his support to CTC Delhi Chapter. In continuation to the function, Delhi Chapter kept a Full day seminar on Prevailing Industries Issues/Concerns and case studies on Companies Act, 2013. It was attended by 35 delegates. Both the events went very well. I must appreciate efforts of Vice Chairman CA Suhit Agarwal and Hon. Joint Secretary CA Vijay Gupta under the Chairmanship of Mr. R. P. Garg, Advocate for organising so many successful events till today.

Taxcon – Due to lesser enrollment event is cancelled.

Law and Representation Committee under the Chairmanship of Mr. Vipul Joshi, Advocate has sent representation on Draft Guidelines for determining Place of Effective Management of a company. The suggestions were sent to clarify the Threshold Compliance with all provisions of Income Tax, Passive incomes, Year of applicability and Applicability on country. On 30-1-2016, CTC Vice President CA Hitesh Shah, Hon. Joint Secretary Ajay Singh, Advocate, Hon Treasurer CA Hinesh Doshi, Vice Chairman of L&R, CA Krish Waghela and Convenor Nishtha Pandya met External Affairs Minister Smt. Sushma Swaraj Effective representation for taxation and economics weres made by Vice president CA Hitesh Shah. I must appreciate Chairman Mr. Vipul Joshi and Co-Chairman CA Mahendra Sanghvi, Vice Chairman CA Krish Desai, Convenor Amrit Porwal, Davendra Jain, Nishtha Pandya and entire team members of L&R Committee for giving guidance and structuring representation for effective governance of laws prevailing in our country.

The Chamber will soon organise the ***Fourth Dastur Essay Competition*** for the Students pursuing Law and Accountancy in the curriculum. All the Members are requested to encourage their students for participation.

The coming months are full of activities. Many events are planned. I request members to take benefit of the same. During the next Month, Government will present the Union Budget 2016-17 before the Parliament. It seems the Government has taken input from society, stake holders and professionals at large to come out with citizen and tax friendly Budget.

For good team building I would like to share Phip Charter's article on "***ATTITUDE***":

Social psychologists have identified several ways in which attitudes are used by individuals.

One of these is known as the ***"knowledge function"***, where attitudes are used to organise mentally all the knowledge we have amassed about the world and the using of information in this way can help us make more sense of the world.

Another is the ***"ego-defensive function"***, whereby attitude is used to defend self-image or ego. Someone for example, who feels inadequate in the workplace, may try to make someone else appear inadequate or inferior, even in some cases to make them the butt of other people's joke, as a way of shielding their own feelings of inadequacy or inferiority from the scrutiny of others.

The third and probably most common, is the ***"value expressive function"*** which refers to the use of attitudes to express one's values. In this way your attitudes will reveal to others who and what you are and what you believe in and how you are likely to respond or behave in certain situations.

One keyword towards a good attitude to life in general is ***enthusiasm*** and it is this enthusiasm for living that a person with right attitude will convey to others.

Our attitude is something that is noticed by other people more than us and having the right attitude is increasingly important in modern living. When we buy goods, for example, we expect the person serving us to be enthusiastic and knowledgeable about the products they are selling and at the same time be eager to help and anxious to please the customer. It is this type of enthusiasm that people convey to others in all kinds of different situations.

The attitude of individuals can change throughout their life time. These changes may be a result of prevailing circumstances or life experiences, hence the phrase developing an attitude. These changes may be positive, in which case the individual can develop a better attitude or negative in which case the result may be a worse attitude.

Sometimes attempts at changing the attitude of an individual may work or they may have the reverse effect in which the attitude is changed but in an opposite direction to that which was intended.

A degree of self-analysis is often advantageous for us as the more we understand about our own attitudes and beliefs, the more chance we have of identifying and changing our negative attitudes to more positive ones.

I would like to end my communication with an

Alcoholics Anonymous quote *"Acceptance is the answer of all my problems today, I can find no serenity until I accept that person, place, thing or situation as being exactly the way it is supposed to be."*

Aesop *"Be content with your lot; one cannot be first in everything."*

Jai Hind

With Personal Regards

AVINASH LALWANI

President

Chairman's Communication

Dear Readers,

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. BEPS schemes themselves can be extremely complicated, but the basic idea is simple: shift profits across borders to take advantage of tax rates that are lower than in the country where the profit is made. Three popular mechanisms for doing this are hybrid mismatches, special purpose entities (SPE), and transfer pricing. BEPS is said to be an "attempt by the world's major economies to try to rewrite the rules on corporate taxation to address the widespread perception that the [corporations] don't pay their fair share of taxes".

The OECD launched a 15-point Action Plan that will give governments the domestic and international arms they need to combat BEPS. The Plan recognises that greater transparency and improved data are needed to evaluate and stop the growing disconnect between where money and investments are made and where MNEs report profits for tax purposes. The Action Plan will for example stop the abuse of transfer pricing by ensuring that taxable profits can't be artificially shifted through the transfer of patents, copyright or other intangibles away from countries where the value is created, and it will oblige taxpayers to report their aggressive tax planning arrangements.

Multinational companies may see an increased tax burden around the world, and there's a strong likelihood that rule changes will affect the optimal structure for enterprises global operations. While the OECD BEPS project only finalised its recommendations in October 2015, some countries have already begun implementing changes to their tax systems. Companies will need to begin assessing the impact on business operations now. New reporting requirements for larger companies will make detailed country-by-country tax and financial information visible to many eyes, and possibly (in the future) not just those of tax authorities. In addition, the volume of data disclosed will be much more than companies are currently reporting worldwide, so the compliance burden will likely grow substantially. This month's Special Story is an attempt to address some of the important issues concerning BEPS.

I would like to thank Shri Hinesh Doshi for the design of this issue of Special Story. I am grateful to all the authors for the Special Story for their articles delivered in time and also providing indepth analysis for the benefit of the members. I would also like to thank Shri Paras K. Savla and Shri Manoj C. Shah for co-ordinating with authors.

CA HARESH KENIA
Chairman – Journal Committee

CA T. P. Ostwal

Introduction to Base Erosion & Profit-Shifting ('BEPS')

The public has always been familiar with the terms tax dodging, tax avoidance, and tax structuring. However, in today's international tax parlance, terms have evolved into more creative and catchy phrases. One may have probably encountered the terms "Double Irish" and "Dutch Sandwich", more often combined as "Dutch Sandwiches washed down with a Double Irish", as well as the so-called "Bermuda Triangle".

As appealing as the terminologies may sound, tax authorities from around the world are going after multinational companies (MNCs) that employ these tax strategies. So what exactly did MNCs do earn the ire of tax authorities?

In the current economic environment, companies that operate on a multinational level no longer employ a straightforward structure with one entity per jurisdiction to take charge of its operations in such country. Gone are the days where operations and market consumption are the main motivating points in establishing foreign presence. International tax rules drawn some 80 years ago have not kept up with the fast-changing business environment. The host of driving forces has invariably changed: Instead, we now see tax-driven structures taking advantage of low-tax jurisdictions, favourable tax treaties, and country mismatches in taxation of entities, products and income streams. These are all considered base erosion and profit shifting schemes, or simply "BEPS".

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. Double Irish and Dutch Sandwich both make use of Ireland and the Netherlands as pass-through locations, and adding a tax haven into the combo makes up the Bermuda Triangle. Instead of planes and ships disappearing, profits disappear - at least from the eyes of the tax authorities.

The interplay of multiple domestic tax systems often lead to an overlap of rules, which may result in double taxation. However, the same scenario can also create loopholes which could lead to an income not being taxed anywhere, thus resulting in double non-taxation. This gives MNCs undue competitive advantage as compared to enterprises that operate on a domestic level. Numerous economic and tax publications reveal MNCs from a developed country selling products in another high-tax country actually route profits through a web of companies located in multiple low or no tax jurisdictions.

The ultimate goal of the big corporate tax dodgers is what is prominently known as "stateless income"- siphoning profits out of high-tax countries like US, India, Europe, Japan, etc. and moving them around under various tax treaties until they are not subject to any tax because they are being reported in a non-existent country called Nowhere. Thus, tax bases are eroded from jurisdictions where they were actually collected and shifted to low or zero-tax regimes. Overall, billions are saved through the shifting manoeuvres.

Base Erosion poses serious risk. Opportunities for MNCs to pay less or no tax will harm everybody – corporations and individuals alike. Governments lose revenue and may have to cut public services, including education and healthcare, and increase taxes on everybody else – individuals, small businesses, domestic-level enterprises and new firms that cannot compete with MNCs that shift profits across borders to avoid or reduce tax.

Over the past years, giant companies have been slapped with tax bills for shifted profits. The taxation of MNCs is an arcane topic that has traditionally been of interest only to a small coterie of specialists. Recently, however, it has attracted an unprecedented level of political attention and public interest. In response to this long-standing outcry, the Organization for Economic Cooperation and Development (OECD) has announced an international action plan, called "Project BEPS", to target multinational businesses strategies of tax avoidance and aggressive tax planning. The OECD is an international economic organization, founded in 1961 with 29 member countries (presently stands at 34 member countries) to stimulate economic progress and world trade. Approved by the G20 (Group of 20, which is an international forum for governments and central bank governors from 20 major economies), the leaders of the G-20 group of nations issued a communiqué following their meeting in Los Cabos, Mexico in June 2012, stating that: "*We reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area.*" This "ongoing work" – the OECD's initiative on BEPS – led to a major report issued in February 2013 and to an action plan produced in July 2013. The latter consists of fifteen specific action items that are intended to facilitate multilateral cooperation among governments with regard to the taxation of MNCs, with the general objective of seeking to "better align rights to tax with economic activity". While there are no easy solutions to address BEPS issues, the OECD is in an ideal position to support countries' collective efforts towards drawing up effective and fair tax rules and at the same time provide a more or less level playing field for businesses, whether domestic or multinational.

1.1. What exactly is BEPS?

1.1.1. Anatomy of BEPS problem

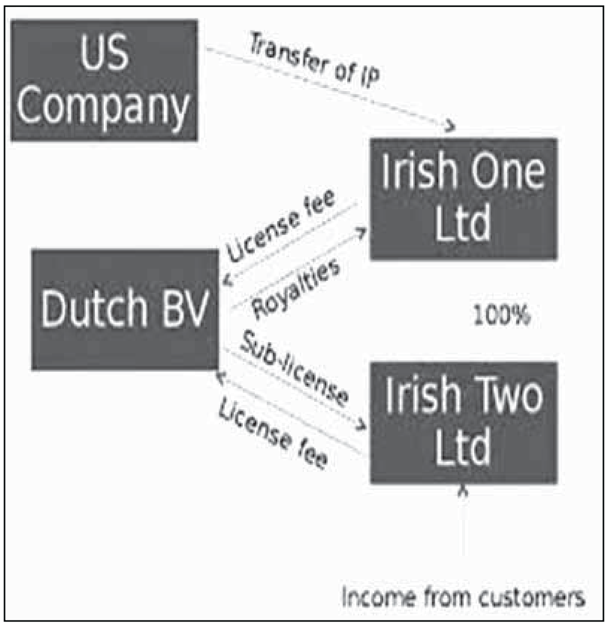
BEPS has attained its standard by peculiar development apropos continuous tax fugitive activities by MNCs. These developments have opened up opportunities for multinationals to greatly minimise their tax burden by migrating or moving their effective place of management/ central management control to a tax climate of a country which suits their interest in double non-taxation of profit, this results in Governments losing their right to tax because base is eroded to another country. At this juncture, it's crucial to understand what is Base Erosion? And what is Profit shifting?

1.1.2. What is Base Erosion?

The tax base of a country is defined as the persons and the profits that a country is permitted to tax. Base erosion refers to the reduction of the companies and amount of profits that a country can tax. If a company moves its residence to different country or causes its profit to arise in a different country or another country (e.g., by transferring its intellectual property to another country so that royalties go there), then the ability of the original country to collect corporation tax will be diminished to the extent of royalty payments. Base erosion is thus caused either by companies or their profit ceasing to be taxable in the country.

1.1.3. What is Profit Shifting?

MNCs are engaged in active 'aggressive tax planning' so that profits are not taxed. They focused planning on shifting profits out of higher tax country into lower tax country. The country where profit is shifted are offering low tax regime along their normal corporation tax system to MNCs. Most of MNCs to avoid double non-taxation use structures and new technologies to save deflating high to low tax jurisdiction, it will result in saving tax (for example, CFC and manipulating transfer pricing). Thus profit is shifted by MNCs to a tax saving country 'Safe Tax Heaven'.



1.2. Causes of the evolution of BEPS

Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for developed and developing countries alike.

- Archaic tax rules not suited to new age: domestic tax laws have not kept pace with global corporations, fluid capital, and the digital economy, leaving gaps that can be exploited by companies who avoid taxation in their home countries by pushing activities abroad to offshore or mid shore jurisdictions

- Mismatch in domestic tax systems: the interaction of domestic tax systems (including international tax rules) leads to gaps that provide opportunities to eliminate or significantly reduce taxation on income in a manner that is inconsistent with the policy objectives of such domestic tax rules and international standards.

	Revenues from UK sales	Estimated profit on UK sales	UK tax if levied	Tax actually paid in the UK
Apple	£6bn	£1.3bn	£370m	£10m
Amazon	£3.2bn	£150m	£42m	£517,000
Google	£2.1bn	£750m	£210m	£5m
eBay	£800m	£180m	£50m	£3.4m
Facebook	£100m	£51m	£14.2m	£396,000

Sources: SEC FILINGS, ENDERS, COMPANIES HOUSE

- Conscious tax aggressive planning and tax dodging: Governments lose substantial corporate tax revenue because of planning aimed at shifting profits in ways that erode the taxable base to locations where they are subject to a more favourable tax treatment. Some MNCs are being accused of dodging taxes worldwide, and in particular in developing countries, where tax revenue is critical to foster long term development.

1.3. Why there is need of BEPS Action Plan?

BEPS has become a critical issue for the Governments across the globe. Governments are agitated by the use of 'aggressive tax' planning by multinationals in order to secure erosion and profit shifting. These types of aggressive planning by MNE's for diluting the tax liabilities in the shadow of 'safe tax haven' and by profit shifting to low tax depleting countries, causes massive loss of revenue to the Country, especially in financial crises. Recently, this state of affairs got momentum. This also led to a tense situation in which taxpayers and Governments have become more sensitive to tax fairness issues. For instant, in UK itself, there has been a fuss about the MNCs like Google, Amazon, Starbucks, Tesco's, etc. not paying fair amount of share. The House of Commons public accounts committee interrogated the issues. Chair Margaret Hodge MP has been the interrogator of companies that aggressively avoid paying tax. Furthermore, recently, newspapers reported that the Government was "failing to tackle tax avoidance and evasion" for example, Vodafone and Starbuck cases, where a top tax officer of HRMC was criticised (heavily) for "settlement" & allowing big companies to submit voluntary tax accounts which resulted into BEPS. Be that as it may, but still the problem is protection of tax arbitrage is wishy-washy because of the absence of strict rules and regulations. Therefore, the concern is to toughen up tax avoidance rules; new criminal standard, harsher fine and working upon international tax rules are contestable issues. Similarly, Orwellian term for something that most of us would simply call "shifting profits to tax havens".

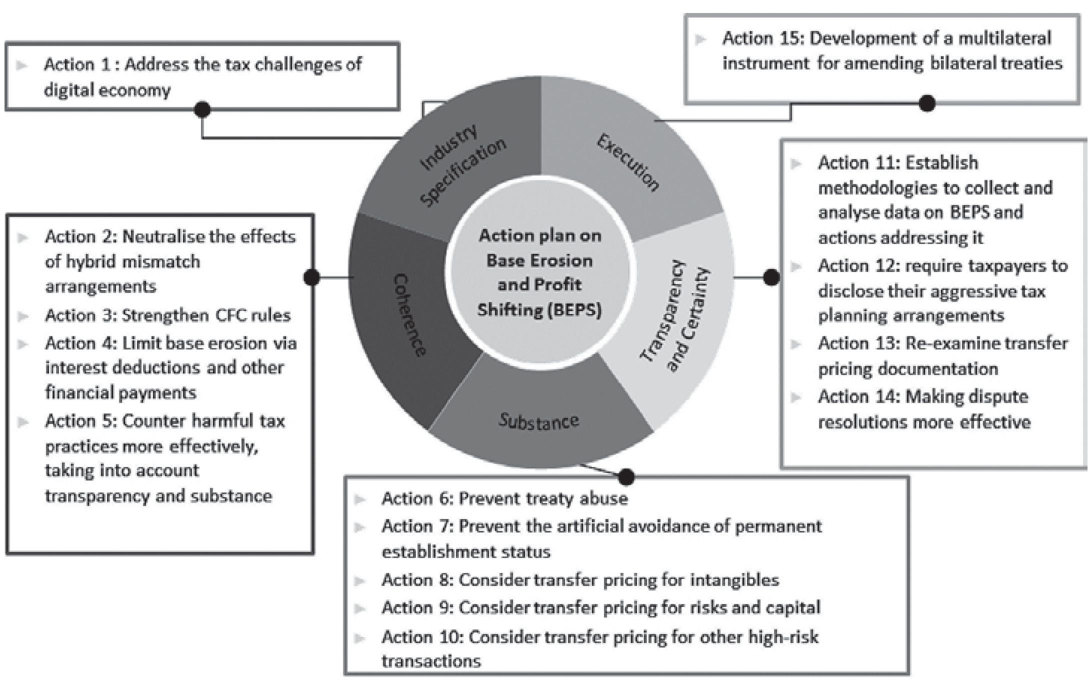
As base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike. With global economy slowing down, political leadership across the world has become increasingly worried of practices followed by multinationals that plan their affairs in a manner that countries are deprived of their legitimate share of tax.

2. Overview of BEPS Action Plans

Fundamental changes are needed to effectively prevent double non-taxation / low taxation associated with practices that artificially segregate taxable income from the activities that generate it. Transfer pricing and Intangibles also the significant factors and hence the need of new international standards to ensure the coherence of corporate income taxation at the international level has arisen.

2.1. Aim of the Action Plan

2.1.1. The Action Plan aims to address BEPS concerns by establishing international coherence of corporate income tax systems; restring the full effects and benefits of international standards; ensuring transparency while promoting increased certainty and predictability; and establishing a multilateral instrument to implement the responses to BEPS swiftly. The 15 action plans can be segmented into 5 parts i.e. i) Industry Specification, ii) Coherence, iii) Substance, iv) Transparency and Certainty and v) Execution. These 5 segments are represented in the chart as follows:



2.1.2. The Plan recognizes the tremendous benefits of globalization for domestic economies, but expresses concern that the increasing globalization of the economy and of multinational corporations (MNCs), coupled with the growing digital economy, has made it easier for MNCs to locate many productive activities in geographic locations that are distant from the physical location of their customers. The Plan asserts that these developments have created opportunities for BEPS, which occurs through the interaction of different tax rules that leads to double non-taxation or less than single taxation and through "arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place." The Plan states that this has resulted in reduced revenue for Governments and higher costs of enforcement, a shifting of the tax burden to other taxpayers, and competitive disadvantages for businesses that do not engage in BEPS. It also has caused some interest groups to question the fairness of tax systems.

2.2. The main targets of the BEPS initiative

The main target of the BEPS action plan is to design a new international standard to ensure the coherence of corporate income taxation at the international level. BEPS concern to tackle the new issue arose because of the revolution in the digital economy. However, there are major key pressure areas which are chiefly targeted through the Action Plan in curbing BEPS.

Key pressure areas

The BEPS report highlight number of key pressure areas; which are as follows: International mismatches in entity and financial instrument characterisation; (i.e., the use of hybrid instrument and hybrid entities); the application of treaty concepts to profits derived from the delivery of digital goods and services; the tax treatment of intra-group financial transactions; transfer pricing, in particular in relation to the shifting of risks and intangibles; the effectiveness of anti-avoidance measures; the availability of 'harmful preferential regimes'.

3. The Action Plan

Action Point 1 – Address tax challenges of the digital economy

What is the concern?

The digital business model has driven massive changes in business models, and the international tax framework has not kept up. A particular (but not the only) issue mentioned is that a company can have a significant digital presence in the economy of another country without being liable to tax. In the digital economy, there is continuous innovation and several business models through which business is carried out. Furthermore, the majority of activity is intangible, which makes it more difficult and subjective as far as taxation is concerned.

The report acknowledges that digital economy is increasingly becoming the economy in itself; it would be difficult to ring-fence the digital economy from the rest of the economy for tax purposes.

How might this concern be addressed?

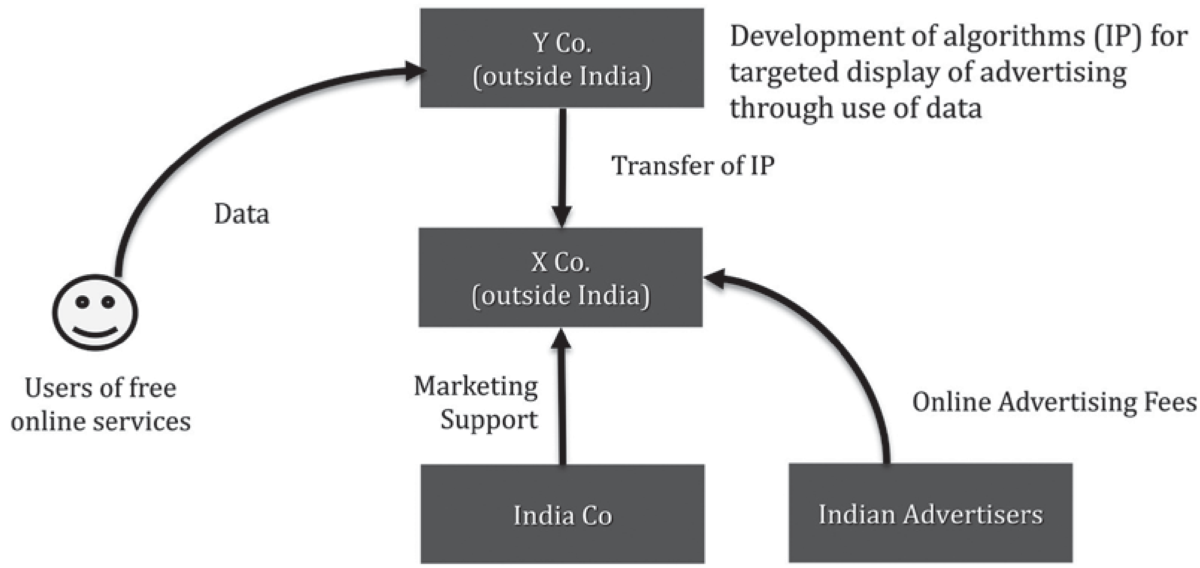
This is perhaps the most fundamental concern of the OECD and national Governments, but perhaps also the one where it is least clear how resolution can be achieved. Many countries have been taking a unilateral approach to deal with this issue. The action is not only to develop options for how to respond, but also to identify more fully the difficulties that the digital economy might pose, various business models and a better understanding of how value is created and possible actions to address issues.

Indian perspective

In India, taxation of the digital economy has been subject to a lot of interpretation and litigation. The amendments *vide* Finance Act 2012 to section 9(1)(vi) of Income-tax Act, 1961 ('ITA') on taxation of royalty has widened the scope of taxing such e-commerce business models.

However, these models get out from the royalty article provided in the tax treaties due to the restrictive definition. Development on this action point would provide more clarity. Furthermore, India has a high user base in the digital economy and hence would be particularly interested in this action point, especially from the point of view that source countries should also get their fair share of revenues as value is also created there to some extent.

Challenges in the digital economy – India Illustration



Significant challenges in:

- The determination of the jurisdiction where value creation occurs
- The application of traditional concepts of source and residence

US Reservation

US has opposed the options set forth in the September 2014 report with respect to modifications to the permanent establishment exemptions, a new nexus standard based on significant digital presence, a virtual permanent establishment, and creation of a withholding tax regime on digital transactions.

Action Point 2 – Neutralize the effects of hybrid mismatch arrangements

What is the concern?

The report on Action 2 - Neutralize the effects of hybrid mismatch arrangements sets out general and specific recommendations for domestic hybrid mismatch rules and model treaty provisions which will put an end to multiple deductions for a single expense and deductions in one country without corresponding taxation in another. Among various recommendations, the report suggests denial of a dividend exemption for the relief of economic double taxation in respect of deductible payments made under financial instruments.

The situations where payments under a hybrid mismatch arrangement that are deductible under the rules of the payer jurisdiction and not included in the ordinary income of the payee or a related investor are referred to as Deduction/ Non Inclusion outcomes. In Deduction/Non Inclusion outcomes, the Report recommends that the response should be to deny the deduction in the payer's jurisdiction.

How might this concern be addressed?

The recommendations include a defensive rule that a country can apply to neutralize a hybrid mismatch that arises within its jurisdiction when the counterparty jurisdiction does not have its own domestic hybrid mismatch rules. The effect of having both a primary and defensive rule is that a country does not need to rely on the domestic laws of another country in order to neutralize hybrid mismatches.

The Hybrid report recommendations once implemented by a country, they will neutralize the hybrid mismatch effects of "US check-the-box planning" in those countries.

Dual-resident companies – The report provides that the issue of dual-resident entities by providing that cases of dual treaty residence would be solved on a case-by-case basis rather than on the basis of the current rule based on place of effective management of entities.

Treaty provision on transparent entities – The proposes to include in the OECD Model Tax Convention a new provision and detailed Commentary that will ensure that income of transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the Partnership Report. This will not only ensure that the benefits of tax treaties are granted in appropriate cases but also that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity as the income of one of its residents.

Patent box and preferential review – One of the key priorities of the BEPS Project has been to focus on whether or not there is substantial activity associated with any preferential regime. The initial focus of BEPS work has been on preferential regimes related to intangible property. Much of the work has been on the nexus approach, which makes a link between the expenditure incurred in a country (essentially capturing the work or activity undertaken) and the amount of income that can benefit from a preferential regime. The next step is to reach consensus on the best approach to evaluate substantial activity so as to review the IP regimes in the light of the newly elaborated substantial activity factor and all regimes including Patent Box.

Indian perspective

This may not have a significant impact on the Indian context as India does not recognize different tax treatments for hybrid financial instruments or the concept of fiscally transparent entities.

Action Point 3 – Strengthen CFC rules

What is the concern?

CFC rules in some countries do not always counter BEPS in a comprehensive manner.

How might this concern be addressed?

The OECD plans to develop recommendations regarding the design of CFC regimes. The implication of the BEPS Action Plan is that CFC rules should discourage not just the diversion of profits from the parent jurisdiction, but also diversion from source countries generally. Whether this approach will be followed by many countries remains to be seen.

The discussion draft considers all the constituent elements of CFC rules and breaks them down into the building blocks necessary for effective CFC rules. The building blocks include:

- Definition of a CFC
- Threshold requirements
- Definition of control
- Definition of CFC income
- Rules for computing income
- Rules for attributing income
- Rules to prevent or eliminate double taxation

As with the discussion draft as a whole, the approaches to defining CFC income do not reflect a consensus view and there are clearly some material concerns from a tax competitiveness perspective.

One proposal MNEs will want to consider carefully is the an 'excess profits' approach under which income attributable under the CFC rules would be the profits in excess of a 'normal return', being a specific rate of return on the equity properly to be regarded as utilised in the business of the CFC.

Indian perspective

At present India does not have CFC provisions. However, the proposed Direct Taxes Code does lay down the CFC provisions, which are quite exhaustive. They also envisage various scenarios e.g., income resulting from transactions with related parties may be considered as passive income. India will have to relook at the proposed CFC provisions and consider if any change is required to make them consistent with the CFC rules as stipulated by the OECD.

Action Point 4 – Limit base erosion via interest deductions and other financial payments

What is the concern?

The Plan states that deductible interest payments may give rise to double non-taxation in both inbound and outbound scenarios. The Plan also states that deductions for other financial payments raise similar concerns, particularly in the context of transfer pricing.

The objective of Action 4 is to identify coherent and comprehensive solutions to address base erosion through interest deductions and economically equivalent payments, for both inbound and outbound investments. The plan acknowledges the general principle that groups should be able to obtain tax relief for an amount equivalent to their actual third party interest costs.

Although the critical objective is to counter base erosion, the OECD acknowledges that whatever solution is ultimately adopted also should minimize distortions to competiveness and to investment decisions. These may arise, for example, if different financing arrangements give rise to differing tax outcomes for transactions that are otherwise economically similar. Action 4 proposes to evaluate the effectiveness of different types of limitations and develop 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 will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives, and captive and other insurance arrangements.

The Plan states that this work will be co-ordinated with the work on the Actions on hybrids and CFC rules.

How might this concern be addressed?

There is a plan to develop recommendations, this time regarding best practices in the design of rules to prevent base erosion through interest expense. In addition, TP guidance will be developed regarding the pricing of guarantees, derivatives and captive and other insurance arrangements.

The options set out in the discussion draft are likely to have far-reaching implications for multinational groups, in part due to the greater compliance burden. An interest cap allocation rule could have an impact on businesses' investment choices. The rule could also increase the effective cost of capital, reducing real investment overall. Compliance issues for any best practice rule will include the need for consistency regarding the use of accounting figures under different GAAP (the OECD acknowledges the potential for mismatches to arise between accounting and tax amounts).

The OECD specifically rejects the arm's length standard and withholding tax regimes as efficient tools to prevent BEPS in this area. But the other policy considerations, including

- minimizing distortions to competition and investment, promoting economic stability, providing certainty, avoiding double taxation, and reducing administrative and compliance costs
- potential different approaches to specific sectors and industries - comments are particularly requested on financial, infrastructure, and extractive industries
- the importance of addressing EU law
- interaction with other BEPS Actions items (including controlled foreign corporations, hybrids, debt pricing, treaty abuse, risks and capital valuation, country-by-country reporting, and dispute resolution).

Indian perspective

Although thin capitalization norms are presently not part of the provisions directly in India, they could be generally covered within the ambit of the Indian TP regulations coupled with the proposed general anti-avoidance rule (GAAR), which will be effective in a couple of years.

Action Point 5 – Counter harmful tax practices

What is the concern?

Preferential tax regimes are still driving a "race to the bottom", although the focus seems to have moved towards low rates on particular types of income (e.g. finance income from intangibles).

The Plan references the OECD's 1998 report on harmful tax practices and states that concerns about a "race to the bottom" with respect to corporate tax rates on mobile income continue to be relevant.

How might this concern be addressed?

The OECD produced a report in 1998 on "harmful tax practices" that has largely gathered dust since then. It is now proposed to revamp this work. A new suggestion is for "compulsory spontaneous exchange on rulings related to preferential regimes", although it is unclear how this would work.

The focus on aligning taxation with the "substance" of transactions seems to be defined as determining where people are located, and where the performance of significant people functions takes place. Nonetheless, determining the location of substantial activity is inevitably a subjective determination, making objective criteria difficult.

Proposals for improving transparency through compulsory spontaneous exchange on taxpayer-specific rulings related to preferential regimes contribute to the third pillar of the BEPS project, which is to ensure transparency while promoting increased certainty and predictability. It should also be noted that the word "compulsory" is understood to introduce an obligation to spontaneously exchange information wherever the relevant conditions are met, meaning this is a further step in moving more generally from exchange of information upon request to automatic exchange of information. The work will now move on to consider the regimes of non-OECD members before then revising as required the existing harmful tax framework.

Indian perspective

As far as India is concerned, it has been countering harmful tax practices by adopting the principle of substance over form and has been using judicial precedents to invoke those principles. This Action Plan reiterates that it would be critical to satisfy the substance test.

Action Point 6 – Prevent treaty abuse

What is the concern?

Treaty abuse is one of the "key pressure areas" of the OECD's BEPS project. Tax treaties are giving rise to double non-taxation in some cases, by granting excessive treaty benefits. Particular examples are third-country branches and conduit arrangements.

How might this concern be addressed?

The Action Plan is to develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits, in appropriate circumstances. It also aims to clarify that a tax treaty does not intend to create scenarios where there is double non-taxation.

However, for implementing this Action Plan, it would be critical to get the consensus of all the sovereign states involved, as it is more of a domestic law affair and one for which the OECD cannot mandate any country.

One important point to note here is that looking at tax treaties as only a measure to avoid double taxation would be narrowing the scope of tax treaties. Before entering into tax treaties, there are several economic and political considerations other than tax which are considered by countries. Hence, even if guidelines are laid down, it will depend on each state on how and when to implement them.

Indian perspective

As far as India is concerned, the Indian tax authorities have always been vigilant and have been trying their level best to ensure that there is no treaty abuse. India has already incorporated GAAR provisions under the domestic law though yet to be effective. The GAAR provisions provide that tax treaty benefits would be denied in the case of an impermissible avoidance arrangement. Furthermore, all the recent treaties which India has signed contain the limitation of benefits clause and GAAR Provisions in order to ensure that the benefit is granted only to those entities which are not conduit entities and safeguard Indian Revenue interest.

Action Point 7 – Prevent the artificial avoidance of PE status

What is the concern?

MNCs can sell into countries using a local sales force, but avoid being taxed on the profit from the sales. Two particular examples are mentioned – commissionaire arrangements, where an overseas principal avoids a local PE, and fragmentation of activity to take advantage of preparatory and auxiliary exceptions.

The Plan states that the PE definition must be updated to prevent abuses, citing in particular the agency-PE rules, the treatment of commissionaire arrangements, and the PE exceptions for preparatory and ancillary activities. In this regard, OECD has advocated in adoption of UN standards in its DTAA model to suit changes based on the requirement.

How are profits diverted?

Businesses that enter into arrangements to divert profits that reduce the tax base by either:

- designing their activities to avoid creating a taxable presence (a permanent establishment) ; or
- creating a tax advantage by using transactions or entities that lack economic substance.

How might this concern be addressed?

Action 7 proposes to develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements, and the sspecific activity exemptions. This Action also will address related profit attribution issues.

It would potentially be easy to restrict the scope of the PE exclusions for:

– agents of independent status; and

– preparatory and auxiliary activities.

It is possible that the requirement for a dependent agent to have and habitually exercise an authority to conclude contracts will be watered down or even removed.

Indian perspective

In India, determination of PEs has been more stringent. The tax authorities have been very vigilant in checking whether there is a PE or not. Furthermore, India's position on the OECD Model Tax Convention pertaining to PEs such as agency PE, installation PE and attribution of profits to PE also reflects the view that India treats PEs more strictly than many other countries across the world.

Action Point 8 – Intangibles

What is the concern?
Intangible assets are being transferred to related parties for less than full value and intangibles are not being taxed consistently with the value creation underpinning them.

How might this concern be addressed?
The general direction of travel appears to be towards rewarding people rather than capital or the legal ownership of assets. Many countries already have well-developed anti-avoidance rules on transfers of intellectual property. The Action Plan also calls for more practical steps, such as an improved broader definition of intangibles, TP rules to deal with hard-to-value intangibles and updated guidance on cost contribution arrangements.

While the key sections of the revised Transfer Pricing Guidelines on intangibles have not yet been finalised, the ultimate goal of the latest G20-approved report seems to be that functional value creation remains to the fore with the starting point being an analysis of the group global value chain to show how intangibles interact with other functions, risks and assets.

On the revised definition of intangibles, Chapter VI of OECD Transfer Pricing Guidelines will state the importance of distinguishing between intangibles and market conditions or local market circumstances which are not capable of being owned or controlled.

Regarding location savings or local market features, the most reliable approach is stated to be local market comparables and only if they don't exist to consider advantages and disadvantages and whether they're passed on to customers.

The benefits of an assembled and experienced workforce may affect the arm's length price. The transfer of such people within an MNE should not be separately compensated but reflected to the extent that there are time and costs savings (except where there is a transfer of know-how or other intangibles).

Group synergies should result in arm's length remuneration only if they arise from deliberate concerted group actions that provide a member of an MNE group with material burdens or advantages not typically available to comparable independent entities.

Action Point 9 – Risks and capital

What is the concern?
Excessive risks and / or capital can be allocated to low-tax affiliates, thus boosting the affiliate's profits under arm's length principles.

How might this concern be addressed?
Either TP rules will be amended or "special measures" will be adopted to ensure that excessive returns cannot accrue to an entity in this situation.

Action Point 10 – Other high-risk transactions (transfer pricing)

What is the concern?
MNCs are engaging in transactions which would rarely, if ever, take place between third parties. Management fees and head office expenses are specifically mentioned.

How might this concern be addressed?
The Action Plan talks about clarifying when a re-characterization of transactions can take place, clarifying the application of TP methods to global value chains and providing protection against management fees and head office expenses.

Indian perspective for transfer pricing – Action Points 8, 9 and 10

Key purpose of the TP related measures

What constitutes "value creation"? This is not defined in the Action Plan. This suggests the importance of conduct and substance over contractual terms

The existing TP Rules in India provide for related party transactions to be on an arm's length basis. Arm's length analysis needs to be conducted following the prescribed Rules and Methods and the most appropriate method would be adopted to determine the arm's length price.

Arm's length analysis typically takes into account prices / margins of companies having a comparable functions, assets and risks profile and does not refer to value creation *per se*. However, "value creation" mentioned in Action Plan 8 ought to refer to the value associated with the actual substance of the transactions and the conduct of the parties in terms of the functions and risks as against the contractual allocation of functions and risks in determining the appropriate comparables in an arm's length analysis.

In practice, the Indian Government does seek to look into the substance of a transaction in case the actual function, asset and risk profile is different from the contractual function, asset and risk profile. There has been lot of litigation in and around this point. A recent Circular issued by the Indian Revenue in relation to contract research and development (R&D) not only seeks to identify what constitutes "economically significant functions" in creation of intangibles (through R&D) but also specifically states that the conduct of the parties (and not the contractual terms) would be the final determinant of who "controls the risk".

No new legislation as such may be required in India in adopting "value creation" as a driver for measurement of profits under a TP analysis. However, since value creators in every transaction would differ from case to case, identifying the actual "value creators" in all cases may be debatable. Hence, it would be useful to see whether the Action Plan provides any specific meaning to value creation.

Global value chains, management fees and HO expenses classified as "high-risk transactions" – robust substantiation may be required

The Action Plan suggests that certain transactions typically would not or would rarely occur between unrelated parties. The Action Plan considers such transactions "high-risk" transactions. The OECD seems to be open to re-characterizing transactions which seem abusive and base eroding. This again takes us back to the substance over the form of the transactions. However, since the OECD specifically considers them "high-risk", the substance of such transactions would be scrutinized with far more rigour. The Indian Revenue Authorities have also taken a very aggressive stance against similar payments such as management fees, and hence, such payments have been a subject matter of extensive litigation in India.

The arm's length principle only deals with pricing of transactions and hence the applicability of the above test ought not to apply to the validity of the transaction itself, but only to what the pricing would have been in similar transactions between related parties.

In India, similar transactions are substantiated by applying the "benefits test", the "need test", the "computation test" and the "evidence test". Considering the intense scrutiny of such transactions, in India and otherwise, robust documentation not only in terms of contracts and invoices but also documents evidencing the actual conduct and benefits derived (e.g., minutes of meetings, e-mail correspondences (internal and external), inter-office memos, final reports, results achieved) would need to be maintained to substantiate this.

Global formulatory approach versus profit split – Value driver versus value allocation

Action Plan 10 refers to the "profit split method" rather than a generic formulatory approach (i.e., an approach where value is allocated to each leg of the global supply chain regardless of the fact that it does not have any significant value addition or unique contribution to the profitability). The profit split method is a specific method which falls within the realm of "arm's length analysis" and provides for splitting of profits based on contribution of value by various parties to a transaction. The profit split method in arm's length analysis is applied in very specific situations where there is a "transfer of unique intangibles" or "in multiple transactions which are so inter-related that they cannot be evaluated separately". Such a method cannot be applied generally in all situations in the context of global value chains. The Action Plan hence does not seem to suggest the application of a generic formulatory approach in conducting TP analysis. Hence, profit split may be applied where there is significant value addition – a global formulatory approach by way of value allocation ought to be avoided and this also does seem to be the aim of the Action Plan.

As far as India is concerned, practically, the profit split method is rarely used. Further, there are limited resources and databases also which would help in determining the arm's length price as per the profit split method.

Guidance on documentation and evidence especially regarding "conduct" would be essential

The Action Plan hence seems to suggest that adequate documentation needs to be maintained and submitted by the taxpayers in respect of the entire global value chain to enable the tax authorities to see the "big picture" in relation to global activities. This would enable them to:

- determine the location of significant value creation *vis-à-vis* the entire value chain; and
- understand the role of other associated enterprises in the value chain to better appreciate the criticality of the jurisdictional taxpayer in the value chain and consequentially assess the transfer price accurately.

Typically in India, information relating to the Indian taxpayer entity is submitted. However, the MNCs are reluctant to share detailed information regarding their associated enterprises and global operations. If the current Plan is implemented, the OECD may, by way of specific legislation/guidance, require taxpayers to submit information on the entire value chain, including information relating to entities in various jurisdictions. MNCs need to take this into account in devising their documentation strategy and need to also devise internal systems enabling sharing of relevant information amongst associated enterprises globally, mindful of the internal and external confidentiality requirements.

Action Point 11 – Methodologies to collect and analyse data on BEPS

What is the concern?

There is recognition that there has been a lack of sufficient evidence to quantify the extent to which governments lose substantial corporate tax revenue because of planning aimed at eroding the taxable base and / or shifting profits to locations where they are subject to a more favourable treatment. The plan seeks to correct this in future and also to enable analysis of the impact of the various actions which are implemented.

How might this concern be addressed?

Action 11 proposes to develop 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, which will involve developing an appropriate economic analysis, assessing existing data sources, identifying new data that should be collected, and developing methodologies based on aggregate data (such as foreign direct investment and balance of payments) and micro-level data (such as data from financial statements and tax returns). The Plan notes that this work will take into consideration the need to respect taxpayer confidentiality and the cost for both tax administrations and businesses.

Taxpayers will be asked to provide more data to tax authorities. However, details are sparse and it appears that the OECD needs to do much more thinking about what it actually wants to see in this area.

Action Point 12 – Disclosure of aggressive tax planning

What is the concern?

Tax authorities do not find out about aggressive tax planning quickly enough.

How might this concern be addressed?

Action 12 proposes to develop recommendations on the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the costs for tax administrations and businesses and drawing on the experiences of countries that have such rules in place. The Plan indicates that this work will use a "modular design" that aims at consistency, but that allows for country-specific tailoring. An identified area of focus is international tax schemes, and the work will explore how a broad definition of "tax benefit" can be used to capture such transactions. The Plan states that this work will be co-ordinated with OECD work on co-operative compliance, and will thus involve designing enhanced information sharing models for tax administrations to use. There will be a particular focus on international tax schemes and sharing such information between jurisdictions. The expected output of this Action is recommendations on domestic rules.

Several countries – including the UK and the US – already have some form of "disclosure rules", which require taxpayers to inform the tax authority of situations where certain types of tax planning are implemented. These rules could be introduced in more countries, and also potentially made more multilateral. At present, for instance, the UK disclosure rules are very much focused on UK tax avoidance. Future rules could perhaps lead to information flowing to multiple tax authorities.

Indian perspective

More disclosure would be required in tax returns. Furthermore, once this tax planning is reported, it is likely that tax authorities will look into this transaction in detail to ensure that the tax planning is within the four corners of law and does not amount to tax avoidance.

Action Point 13 – Re-examine TP Documentation/Country by Country Reporting (CbyCR)

Country-by-country reporting is one of the cornerstones of the OECD's proposed approach to tackling the existence of BEPS. The principle behind country-by-country reporting is that multinational enterprises will be required to complete an annual report in relation to each territory in which they operate which will form part of the new three-tiered approach to transfer pricing documentation in the post-BEPS world (the other two aspects being the preparation of a master file and individual local files).

The country-by-country report will show the key indicators of economic activity, as well as indicate the kinds of assets and the number of staff that the multinational in question has in each jurisdiction in which it operates. The report will also state the amount of tax that the multinational pays in each of those jurisdictions.

The September 2014 deliverable on country-by-country reporting proposed a standard form template as the basis of country-by-country reporting, but left much of the detail concerning domestic implementation, sharing of the country-by-country report and safeguards on confidentiality to be more fully worked out. The February 2015 update provides answers to most of those outstanding questions.

Financial threshold for application of country-by-country reporting

The most significant point addressed in the February 2015 update to country-by-country reporting is the OECD's proposal regarding which categories of multinational enterprises should be required to file country-by-country reports. The OECD has opted to propose a system under which, in principle, all multinationals prepare country-by-country reports (i.e. there will be no carve-outs for particular sectors or categories of taxpayers save for an extremely narrow exemption for businesses involved in international transportation or transportation on inland waterways). However, the OECD has proposed a financial threshold filter: under the filter, only groups the annual consolidated group revenue of which exceeds EUR 750 million (or the nearest equivalent in the domestic currency of the parent of the multinational group) will be required to file country-by-country reports.

Mechanism for sharing country-by-country reports

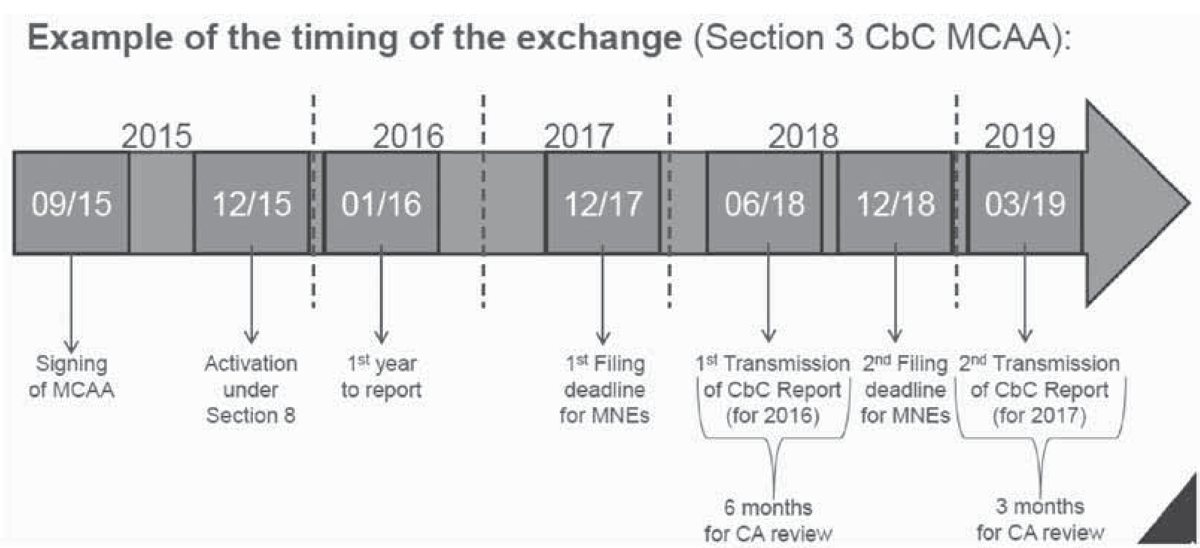
The February 2015 update providing guidance on country-by-country reporting also covered the OECD's proposed mechanisms for the sharing of such reports between different jurisdictions. Under the OECD's proposals, the parent company of the multinational group will prepare the country-by-country report and will submit it on a confidential basis to the tax authority of its home jurisdiction. That tax authority will then automatically share the report with other relevant tax authorities.

The OECD proposes that the sharing of the country-by-country report be undertaken using existing information exchange mechanisms, such as income tax treaties or tax information exchange agreements. This is principally in order to ensure efficiency of exchange, but the OECD states that it will also be pivotal in ensuring that the high standards of confidentiality applicable to those existing mechanisms will apply to country-by-country reports.

A Indian-headed group with operations in Italy, Spain and the United Kingdom, for example, would file its country-by-country report with the CBDT. In turn, the CBDT would share that report with the domestic tax authorities in Italy, Spain and the United Kingdom.

Timing for implementation of country-by-country reporting

The February 2015 update paper also contains the OECD's recommended timeline for implementing country-by-country reporting. The paper proposes a country-by-country reporting start date of 1st January 2016 and proposes that multinationals have 12 months from the end of the relevant accounting period in which to file their report. As a given country-by-country report will cover a 12-month period, a start date of 1st January 2016 will mean that the first country-by-country reports will be filed by 31st December 2017 for groups that prepare accounts to 31st December each year.



Indian perspective

Guidance on documentation and evidence especially regarding 'conduct' would be essential. There would be fewer implications as far as India is concerned as there are detailed documentation requirements under the present TP regulations in India.

Action Point 14 – Dispute resolutions

What is the concern?

The current mutual agreement procedure (MAP) may provide inadequate protection from double taxation. Most tax treaties do not entertain arbitration provision.

How might this concern be addressed?

A discussion draft of 18th December 2014 acknowledges that the OECD should complement its actions to counter BEPS by improving the effectiveness of the mutual agreement procedure (MAP) but views global consensus on mandatory binding arbitration as unlikely in the near term, so it proposes a three-pronged framework for improving MAP dispute resolution:

- political commitments to effectively eliminate taxation not in accordance with the tax treaty in question
- a monitoring mechanism (peer review by competent authorities) to ensure proper implementation of the political commitment
- new measures to improve access to MAP and procedures.

Many tax authorities lack sufficient resources, and the MAP process can be lengthy, inefficient, and unpredictable. The BEPS initiatives and Governments' unilateral actions will undoubtedly place further strain on administrative processes. The draft proposes several administrative best practices, including (i) sufficient resources that are autonomous from tax audits and (ii) appropriate incentives to resolve cases.

The OECD seeks to implement four principles:

- MAP-related treaty obligations are fully implemented in good faith. A revised Model Treaty Commentary would oblige a competent authority 'to seek to resolve' cases in a 'practical, fair and objective manner.'
- Authorities promote prevention and resolution of treaty-related disputes.
- Taxpayers can access MAP when eligible.
- Cases are resolved once they are in MAP.

The OECD encourages the use of alternative dispute resolution options, such as bilateral Advance Pricing Agreements (APAs), which would proactively increase certainty and decrease the risk of double taxation. It is disappointing that the OECD has been unable to reach broad consensus on the need for mandatory binding arbitration.

Indian perspective

India has strongly opposed an international proposal to make arbitration binding and mandatory under the mutual agreement procedure (MAP) to resolve disputes in tax treaties. While India supports the BEPS Project, it is necessary to underline that the concerns of developing countries regarding BEPS may be different from those of developed countries. These concerns are required to be taken on board in a more consultative manner, while developing consensus on the various issues. One of the major concerns from the point of view of developing countries is regarding the approach adopted for making dispute resolution mechanisms more effective which includes introduction of mandatory and binding arbitration in the Mutual Agreement Procedure of the Tax Treaties. This not only impinges on the sovereign rights of developing countries in taxation, but will also limit the ability of the developing countries to apply their domestic laws for taxing non-residents and foreign companies.

Action Point 15 – Develop a multilateral instrument

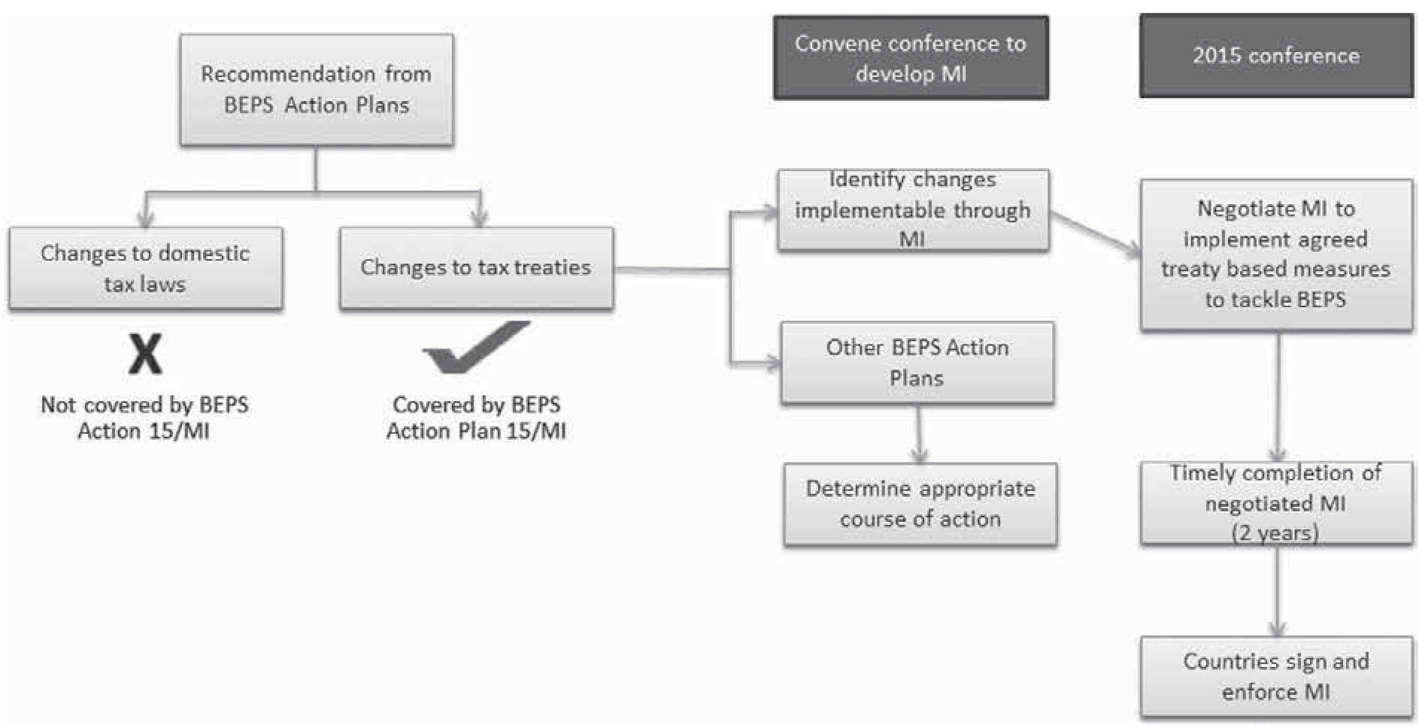
What is the concern?

Updating principles of international taxation will take years through the current practice of updates to the OECD Model Convention slowly filtering through to individual tax treaties.

The September 2014 report confirms that a multilateral instrument is both desirable and, from a tax and public international law perspective, technically feasible. There is an indication that such an instrument could, in addition to updating bilateral treaties, be used for other things, such as to "express commitments" to implement certain domestic law measures or provide the basis for exchange of the country-by-country template, discussed above. There is no discussion of the practicalities of such an instrument but the reference to the fact that "interested countries" may wish to develop a multilateral instrument perhaps hints at the difficulties of achieving a full consensus in this area.

How might this concern be addressed?

The thinking is at an early stage but the OECD envisages some kind of multilateral instrument that would enable participating jurisdictions to implement BEPS measures simultaneously through multiple treaties. Work on the development of the Multilateral Instrument to implement the tax treaty-related Base Erosion and Profit Shifting (BEPS) Action Plan began on 27th May 2015 in Paris. As per the OECD / G20 mandate, the *ad hoc* Group that will complete the work under Action 15 has been established, with over 80 countries participating (the US being a notable absentee at this stage). Participants also agreed on a number of procedural issues so that the substantive work can begin at an Inaugural Meeting which will take place on 5-6th November 2015 (back-to-back with the 20th Annual Tax Treaty Meeting for Government officials which will take place on 3-4th November 2015). A number of international organisations will also be invited to participate in the work as Observers. The sequence of the action plan is represented by a chart as follows:



Indian perspective

This appears to be a practical solution oriented approach since it would otherwise be cumbersome for the Indian Government to renegotiate all its tax treaties. Even more so, this could ensure that the article on exchange of information would be consistent for all tax treaties which India has, rather than interpretational issues arising on account of varying clauses in different tax treaties. At the same time, if the right of obtaining information under an automatic exchange of information clause is provided, then the taxpayers could perceive a threat of roving/fishing enquiries being initiated. As rightly identified by the OECD, the taxpayers would also need to be convinced on the confidentiality of data being shared between various tax authorities. One wonders how such confidentiality safeguards will be developed in the Indian context since the recent advance pricing agreement provisions also do not guarantee confidentiality of information suo motu shared by taxpayers.

4. How realistic is BEPS Action Plan?

Whether this action plan actually is going to meet fundamental changes in international taxation? Does the BEPS initiative have a robust international tax system capable of producing an enduring and fair allocation of the tax revenues of MNCs; to precisely answer these questions in affirmative is very knotty, at this juncture. An optimist might view publication of Action Plan as the crucial point for curbing BEPS and securing greatest tax pie from MNCs. The penumbra associated with technical issues in Action Plan cannot be discarded, *per se.*

Ironically, the fact remains that whilst there are countries which are prepared to act as tax haven by welcoming subsidiaries of MNE's as tax resident without charging them very much tax. What is needed to be analysed is the root cause as to why certain countries choose to act as tax haven for example, Cayman, Ireland, Mauritius, etc. in many cases act as tax havens.

The two main criticisms that are highlighted apropos tax arbitrage planning by MNCs is First, it assumes that revenues from corporate tax can be increased without corresponding decrease in revenues from employee and shareholder taxation. Is it realistic to assume that holding company of the MNE's will maintain current levels of dividend payments if corporate tax liability is increased? Secondly, developing nations do not generally have the capacity to develop or administer the type of sophisticated anti-avoidance legislation required to counter BEPS. There is a danger that OECD countries tightening up their rules for taxing corporation, MNCs may turn their focus to tax avoidance in developing countries. Here, it's argued that Action Plan missed out these concerns *qua* developing countries.

USA belatedly appears to realize what BEPS does to a country and to business. At an OECD International Tax Conference in Washington on June 10, 2015 Robert Stack, US Treasury deputy assistant secretary (international tax affairs) expressed extreme disappointment in the OECD BEPS work. In addition, the USA has decided not to join the 80 countries working on BEPS Action 15, Multilateral Instrument. Altogether, the US does not appear to follow meekly the BEPS recommendations; on the contrary it will look at what's in it for them and for US business.

India has strongly opposed an international proposal to make arbitration binding and mandatory under the mutual agreement procedure (MAP) to resolve disputes in tax treaties. This not only impinges on the sovereign rights of developing countries in taxation, but will also limit the ability of the developing countries to apply their domestic laws for taxing non-residents and foreign companies.

As it stands today, the OECD's biggest challenge is "keeping the consensus" going on international tax principles amongst the countries participating in the BEPS project.

CA. Shefali Goradia[1]

Addressing Tax Challenges of the Digital Economy

Onset of digitisation

The impelled use of internet has transformed business models and with the onset of digitisation, businesses are now only a "click" away from consumers. Digitisation has offered speed and cost efficiencies and has now transformed the way businesses are undertaken – communication is electronic, advertisements are online, goods/services are offered through website, goods/services are delivered online and contracts are executed through software. The digital economy has accelerated and changed the spread of global value chains in which multinationals integrate their worldwide operations.

The ability in digital environments to collect valuable data on customer preferences and behavioural patterns of customers on a real time basis has also helped improve and customize offerings. Digital businesses in some cases are characterised by participation of consumers themselves in businesses – such as multi-sided models like YouTube where consumers participate in uploading and sharing data; or network effects, for example social media sites where benefit of existing users increases when more users join. This has fundamentally changed the value dynamics of different factors of production.

Mobility is an important feature of the digital economy – intangibles related to the business can be placed in any jurisdiction; consumers can access goods or services while travelling; and business functions need not necessarily be located close to the consumers.

Challenges in taxation of digital businesses

Tax evasion, tax avoidance and tax planning have been hotly debated topics globally and concentrated efforts have been initiated by tax policy makers worldwide to curb these practices and check the loopholes in the policy framework. These issues/concerns are not unique to digital businesses and prevail across business segments, though digitisation seemingly presents increased opportunities to multinationals for structuring business models so as to take advantage of loopholes. This may be because while the business has opportunely adapted to technological advancements and embraced mobility, tax policy has not been able to keep pace and adapt to the spurted growth and changes in business models due to digitisation.

The mobility accorded in digital business and other features digitisation have posed concerns and challenges before the tax administration, since it has allegedly enabled businesses, especially multinationals operating in multiple jurisdictions to save/avoid taxes by identifying beneficial treatments arising on account of interplay of tax policies in different jurisdictions. The sophisticated

1. The author would like to acknowledge input from Pooja Thakkar, Manager and Barkha Dave, Associate, BMR & Associates LLP

tax planning implemented by multinationals have allegedly resulted in tax outcomes which are not aligned to intent and basic principles of international taxation and resulted in what is now a common phenomenon of "state-less income". As a result, the flag-bearers of digital businesses have become the poster-boys for Governments to crack their whip on aggressive tax planning.

How are multinationals earning state-less income?

Allegations have been made worldwide and especially in Europe, that multinationals and in particular those engaged in digital businesses, have diverted profits to low-tax jurisdictions where economic activity and value creation is nil or negligible. Also, companies have structured their presence such that they have managed to avoid having a taxable presence or a Permanent Establishment ('PE') in the source country. Aggressive structures adopted by some companies have been made a political issue and Governments have been compelled to investigate and change tax policies of their countries to protect their tax base. Companies like Google, Apple etc. have been publicly targeted and shamed into paying taxes.

So, how do the companies earn state-less income? To illustrate simply, in the digital economy, delivery of services, for instance streaming of video content or provision of online services, can be easily done from overseas without necessitating any part of the activity being performed or any employees being hired in the country where customers are located, thereby avoiding a taxable presence . This is aggravated by the fact that enterprises providing such services from overseas may use an entity based in a low-tax jurisdiction to earn the primary revenues from such activities and accumulate income there.

The two key issues which emanate in concept are: (a) shifting of IP to low-tax jurisdictions and denying taxing rights to the jurisdiction where value creation is undertaken and (b) artificial avoidance of taxable presence coupled with an inefficient application of the traditional PE concept which relies on physical presence. However a careful evaluation is required before proposals tackling (a) and / or (b) are implemented as they may result in overhaul of the international tax principles. As per one argument, the creation of so called "state-less" income is attributable more to the inefficiency of Controlled Foreign Corporation ('CFC') rule, which fails to capture the surplus income parked in offshore subsidiaries in the country of residence of the multinational. Changing the concept of PE in order to accord taxing rights to the market jurisdiction may not be warranted, since taxation is more appropriate where based on participation in economic activity rather than mere location of customers.

BEPS proposals

The OECD *vide* its Base Erosion Profit Shifting ('BEPS') initiative has sought to target / address these practices; to align tax principles worldwide and specifically in the context of digital economy, address tax challenges.

The work done under Action Plan 1 (Addressing the Tax Challenges of the Digital Economy) involved studying various business models such as several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services. The Task Force on the Digital Economy ('Task Force'), a subsidiary body of the Committee on Fiscal Affairs was established in September 2013 to develop a report identifying issues raised by the digital economy and detailed options to address them. The Task Force considered many alternatives such as nexus rules based on significant digital presence; virtual PE; withholding tax on digital transaction; imposing tax on bandwidth use; and collection of VAT / GST on cross-border transactions. Some of these proposals were considered keeping in mind that digital businesses are able to generate and enhance a customer base in the market jurisdiction without requiring a physical local infrastructure in the market jurisdiction. The Task Force further refined the alternatives and formulated revised alternatives, viz. – (a) a new nexus in the form of a significant economic presence; (b) a withholding tax on certain types of digital transactions and (c) an equalization levy. It was however felt that implementation of these proposals may not be required at this stage and that work done under the holistic BEPS project is expected to resolve tax issues in the digital economy as well. Though, countries could introduce some of these recommendations in their domestic tax law keeping in mind that domestic tax measures do not affect their existing commitments under tax treaties.

The Task Force also discussed the possibility of formulating separate taxation rules for digital economy, though this path was not adopted after noting that the digital economy is becoming the economy itself and it was considered difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes and that it would require arbitrary lines to be drawn between what is digital and what is not.

The proposals under the holistic BEPS project which are expected to resolve issues of taxation of digital businesses are as follows:

- ***No exemption for activities which are "core" and counter against artificial fragmentation***
  Action Plan 7 (Preventing Artificial Avoidance of PE status) recommends changes to the definition of PE to ensure that core business activities undertaken in a source state do not benefit from the stated exception to PE – i.e. where activities are not merely of a "preparatory or auxiliary" character. It also proposes introduction of a new anti-fragmentation rule that seeks to counter arrangements involving artificial segmentation and separation of activities, where each activity qualifies as "preparatory or auxiliary" and is excluded from PE, though the activities viewed in aggregate are substantial enough to constitute a PE for the non-resident taxpayer.

- ***Thrust on activities leading to contract conclusion and guidance for standard online contracts***
  Proposals have also been formulated for addressing arrangements where sales in the market jurisdiction result in effective conclusion of contracts, though the current rules on PE make it possible for multinationals to contend against constitution of a dependent agent PE. A substance based approach relying on where the activities resulting in contract conclusion are performed as against where contracts are formally concluded has been recommended. In this respect, interestingly and relevant for the digital economy, it has been expressed that in case of standard online contracts, the fact that the contract terms cannot be varied does not mean that contract conclusion is not the direct result of activities performed by the sales force locally and that convincing customers to accept standard terms is a crucial element leading to contract conclusion which may result in a dependent agent PE constitution.

- ***Counter against transfer of intangibles and aligning taxation to economic activity***
  There is also focus under Action Plans 8-10 to counter against practices of transferring intangibles to group companies solely with tax motive and also to ensure that entities contributing to development and maintenance of intangibles are rewarded appropriately. Thus legal ownership of intangibles will not solely entitle an entity to premium profits unless backed by economic activity and value creation.

- ***Design effective CFC rules***
  Measures are also being undertaken under the BEPS initiative to design effective CFC rules. These rules once implemented are expected to counter practices of multinationals shifting their income to low-tax jurisdictions by locating key intangibles there without the CFC performing significant activities in the low-tax jurisdiction.

Will BEPS Action Plans resolve taxation issues in digital economy?

While the BEPS Action Plans discussed above, once implemented in an aggregated and effective manner, are expected to resolve some concerns relating to taxation of digital economy, more work needs to be done to address some other issues. One such issue is the collection of data which is possible in digital businesses and whether any value is attributable to the revenue which an enterprise may generate on account of use and analysis or monetization of the data collected. Presently there are no clear views or guidelines on the manner in which revenues or value should be allocated to data. There is also no clarity on attribution in multi-sided business models. Whether consumption based taxes are a desirable substitute to bridge the gap in collection of fair level of income tax, is another debatable issue. The issue of characterisation also assumes significance since in absence of a taxable presence, it provides allocation of taxing rights to the source state on gross basis. There is presently little or no authoritative guidance on characterisation of certain new revenue streams such as payment for cloud computing services. Accordingly, characterisation of these payments should be evaluated and the much needed clarity should be provided.

Thus, the analysis of where economic activities are undertaken and where value is generated in digital economy is likely to continue to be a bone of contention between countries since businesses are conducted across jurisdictions and goods/services are accessed from any location globally. Moreover, while taxing principles are in the process of aligning to the new business models, it is likely that the business models in the digital space may further evolve with the help of technological development, thus making it important that revised taxing principles are flexible and sustainable.

Going forward

The current proposal under Action Plan 1 is to mainly resolve tax challenges in digital economy through imposition of consumption taxes and let the holistic implementation of other BEPS Action Plans resolve the overall concern of source countries. A follow on work based on evolution of businesses in digital economy and other developments is expected to be presented in 2020.

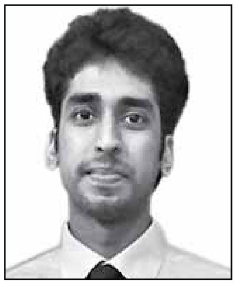
Some countries have reacted to the tax challenges pending formalization of BEPS proposals by introducing changes to their respective domestic tax laws – UK has introduced a "diverted profit tax[2]" from April 2015, which is aimed at tackling tax challenges resulting due to artificial avoidance of PE and intra group transactions lacking economic substance. Tax is imposed at 25% on deemed profits ignoring structures that artificially avoid a PE or intra-group transactions lacking substance. Vietnam has proposed new rules for dependent agent PE which are based on representation relationship. Australia, in its parliamentary board, has proposed the Multinational Anti-Avoidance Law on profit attribution which are applicable for attributing profits where a PE has been artificially avoided (for instance where companies which make sales in Australia but book revenue offshore).

It is also possible that the revenue authorities in some countries may litigate against companies citing the examples in BEPS reports and the developments in other countries. This would lead to more uncertainty, at least at the lower levels.

India has expressed its alignment to the BEPS proposals and has been positive in its approach to respect the implementation of BEPS and laudably, has avoided any unilateral actions in this respect. Some proposals aligned with BEPS relating to reporting and collection of information from taxpayers are expected in the upcoming Union Budget.

A complete overhaul and alignment of tax policy framework worldwide may be difficult to achieve unless all countries act in tandem. One will have to monitor the execution of the multilateral instrument in this respect. Until such time, the proposals under various BEPS Action Plans may only be mere guidance to multinationals for planning or amending their structures.

2. Also known as 'Google tax'

CA Nilesh Vichare & CA Noomit Ranghwani

Action Plan 2 – Neutralising the Effects of Hybrid Mismatch Arrangements

BEPS refers to tax avoidance strategies resulting in double non-taxation, or less than single taxation, on account of differences in tax rules across jurisdictions. It includes shifting of profits away from jurisdictions where the economic activity takes place by using arrangements that exploit gaps and mismatches in tax rules.

"Coherence", "transparency" and "substance" – the three pillars to tackle BEPS have become the focal point of every discussion surrounding the tax world today. The relevance of these terms in the Indian tax world was seen with the advent of GAAR in the Direct Tax Code and retroactive amendments for taxation of indirect transfers. One can be certain that with the adoption of BEPS action points, these three pillars shall be the key mantra surrounding all arrangements.

The call to prevent BEPS originated primarily from developed countries that had earlier supported globalization because it offered new markets for their companies. These countries are now realizing that global operations may have been used by multinational companies to reduce their legitimate tax share across geographies. In this context, the Organisation for Economic Cooperation and Development (OECD), at the request of the G20 nations, developed comprehensive action points to address BEPS. The plan identified 15 action points to tackle BEPS.

On 5th October 2015, OECD released Final Reports on all 15 focus areas identified in its Action Plan on BEPS. The output from the BEPS Action Plan, which is in the form of recommendations for the design of countries' domestic laws, proposed changes to bilateral tax treaties and to the OECD Transfer Pricing Guidelines (TPG), broadly falls in the following categories:

(1) Agreed minimum standards

(2) Reinforced international standards

(3) Common approaches and best practices for domestic tax law

The OECD also briefly discusses the "post-BEPS environment", stressing the importance of focusing on implementation of the BEPS recommendations in a consistent and coherent manner, monitoring the impact on both double non-taxation and double taxation.

Overall, some of the measures may have an almost immediate effect in a number of countries while some require treaty based action or legislative action by countries for which the action provides recommendations/ suggestions.

One such action plan that provides such suggestions to domestic law and treaties by countries is "Action 2 – Hybrid Mismatch Arrangements". Before we move into analysing the recommendations set forth in this action plan, let us understand the meaning of Hybrid Mismatch Arrangements ('HMA').

What is HMA?

HMA is an arrangement that exploits differences in tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral.

HMAs, featuring in a cross-border scenario, thrives on mismatches in domestic law treatment. Basically, it identifies and exploits arbitrage opportunities in two or more tax jurisdictions.

HMA can be broadly classified in the following three categories –

- *Hybrid financial instrument* – An instrument that is treated as a debt in one jurisdiction and equity in another jurisdiction
- *Hybrid transfers* – An asset transfer that is treated by its form in one jurisdiction and by its economic substance in another jurisdiction
- *Hybrid entities* – An entity that is treated as a taxable entity in one jurisdiction, but tax transparent in another jurisdiction (such as US "Check the box" entities)

These types of arrangements are widespread and result in substantial erosion of the taxable bases of the countries concerned and create an overall negative impact on competition, efficiency, transparency and fairness.

An overview of the Action Plan

Action Plan 2 provides for recommendations in two parts i.e. Part 1 contains recommendations for changes to domestic law and Part 2 contain recommendations for changes to the OECD Model Tax Convention.

In order to introduce coherence of corporate income tax at an international level, the design of domestic rules and the development of model treaty provisions should neutralize the following hybrid mismatches –

- Deduction in one jurisdiction with no corresponding increase in the taxable income in another jurisdiction (i.e. Deduction / No Inclusion mismatch - "D/NI")
- Deductions in multiple jurisdictions for the same expenses (i.e. Double Deduction – "DD")
- Accessing tax credits in multiple jurisdictions for the same expense (i.e. double tax credit)

Guiding principles for implementation and co-ordination

While the objectives that the recommendations should achieve have been distinctly set out above, it is imperative that the recommendations do not have a dramatic disruption on present domestic laws and should provide necessary flexibility, ease in implementation and minimal compliance cost. Also, necessary regulation to ensure smooth transition of existing structure or rules for 'grandfathering' the same need to be factored. Some of the key guiding principles to be considered while implementing the recommendations, as provided by the Action Plan are as follows –

- Ensure minimum disruption to existing domestic law. To neutralize the mismatch rather than reverse tax benefit that arises under one jurisdiction.
- Be workable for taxpayers and tax authorities in terms of minimal compliance cost and administrative burden.
- Be comprehensive, clear and transparent in operation and avoid double taxation through co-ordination
- ***No Grandfathering of existing provisions*** – Countries to identify need for transitional

measures and ensure the same provide sufficient flexibility for the rule to be incorporated into the laws of each jurisdiction. The report also expressly states that there will be no presumption as to the need to grandfather any existing arrangements as the same may lead to inconsistencies in application.

In the absence of grandfathering provisions, it is imperative that the taxpayer be given sufficient notice and time to determine the likely impact of rules in order to restructure existing arrangements to avoid any adverse and unintended tax consequences.

Based on above backdrop, the recommendations set out in the Action plan are as follows –

Part I – Recommendations for domestic law

In order to ensure minimum disruption to domestic laws, these recommendations take the form of linking rules to address the following mismatches in tax outcomes–-

- Payments made under a hybrid financial instrument; or
- Payments made to or by a hybrid entity; or
- Rules to address indirect mismatches that arise when the effect of a hybrid mismatch arrangement are imported into a third jurisdiction

Since the recommendations take the form of linking rules, they simply align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction and otherwise do not disturb the commercial outcomes.

In order to prevent double taxation, a rule order is in place in the form of a primary rule and secondary rule or defensive rule. This prevents more than one country applying the rule to the same HMA and therefore avoids double taxation.

In simple terms, under a primary rule the country denies the taxpayer deduction for a payment to the extent it is not included in the taxable income of the recipient or treated as a deduction in such counter party jurisdiction. Alternatively, in case the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule that requires the deductible payment to be included in the income or deny the duplicate deduction, as applicable.

Thus, the recommendations have both primary and defensive components, thereby allowing jurisdictions to unilaterally address issues with minimal global co-operation. A general overview of the recommendations[1] are provided below -

Mismatch	**Arrangement**	**Specific Recommendations on improvements to domestic law**	**Recommended hybrid mismatch rule**		
			Response	**Defensive rule**	**Scope**
D/NI	Hybrid Financial Instrument	No dividend exemption for deductible payments. Proportionate limitation on withholding tax credit	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements

1. Table extracted from OECD report on Action Plan 2

Mismatch	Arrangement	Specific Recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
	Disregarded payment made by hybrid		Deny payer deduction	Include as ordinary income	Controlled group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque	Deny payer deduction	–	Controlled group and structured arrangements
DD	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response, defensive rule applies to controlled group and structured arrangements
	Deductible payment made by dual resident		Deny resident deduction	–	No limitation on response
Indirect D/NI	Imported mismatch arrangements		Deny payer deduction	–	Members of controlled group and structured arrangements

Now, let us move towards a brief discussion on the above rules –

A. Hybrid Financial Instrument (FI) Rule

A financial instrument is treated as a Hybrid FI if, by virtue of **"terms of the instrument"**, a **"payment"** under the instrument is **"deductible"** to the payer, but is not included in ordinary income by the payee.

Based on above, the mismatch must arise only on account of **terms of the instrument** and not any other reason.

Further, there must be a payment under the instrument which includes any transfer of value and inter alia includes interest, accrual of future payment obligations, discounts, and redemption premiums. It does not, however, include any 'notional' deductions. FIs inter alia include debt, shares, finance leases and deferred purchase price (treated as interest) on transfer of assets.

Also, it is worth noting that the payment should be 'deductible' to the payer which means that as long as the payer is entitled to take a deduction on the payment it would satisfy the condition. Deduction in any jurisdiction is sufficient to trigger application of the rule.

Applicability

The rule is applicable to a scenario where the mismatch is attributable to terms of the FI and where the arrangements are structured in a 'controlled group' and to 'structured arrangements'. The meaning of controlled group and structured arrangements are provided below -

- 'Structured arrangement' is where the hybrid mismatch is priced into the terms of the arrangement, or facts and circumstances indicate that it has been designed to produce a hybrid mismatch. However, a taxpayer won't be a party to a structured arrangement if that taxpayer and its group could not have been expected to be aware of the hybrid mismatch and did not share the tax benefit.
- Same 'Control Group' will arise where there is at least 50% investment (direct or indirect) or effective control by one party in the other or by a third party in both. Also, if they are consolidated for accounting purposes or can be regarded as associated enterprises under Article 9.
- Separately, two parties shall be treated as related party where they are part of the same Control Group or where there is a 25% investment by one party in the other or by a third party in both entities.

There are certain scenarios that have been specifically carved out from the applicability of the above rule, which inter alia are as follows –

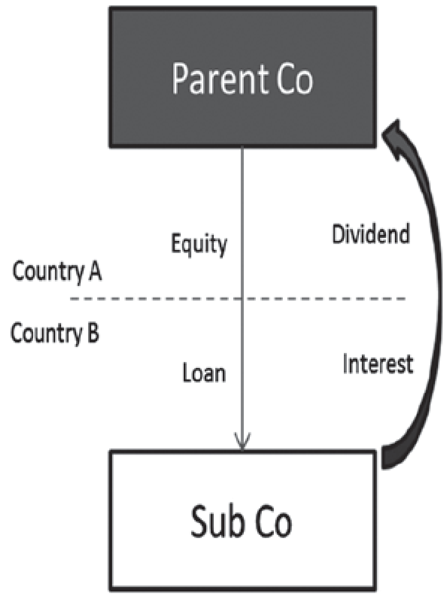
- If mismatch is on account of non-taxability due to tax status of the taxpayer, for example – exemptions granted to pension funds/ charitable institutions
- Mismatch on account of timing difference of taxation provided the income is included in the hands of the payee within 'reasonable time.' 'Reasonable time' has not been defined and burden of proving that the payment is taxable within reasonable time to the tax authorities lies on the payer
- Mismatch due to valuation
- Income is included in any other jurisdiction (including on account of CFC) is sufficient to discharge application of the rule. It has been recommended that where hybrid mismatch arrangements are captured under CFC rules, that the hybrid rules would not apply subject to relevant investor demonstrating to tax authorities that the hybrid payment has been fully taxed.
- Investment vehicles (like REITs), where holder is subject to tax on payments
- No payment made. However, the jurisdiction grants interest deduction on a notional basis.

Case Study

Background

- Parent Co infuses fund into Sub Co through a Hybrid instrument (HI)
- HI is treated as Equity in County A and Loan in Country B
- Payment of interest on the HI is deductible to Sub Co in Country B and dividend is exempt to Parent Co in Country A

The above scenario leads to a mismatch outcome where deduction is claimed in one jurisdiction, while no corresponding income is taxable in the other



Impact of Action Plan 2

- Primary rule –Country B to deny interest deduction to Sub Co (payer)
- Defensive rule – Dividend to be included in income in hands of Parent Co in Country A

No-re characterization

The Action Plan does not involve re-characterization of the instrument or its terms, in any jurisdiction. Accordingly, even if the primary rule i.e. denial of interest deduction is introduced, the Indian tax implications viz. withholding on interest, transfer pricing, other provisions applicable to interest shall continue to apply.

India impact

The rule on Hybrid Financial instruments may be considered most relevant from an India perspective. However, the introduction of primary rule (i.e. disallowance of deduction) in India may still keep repatriation by interest payment as tax efficient on account of the following –

- Most treaties have 10% withholding requirement on interest vs. a 20% dividend distribution tax making interest payment more beneficial
- Since India is a high debt cost country, the TP benchmark rate is also on a higher side
- Disallowance under HMA will not impact MAT
- So long as borrowed funds are used for earning taxable income, there no thin cap rules or no limitation on quantum of interest payment to impact the same.

Overall, the efficiency of interest payment shall need to be evaluated if India does not introduce primary rule of disallowance under domestic law.

Further, from an outbound perspective, Indian entities do not have any real India 'tax' advantage of having outbound hybrid instruments.

B. Disregarded Hybrid payment rule

Applicability

This rule covers a scenario where a party claims deduction for a payment made in its jurisdiction which is disregarded as income for tax purposes in the payee jurisdiction resulting in a mismatch.

In other words, the payment is deductible for the payer but not recognized under the laws of payee jurisdiction **for the reason that the payer is treated as a transparent entity under laws of the payee jurisdiction.**

The above rule is limited in scope to parties within the same control group or where payment is made under a structured arrangement to which taxpayer is a party. Further, the nature of payments includes items of current expenditure such as service payments, rent, interest and other deductible amounts.

Recommendation

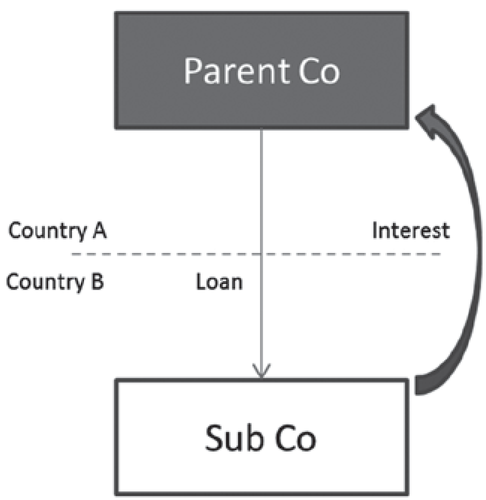
Primary response: The payer jurisdiction to deny a deduction to the extent of D/NI outcome.

Defensive rule: Include the payment amount as ordinary income in the payee jurisdiction

Case study

Background

- Sub Co pays interest to Parent Co against loan taken
- Sub Co is a hybrid entity i.e. disregarded as a separate entity (e.g. treated as a Branch of Parent Co) in Country A, but treated as a separate entity in Country B. Therefore, Parent Co pays no tax on such interest income.



Impact of Action Plan 2

- Primary rule – Country B to deny interest deduction to Sub Co (payer)
- Defensive rule – Interest to be included in income in hands of Parent Co in Country A

India impact

This rule is unlikely to have any significant impact under an India scenario on account of the following –

India as payee – It is unlikely that India shall be treated as a payee in the above scenario since there are no rules for disregarding a separate legal entity.

India as payer – India as payer may need to provide for primary rule to deny deduction of payment if Indian entity is hybrid in recipient jurisdiction (provided income of B Co is not included in hands of Parent Co)

C. Reverse Hybrid Rule

Applicability

When a party/person is treated as a transparent entity under its jurisdiction but it is treated as a separate entity by the investor/parent jurisdiction. Such a party is called a Reverse Hybrid Person ('RHP').

A mismatch outcome arises when payment made to such RHP is deductible in jurisdiction of the payer but not taxable in hands of the RHP since the entity is transparent under its jurisdiction. Further, there is no tax implication in the jurisdiction of the parent of such RHP since the RHP is treated as a separate entity in the parent jurisdiction.

The rule is applicable when the RHP and payer are members of the same control group or payment is made under a structured arrangement. The above is not applicable in case the income is taxable in either (payee or investor) jurisdiction since in such a scenario the mismatch ceases to exist.

Recommendation

Primary response: Payer jurisdiction to deny deduction

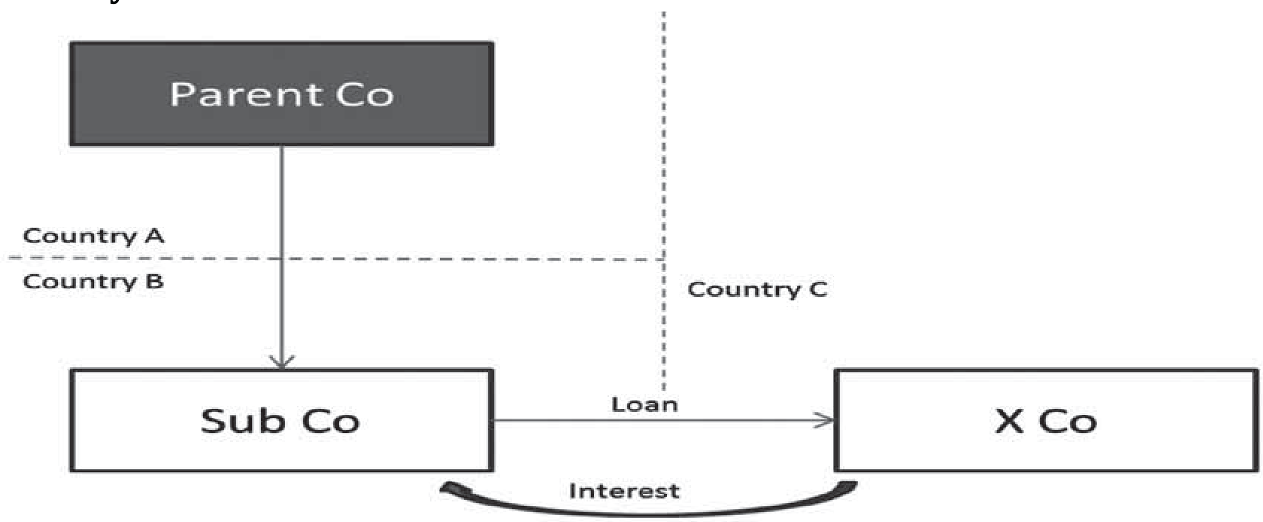
Defensive rule: No defensive rule

Other specific recommendations[2]: Include payments made to such RHP in income of parent under CFC rules / other offshore investment regimes; limit the tax transparency status to

2. These are general recommendations and the report does not specifically mandate cumulative application of the same.

resident investors and also "turn off" tax transparency rules which result in such mismatch. Separately, introduce stricter information reporting for intermediary entities.

Case study



Background

- X Co (resident of Country C) pays interest to Sub Co on funds borrowed from Sub Co
- Sub Co is fiscally transparent under the laws of Country B and treated as a separate entity under laws of Country A
- Based on above, while interest payment is deductible in hands of X Co in Country C, however, income is not subject to tax in hands of Sub Co (fiscally transparent in Country B) nor in Country A where Sub Co is treated as a separate entity

Impact of Action Plan 2

- Primary rule – Country C to deny deduction to X Co.

India impact

India as parent – India unlikely to be treated as a parent entity in absence of rules / provisions to treat foreign entity as transparent

India as RHP – May apply to partial pass through entities like REITs which shall pursuant to the above recommendation, need to restrict tax transparency rules and increase information reporting

India as payer - India may need to introduce the primary rule and deny deduction of payment

D. Deductible Hybrid Payments Rule

Applicability

When a payment made by a payer (such as a branch or hybrid person) is deductible in jurisdictions of both - the payer and also its parent/investors.

The mismatch in above arrangement is on account of double deduction. No mismatch if deductions are claimed against the income taxed in both jurisdictions.

Rule covers all payments which can be used to generate double deductions, including non-cash items such as depreciation.

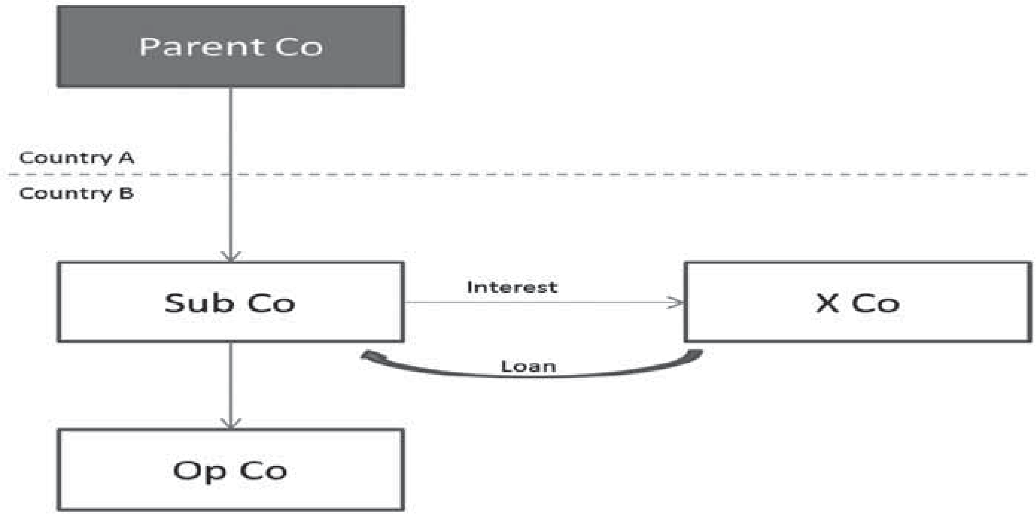
Recommendation

Primary response: Parent jurisdiction to deny deduction

Defensive rule: Payer jurisdiction to deny deduction

There is no limitation on scope for applicability of primary rule. However, the defensive rule is applicable only if the parties to the mismatch are in same control group or where taxpayer is party to the structured arrangement.

Case study



Background

- Sub Co borrows a loan from X Co and pays interest on the same. Sub Co has no source of income.
- While Sub Co is treated as a transparent for entity tax purposes (i.e. treated as a Branch) as per Country A, it is treated as a separate entity in Country B.
- Sub Co and Op Co file consolidated tax return in Country B and claim deduction of interest.
- Based on above –
  - o Country A – Parent Co. to avail interest deduction without inclusion of any income of Op Co.
  - o Country B – Sub Co and Op. Co. file consolidated returns and claim deduction of interest

Impact of Action Plan 2

Primary response: Country A to deny deduction to Parent Co

Defensive rule: Country B to deny deduction to Sub Co

India impact

This rule is unlikely to have an impact under an India scenario on account of the following –

India as parent – India unlikely to be treated as a parent entity in absence of rules / provisions to treat foreign entity as transparent. In case India as parent has a foreign branch, there may be comprehensive taxation of income of that branch in India and accordingly the rule ought not to apply.

India as payer – India as payer may not apply since there are no provisions for consolidated / group returns.

E. Dual resident payer rule

Applicability

The rule is applicable in a scenario where the payer is treated as a resident for tax purposes under the laws of two or more jurisdictions. This shall entail the payment being eligible for deduction under both jurisdictions (For example – jurisdiction of the payer and jurisdiction where accounts are consolidated) without corresponding taxation of income in both jurisdictions.

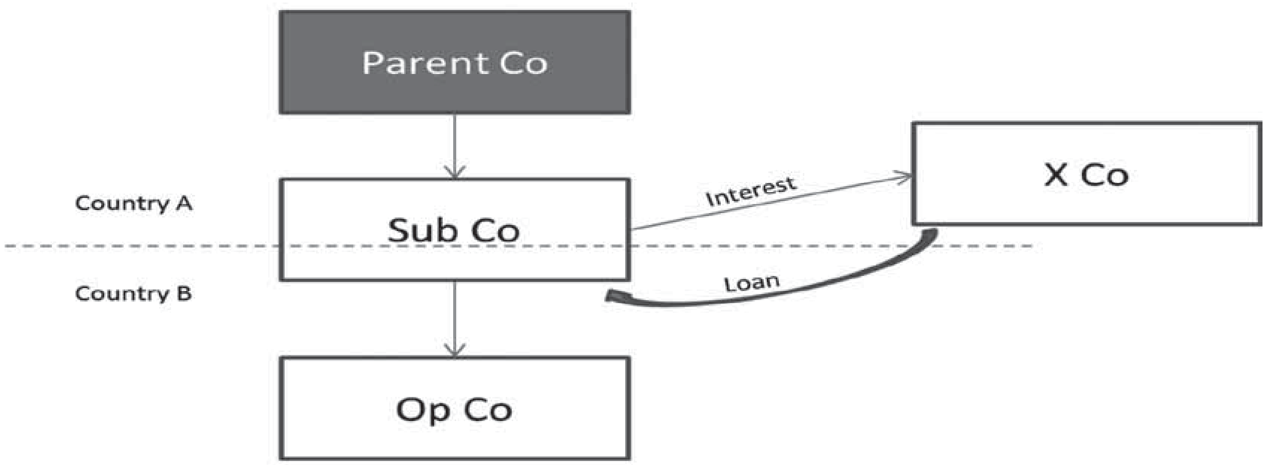
Rule applicable to all payments and losses which can be used to generate double deduction.

Recommendation

Primary response: Deny deduction for such payment in country of residence. This may result in both jurisdictions applying the primary response and therefore a risk of double taxation. No clear guidance on which jurisdiction can apply the rule first.

Defensive rule: None

Case Study



Background

- Sub Co is a dual resident i.e. it is resident in both Country A and B
- Sub Co pays interest on loan borrowed by X Co and does not earn any income
- Sub Co is consolidated for tax purposes with both Parent Co and Op Co in Country A and B respectively and claims deduction for interest expenditure under both country jurisdictions

Impact of Action Plan 2

Primary response: Deduction to be denied in country of residence. This may result in both jurisdictions applying the primary response and therefore a risk of double taxation. No clear guidance on which jurisdiction can apply the rule first.

India impact

Presently, India's treaties are worded such that the tie breaker rule of POEM is used to determine country of residence in case of such dual residency.

Further, in absence of consolidated group returns in India, this rule may not have importance from an India perspective.

F. Imported mismatch rule

The key objective of this rule is to maintain the integrity of other HMA rules.

The recommendations mentioned earlier are intended to be implemented through domestic law in all participating countries. There is a possibility that HMAs are entered into such that a payment is made to a payee that is not subject to the above rules.

The intent of the rule is to prevent taxpayers from entering into a structured arrangement within group members that shift the effect of an off-shore hybrid mismatch into the domestic jurisdiction using a non-hybrid instrument (For example – Loan)

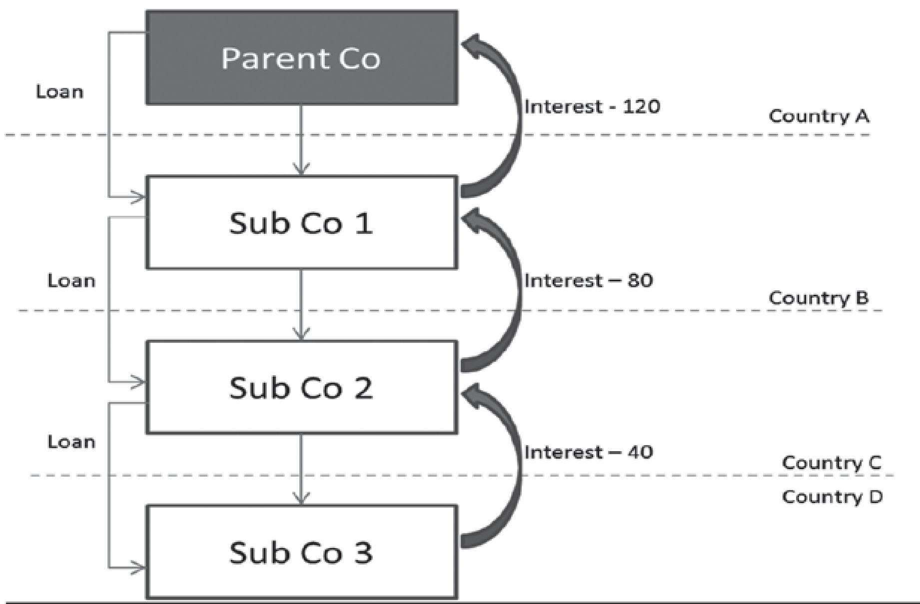
Imported mismatches rely on the absence of effective HMA rules in offshore jurisdictions in order to generate mismatch in tax outcomes which can then be imported into the payer jurisdiction.

Recommendation

The recommendation is in the form of a linking rule where the payer jurisdiction is to deny deduction to the extent there is indirect D/NI income.

The proposed rules involve an unavoidable degree of co-ordination and complexity; the guidance sets out three tracing and priority rules to be used to determine the extent to which a payment should be treated as set off against a deduction under an imported mismatch arrangement. This is one of the most complex areas of the report and there are a number of examples included in report on this matter.

Case Study



Background

- The above figure illustrates the group financing structure and the total gross amount of interest payments made in each accounting period under this structure.
- All loans are made out of the same intra-group financing arrangement.
- Sub Co 3 is the only group entity resident in a country that has implemented the recommendations set out in the report.

Impact of Action Plan 2 and Analysis

- **Step 1** – Sub Co 1's payment under the hybrid financial instrument gives rise to a direct hybrid deduction
- **Step 2** – Imported mismatch payment (i.e. payment by Sub Co 3) and the hybrid deduction are part of the same structured arrangement

The structured imported mismatch rule requires the payer jurisdiction to deny a deduction under an imported mismatch payment to the extent the income from such payment is offset (directly/indirectly) against a hybrid deduction under the same structure

In order to determine the extent of such deduction a tracing approach is to be followed. The mechanical steps involved in tracing are as follows –

- Lower of Sub Co 1's payment to Parent (120) and Sub Co 2's payment to Sub Co 1 (80) treated as amount of Sub Co 2's indirect hybrid deduction under an imported mismatch arrangement
- The lower Sub Co 2's indirect hybrid deduction (80) and Sub Co 3's payment (40) under the same arrangement.

Based on above, Country D should deny deduction of 40 under the imported mismatch rule.

Part II – Recommendations for tax treaty issues

Part II provides recommendations / changes to the OECD Model tax convention to ensure that hybrid instruments and entities, as well as dual resident entities, are not used to obtain unduly benefit of tax treaties and the tax treaties do not prevent the application of the changes recommended in Part I to domestic law.

A. Dual resident entities

As mentioned earlier in the Dual resident payer rule, the relevant scenario is when a taxpayer, treated as a resident in two or more jurisdictions makes a payment that results in double deduction outcome (without dual income inclusion).

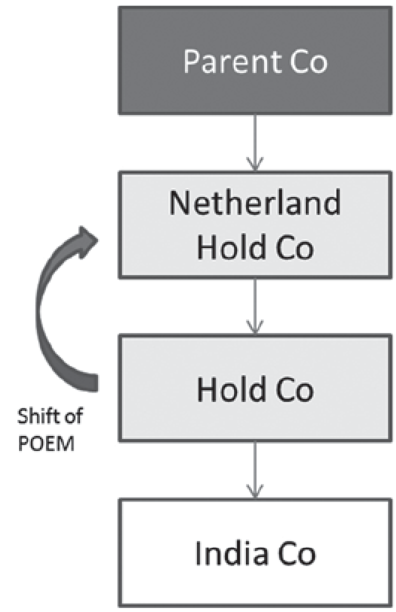
In order to overcome the above mismatch, changes have been recommended to Article 4(3) through Multilateral Instruments (Action 15). While presently the POEM test resolves such dual residency, going forward the Competent Authorities of the relevant jurisdictions shall endeavour to determine by mutual arrangement the residence of the dual resident entity. Further, in absence of direction, the dual resident entity cannot claim treaty benefits from any of the jurisdictions involved (similar to present India-US DTAA).

The Action Plan mentions that the treaty amendments may not meet all concerns on BEPS associated with dual resident entities (i.e. residency tie breaker may still break in favour of the tax favourable jurisdiction where tax avoidance by mismatch may be possible) and therefore, it suggests changes to domestic law. These changes include denial of residency to an entity under domestic law if the entity is treated as a resident in another jurisdiction under applicable treaty.

Case Study

Background and analysis

- Parent Company holds Indian company through Hold Co.
- Hold Co is situated in a non-treaty jurisdiction.
- POEM of Hold Co is shifted to Netherland making it a resident of NL and eligible for treaty benefits.
- Change of POEM would not entail capital gain implications.
- Pursuant to shift of residency, dividend and capital gains of Hold Co from Indian Company may not be taxable in India under tax treaty.



Impact of BEPS Action Plan 2

- Hold Co residency to be resolved through Competent Authorities.

B. Treaty provisions on transparent entities

Transparent/Hybrid entities are entities that are not treated as taxpayers by either or both jurisdictions that have entered into a tax treaty (such as partnerships). This section of the Action Plan deals with application of tax treaties to such hybrid entities.

Objective is to ensure treaty benefit is granted in 'appropriate case'. The Action Plan acknowledges grant of proportionate relief i.e. if member from the Hybrid entity jurisdiction holds 50% stake and balance is held by person from a non-treaty jurisdiction, then 50% treaty benefit is granted.

The changes proposed in the OECD language are such that the income derived by or through an entity or arrangement that is partially or wholly fiscally transparent under the tax law of a contracting state shall be treated as income to the extent it is treated as income of a resident of that state. No domestic guidance is provided on characterization of hybrid entities for the purposes of claiming treaty benefits.

From an India perspective, there are no rules/ guidelines on circumstances under which a foreign entity is to be classified (or even disregarded) as a company/ partnership/ AOP.

C. Interaction between Part I and tax treaties

The Action Plan provides for special attention to address potential treaty issues that could arise from recommendations in Part I. The key factors considered are as follows –

- In relation to treaty issues related to rules that would result in the denial of deduction or would require the inclusion of a payment in ordinary income (as per Part I), the tax treaties would generally not prevent the application of such rules.
- In relation to rules concerning non-discrimination on the recommendations of Part I, the report concludes that as long as the domestic rules that will be drafted to implement these recommendations are properly worded, there should be no conflict with these non-discrimination provisions.

Key takeaways

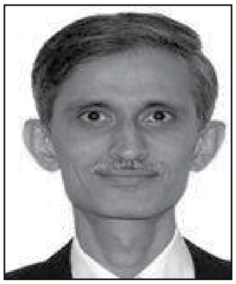
From an India perspective, Action Plan 2 may not treated as high priority item, the impact of Action Plan 4 may also need to be considered. Action Plan 4 – "Limiting Base Erosion involving Interest Deductions and other Financial Payments" if implemented may result in whole/ partial interest disallowance for highly leverage or capital intensive entities. However, as discussed earlier, as long as the tax implication on interest (Withholding tax ~10% based on a number of treaties) is lower than dividend distribution tax (~20%), India shall still remain a favourable jurisdiction from an inbound perspective.

However, possibility of tax scrutiny on whether the financial instrument (subject to HMA restriction) can be considered as debt would need to be taken into account. Recharacterization of interest payment on such debt as dividend shall entail default in DDT along with interest, penalty and prosecution implications.

Overall, some of the key action points to be considered by India business houses are as follows –

- Amendment to Article 4(3) of the treaty regarding dual resident entities would be need to be evaluated for such existing structures
- Indian multinational with offshore HMA will need to evaluate the impact on such arrangements based on how the relevant country incorporates changes in its domestic law based on the Action Plan
- Impact of Action Plan 2 must be analysed in concurrently with other related Action Plans viz. Action Plan 3 (CFC), Action Plan 4 (interest limitation), Action Plan 6 (Treaty Abuse)
- Further, it is important that in absence of grandfathering provisions to existing structures, a prior analysis on the implications of all existing structures and instruments shall need to be carried out so that necessary modifications can be made to comply with such recommendations.

Overall, it is important to note that the recommendations need to be adopted into domestic law before they apply. This may result in piecemeal adoption of these recommendations over the course of time. At this stage it is difficult to assess whether the primary, defensive or imported rules shall apply and the possible effect of these rules shall need to be analysed under various scenarios.




CA Pranav Sayta & CA Harshal Shah

Designing effective CFC Rules***

2015 finally saw the Indian entrepreneur announce his arrival to the global stage. The Indian e-commerce giant (Flipkart), in just 8 years of its operations, is already being valued over $15 billion dollars and has already begun to dream of a US listing. This allows Flipkart to fearlessly rub its shoulders with large global corporations, such as Amazon, Ebay, Alibaba, etc., already having presence around the world. To cite another example, Zomato, in a mere 6 years of existence, has presence already in 22 countries around the world. Flipkart and Zomato are amongst the young breed of home grown companies which have achieved substantial global presence within just a few years of their operations. There is no denying that the Indian entrepreneur with global ambitions and presence is here to stay.

In this background, shouldn't our tax laws, also encourage this spirit? If not encourage, shouldn't they atleast be designed in a way which would prevent Indian entrepreneurs loosing competitiveness whilst they lock horns with their global competitors.

Before introducing any anti-avoidance measure in tax law, it is important to first identify the tax avoidance which it is trying to curtail. Broadly speaking, in the case of the CFCs, there are broadly two types of base erosion which a CFC provision may seek to curtail. The first type would be to prevent the home country's base (India in our case) being eroded. Countries such as UK have successfully designed their rules with this basic intent in mind. The second type prescribe all-encompassing CFC rules, as for instance in Japan where, even if a third country's base (i.e. other than the home country and the source country) is being eroded they would want to bring such stateless income within its ambit.

The question remains, which of the two approaches should India seek to adopt? Whichever be the approach, defining the policy objective clearly, is something one must first strive to achieve, in any tax law. In this paper, an effort has been made to examine the various considerations which need to be kept in mind, while deciding on the introduction of CFC provisions and designing rules in relation to Controlled Foreign Corporations ("CFC") in light of the Action Plan 3 of the OECD Base Erosion Profit Shifting Report ("CFC Report").

1. OCED BEPS Report

The CFC Report was released on 5 October 2015 as part of the BEPS package. Recommendations of the CFC report are not a 'minimum standard' and therefore, partner countries are not obligated to enforce / amend CFC legislations based on the recommendations. The OECD recognizes that each country prioritises policy objectives

***The paper writers would like to sincerely thank the contributions made by Amish Behl, Peter Lloyd & Ashwini Kothawade

differently. Accordingly, the CFC report contains recommendations / design options that could be implemented by countries choosing to enforce / amend CFC regulations, so that BEPS concerns may be adequately addressed.

The CFC report sets out the following six building blocks for the design of effective CFC rules:

- Definition of a CFC
- CFC exemptions and threshold requirements
- Definition of CFC income
- Rules for computing income
- Rules for attributing income
- Rules to prevent or eliminate double taxation

Prior to delving into the building blocks, it is imperative to analyse the suitability of introduction of CFC rules in India, given the current economy and regulatory landscape.

2. Introduction for CFC in India

In the Indian context, there are pressing reasons to reconsider and assess whether there is desirability and rationale for introducing CFC rules in India. In this regard it is pertinent to note that the OECD does not consider the recommendations of the CFC report as a minimum standard.

The policy perspective for not introducing CFCs is discussed further below:

- Improving the international competitiveness of the Indian economy should be a major policy goal. This can be improved if Indian MNEs (i.e., businesses headquartered in India that operate abroad) are able to effectively compete in foreign markets. CFC rules pose a hindrance to free movement of capital and will hinder international investment and result in a competitive disadvantage for Indian MNEs.
- In the Indian context, in the absence of capital account convertibility, exchange control regulations still inhibit outbound investment. Also, the quantum of outbound investment is still not comparable to the levels in relation to countries where there is a free foreign exchange regime. Therefore, introducing a CFC regime at present would further constrain Indian MNEs looking to become global players.
- The principle of capital import neutrality promotes the competitiveness of Indian-based MNEs. Under the principle of capital import neutrality, any business would see the return from its investment in any given foreign country taxed only by that foreign country. If India introduces CFC rules Indian taxation in the case of an Indian MNE may apply differently than residual taxation by another capital-exporting country. The result may be that the after-tax return to an investment by an Indian MNE in a given foreign country may be less than the after-tax return earned by another investor (global competitor), making an identical investment.
- CFC rules essentially impose a tax that is extra-territorial in nature, in order to protect a country's own tax base. However, given the revised robust transfer pricing guidelines proposed by OECD in the BEPS project, coupled with the impending strengthening of tax treaties to include limitation on benefits, base erosion on account of non-operating CFCs should reduce considerably. Further, such measures could address tax avoidance, with significantly less detriment to genuine business activity and intent, as compared with CFC rules.

- Since CFC rules are inherently complicated, prescribing various tests and filters, the costs and burden of compliance will be detrimental to business. This has also been acknowledged / recognised by the OECD.

In the light of the above discussion, there is a serious need for India to rethink on the desirability and rationale for introducing CFC rules in India. In any case, if India were to decide to introduce CFC rules, striking the right balance between protecting India's tax base whilst allowing the Indian entrepreneur to remain competitive, becomes imperative.

Going forward, our approach in this respect is to go over each block outlined by OECD as constituting an important part of an effective CFC legislation. We have set out the OECD recommendations for each block, followed by the corresponding provisions that were proposed in DTC 2013. We have then discussed certain international best practices with respect to that particular block.

3. CFC Rules in DTC: Need for a change of approach

Before, we engage in a discussion about the various building blocks as discussed in the CFC Report, one fundamental shortcoming of the CFC rules in DTC 2013, was the "all or nothing" approach proposed therein. Simply speaking, once a foreign company is regarded as a CFC, all of its income (and not just passive income) is subjected to tax. This approach makes the DTC provisions too broad. It not only results in taxation of active income which is not a matter of concern for CFC rules but severely impact competitiveness of the Indian entrepreneur. There is a dire need to rethink this approach.

One may also note that the substance threshold was 75:25 under DTC 2013. This results in the entirety of an entity's profits falling within the CFC charge if more than 25% of the profits are derived from passive income. A threshold is not defined in the majority of other jurisdictions' CFC rules and is not recommended in the Report. Best practice would suggest that this arbitrary limit is not included in any new CFC rules and that only tainted income is considered to be within the scope of CFC rules.

CFC rules must strike a balance between the reduced complexity inherent in mechanical rules and the effectiveness of more subjective rules. For the purpose of determining CFC income, best practice would be to apply a transactional approach that looks at specific income streams rather than simply focusing on the entity. This would ensure that the rules act as targeted anti-avoidance.

This is one of the principal recommendations under Action 3 and is reflected in the targeted CFC rules of other jurisdictions. For example US, UK and Germany follow a similar approach i.e. only tax that income which is considered as tainted, rather than the "all or nothing" approach adopted by DTC.

4. Discussion on Building Blocks for CFC Legislations

a) Rules for defining a CFC

I. Type of Control

The CFC Report recommends that determination of control for the purposes of a CFC should be an objective and mechanical set of tests that focus on both the legal and economic ownership of a company. The DTC has both legal and economic provisions by which control could be deemed. This seems consistent with the OECD recommendations.

However, the clear outlier, as far as the DTC is concerned, is the additional provision at Paragraph 5 (b) (iii) which make the "exercise of dominant influence on the company due to special contractual relationship" a relevant factor for determination of a CFC. This type of provision could result in differing opinions between taxpayer and tax administration and could potentially lead to considerable uncertainty which should be avoided in scoping CFC rules.

It is important to ensure that such targeted anti avoidance rules meet the tests of clarity and simplicity.

II. Level of control

In terms of the level of control which should be used in any prospective CFC rules, the Report suggests that this should be in excess of 50%. The DTC extant provisions detail 50% and greater as conferring control.

However under the DTC provisions, there is no protection for genuine small investors falling within the CFC rules and the corresponding administrative burden linked with it. By virtue of the methodology suggested under the DTC, proportionate income is computed depending upon their percentage level of holding.

There is a dire need, for the 50% control test to be restricted to cases where an individual owns more than 10% voting rights and together in concert with other parties exerts over 50% control. This is for the reason that recognition of collective control may result in hardship to such minority shareholders, since they suffer from tax even though they do not have a decisive power to compel distribution of income, which is against the very rationale behind enforcement of CFC regulation. The safe habour suggested, is also aligned to the approach favoured in the CFC Report and CFC regimes of various countries (for example China, US).

b) Threshold requirement

The CFC Report recommends that a tax rate exemption which is based on the effective tax rate ("ETR") would be the most accurate approach to defining the limits of CFC rules. ETR could be adopted on an item of income basis or broadly on an entity-by-entity or country-by-country basis.

The DTC proposes that a company be regarded as subject to a "lower rate of taxation" if the ETR of the foreign entity is less than 50% of the ETR, if it were calculated by deeming the foreign entity to be a domestic company. This approach aligns with the OECD recommendations for a low tax threshold calculated on an entity's ETR and seems an appropriate threshold to ensure focus on potential tax avoidance, rather than inadvertently capturing genuine overseas economic activity.

However, it should be noted that use of the ETR calculation is prone to practical difficulties, such as group consolidation / fiscal unity and the potential impact of timing differences. Entities which are covered by fiscal unity / tax consolidation should be acknowledged as such for the purposes of evaluating the comparable tax test exemption and a clarification provided that in such cases, tax paid by a tax consolidated group entity should be considered as tax paid by the concerned CFC.

With the applicability of any extra-territorial law, one cannot overlook the cost of administration and compliance from the perspective of Indian Revenue and Indian entrepreneur, respectively. In that backdrop, having effective *de-minimis* exemptions, is extremely critical for smooth administration of such laws. The DTC included a threshold limit of INR 2.5 million for applicability of *de-minimis* exemption. This is exceedingly low and will not function effectively as a measure to target high risk tax avoidance practices.

c) Definition of CFC income

Once a foreign company has been determined to be a CFC in terms of the first 3 blocks, the next question that arises is which of its income should be attributed in the hands of controlling persons. While as a general principle, highly mobile and/ or passive income should be covered, the scope of this block depends upon policy considerations or CFC objectives of the specific jurisdiction.

The OECD did not reach definitive conclusions regarding what should constitute CFC income and the CFC Report provides merely an overview of the potential features to be included in effective CFC rules.

In the context of India, one of the conditions under DTC to qualify as a CFC is that the CFC is not engaged in any active trade or business. The DTC stated the twin conditions of active trade and income composition. Once both of these conditions have been satisfied, a company is deemed to be engaged in an active trade or business. The conditions are as follows:

(i) Active trade test - Actively participates in industrial, commercial or financial undertakings through employees or other personnel in the economic life of tax resident country and

(ii) Income composition test - Less than 25% of annual income comprises of specified passive income, such as interest, royalties, rent, capital gains, dividends and also income from active trading with related parties (i.e. base company income).

I. Active Trade Test

The Active trade test under the DTC does provide a safeguard for genuine business activities. The substance of active trade is evaluated based on active participation by a company through employees or other personnel in the economic life of the tax resident country. To that extent, DTC follows the Employee and Establishment approach as elaborated in Action 3. This approach is more mechanical and an easier way of determining whether the business set-up and employees required to earn the income are located in the CFC jurisdiction.

However, there are certain shortfalls to this approach –

- This approach will subject income to CFC taxation if the CFC outsources its core business functions and some of the value-creating activities are actually undertaken elsewhere. Therefore, the CFC itself must have the employees and establishment necessary for earning the actual income, rather than just the employees and establishment necessary for managing or overseeing the value-creating activities.

- Second, this approach does not require an analysis of risks or asset ownership. Instead, it just asks whether the CFC had the employees and establishment necessary to earn the income.

Instead of Employee and Establishment approach, the Viable Independent Entity approach may be adopted to evaluate the substance of the business. Under this approach, the focus is on Functions performed, Assets owned and Risks undertaken (similar to FAR analysis in transfer pricing (“TP”)) in order to determine whether the foreign company acts as an independent unrelated entity.

The principles adopted under approach are similar to TP principles or PE profit attribution principles. Hence, there is a reduction in overall administrative complexity and compliance costs because of readily available TP documentation. Adoption of this approach under CFC rules will also complement TP rules in a true sense.

II. Income Composition Test

With regard to the income composition test, it may be observed that various streams of specified incomes like royalty, capital gains, interest, dividend, capital gains, annuity payments, etc. are considered to be passive income even if they are derived from third parties dealings at arm’s length and even if the activities are pursued as commercial activity.

Therefore, based on substance of the activities, such so-called passive income should be excluded from CFC ambit if it is derived from an active trade or business of a company. In this context, guidance provided under BEPS Action 3 is worth consideration:

Types of income	Description
Dividends	Exclude if it is paid out of active income (or by related parties out of active income) or if the CFC is in the active trade/ business of dealing in securities
Interest and other financing income	Exclude if the CFC is in the active trade or business of financing and is not overcapitalised by artificially overleveraging its parent (e.g. the UK CFC rules include a safe harbour for banking income)
Insurance income	Focus on one or more of the following factors - • Whether the income is derived (directly or indirectly) from a related party (and, for a narrower rule, whether the related party is able to deduct insurance premiums paid to the CFC); • Whether the parties to the insurance contract or the risks insured are located outside the CFC jurisdiction; • Whether the CFC is overcapitalised
Sales and services income	Exclude unless it is earned from a related party or the CFC lacks the substance to earn the income itself
Royalties and other IP income	Consider whether the income is earned from a related party (including whether it was earned for IP developed with a related party) and whether the CFC carried out the required activities to develop the IP underlying the asset or whether an entity borne the financing risk and risk of failure

d) Rules for computing income

The rules to be adopted regarding how the income should be computed need to be simple and allow consistent application from both the taxpayer and the tax authority's perspectives. Para 4 of the DTC provisions details a formula for computation of CFC income which is based on Net Profit After Tax (NPAT) as per the profit and loss account (P&L a/c) prepared in accordance with IFRS or GAAP or International Accounting Standards (AS) or AS notified under the Companies Act, 2013. The approach laid out in the DTC provisions reflects the recommendations of the CFC Report.

The policy objective of following accounting profits as opposed to calculation of taxable profit seems to be imbedded in administrative convenience. One does appreciate the policy objective behind such an approach, however, in a situation where a particular item is income for accounting perspective but an exempted capital receipt for tax purposes, it may lead to unintended income inclusion as CFC's income.

While the starting point for computation of CFC income is NPAT in the DTC provisions, certain adjustments are made including the setoff of brought forward losses of the CFC (loss not already taken into account of an earlier accounting period) against the current year NPAT. The set-off of losses of the CFC against income of the parent / shareholders (only positive income is attributed) or against other CFCs is not permitted.

This limited recourse to set off losses of the CFC is too narrow. The OECD recommends that CFC losses should be permitted to be set off against profits of CFCs in the same jurisdiction as reflected in existing CFC rules of various countries.

Also, while the extant CFC provisions in DTC provide that there will be no attribution when specified income is nil and brought forward losses will be adjusted against current year NPAT, it should be explicitly clarified that losses of such CFCs are permitted to be carried forward. Such carry forward and set off of losses should be permitted without any limitation (e.g. limitation of 8 years as applicable to Indian companies).

e) Rules for attributing income

Action 3 suggests the following process for attribution of CFC income:

I. Determining which taxpayers should have income attributed to them

The threshold for attribution should be linked to the minimum control threshold. Under the DTC provisions, proportionate income is computed for the period a foreign company is a CFC during the accounting period and then such income is attributed to investors depending upon their period holding and percentage level of holding.

It is best practice, as mentioned in the CFC Report, to tie the attribution threshold to the control threshold adopted or to use another attribution threshold that attributed income, at a minimum, to taxpayers who could actively manage and direct the CFC. This would use the same mechanisms to determine control as detailed in the section "Definition of Control". This would mean that only shareholders with holdings greater than 10% would be subject to a CFC charge and would protect small, genuine investors.

II. Determining how much income should be attributed

Action 3 recommends that the amount of income to be attributed to each shareholder should be calculated by reference to the shareholder's proportion of ownership in the CFC and the period of such ownership. As mentioned above, similar provisions exists in DTC where attribution is proportional to the period of holding and percentage of holding. However a provision should be set out that under no circumstances, the income attributed to all controlling persons should exceed the total income of a CFC. The following example illustrates this:

Mr. A & Mr. B are both resident shareholders that enter into a joint venture through a Special Purpose Vehicle (SPV) established in the Cayman Islands with a 50% capital contribution each. Mr. A and Mr. B possess 40% and 60% of voting power respectively. Now, since the company is controlled by residents it can be regarded as CFC if the company fulfils the other conditions. As per the given formula, 'specified income' of CFC is to be attributed to the residents to the extent to its % holding of capital value or voting share or interest, whichever is higher, further adjusted for number of days such capital / voting share / interest is held by them.

Considering the above formula, in the given case, Mr. A will be taxed for 50% (higher of 50% & 40%) of specified income; similarly Mr. B will be subject to tax for 60% (higher of 50% & 60%) of specified income. This will result into taxation of more than 100% of income of CFC. There is no explicit provision under DTC to counter such situation. Rules would be necessary in order to ensure that amounts taxable in the hands of domestic taxpayers do not exceed the profits of CFC.

f) Rules to prevent or eliminate double taxation

The CFC Report identifies certain situations which could lead to double taxation:

a. Where the attributed CFC income is also subject to foreign corporate taxes;

b. Where CFC rules in more than one jurisdiction apply to the same CFC income;

c. Where a CFC actually distributes dividends out of income that has already been attributed to its resident shareholders under the CFC rules or a resident shareholder disposes of the shares in the CFC.

With respect to the first two situations, countries should allow a credit for foreign taxes actually paid, including a CFC tax on intermediate companies. In the third situation, dividends and gains on disposition of CFC shares should be exempted if the income of the CFC has previously been subject to CFC taxation.

The DTC provisions did not include any mechanism to avoid the potential for double taxation. The foreign tax credit mechanism is well established in international practice and is an important feature in the most mature tax regimes (for eg. United Kingdom, Germany, United States).

Similarly, there is potential for double taxation where a CFC's profits are taxed under multiple jurisdictions' CFC rules. The most appropriate mechanism to avoid double taxation in this instance would be through indirect foreign tax credits, although this would need to be allied to amended double taxation relief provisions such that CFC tax paid in an intermediate country would qualify as a foreign tax eligible for relief.

Following on from this, relief should also be given when the CFC profits are actually distributed to the parent entity. Most jurisdictions provide some type of relief for subsequent dividends paid by a CFC. In the majority of these jurisdictions, the dividends will qualify for the regular participation exemption for foreign dividends or there will be special provisions to ensure the dividends are not taxed. It should be considered that underlying tax credits to relieve economic double taxation of foreign dividends could be implemented. This would encourage Indian groups to repatriate their foreign earnings rather than re-invest or retain their earnings overseas. For example, in the US, Sub-part F income that is taxable as a deemed inclusion to a US shareholder becomes "previously taxed income" (PTI). Subsequent actual distributions of PTI are not taxed to the US shareholder.

Lastly, consideration needs to be made to ensure that there is no double taxation on the eventual sale of the CFC. The Report underlines the difficulty of eliminating double taxation in this scenario due to different jurisdictions' approaches to taxing gains on assets. However, the general ethos should be that countries do not tax subsequent gains realised by a taxpayer in respect of the shares of a CFC to the extent that the same amounts have previously been taxed under CFC rules operating in the taxpayer's jurisdiction.

International practice is again illustrative in this regard. The US rules provide that the gain from the sale of CFC stock may be taxed as a dividend to the extent of the CFC's previously untaxed earnings; the remaining gain will be taxed as gain from the sale of stock.

5. Conclusion

To sum up, designing CFC rules in any shape or form is likely to be very complicated affair. One must commend the Government of India, for designing CFC rules in DTC 2013, which from a broad conceptual level are in line with international thinking, as demonstrated in the CFC Report. However, as demonstrated earlier, there is still a lot to be desired, to make these provisions more mature and targeted.

Having said that the fundamental question, which the Government is first likely to grapple with, is whether this is the right time to introduce these provisions in India? The businesses which are likely to be directly impacted by these rules, will not merely be the well-established Indian multi-national enterprises but also the young Indian entrepreneurs, who have finally dared to think big!

CA Jayesh Gunvantrai Kariya & CA Aniket Mhatre

BEPS Action Plan 4 – Interest Deduction and Other Financial Payments

1. Backdrop

1.1. What is BEPS

It has been observed that many multinational companies around the world indulge in aggressive tax planning by strategizing and implementing their business structure and operations across the jurisdictions. There are instances where the companies, as a process of optimizing tax cost, select jurisdictions which offer maximum tax advantages or use inter-corporate funding arrangements leading to erosion of taxable income base in such jurisdiction and its profits are thereby shifted from high tax jurisdictions to the lower ones. This not only reduces the tax revenue of the jurisdictional Government but also affects integrity of the tax system of the country. Base Erosion and Profit Shifting ('BEPS') is a technical term referring to the negative effect of such aggressive tax planning thereby leading to tax avoidance or double non-taxation.

In 2012, the G 20 called upon the Organisation for Economic Co-operation and Development ('OECD') to analyse the issue of BEPS and develop Action Plans to address the concerns in a co-ordinated and comprehensive manner. In July 2013, the OECD released 15 BEPS Action Plans addressing different aspects of BEPS risk. OECD recently released, G 20 Nations endorsed, final report on 15 Action Plans, which is expected to bring in major shift in the global tax and regulatory environment.

The result of each of the BEPS Action Plan is intended to work out a comprehensive and cohesive approach to international tax framework. It also provides for domestic law recommendations, modifications in international tax principles in model tax treaties and transfer pricing guidelines. The three key pillars of BEPS Action Plans are:

- Substance thereby avoiding tax abuse,
- Transparency and Certainty in tax matters, and,
- Cohesive approach on international taxation among various countries.

The output is broadly classified as 'minimum standards', 'best practices' and 'recommendations' for the Government to adopt suitable approaches in a cohesive manner.

1.2. What is Action Plan 4

One of the major aspects in addressing the BEPS risk is the usage of interest payments. The detailed discussion on how the interest payments would lead to BEPS risk is in ensuing paragraphs. On December 18, 2014, the OECD released a public discussion draft entitled 'BEPS Action Plan 4 – Interest Deduction and Other Financial Payments'. Pursuant to public comments on discussion paper, the final report on BEPS Action Plan 4 has been released by the OECD on October 5, 2015.

The OECD, in its BEPS Action Plan 4, has recommended best practices in the design of rules to address base erosion and profit shifting using interest and payments economically equivalent to interest, by aligning interest deduction with taxable economic activity.

1.3. What is the purpose

The OECD recognises that the use of third party and related party interest deductions and other equivalent financial payments is one of the widely used profit shifting techniques in international tax planning. The fluidity and interchangeability of money makes it relatively simple to adjust the mix of debt and equity amongst the controlled entities.

The OECD noted that multiplying the level of debts through intra-group financing is one of the aggressive tax planning mechanisms adopted by several multinational corporations. Thus, there is a need to regulate and protect base erosion and profit shifting using interest deductions and payments across the tax jurisdictions. The purpose of the Action Plan 4 is an attempt to report the true and correct income in the jurisdiction where the economic activities of the entities are carried out and where value is generated. The focus of Action Plan 4 is to recommend best practice approach to tackle BEPS risk viz., use of third party, related party and intragroup debts to achieve excessive interest deduction or to finance the production of exempt or deferred income.

1.4. What is the rationale / genesis

Most tax jurisdictions / countries tax returns on debt and equity differently for the purpose of their domestic tax laws. Generally, interest on debt is tax deductible expense for the payer and taxed at ordinary rates in the hands of the payee. Dividends or returns on equity, are generally not tax deductible in the hands of the payer but enjoy some form of tax relief viz., exemption, exclusion, credit, etc. The distortion in the tax treatment in the hands of payer towards debt financing in the cross-border context, creates a tax-induced bias leading to the tax planning techniques by multinational groups to reduce tax burden on interest income in the hands of the payee.

Very often, obtaining tax deduction / relief of interest expense, greater than the net interest expense of the group, poses base erosion and profit shifting. Some of the concern areas in this regard are: Intra-group loans to generate interest expense in high tax jurisdiction; to develop hybrid instruments having deductible interest expense but no corresponding taxable income, use of loans to invest in the assets which give rise to income / returns that is not taxed as ordinary income or deferment in the returns from such assets, etc.

Countries have introduced various rules to address issues of BEPS involving third part and intra-group interest such as thin capitalisation rules, overall limit on level of interest deduction for the entity, withholding tax provisions, transfer pricing laws, earning strapping rules, prohibitive rules, black list regime, etc. However, any such robust approach of restricting interest claim by countries independently would affect their attractiveness to international business. Thus, OECD's recommendation of utilizing international best practices as a consistent approach for all the countries would be more effective and efficient way of addressing concerns surrounding the use of interest in base erosion and profit shifting by using funding arbitrage.

2. Action Plan 4 – Technical Aspects

2.1. What is the Action Plan 4

Base Erosion and Profit Shifting risk involved in deduction of interest and other economically equivalent payments may arise in the following basic scenarios:

- Groups placing higher level of third party debts in high tax countries

- Groups using intra group loans to generate interest deductions in excess of the group's actual third party interest expense
- Groups using third party or intra group financing to fund the generation of tax exempt income

To address the BEPS risks arising in the above mentioned situations, the OECD has recommended a best practice approach with a view of providing effective solution to the BEPS risks countries face through interest payments. The best practice approach is based around the Fixed Ratio Rule limiting the net interest deduction to the fixed percentage of earnings of the entity. The Fixed Ratio Rule can be combined with Group Ratio Rule and various targeted rules, explained in the ensuing paras, as per the country's requirement so as to develop the best practice approach which is robust enough against planning by the entities to circumvent its application and at the same time reasonably straightforward for implementation and application for groups and the tax authorities.

Overview of best practice approach–

$\boxed{\text{Fixed Ratio Rule}}$ + $\boxed{\text{Group Ratio Rule}}$ + $\boxed{\text{Targeted Rules}}$

2.1.1. Fixed Ratio Rule ('FRR')

The premise underlying a FRR is that an entity should be able to deduct interest expense up to a specified proportion of its earnings, asset or equity, ensuring that its portion of profits remain subjected to tax in a country. Accordingly, the OECD has recommended the FRR wherein the entity's net deduction for interest and economically equivalent payments would be limited to the percentage of its earnings before interest, taxes, depreciation and amortizations ('EBITDA').

The FRR is determined by a country's government and applies irrespective of the actual leverage of an entity or its group. The computation of interest disallowance under FRR involves following 3 steps:

- Firstly, calculation of earnings of the entity i.e. EBITDA,
- Secondly, application of FRR on EBITDA to determine maximum interest deductible limit, and,
- Lastly, comparison of actual interest expense with the permissible limit and disallowance of excess interest over the benchmarked limit.

Interest expense on third party or intra group debt up to this fixed ratio should be deductible, but any interest that takes the entity's ratio beyond this benchmark is disallowed. The assumption underlying a FRR is that an entity should be able to deduct interest expense up to a specified proportion of its earnings, assets or equity thereby ensuring that a portion of an entity's profits remains subject to tax in a country.

A critical issue for consideration is whether the ratio should apply to a balance sheet or earnings measurement:

- **Asset-based measures** are likely to be more suitable regarding inbound situations, which often results in the recipient of interest not being taxed. For example, an asset-based test that excluded equity investments would prevent many entities with tax-exempt dividend income from claiming a higher level of interest deductions.
- **Earnings-based measures**, referred to in the Draft as related to EBITDA or EBIT, have the advantage that additional interest expense can only be supported by additional taxable income. It would be possible to exclude exempt income, such as dividends, and so can be adapted to both inbound and outbound contexts. However, earnings are volatile compared to balance sheets, in that they are more influenced by factors outside the entity's control.

This methodology does not, however, take into account the fact that groups operating in different sectors and under different market conditions may require different levels of leverage and that groups may adopt different, non-tax, funding strategies. A country should, therefore, have to determine the benchmark ratio which represents an appropriate level of interest expense for all entities operating in all sectors.

The country is recommended to set a benchmark FRR at a level which is appropriate to tackle BEPS risk and at a same time it does not affect its competitiveness to attract investments in international markets or availability of financing.

An effective FRR requires a country to set the benchmark ratio at a level which is appropriate to tackle base erosion and profit shifting. At the same time, it is recognised that countries differ in terms of both their economic environment and the presence of other targeted tax rules which specifically address base erosion and profit shifting risk involving interest. OECD has therefore recommended countries set their benchmark fixed ratio within the corridor of 10% to 30%. Also, countries should considered following factors while determining appropriate FRR, as under:

(i) A country may apply a higher benchmark fixed ratio if it operates a FRR in isolation, rather than operating it in combination with a Group Ratio Rule.

(ii) A country may apply a higher benchmark fixed ratio if it does not permit the carry forward of unused interest capacity or carry back of disallowed interest expense.

(iii) A country may apply a higher benchmark fixed ratio if it applies other targeted rules that specifically address the base erosion and profit shifting risks to be dealt with under Action 4.

(iv) A country may apply a higher benchmark fixed ratio if it has high interest rates compared with those of other countries.

(v) A country may apply a higher benchmark fixed ratio, where for constitutional or other legal reasons (e.g. EU law requirements) it has to apply the same treatment to different types of entities which are viewed as legally comparable, even if these entities pose different levels of BEPS risk.

(vi) A country may apply different fixed ratios depending upon the size of an entity's group.

OECD observed that the FRR does not take into account the fact that groups in different sector are leveraged differently. The application of benchmark FRR in isolation would make certain highly leveraged groups unable to claim deductions of their net third party interest expense. Further, entities in large groups are in different position when raising third party debts as compared to small and medium sized groups. The OECD recommends a higher ratio to small and medium sized groups with a view of creating a level playing field for them with the large groups. Accordingly, it is recommended that countries may consider combining a FRR with Group Ratio Rule.

2.1.2. Group Ratio Rule ('GRR')

OECD recognised that some groups are highly leveraged with third party debt due to its business situations and in that case, FRR would work as counterproductive to business. The GRR could be used as a separate rate or as an integral part of an overall rate considering FRR.

GRR limits an entity's deductible interest expense with reference to the actual position of its worldwide group. GRR attempts to match net interest expenses within a group to the economic activity in the jurisdiction, so that the group's aggregate interest deduction does not exceed its actual third party interest expenses. In GRR, where the entity has exceeded its benchmark FRR, the entity is allowed to deduct its net interest expense up to its group's worldwide net third party interest to EBITDA ratio, if such ratio is higher than FRR.

- **Group-wide interest allocation**: Allocating a group's net third-party interest expense between group entities in accordance with a measure of economic activity. This would work by calculating an interest cap per entity by comparing the entity's economic activity (based on earnings or assets) within the group's overall position.
- **Group ratio:** Compares relevant financial ratio of an entity (for example the net interest to earnings or net interest to asset value) to the equivalent financial ratio of the entity's worldwide group. Where an entity's ratio is equal to or below that of the group, all of its third-party and intra-group interest expense would be deductible. Any interest expense that increases the entity's ratio beyond the group's ratio would be disallowed.

The above approaches both aim to ensure that net interest expense within a group is matched with economic activity and they should deliver similar outcomes. It is likely, however, that in either of the above and as a result of disallowed deductions in some entities, it may occur that the total interest deductions throughout a group may be less than their external third-party interest costs.

Where the countries adopt GRR as a supplement to FRR, only net interest expense which exceeds both the benchmark FRR and the ratio of its worldwide group should be disallowed. The computation of net interest deductible under GRR involves following 2 steps:

- Firstly, determining the group's net third party interest to EBITDA ratio, and;
- Secondly, applying the GRR to an entity's EBITDA to determine maximum interest deductible limit and its comparison with the actual interest expense.

GRR requires entity to derive ratio considering net third party interest expense and the EBITDA of its worldwide group. Consolidated financial statements in this regard provide the most reliable source of financial information to determine GRR. For the purpose of applying a GRR, a group includes a parent company and all entities which are fully consolidated on a line-by-line basis in the parent's consolidated financial statement.

While computing the net third part interest expense, the figures may be taken from the group's consolidated financial statements. Further, OECD has recommended the countries to allow the uplift of 10% to the net third party expenses knowing that fact that all the third party expenses cannot be aligned throughout the group and also to prevent double taxation, in case some of a group's third party interest may be subject to disallowance under the provisions of domestic laws of that country.

A group-wide interest allocation rule would be implemented in fundamentally similar ways in all participating countries. What this means is that countries would have to agree to an approach defining which entities are covered by the rule, how net third party interest expense of a group would be calculated, and how an interest cap would be allocated between entities. Countries may have some flexibility in implementing the rule (for example, taking into account whether they tax local entities separately or on a consolidated basis). However, the interest cap method may result in mismatches where the approach agreed by countries is not aligned with a country's domestic tax system.

The GRR, on the other hand, gives countries greater design flexibility than the group-wide interest allocation rule, which may also result in a reduction in mismatches between group and entity ratios. This flexibility may, however, result in increased compliance costs, difficulties in adjusting intra-group financing to comply with domestic rules, further opportunities of base erosion and profit shifting and the possibility of double taxation.

Following key questions remain to be considered in adopting GRR:

- Definition of an interest limitation group: Proposal to apply GRR to entities in a financial reporting group.
- Determination of a group's net third-party interest: Consolidated financial statements to be regarded as an appropriate starting point to gather relevant information.
- Measurement of economic activity: Discussion of both earnings and asset values being measures of economic activity as well as an entity's borrowing capacity.
- Other questions requiring resolution include: potential accounting and tax mismatches; the treatment of cash and the risks posed by connected and related parties.

2.1.3. Best Practice Approach

Best Practice Approach recommended by OECD focuses on providing an effective and robust solution to BEPS risks and against tax avoidance. Also, the implementation of such approach would be reasonably straightforward for groups and tax authorities to apply.

Overview of the Best Practice Approach:

De-minimis monetary threshold to remove low risk entities
Optional
Based on net interest expense of local group

+

Fixed Ratio Rule
Allows an entity to deduct net interest expense up to a benchmark net interest/EBITDA ratio
Relevant factors help a country set its benchmark ratio within a corridor of 10%-30%

+

Group Ratio Rule
Allows an entity to deduct net interest expense up to its group's net interest/EBITDA ratio, where this is higher than the benchmark fixed ratio

Option for a country to apply an uplift to a group's net third parts interest expense of up to 10%

Option for a country to apply a different group ratio rule or no group ratio rule

+

Carry forward of disallowed interest/unused interest capacity and /or carry back of disallowed interest
Optional

+

Targeted rules to support general interest Limitation rules and address specific risks

+

Specific rules to address issues raised by the banking and insurance sectors

The Best Practice Approach recommended by the OECD is based around the FRR. As a minimum, the FRR should apply to entities in multinational group. A country may decide to supplement FRR with the GRR thereby allowing an entity to exceed its interest deduction limit for certain highly leveraged sectors, as compared to the limit determined under FRR. In such cases, the entities would have an option to exceed the deduction limit set by the FRR to the extent of restriction being derived through GRR. Inversely, if any entity has GRR derived from its worldwide group lower than the benchmark FRR of its country, it will still be able to claim its interest deduction to the extent of limit set by FRR.

A country may choose not to introduce any GRR. In such case, a country should apply the FRR to entities in multinational and domestic groups without improper discrimination.

The recommended Best Practice Approach allows countries to supplement the FRR and GRR with other provisions that reduce the impact of the rules on entities or situations which pose less BEPS risk, such as:

- A *de-minimis* threshold which carves-out entities which have a low level of net interest expense.
- An exclusion for interest paid to third party lenders on loans used to fund public-benefit projects, subject to conditions. In these circumstances, an entity may be highly leveraged but, due to the nature of the projects and the close link to the public sector, the BEPS risk is reduced.
- The carry forward of disallowed interest expense and/or unused interest capacity for use in future years.

A *de-minimis* threshold is based on the monetary value of net interest expenses. Entities falling below this threshold may deduct interest expense without restriction. Where a group has more than one entity in a country, the threshold should take into account the total net interest expense of the entire local group, including all entities in that country. A country is recommended to consider including anti-fragmentation rules to prevent a group avoiding the application of an interest limitation rule by establishing a number of entities, each of which falls below the threshold.

In case an entity's interest expense and earnings arise in different periods as a result of volatility in earnings (i.e., ability of an entity to deduct interest changes from year to year, or entity incurring interest expense to fund an investment which will give rise to earnings in a later period), a country may permit entities to carry forward disallowed interest expense or unused interest capacity for use in future periods, or carry back disallowed interest expense into earlier periods.

A general interest limitation rule may operate directly, by restricting the amount of interest an entity may deduct for tax purposes, or indirectly, by restricting the amount of debt with respect to which an entity may claim deductions for interest. Factors to be considered for Best Practice Approach:

- Base erosion and profit shifting using interest is driven by the level of tax deductible expense incurred by an entity. A rule which directly limits the level of interest deductions an entity may claim addresses BEPS concern using interest expenses.
- A rule which limits the level of debt in an entity will not necessarily address base erosion and profit shifting risks where an excessive rate of interest is applied to a loan. Therefore, applying an arm's length test or apportioning an entity's actual interest expense would help. But these approaches add a step to the operation of a rule and increase complexity.

- A best practice approach should be easier for entities and tax authorities to identify and value the payments of interest (and economically equivalent payments) for which tax relief is being claimed.
- The level of debt in an entity may vary throughout a period. However, the level of interest expense in an entity will reflect all changes in borrowings throughout the period which may give a more accurate picture of the entity's actual position over the period.
- A rule that directly limits the level of interest expense could make it difficult for an entity to enter into long-term borrowings if there is a risk that interest rates could increase and it would suffer an interest disallowance in future periods.

The Best Practice Approach places a general limit on the level of net interest expense that an entity may deduct for tax purposes. The FRR should be applied consistently to all interest paid to third parties, related parties and group entities. However, a country may choose to exclude interest expense incurred on specific third party loans and public benefit projects from the scope of the FRR and GRR.

2.1.4. Targeted Rules

The OECD recommended FRR and GRR impose an overall limit on an entity's interest deductions and hence, such rules are referred to as general interest limitation rules. Targeted interest limitation rules include any provisions which apply to restrict interest deductions on payments made under specific transactions or arrangements. The OECD has recognised that targeted rules can provide an effective solution to some base erosion and profit shifting risk even though the best practice approach recommends general interest limitation rules. Accordingly, the best practice approach should use a general interest limitation rule supplemented by the targeted rules in key areas to provide countries with the comfort that the main risks posed by base erosion and profit shifting are addressed, as well as the groups are able to obtain relief for their real net third party interest expense.

The OECD observed that even though the FRR and GRR provide an effective solution to tackle most base erosion and profit shifting involving interest and payments economically equivalent to interest, a number of specific base erosion and profit shifting risks remain, as discussed below:

- An entity which would otherwise have net interest income enters into an arrangement which involves the payment of interest to a group entity outside the country or a related party to reduce the level of interest income subject to tax in the country.
- An entity makes a payment of interest on an 'artificial loan', where no new funding is raised by the entity or its group.
- An entity makes a payment of interest to a third party under a structured arrangement, for instance under a back-to-back arrangement.
- An entity makes a payment of interest to a related party, which is excessive or is used to finance the production of tax exempt income.
- An entity makes a payment of interest to a related party, which is subject to no or low taxation on the corresponding interest income.

Considering the above scenarios, the targeted rules would be required to be adopted or already existing targeted rules to be continued by the country to prevent circumvention of FRR or GRR and also to address other BEPS risks posed by entities to which FRR or GRR may not apply.

2.2. To whom it will apply

The risk of BEPS can arise within a corporate groups, with connected parties outside a group or through the use of structured arrangement with third parties. The OECD recommends that the best practice approach should apply to all the entities of a multinational group at a minimum. Further, OECD encourages countries to extend the rules in this regard to domestic groups and standalone entities as well.

An entity directly or indirectly controlled by a company, or an entity which directly or indirectly controls one or more other entities, is considered to part of a group. A group operating in more than one jurisdiction, including through a permanent establishment, is a multinational group.

The OECD recommends that the best practice approach may be applied to the following entities:

- Group companies i.e., where one entity has direct or indirect ownership or control over other entities, or two or more entities are under the direct or indirect ownership or control of some other entity
- Entities having common ownership but not in same group i.e., individual, fund or trust exercising control over entities, or entities under common control through shareholder agreement to this effect
- Related parties i.e., significant shareholders and investors along with their family members, or entities having significant relationship (holding 25% or more investment), or third parties where payments is made under structured arrangement.

Two persons (including individuals and entities) will be deemed to be related if they are not in the same group but they satisfy any of the following conditions:

- Owing to the investment, the first person has an effective control of the second person, or a third person holds investments that provide that person with effective control over both persons;
- The first person has a 25% or greater investment in the second person, or there is a third person that holds a 25% or greater investment in both; or
- The two persons can be regarded as associated enterprises under article 9 of the OECD model tax treaty.

Even though the multinational entities pose more BEPS risk, Domestic group pose BEPS risk involving interest paid to related parties and third parties under structured arrangements. Thus, the countries may choose to apply a best practice approach to tackle BEPS risk to entities in domestic group too. The rationale (apart from BEPS risk) behind covering domestic groups in the best practice approach by the country may be,

- Avoidance of competition between domestic and multinational groups,
- Balancing the general tax bias in favour of funding with debt over equity, or
- Constitutional obligations for the equal treatment of taxpayers.

Stand alone entities are not part of any groups and are generally small entities, owned directly by an individual, where there are no other entities under common control. In such entities, the BEPS risk is negligible. However, standalone entities may be large entities held under complex holding structures involving trusts or partnerships, controlled by same investor. In such cases, the level of BEPS risk may be similar to that posed by a group structure. Country may adopt FRR to such stand alone entities or may tackle BEPS risk through specific targeted rules.

2.3. Addressing volatility and double taxation

Where a payment of interest relates to a specific transaction intended to give rise to base erosion or profit shifting, or the entity consistently has a level of net interest expense in excess of the benchmark fixed ratio and group ratio, a permanent disallowance of net interest expense may be an appropriate result.

However, in the following cases, a permanent disallowance of interest expense would introduce a level of uncertainty for groups which could make long term planning difficult and which a country may view as undesirable:

- Where the amount of interest expense in an entity exceeds that which is allowable, merely because of a timing mismatch that will correct in a future period or
- Where an entity incurs interest expense to fund a project or investment that will give rise to earnings in a future period.
- Where an entity's EBITDA fluctuates for reasons outside of its control
- Where the amount of net interest expense that an entity can deduct in GRR may be impacted by volatility in EBITDA elsewhere in the group

Under the best practice approach, there is no requirement for a country to allow an entity to carry forward or carry back disallowed interest expense or unused interest capacity. However, a country may choose to allow an entity:

- To carry forward only disallowed interest expense;
- To carry forward disallowed interest expense and unused interest capacity; or
- To carry forward and carry back disallowed interest expense.

It is recommended though that the interest disallowances that arise under any targeted rules (including hybrid and other BEPS restrictions that are applied in priority to Action Plan 4) should not be carried back or forward.

Where the best practice approach limits an entity's net interest deductions, leading to an interest disallowance, there is no intention that the interest expense disallowed should be re-characterised for any other purpose.

A Best Practice Approach links net interest deductions to the level of an entity's EBITDA. In case of volatility in earnings, the use of average figures over, for example, a three-year period, would make the rules more complex, but could help address volatility.

2.4. Interest and EBITDA explained

2.4.1. Interest and payments economically equivalent to interest

Interest cost is treated as a tax deductible expense in most countries, but each country applies its own approach to determine what expenses are treated as interest and consequently, deductible for tax purposes. BEPS Action Plan 4 recommends best practice approach which will directly address the risks relating to excessive interest deductions. It would be beneficial for countries to take a broadly consistent approach to the items that should be covered by the rules, improving certainty for business and ensuring a coherent approach to tackling the issue across countries.

The OECD recommends that the rules to tackle BEPS should apply to interest on all form of debts, payment economically equivalent to interest and expenses related to raising of finance. Further, the OECD has recommended non-exhaustive list of examples which would include, but not be restricted to, the following:

- Payments under profit participating loans
- Imputed interest on instruments such as convertible bonds and zero coupon bonds
- Amounts under alternative financing arrangements, such as Islamic finance
- The finance cost element of finance lease payments
- Capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest

- Amounts measured by reference to a funding return under transfer pricing rules, where applicable
- Notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings
- Certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance
- Guarantee fees with respect to financing arrangements
- Arrangement fees and similar costs related to the borrowing of funds

The OECD has recommended following items to which the deduction limitation rules set out in this Action Plan would not apply for deduction purposes as under:

- Foreign exchange gains and losses on monetary items which are not connected with the raising of finance
- Amounts under derivative instruments or hedging arrangements which are not related to borrowings, for example commodity derivatives
- Discounts on provisions not related to borrowings
- Operating lease payments
- Royalties
- Accrued interest with respect to a defined benefit pension plan.

The Final Report is silent on return on preference shares which are generally treated as economically equivalent to interest under most accounting practices, but economically equivalent to dividend under most tax practices. Further, interest imputed on funding transactions under transfer pricing rules to be included. However, in countries where deemed deduction of interest linked to percentage of equity exist, then such payment should not be treated as interest on payments economically equivalent to interest for the purpose of Action Plan 4.

2.4.2. Measurement of Economic Activities

The OECD, in its final report for Action Plan 4, has analysed both the options of measuring economic activities i.e., using earnings of the entity or by using its asset values.

The measurement of economic activities based on earnings ensure that the ability of the entity to deduct net interest expense is matched with the activities that generate taxable income and drive value creation. Further, it makes a general interest limitation rule more robust against planning as a group can only increase net interest deductions in a particular country by increasing earnings in that country i.e., by value creation.

On the other hand, assets-based approach to measuring economic activity give rise to a relatively steady and predictable limit of the level of interest relief that can be claimed by the group. This is because, in general, asset values are typically more stable (except in the case of revaluations and write-downs, and assets which are carried at fair value under accounting rules). However, applying a FRR based on asset values would be complex as asset values may vary significantly based on the accounting standards and policies applied by different groups. Further, concerns over the recognition and valuation of assets may be less of an issue in applying a GRR.

The OECD has therefore proposed the earning base as an appropriate measure of economic activities while recommending best practice approach by way for FRR and GRR.

2.4.3. EBITDA

In terms of the definition of earnings to be used, earnings before interest, taxes, depreciation and amortisation (EBITDA) and earnings before interest and taxes (EBIT) are both possible options. The most common measure of earning currently used by the countries is the EBITDA, which is recommended to be a tax concept rather than an accounting concept. The entity's EBITDA i.e., its net income, should be adjusted for net interest expense and net payments equivalent to interest payments; and depreciation and amortisation. Non-taxable income such as branch profits or dividend income that benefit from a participation exemption should not be included in the calculation of earnings and hence it should not form part of the entity's EBITDA.

EBITDA is the most common measure of earnings currently used by countries with earnings-based tests. EBITDA excludes two major non-cash costs in a typical income statement i.e., depreciation on fixed assets and amortisation of intangible assets. Thus, EBITDA showcase the ability of an entity to meet its obligations to pay interest expenses.

2.5. How it will work

2.5.1. Operation of FRR

The OECD recommended best practice approach is based on a FRR to limit an entity's net deduction for interest and economically equivalent payments to the percentage of EBITDA. It is expected that a country specifically sets a single benchmarked fixed percentage ratio which would be applicable to all the entities covered by the Action Plan 4 in such country.

Under FRR, a predetermined benchmark fixed ratio is applied to the earnings of an entity or a local group to calculate the maximum deductible interest expense for that entity. The earning of the entity in terms of EBITDA is calculated. The statutory benchmark fixed ratio is applied to an entity's EBITDA and the limit of interest allowance for such entity is arrived at. The amount of interest expense to be allowed as tax deductible is restricted to the limit of interest allowance determined by FRR and the excess interest expense is disallowed.

Countries currently adopting fixed interest to earnings ratios are as under:

- Finland: 25% of EBITDA
- Germany: 30% of EBITDA
- Greece: 30% of EBITDA
- Italy: 30% of EBITDA
- Norway: 30% of taxable EBITDA
- Portugal: 30% of adjusted EBITDA
- Spain: 30% of adjusted operating profits
- United States: 50% of adjusted taxable income

The country is recommended to set a benchmark FRR at a level which is appropriate to tackle BEPS risk and at a same time it does not affect its competitiveness to attract investments in international markets or availability of financing. The corridor for setting a single benchmark fixed ratio by a country is recommended to be within 10% to 30%.

As a part of best practice approach to tackle BEPS risk, the OECD recommends countries to adopt GRR as a supplement to the FRR. Countries adopting GRR allows an entity which exceeds the benchmark fixed ratio to deduct net interest expense up to its group's net third party interest/EBITDA ratio, if this GRR is higher than FRR. Accordingly, only net interest expense which exceeds both the benchmark fixed ratio and the ratio of its group should be disallowed.

2.5.2. Operation of GRR

Determining the amount of net interest expense deductible under GRR involves following 2 stages:

Stage 1 – Determine the group's net third party interest / EBITDA ratio

The calculation of net third party interest expense should be based on figures taken from a group's consolidated financial statements. While the use of unadjusted figures is considered an acceptable approach, there are risks that net third party interest expense could be overstated or understated and it is likely that most countries will wish to make some adjustments to these figures, although in the interests of simplicity these adjustments should be kept to a minimum. Further work is required to assess how information may be obtained from financial statements prepared under different accounting standards and, where adjustments to financial reporting figures are to be made, what amounts should be included and excluded from net third party interest expense.

A country can choose to allow an uplift of net third party interest expense of up to 10% to reduce the risk that all of a group's actual net third party interest expense is not taken into account. It would also reduce the impact of constraints which mean that, even in the long term, a group may not be able to precisely align its net interest expense and EBITDA.

Group EBITDA should be profit before tax plus net third party interest expense, depreciation and amortisation (including impairment charges). To avoid double counting, where net third party interest expense has been adjusted to include capitalised interest (or the amortisation of capitalized interest), depreciation and amortisation should be adjusted to strip out any amounts that represent the amortisation of interest included in the value of capitalised assets.

Further work will be conducted to refine the definition of group EBITDA, including for example whether or not it should exclude items such as dividend income, other finance income and expense not included in net third party interest expense, one-off items resulting from restructurings and mergers, the share of profit from associates and joint venture entities included in the consolidated financial accounts.

Stage 2 — Apply the group's ratio to an entity's EBITDA

Once a group's net third party interest expense and EBITDA have been established, it is possible to calculate the group's net third party interest/ EBITDA ratio. This ratio may then be applied to the EBITDA of an individual entity within a group to determine the limit on net interest deductions that may be claimed under a GRR. Within the best practice, a country may provide for entity EBITDA to be calculated using either tax or accounting principles.

An entity's tax-EBITDA is equal to its taxable profit after adding back tax values for net interest expense, depreciation and amortisation. These values are determined under the tax rules of the country applying the rule. Non-taxable income such as branch profits or dividend income that benefit from a participation exemption should not be included within tax-EBITDA. A group's net third party interest/ EBITDA ratio can be applied to an entity's tax-EBITDA to give a tax-based limit on net interest deductions.

An entity's accounting-EBITDA should be determined using the same formula as for group EBITDA. However, any income which is not subject to tax, such as dividends or branch profits which fall within a participation exemption, should be excluded. An entity's accounting-EBITDA should be based on financial reporting figures prepared under the same accounting rules as used in the consolidated financial statements. A group's net third party interest/EBITDA ratio can be applied to an entity's accounting-EBITDA to give an accounts-based limit on net interest expense. The accounts-based limit may be adjusted to take into account differences between the entity's net interest expense for accounting and tax purposes.

2.5.3. Loss making entities – addressing its impact on ratios

In a scenario where group EBITDA is positive but includes results of certain loss making entities in the group. This may lead to higher GRR and increase capacities of profitable entities to deduct interest more that their actual tax liability. OECD recommend the jurisdiction to cap the total interest deduction allowance to the limit of net third party interest expenditure of group.

Similarly, in a scenario where group has negative EBITDA but include certain profitable entities in it, the GRR would not allow any interest deduction to such profitable entities too. In such situation, the profitable entities could be allowed interest deduction to the extent of, lower of actual interest expense of such entity or net third party interest of the group.

2.5.4. The mechanism of FRR and GRR can be understood with the help of following example

A, B and C are the group entities engaged in the diverse activities in different tax jurisdictions P, Q and R respectively. These entities have interest expenses in favor of third party debts. P, Q and R jurisdictions have adopted FRR of 20%, 30% and 15% respectively. Jurisdiction Q and R does not apply GRR as supplement to FRR. Jurisdiction P applies GRR and also provide 10% uplift on net third party interest expense. The interplay between FRR and GRR within the group entities is as under:

	A (revived from bankruptcy)	B (start-up phase)	C (normal operations)	Group
Jurisdiction	P	Q	R	
EBITDA	50	(100)	400	350
Net interest expenses	60	35	80	175
Group net third party interest to EBITDA ratio	120%	NA	20%	50%
Benchmark for FRR	15%	30%	25%	
Interest allowed as per FRR	7.5	Nil	100	
Interest allowed as per GRR	25	NA	NA	
Interest allowed as per uplifted GRR	27.5	NA	NA	
Disallowed Interest expenses	32.5	35	NIL	68.5

The computation of FRR would be relatively simple as compared to the GRR. Collation of worldwide information of a group / particular sector, which could be dynamic and prone to manipulations by such sector, would be a difficult task for the countries to freeze out at sector wise GRR. Thus, more detailed work regarding design and operation of GRR would be undertaken by the OECD for its implementation by the countries.

3. Implementing Best Practice Approach

A country may supplement the best practice approach of FRR and GRR with other general or targeted interest limitation rules, either to address base erosion and profit shifting risks it faces or to achieve wider tax policy aims.

A country may apply the FRR and GRR together with targeted rules to tackle specific base erosion and profit shifting risks or interest limitation rules, such as arm’s length rules, rules to disallow a percentage of all interest expense and thin capitalization rules.

Where a country applies withholding tax to payments of interest, this should in no way be impacted by the application of the FRR, GRR or targeted rules described in this report. Withholding tax on interest is typically imposed in order to allocate taxing rights over income to a source country, although it is recognised that an effect of withholding taxes may be to reduce the benefits to groups of base erosion and profit shifting involving interest.

3.1. Transitional Rules

Any rule to limit tax deductions for an entity's interest expense could involve a significant cost for some entities. Therefore, it is expected that a country introducing a FRR and GRR would give entities reasonable time to restructure existing financing arrangements before the rules come into effect. A country may also apply transitional rules which exclude interest on certain existing loans from the scope of the rules, either for a fixed period or indefinitely.

3.2. Countries applying separate entity taxation systems

Where a country taxes each entity within a group separately, the FRR and GRR may be applied in any of the following three ways at the discretion of the country:

- Application of rule separately to each entity based on its EBITDA.
- The country may treat entities within a tax group as a single entity for the purposes of applying the FRR and GRR. The benchmark fixed ratio would be applied to the tax group's total tax-EBITDA and the interest capacity would then be allocated within the tax group in accordance with rules developed by the country.
- The country may treat all entities in the country which are part of the same financial reporting group as a single entity for the purposes of applying the FRR and GRR.

3.3. Countries applying group taxation systems

Where a country taxes entities on a group or consolidated basis, the FRR and GRR may be applied in any of the following ways at the discretion of the country:

- The country may treat entities within the consolidated tax group as a single entity for the purposes of applying the FRR and GRR.
- The country may treat all entities in the country which are part of the same financial reporting group as a single entity for the purposes of applying the FRR and GRR.

3.4. Interplay with Hybrid Mismatch rules

Where a country has introduced a FRR, the potential base erosion and profit shifting risk posed by hybrid mismatch arrangements is reduced, as the overall level of net interest deductions an entity may claim is restricted. However, the risk is not completely eliminated. Entities may indulge in in hybrid instruments for double deduction of expenditure or non-inclusion of income thereby increase in net third party interest expense of group.

OECD recommends that the rules to address hybrid mismatch arrangements should be applied by an entity before the FRR and GRR to determine an entity's total net interest expense. Once this total net interest expense figure has been determined, the FRR and GRR should be applied to establish the extent of net interest expense to be allowed for the entity.

3.5. Interplay with Controlled Foreign Company ('CFC') rules

BEPS Action Plan 3 (Designing Effective Controlled Foreign Companies Rules) address situations where an entity makes an interest payment which is deductible, but the payment is made to a CFC which is subject to a low rate of tax.

Countries applying CFC rules may include CFC income, which is subject to tax on the parent company, in the calculation of the parent's EBITDA when applying the FRR and GRR. Accordingly, the interest income or expense included in such CFC income should be included in the calculation of the parent's net interest expense and excluded from the calculation of the parent's EBITDA.

Interplay of CFC rules under Action Plan 3 and recommended approach under Action Plan 4 would encourage groups to spread their net interest expense between its group entities so that there is a greater link to taxable economic activity of such entities.

3.6. Interplay with European Union ('EU') directives

The Parent Subsidiary EU Directive eliminates cross-border withholding taxes on dividend payments made by a subsidiary to a parent company and also eliminates double taxation of such income at the level of the parent company. The countries reclassifying excessive interest as a dividend as per the BEPS Action Plans may be granted the benefits of the Parent Subsidiary Directive under EU directives.

The Interest and Royalty EU Directive provides the exemption from all the taxes on the payment of interest and royalty arising in an EU Member State, whether by deduction at source or by assessment. Thus, disallowing a deduction for excessive interest as per the best practice approach recommended by the OECD under Action Plan 4 could be considered as taxation of interest and, thus, fall within the scope of the EU directive.

4. Impact of Action Plan 4

4.1. General Impact

The implementation of recommended FRR and/ or GRR may have significant implications on multinational financing costs. The G20/ OECD have concluded that the approach on interest deduction restrictions should be a best practice, which means that the action will not be adopted by all countries participating in the BEPS project. Though it may be difficult to accurately anticipate the consequences of the recommendations under Action Plan 4, consideration should be given to some general issues and potentially adverse consequences

- Unless there are changes to the existing deduction provisions, any changes proposed at the global level will still need to comply with the specific interest deductibility rules.
- The impact on deductions in multiple jurisdictions, significant restrictions on where debt may be allocated and deductions taken and limitations on debt-pushdowns upon acquisitions. This can also affect cash-rich multinationals that use intra-group debt to fund group operations.
- The negative impact on external and internal debt management, for example multinationals with significant interest deductions at headquarter level with relatively little economic activity and the resultant minimal allocation of interest to the headquarter.
- An additional compliance burden on multinationals including the gathering of necessary information, managing debt and currency positions and the increased burden on tax reporting on a global basis.

4.2. Impact on Industry

Currently, certain industries require heavy capital investment to start and set its business for operations. Even though the revenue generating activities starts in future and then the profits are earned, the deduction for interest expenses will be available in the current year when such expenses are incurred. This being a genuine commercial activity, it should not be deemed to be tax avoidance in any way. However, the recommended rules under Action Plan 4 may affect the interest deductibility on such investments with delayed returns.

The recommended FRR under BEPS Action Plan would be a significant change for those countries having interest limitation rules based on debt/ equity ratios. The existing debts financing structure Experiences in countries having such rules has shown that this can be a threat in times of economic crisis. The OECD recommendations may introduce significant complexity in international cash management planning.

Debt financing within the group entities is not a new structuring technique in the business. Many multinational groups indulge in intra group debt financing not with a sole intention of avoidance of tax. But there are many other non-tax reasons, like availability of finance in a particular jurisdiction, political stability, constitutional and statutory compliances relatively lesser in some jurisdictions, interest rates, creditworthiness of entities in their respective jurisdiction and become a deciding factor in perusing debts from the finance market in the jurisdiction. Implementation of recommended FRR or group ration rule by countries would definitely lead to major debt finance restructuring within the group of multinational corporations which may be burdensome and tedious task.

4.3. Impact on Specific Sectors

4.3.1. Banking and Insurance Sector

OECD has acknowledged that Banking and Insurance sector may be particularly affected by the rules recommended in the Action Plan 4. Accordingly, OECD is in the process of creating separate rules for such industries.

4.3.2. Financial and Infrastructure Sector

It is recognized that the FRR and GRR are unlikely to be effective in addressing BEPS involving interest in the Infrastructure and Finance sector wherein there is huge initial capital outlay leading to huge interest expenses with no corresponding income or revenue generated in such sector at the initial phase.

For such section, a country may choose to exclude interest expense incurred on third-party loans to build or acquire privately-owned public-benefit assets financed using a high proportion of debt (e.g., infrastructure assets). But these exclusion would not be applied to related-party or group loans, as it may defeat the check of BEPS issues.

4.4. Inbound and Outbound transactions

BEPS Action Plan 4 stresses the need to address base erosion and profit shifting using interest payments that can give rise to double non-taxation of income in both inbound and outbound investment scenarios. The discussion report of OECD prominently sets out following concern areas:

- From an inbound perspective, concerns focus on excess interest deductions thereby reducing the taxable profits in operating companies in high tax jurisdiction. The corresponding income is recognised by the related lender company in the low tax jurisdiction. Further, it may be possible that the worldwide multinational group as a whole has very little or no external debts.
- From an outbound perspective, company may use debt finance to produce tax exempt or deferred income, thereby claiming a deduction for interest expense against its other taxable income, while the income related to the investment through such debts would be brought to tax later or not at all.

The use of hybrid arrangement both at the entity level and the financial instruments level results in overall tax efficiency for the group leading to tax optimization thereby increasing BEPS risk. Further, the incentives provided under the domestic tax legislation like participation exception, EU directives, holding company regime, etc., are creating more pressure on base erosion theory thereby increasing BEPS risks.

The approach recommended by the OECD in the Action Plan 4 seems to suggest that borrowings to finance investment in a related company would pose BEPS risk as the borrowings to invest in equity typically creates tax exempt income and borrowing to lend to other group companies may create excessive interest deductions for the borrowers. The application of FRR and GRR to regulate interest deduction for the entities is an attempt to restrict the excessive allowance of interest expense in a high tax jurisdiction.

4.5. Action Plan 4 vs. Thin Capitalisation, GAAR, TP

A company is typically financed through a mixture of debt and equity. Tax law typically allows deduction for interest paid or payable on debts in arriving at the tax measure of profit and returns on equity are not tax deductible. Accordingly, the higher the level of debt in a company, the lower will be its taxable profit owing to the tax deductible interest expenses payments. For this reason, debt is often a more tax efficient method of finance than equity. A situation in which a company is financed through a relatively high level of debt compared to equity is referred to as thinly capitalised or highly leveraged entity.

The rules implemented by various countries with regard to the thin capitalisation i.e. the debt-equity ratios, have the effect of reducing the total debt of the entity or group. However, OECD observed that the thin capitalisation rules based on debt to equity ratios are not recommended as a best practice in the context of a general interest limitation rule for tackling base erosion and profit shifting. This is because the thin capitalisation rules do not focus directly on the level of interest expense in an entity. These rules might be effective in reducing intra-group debts but lead to an increase in third party debt, thereby continuing to incur high interest expense (which is the main risk area in base erosion and profit shifting using interest expense). OECD recommended approach in Action Plan 4 would help the countries restrict the interest expense *vis-à-vis* its earnings instead of restricting the debts as the case under thin capitalisation rule.

Generally, if any arrangement between the corporates does not have a substance and is mainly designed or intended to avoid taxation, then such a transaction should be subjected to GAAR or SAAR provisions. Under GAAR/ SAAR provisions, such expenses under the aforesaid transactions are either disallowed or the entire transactions may get recharacterised from debt to equity, etc. The recommended approach under Action Plan 4 could have dual impact when GAAR / SAAR provisions already exist in a particular jurisdiction and additionally Action Plan 4 is also implemented. The approach of restricting interest deduction under Action Plan 4 shall consider and reconcile with the provisions of GAAR / SAAR to avoid double disallowance situations while tackling BEPS risk.

Similarly, Transfer Pricing regulations tackle BEPS risk by disallowing excess interest payments to related concerns or attribution of income on the basis of benchmarking in this regard. The approach for tackling BEPS risk under Action Plan 4 and its interplay with already existing transfer pricing guidelines would be necessary to avoid double disallowance.

5. India perspective – Comments / Thoughts

Debt financing and borrowings from outside India are subject to external commercial borrowings related regulations of Reserve Bank of India. These guidelines regulate limits of debts as well as provide regulatory capping of interest on such debts. Further, interest deduction for tax purpose is subject to satisfaction of business purpose test in India. There are various provisions under the Income-tax Act, 1961, governing the quantum of deduction of interest expenses for the entities on the basis of its purpose, subject to satisfying of certain conditions or withholding tax requirements, etc.

India is one of the fastest growing economies in the world. The basic crux of the financial growth of any country is majorly dependent on growth of its industry. 'Make in India' concept implemented by the Government has led to huge inbound investments. Adoption of recommended best practice approach under BEPS Action Plan 4 might hamper the flow of investments from outside India and would in turn affect the industrial growth. The multinational companies should be granted reasonable time to restructure its existing finance transactions.

The domestic laws in India has provisions for disallowances of expenditure incurred in relation to exempt income i.e. section 14A and granting of deduction for interest expense under section 36(1)(iii) in domestic law. Separately, Indian government may introduce carry forward of disallowed interest, unutilized interest capacity, etc.

Infrastructure sector of India is growing rapidly. Infrastructure sector require huge upfront investments for its projects to start with. The revenue generating activities however start at a later stage. In such situation, infrastructure companies may face dilemma with applicability of recommended approach of interest deduction as per Action Plan 4. The applicability of FRR to the infrastructure sector companies would lead to huge disallowance of interest expense in the initial phase where corresponding revenue or income flow from such investments is absent. Hence, separate approach for such industry sectors India need to be evaluated to tackle BEPS issues and at the same time to preserve the economic growth of such sector. Recommendations like carry forward of disallowed interest at the initial phase or utilization of unused capacity to deduct interest when the income flow would start in future, would prove to be beneficial for infrastructure or other similar capital incentive sectors.

India has been introducing number of measures with an intention of countering BEPS. One of such measures is the introduction of broad general anti-avoidance rules ("GAAR"), economic substance relevant for taxation, overseas transactions with underlying interests in India are covered in tax brackets, focus on covering maximum profit attribution to permanent establishments in India, transfer pricing and other measures.

Transfer pricing regulations and guideline to check related party transactions are already in place in the tax laws of India. The adoption of recommended approach to tackle BEPS in domestic tax law would regulate the interest deduction on the basis of FRR and GRR. As far as interest on intra corporate borrowings is concerned, OECD recommendations may lead the Indian business to move away from arm's length principle and business purpose test currently placed for interest disallowances in this regard.

India has been actively participating in the OECD discussions and have also been contributing its views on various Action Plans. In fact, India has been aggressive in some of its approaches in tackling BEPS risks.

India may adopt Action Plan 4 considering that it is typically regarded as a high tax jurisdiction, though till date, the stand of India on BEPS is not known. India's adoption of BEPS recommendations for limiting interest deductions would impact not only multinationals operating in India but also domestic groups. Common benchmark FRR. If applied across all sector, could impact highly geared sectors like infrastructure thus leading to disallowance of legitimate interest deductions.

Limiting interest deduction and its consequent impact thereon may require amendments in local law. Introduction of rule recommended under Action Plan 4 by India may overrule the decision of the Courts wherein it was held that revenue authorities cannot decide the reasonableness of expenditure incurred by business. We may expect some amendments or announcements in this regard in the forthcoming budget.

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6. Challenges / Issues

When considering an investment into an overseas territory, debt can be preferred due to the additional flexibility it provides for future cash repatriation particularly where there are foreign exchange controls and in general debt ranks equally with other creditors. There are also practical issues of raising debt at a local level which cannot be overlooked in any attempt to create a level playing field. These factors would also play a deciding role while implementing recommendations of Action Plans in the jurisdiction.

The effort to counter BEPS is a need of an hour, but it is also important to protect taxpayer rights, avoid double taxation, reduce litigation and check the additional burdensome statutory compliances to the taxpayers due to the adoption of BEPS related Action Plans in the country tax laws. The OECD has pointed out that unilateral measures by countries could lead to global tax chaos marked by the massive re-emergence of double taxation.

Different countries adopting different approaches of Action Plan 4 recommended by OECD may result in mismatch thereby creating a situation of double non-deduction or double deduction. Double taxation can arise where the adoption result in a disallowance of interest expense in one territory while full taxation continues in the territory of the recipient.

Ensuring cohesiveness and coherence in the entire implementation of Action Plan 4 across various countries is a serious challenge as different countries will have different economic considerations, level of economic development, need for attracting foreign capital, existing tax incentives / rules trashing out resulting in "estoppel of promise", etc.

While applying GRR, compiling the data from across the countries is a challenge. Further challenges would be – different accounting year, different accounting policies and countries applying different GAAP, different meaning of the term 'interest' and different treatment of various transactions, inconsistent allocation of expenses during consolidation, conversion of foreign currency transaction into single reporting currency, etc. Effective implementation of exchange of information amongst countries, co-operation amongst the countries for sharing of information, etc., would pose challenges in implementation of recommendations under Action Plan 4.

Implementation of various interdependent Action Plans suggested by OECD by different countries at different points in time could yield different results. Further, the outcome of Action Plan 4 is dependent on the roll-out of other Action Plans like Action Plan 2 – Hybrid mismatch, Action Plan 5 – Countering Harmful tax practices, Action Plan 6 – Prevention of Treaty Abuse, Action Plan 8 – Transfer Pricing, etc.

A need to apply a consistent Generally Accepted Accounting Principles (GAAP) across the group, the need for every group company to collect detailed financial information on every other group company, understanding country risk profile, etc., would pose challenges in adoption of GRR by the country.

7. Suggestions / Way forward

Implementation of recommended approach by the countries shall be made in the phased manner thereby giving the industry sufficient time to absorb the recommendations and accordingly adjust their business to such changes. Also, transition relief shall be provided by the country to the entities i.e. grandfather pre-existing obligations and application of recommended best practice approach for new debts financing structure.

The lender and borrower have expectations based on the favourable conditions set by the country providing benefits on making the investments or debt financing, as to the cost of that investment. Thus, the economic bargain in a pre-existing debt instrument should be preserved for the benefit of industry and the economic growth of the country as a whole.

As per the best practice approach recommended by the OECD, the limit on interest expense deduction via FRR or GRR is linked to the EBITDA of the entity. However, in certain capital intensive industries where the entities incur high interest expense but may not have positive EBITDA in the initial phase of its operations, the disallowance of interest expenses based on the FRR and GRR applied on EBITDA would be a blunt approach for such entities. Here, it may be recommended that the interest deduction limit based on FRR and GRR may be derived at by linking the ratios to the gross revenues or operational receipts of the entities instead of its EBITDA.

As many countries look forward to adopt recommendations made by OECD in their actions Plans to tackle the issue of BEPS, changes to the international tax reporting requirements as well as the additional time and resources required for multinational corporations to implement such recommendations in their business operations, would be a cause of concern. The best defense is to act early and with confidence, as multinational corporations will need to deliver transparent BEPS reporting to required authorities with efficiency, accuracy, and reduced risk of audit.

8. Points to Ponder

8.1. Whether BEPS Action Plan 4 "best practice approach" would be applicable to domestic group where the holding company borrow at high interest rate and pumps in the funds into its subsidiaries at low interest rate.

Comments: Though OECD had analysed measurement of earnings of entity based on the asset value, the measurement of earning based on EBITDA was considered as proposed approach. However, for certain industry situations as discussed above, representation may be made before the countries implementing the Action Plan 4 to consider interest deduction linked to gross earnings instead of EBITDA in certain relevant sectors.

8.2. How will the countries adopt recommendations of BEPS Action Plan?

Comments: Generally, it is understood that the domestic tax laws of the countries would be amended to adopt the recommendations of OECD to tackle BEPS risks as unilateral measures. Similarly, in bilateral situations, the DTAAs between the countries would be revisited to incorporate Action Plan and amend definition of interest, etc. However, time would bring clarity in this regard.

8.3. Would entities having genuine third party debts and legitimate interest expenditure thereon be subjected to limit on its interest deduction as per applicable FRR?

Comments: As per FRR, the interest expenditure exceeding the limit set by the FRR to its EBITDA would be subject to disallowance. Recommendations may be made to the jurisdiction to exclude disallowance of legitimate interest on third party debts where there is no scope of tax avoidance or BEPS risk e.g., infrastructure companies or debts borrowed for public benefit projects, etc.

8.4. Any difficulties under Action Plan 4 around inclusion of amounts with respect to Islamic finance?

Comments: Islamic finance refers to the means by which corporations in the Muslim world, including banks and other lending institutions, raise capital in accordance with Sharia, or Islamic law. Since charging of interest on borrowed capital is prohibited, the finance corporations share profits of the entities that it underwrites for finance purpose. In absence of clarity on whether amounts under Islamic finance should be treated in the same way as interest, the tax authorities apply different interpretations of what is interest or taxpayers seek to characterise payments as something other than 'interest'.

8.5. What are the problems that may arise in a rule applying to net interest expense as against gross interest expense?

Comments: In a far-fetched situation, a manufacturer may plan to convert all its sales to leases in order to generate interest income. However, since this is very unlikely, the net interest expense is a reasonable approach.

8.6. Any specific issues or problems in applying a GRR to a group engaged in several different sectors?

Comments: Groups with holdings in entities operating in widely different industry sectors, with disparate capital requirements (both in frequency and overall leverage) would have varying interest expenses. Industries having high earning to operational asset ratios, such as manufacturing businesses, would obtain a higher level of leverage than borrowers engaged in the services industry where no significant levels of tangible assets exist. Typically from a credit-risk perspective, lenders are more amenable to borrowers with diversified operations. Hence, the consolidated group may be able to obtain high leverage than the total absolute leverage that could have been obtained by its subsidiaries acting independently and *vice-a-versa*.

8.7. Which sector would be affected by FRR and how could this be addressed?

Comments: Sectors that will be particularly impacted by the FRR include:

- Infrastructure
- Property and real estate
- Private equity backed businesses
- Financial services (see question 34 below)
- Companies in the service sector

As recommended in the OECD, the country shall consider various industry specific or sector specific circumstances to arrive at benchmark FRR. Further, application of targeted anti-avoidance rules to such specific sectors rather than implementing FRR that could potentially damage these important business sectors, would be looked into.

8.8. Any specific items which should be covered by a best practice rule and which is not covered by the approach of Action Plan 4?

Comments: Following items may be addressed by the approach adopted under Action Plan 4:

1) Forward contracts contain an element of compensation for the time value of money.

2) Businesses that accept delayed payment for goods ('buy now pay later'), where an element of the purchase price could be 'interest' but the 'interest expense' is accounted for as the cost of the purchase.

8.9. What is 'Equity Escape Rule' and how does it work?

Comments: The earnings-based worldwide GRR can be replaced by different GRRs, such as the "equity escape" rule (which compares an entity's level of equity and assets to those held by its group) currently in place in some countries.

Under the Equity Escape Rule, the FRR does not apply to entities that are part of a group, if the entity can demonstrate that its equity/total assets ratio is equal to or higher than the equivalent group ratio. An entity which is leveraged more highly than its group cannot deduct interest expense up to its group's ratio.

8.10. What would be the impact of loss making entities while determining GRR?

Comments: In a scenario where the group EBITDA is positive but includes results of certain loss making entities in the group, then this may lead to higher GRR and increase capacities of profitable entities to deduct interest more that their actual tax liability. The OECD recommends the jurisdiction to cap the total interest deduction allowance to the limit of net third party interest expenditure of a group.

Similarly, in a scenario where a group has negative EBITDA but include certain profitable entities in it, the GRR would not allow any interest deduction to such profitable entities too. In such situation, the profitable entities could be allowed interest deduction to the extent of, lower of actual interest expense of such entity or net third party interest of the group.

OECD, however, has confirmed that further work in this regard would be carried out to address the impact of loss making entities on its group ratio.

8.11. Is India ready for adoption of BEPS Action Plan 4 recommendations?

Comments: India already has various provisions under its domestic tax laws to regulate the interest expenditure. Further, the ECB guidelines of RBI keep a tap on the inbound and outbound debt funding for organisations in India. BEPS Action Plan 4 may make India less attractive as an investment destination, specifically around 'make in India' initiative of the government.

9. Summing Up

Lot of work has been done thus far on BEPS Action Plans and good amount of work is being done at the OECD level. Most important aspect under OECD's Action Plans is – cohesiveness, co-operation, tax transparency and curb tax avoidance. The countries implementing approaches of Action Plan 4 shall ensure that minimum impact is being done on business, cross-border transactions, cross-border financing and allowing flexibility for corporates to align its finance structure. Further, the implementation of BEPS action plans should be done carefully so that it tackles tax avoidance but does not result in taking away tax efficiency. While implementing BEPS Action Plans, changes to domestic tax laws and tax treaties would be carried out and in this process, avoiding conflicts and mismatches would be of essence. Further, the Action Plan 4 should reconcile with the existing tax avoidance measures like GAAR, SAAR, Transfer Pricing, etc. adopted by the country.

As BEPS Action Plans discussion progresses, many countries have introduced few legislations in their domestic tax regime to tackle BEPS risks and curb tax avoidance e.g. GAAR introduced by the Netherlands effective January 1, 2016, Diverted Profit Tax introduced by the UK made effective from April 1, 2015, Multinational Anti Avoidance Law legislated by Australia in December 2015, etc. It is important to watch and observe how India reacts to the BEPS Action Plans recommendations and roll out legislative changes in the ensuing Finance Bill, 2016. Nonetheless, it would be interesting and challenging times going forward.

All knowledge that the world has ever received comes from the mind; the infinite library of the universe is in our own mind.

— *Swami Vivekananda*

CA Liyod Pinto

Patent Box – Overview of Select Current Patent Box Taxation Regimes

1. Introduction

Although the patent box regime seems a very recent introduction in the tax lexicon, it was actually first introduced by Ireland in 1973. Most other nations however only introduced such regimes in the last decade. In simple terms, a patent box regime allows income from the sale of patented products to be taxed at a preferential tax rate as opposed to regular corporate income tax rates.

Although the Patent Box regime originally started as an incentive for only patented products, several countries subsequently expanded this concept and established "Innovation Boxes" – that allowed income from copyrights, designs and trademarks to be also taxed at patent box rates. The key argument here was that in several high-tech industries like software, there was a significant amount of innovation and Research and Development (R&D), however this was not always a patentable activity. Hence countries like The Netherlands decided to build on this concept and introduce an "Innovation Box" which was much broader in scope.

2. Rationale of a Patent Box regime

One of the key reasons for the proliferation of these regimes recently has been the global race to attract innovation based companies and to thus harbour the potential for high-potential companies and significant job creation. In today's global economy, talent is highly mobile and thus in order to attract high-tech innovative companies, countries have realized that they need to create a fiscal and regulatory environment that allows such companies to not only establish and grow but also enjoy the benefits of their innovation and maximise their economic benefits.

Some of the countries which have introduced Patent Box regimes are

- Belgium
- Netherlands
- United Kingdom (UK)
- Luxembourg
- Spain
- Switzerland
- China
- Italy

As with many preferential tax regimes, these are vulnerable to misuse and companies started using treaty shopping routes to take advantage of such regimes without having strong substance and economic activities in these jurisdictions. Pursuant to the OECD's Base Erosion and Profit Shifting (BEPS) Project, significant work was done on preferential tax regimes which led to the release of this report titled – Final Report on Action 5 – Countering Harmful Tax Practices more effectively, taking into account Transparency and Substance. This report suggested measures to curb misuse of preferential tax regimes and bring in higher standards of substance for availing the benefits of such tax incentives.

Several jurisdictions have already taken note of these suggestions and are incorporating this into their preferential tax regimes.

We will discuss below some of the current Patent Box regimes in a few jurisdictions. These will however undergo changes post 30th June 2016. Countries are permitted to introduce grandfathering rules, which will allow existing taxpayers to continue to enjoy incentives under the current regimes till 30th June 2021. The current regimes will be closed to new entrants subsequent to 30th June 2016.

In light of the above, we are discussing some of the existing patent box regimes in 4 jurisdictions.

3. Overview of Current Patent Box Regimes

A. UK

Overview

The UK Patent Box regime provides a reduced corporate tax rate of 10% on worldwide income arising to companies from the exploitation of inventions which benefit from a qualifying patent.

This regime was effective April 1, 2013 and was subject to phasing-in rules. The phasing-in rules meant that the 10% effective rate would be phased in over a 4 year period. The full benefit of the 10% rate would only be effective from April 1, 2017. The current rules are only applicable to arrangements entered into before 30th June 2016.

Qualifying Entities

Companies that are subject to UK corporation tax are eligible for the patent box regime. This includes

UK resident companies and non-resident companies that operate in the UK through a UK permanent establishment.

Companies that are members of groups and/or conduct their activities via tax transparent partnerships are also eligible for this regime but are subject to additional rules.

Qualifying Intellectual Property (IP)

A company can avail the benefits of the Patent Box regime in the following scenarios

- The company owns the qualifying IP or has licensed it. In case the IP rights are licensed, the licensing rights must be exclusive, at least as regards one or more countries and must exclude all other persons, including the person granting the licence.
- A company can also benefit from the Patent Box if it receives income in relation to qualifying IP which it no longer owns or over which it no longer has the benefit of an exclusive licence, provided that the event giving rise to such income occurred when the company did qualify for the regime. This would cover income received in subsequent periods in respect of the sale of patents in an earlier period. It would also cover damages received by a company for patent infringement received in subsequent years after the expiry of a patent.

The regime is applicable only to patents granted by the:

- UK Intellectual Property Office
- European Patent Office
- Following countries in the European Economic Area:
  - Austria
  - Bulgaria
  - Czech Republic
  - Denmark
  - Estonia
  - Finland
  - Germany
  - Hungary
  - Poland
  - Portugal
  - Romania
  - Slovakia
  - Sweden

Development Conditions

In order to benefit from the Patent Box regime, the company or another group company must also undertake qualifying development activities for the patent by making a significant contribution to either:

- The creation or development of the patented invention
- A product incorporating the patented invention

The "significant contribution" condition will be a facts and circumstances test. The UK HM Revenue and Customs (HMRC) considers that simply applying for a patent will not be sufficient for these purposes, nor will acquiring rights to and marketing a fully-patented product.

A company satisfies the development condition either if it carries out development activity itself, or another company in the group carries out such activity. Companies that are members of a group must also meet an "active ownership" requirement.

Qualifying Income

Income qualifying under this regime includes

- Income from the worldwide sales of the patented product, or of any item that physically incorporates a patented item
- Worldwide licence fees and royalties from licensing or sublicensing qualifying IP rights
- Income from the sale or disposal of qualifying IP rights
- Payments received as compensation for infringement of the company's qualifying IP, and
- Where patents are used internally by the company, a notional arm's length royalty equal to the amount that the company would have received if it licensed its qualifying IP to an unrelated third party.

B. The Netherlands

Overview

The Netherlands introduced its "Patent Box" regime in 2007. However it was restrictive and complex and hence not very attractive. The Dutch Ministry of Finance introduced, as of January 1, 2010, an improved version of the regime, and renamed it to "Innovation Box."

The Innovation Box regime provides for a special tax rate of 5% and this rate applies to the income generated by a qualifying intangible to the extent the income from the intangible exceeds the related R&D expenses, other charges and amortization of the intangible. This regime is quite attractive considering the regular Dutch corporate income tax rate is currently 25% and the incentive tax rate under the Patent Box regime was 10%.

Qualifying Entities

One of the key qualifying conditions is that the Dutch Company must be the economic owner of the IP and bear the risks associated with the ownership of the IP.

Qualifying IP

The scope of the Dutch Innovation Box is, by contrast, wider in so far as the regime extends to profits derived from

– Both foreign and domestic patented intangibles as well as

– Non-patented intangibles that result from R&D activities with respect to which an R&D statement is obtained from the Ministry of Economic Affairs (R&D intangibles).

Any intangible asset can qualify as long as at least 30% of the expected income generated by that asset can be allocated to the patented IP right or R&D intangibles.

Development Conditions

One of the key development conditions is that the patent or IP must be developed through R&D which is paid for and is conducted at the risk of the Dutch taxpayer. For patents, the R&D activities can be carried out either in the Netherlands or abroad.

For IP which has an R&D declaration from the Dutch government, generally at least 50% of the R&D must be performed in the Netherlands and the Dutch entity must play a key co-ordinating role in the development.

Qualifying Income

Income qualifying for these tax incentives include

– All net profits attributable to qualifying IP, as well as

– All net capital gains derived from qualifying IP.

The regime is not restricted to the income directly attributable to the patent or R&D IP; it also can apply to profits embedded in the sales price of goods or services. However, in the case of patents in

order for income to qualify more than 30% of the derived income must be attributable to the patent right itself.

C. Belgium

Overview

Belgium introduced in 2007 a Patent Income Deduction (PID). Taxpayers subject to Belgian Corporate Tax, irrespective of their size or industry, are entitled to an 80 per cent deduction of their gross patent income from their tax base. The result is an effective tax rate of a maximum of 6.8 per cent on this income. Any excess PID cannot be carried forward nor is it refundable.

Qualifying Entities

The Belgian PID regime applies only to patents or supplementary protection certificates which are owned by a Belgian company or a Belgian PE as a direct result of its own patent development activities. The incentive is also applicable to patents acquired from related or unrelated parties.

Qualifying IP

This tax incentive only applies to qualifying patents and supplementary protection certificates. Other IP rights (copyrights, knowhow, designs, trademarks, models, secret formulas, operating procedures, manufacturing processes, information on experience in the field of trade and science, etc.) do not qualify.

The benefit of the PID is not limited to self-developed patents. Acquired patents can also benefit from the PID providing the additional condition of further improving the patent is met. There is no obligation for this "further improvement" of the patent to lead to a new patent.

Development Conditions

This condition requires the patents to be developed or improved in an R&D branch in Belgium or abroad. If a Belgian taxpayer owns a patent and works at an R&D centre, it can benefit from the PID. If a Belgian taxpayer owns a patent, develops or improves the patent but outsources the R&D operations by using contract R&D operators, it can also benefit from the PID provided the overall responsibility and management of the R&D activities lie with the company

Qualifying Income

The PID applies to income received by the owner and the licence holder derived from licensing a patent but is also applicable to patent income that is embedded in the sales price of a patented product or service. The service provider cannot benefit from privileged IP income. The law does not stipulate that there should only be one owner. So, in principle, all co-owners can benefit from this tax measure according to their ownership percentage. In this respect, also the economic owner of a patent should qualify for the PID provided it is demonstrated that all patent development costs have been borne by the economic owner.

Capital gains from the sale of Qualified IP however do not qualify for PID.

D. Italy

Overview

Introduced in 2015, the recent Italian Patent box regime allows a taxpayer to exclude from its tax base a percentage of the income derived from the relevant intellectual property. The regime ultimately looks to exclude 50% of relevant income, although in the 2015 and 2016 fiscal years the exemption is limited to 30% and 40% respectively.

Qualifying entities

The Italian patent box regime is available to resident entities or individuals who are the holders of the economic right to use the IP and thus includes licensees. This regime is available *inter alia* to resident individuals, companies, partnerships and Italian branches of non-residents.

Qualifying IP

The following IP will qualify for this preferential tax regime.

- Software protected by copyright
- Industrial patents
- Trademarks (including collective brands) already registered or in the process of being registered
- Models and designs capable of being legally protected
- Business and technical-industrial know-how, including commercial or scientific, capable of being protected as confidential information and capable of being legally protected.

Development Conditions

The regulations provide a detailed list of R&D activities performed for the development and maintenance, as well as for the improvement, of the value of any qualifying IP. Some key conditions are as below

- Fundamental & Applied Research
- Design to be intended as the conception and planning of products, processes and services, including their external appearance (and of every component), and the brand development activities
- The conception and the realisation of software protected by copyright
- The preventive research, test, market survey and other studies and actions for protection and renewal of IP rights
- Presentation, communication and promotion activities with respect to trademarks

Qualifying Income

The income qualifying for this incentive includes

- Royalties received in respect of the relevant intellectual property
- Pro rata share of profit deriving from business activities where the intellectual property is used in producing goods or services for sale
- Capital gains arising on the sale/transfer of intellectual property
- If 90% or more of the proceeds are re-invested in similar assets then the exemption on capita; gains from transfer of IP is 100%

4. Impact of OECD BEPS on Patent Box regime

OECD's BEPS programme has led to a massive rethinking among nations having the patent box regime and several countries have announced that they will make suitable changes to their patent box regimes to bring it in line with the OECD recommendations.

One of the key arguments against preferential IP tax regimes was the lack of economic substance in the country where the incentive was provided. The Forum for Harmful Tax Practices (FHTP) proposed the Modified Nexus Approach based on the location of the R& D Expenditure incurred in developing the patent or product.

The preamble to the Final report on Action 5 Countering Harmful Tax Practices more effectively, taking into account Transparency and Substance stated that the report set out an agreed methodology to assess whether there is substantial activity. In the context of IP regimes such as patent boxes, agreement was reached on the "nexus approach" which uses expenditures as a proxy for substantial activity and ensures that taxpayers can only benefit from IP regimes where they engaged in research and development and incurred actual expenditures on such activities.

There were however some concerns amongst member nations regarding this approach. The UK & German governments collaborated to develop a joint proposal which provided some solutions to address the concerns raised while still providing adequate safeguards against profits shifting.

The four points put forth in the joint statement issued by the UK & German governments were as follows :

Uplift of Qualifying Expenditure – Where related party outsourcing or acquisition costs are incurred, which do not constitute qualifying expenditure, companies will be able to obtain a maximum 30% uplift of their qualifying expenditure (subject to a cap based on actual expenditure) included within the formula; the 30% uplift refers to the overall expenses for both, outsourcing and acquisitions costs.

Closure and Abolition of IP Regimes – To allow time for the legislative process, all existing regimes will be closed to new entrants (products and patents) in June 2016. These schemes will be abolished by June 2021.

Grandfathering – To allow time for transition to new regimes based on the Modified Nexus approach, IP within existing regimes will be able to retain the benefits of these until June 2021.

Tracking and Tracing – The FHTP should work to reach agreement by June 2015 on a practical and proportionate tracking and tracing approach that can be implemented by companies and tax authorities, which includes transitional mechanisms for intellectual property from existing into new regimes, and special rules for previous expenditure. The focus of this should be on developing practical methodologies that companies and tax authorities can adopt.

The proposal was accepted by the FHTP and the suggestions provided in this proposal are being built out by the OECD and it released a further document on this subject titled - Action 5: Agreement on Modified Nexus Approach for IP Regimes.

Conclusion

The BEPS project of the OECD is an importance milestone in international tax and countries have already started adopting the suggestions and incorporating provisions in their domestic tax laws to ensure that their preferential tax regimes comply with the OECD recommendations. While each country wants to maximise its tax revenue and attract highly innovative companies and top flight talent to its jurisdiction, they realise that this cannot come at the expense of global tax avoidance and profit shifting. Each country must be able to tax its fair share of revenue based on the economic activities conducted in its own territory. However this is just the beginning.

One fear was however if each country were to take unilateral action inconsistent with such rules, then it could lead to potential double taxation with 2 countries fighting over the same pie of profit.

Looking forward though, with the pace of technological advancement, territorial boundaries have little meaning in cyberspace and as more and more work begins to get done on the cloud, borders will lose much of its significance and capturing fair share of income for a particular country is only going to get tougher.

This is however a welcome first step, the first of many more to come.

 

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BEPS Action Plan 5 : Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

A lot of ground has been covered in the earlier articles in relation to what is BEPS and what is the impact and relevance of BEPS in today's globalized scenario. Also the need for OECD to undertake the BEPS project in line with the expectations of G20 countries has been sufficiently dealt with in preceding articles. This allows us to delve directly into discussing Action 5 which deals with the recommendations for Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance in line with the 'coherence' theme laid out in OECD's BEPS Action Plan released in 2013.

Background

Recognition of the need to counter harmful tax practices with respect to geographically mobile activities, such as financial and other services, including provision of intangibles, dates back to 1998 when the OECD published the report Harmful Tax Competition: An Emerging Global Issue ('the 1998 Report') and set up the Forum on Harmful Tax Practices ('FHTP') to take the work forward. The nature of these activities is such that in the age of globalization and technological innovation they are easy to shift from one country to another, allowing MNEs to shift profits as well.

The availability of harmful preferential regimes is one of the key pressure areas which gives rise to BEPS concerns. BEPS issues may arise either from the loopholes or mismatches in countries' domestic tax laws or from the absence of exchange of information on rulings related to preferential regimes. Such tax regimes offered by countries are not per se illegal. However, where organizations arrange their affairs only to avail of the preferential regime, without really taking up any activity in that country, while continuing to exploit resources of their home country it may lead to artificial shifting of profits.

With a view to counter the BEPS concern arising from such regimes, Action 5 of BEPS Action Plan, 2013 mandated the FHTP to "revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework".

Accordingly, the Final Report on Action 5 is in furtherance of the FHTP's work under the 1998 Report. While the framework for determining whether a regime is a harmful preferential regime was laid down in the 1998 Report, the BEPS Report focuses on requiring substantial activity to assess preferential regimes and on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes.

The work under this action plan is targeted at tackling those preferential regimes which are potentially or actually harmful and not to harmonize or dictate the tax rates or tax structures. The ultimate objective being to move towards a level playing field by reducing the distortionary effect of how mobile financial and service activities are taxed in different jurisdictions due to location of these activities.

It is presumed that the substantial activity requirement recommended under this Action Plan for availing tax benefits will ensure that a country's beneficial tax regime is available only to those taxpayers who have a stake in that country in the form of investment in activity, employment creation, etc.

What is a preferential regime?

A regime can be considered preferential if it offers some form of tax preference in comparison with the general principles of taxation in that country.

The preference may be in the form of reduction in the tax rate or preferential terms for the payment or repayment of taxes.

When does a preferential regime become potentially harmful?

The 1998 Report set out four key factors and eight other factors to determine when a preferential regime becomes potentially harmful.

1. No or nominal tax on income is the starting point to classify a preferential regime as potentially harmful. This criterion must apply for the other factors to come into play.
2. The regime is ring-fenced from the domestic economy.
3. There is lack of transparency in the operation of a regime which may arise from the way the regime is designed and administered.
4. There is lack of effective exchange of information in relation to the regime.

The eight factors other than the above key factors that can assist in identifying harmful preferential tax regimes are:

1. An artificial definition of the tax base.
2. Failure to adhere to international transfer pricing principles.
3. Foreign source income exempt from residence country taxation.
4. Negotiable tax rate or tax base.
5. Existence of secrecy provisions.
6. Access to a wide network of tax treaties.
7. The regime is promoted as a tax minimization vehicle.
8. The regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities.

The substantial activity factor (which was one of the eight factors) has now been included as one of the key factors for determining whether a regime is preferential.

Thus, where a regime meets the no or low effective tax rate factor and on evaluation one or more of the other factors apply, the regime will be characterized as potentially harmful.

When is a potentially harmful regime actually harmful?

A potentially harmful regime may not be actually harmful if it does not appear to have created harmful economic effects. As per the 1998 Report, a regime may be actually harmful if:

1. it shifts activity to the country providing the preferential tax regime without generating significant new activity

2. the level of activities in the country is not commensurate with the amount of investment or income

3. the regime itself is the primary motive for location of the activity

Hence, it is not the existence of the regime but the lack of adequate value creation in the country offering the preferential regime which makes it actually harmful.

Substantial activity requirement for a preferential regime

Action 5 presumes that mandating substantial activity for availing of a preferential regime will align the beneficial tax treatment to value creation in that country. This will deter MNEs from artificially shifting profits to countries with preferential regimes without actually carrying out substantial activities for creation of such profits.

All preferential regimes, whether related to intellectual property ('IP') or not, are envisaged to meet the substantial activity requirement. It is not intended to recommend any particular regime but to lay down the limits for granting benefits such that it does not have harmful effects on other countries.

Substantial activity requirement for an IP regime

IP regimes are designed to encourage research and development ('R&D') activities which contribute to the growth and employment of a country. Where regimes provide tax incentives to IP incomes without corresponding activities to earn such income, BEPS concerns seep in.

The FHTP considered three different approaches for applying the substantial activity requirement to granting tax incentives to IP incomes.

– Value creation approach, which requires taxpayers to undertake set number of significant activities for development of the IP in order to claim benefits against the IP income

– Transfer pricing approach, would allow a taxpayer to claim benefits against the IP income if a set level of important functions were located in the jurisdiction providing the benefits. Where the taxpayer is the legal owner of the IP assets the regime would provide benefits if the taxpayer bears the economic risks of the assets giving rise to the IP income

– Nexus approach, looks to whether there is nexus between the R&D activities undertaken by the taxpayers and IP income receiving benefits.

The nexus approach has been agreed by the FHTP and the G20 for applying the substantial activity requirement.

Substantial activity requirement for a non-IP regime

Other regimes to which the substantial activity requirement apply are geographically mobile activities such as financial and other service activities. These include:

1. Headquarters regime;
2. Distribution and service centre regimes;
3. Financing and leasing regimes;
4. Fund management regimes;
5. Banking and insurance regimes;
6. Shipping regimes; and
7. Holding company regimes

The BEPS concern with these regimes is that they may have ring-fencing features or permit the artificial definition of tax base in addition to lack of substance and transparency.

As in IP regimes, the substantial activity requirement in a non-IP regime should establish a link between the income qualifying for tax benefits and the core income generating activities. The core income generating activities would depend upon the type of regime. Accordingly, detailed consideration of the activities would need to be done when a regime is being considered. However, the action plan does provide some guidance on what could be the core activities necessary to earn the income under each of the regimes.

Although the Action Plan does not specifically provide any mechanism or detailed guidance under these regimes, the limit for applying the tax benefit may be computed as per the nexus approach detailed for IP regimes. This will ensure that benefits are available only to those taxpayers who have undertaken activities to earn that income and the benefits are commensurate with such activities.

Nexus approach in the context of IP regimes

The nexus approach uses the proportion of expenditure incurred as a measure of substantial activity for providing benefits to the IP income arising out of these activities. The expenditure on developing IP assets which give rise to incomes, therefore act as proxy for the activities undertaken and demonstrates the real value added by the taxpayer in the jurisdiction.

The focus on expenditure aligns with the underlying purpose of IP regimes by ensuring that the regimes that are intended to encourage R&D activity only provide benefits to taxpayers that in fact engage in such activity in that jurisdiction. Since the approach is an additive one, all expenditure incurred by the taxpayer over the life of the IP asset are to be considered.

Therefore, under the nexus approach the income eligible for tax benefits under an IP regime is to be calculated as follows:

$$\frac{\text{Qualifying expenditure incurred to develop IP asset}}{\text{Overall expenditure incurred to develop IP asset}} \text{ X Overall income from IP asset.}$$

Where the amount of income eligible for tax benefit as per above calculation exceeds the actual amount receiving benefits, the substantial activity requirement can be said to be met. Where however the income eligible as per the above calculation is less than the actual amount claimed, the benefit needs to be limited to the amount so calculated. The Action Plan further provides guidance on what could comprise IP asset, qualifying and overall expenditures and IP income for the purpose of applying the nexus approach.

IP assets qualifying for tax benefits

Under the nexus approach the only IP assets that can qualify for tax benefits under an IP regime are patents and other IP assets functionally similar to patents and are similarly registered and regulated. Such other IP assets would include patents defined broadly, copyrighted software and other IP assets which are non-obvious, useful and novel.

The approach therefore covers mainly those IP assets which require rigorous R&D activities for development, are innovative, require legal protection and are registered and regulated.

Where regimes provide tax benefits to the residuary type of IP assets, the FHTP has recommended a group-wide turnover criteria coupled with entity-wise revenue criteria, using a five-year average, in order to qualify for such benefits. Further, reporting to the FHTP and exchange of information by jurisdictions providing benefits to income from such IP assets has been directed.

Marketing related IP assets such as trademarks and copyrighted assets, other than software, are not meant to qualify for tax benefits under an IP regime as they do not arise from the same type of R&D activities as patents or software.

Qualifying expenditure to develop IP assets

Although it has been left to jurisdictions to define qualifying expenditures, guidance has been provided that it should include only those expenditures that are actually incurred for R&D activities.

Since the basic principle of the nexus approach is to grant benefits to taxpayers actually undertaking R&D activities. Accordingly, expenditure for acquiring IP asset and for related party outsourcing has been specifically excluded from qualifying expenditure. The rationale behind including expenditure incurred for outsourcing to unrelated parties is that as a business practice a company may outsource the full spectrum of R&D activities, which is fundamental to the value of an IP asset, to a related party but not to an unrelated party.

Hence, expenditures such as interest, building cost, acquisition cost, related party outsourcing costs and other costs not directly linked to developing an IP asset should not be included. However, any cost incurred for improving the IP asset post acquisition should be treated as qualifying expenditure.

A 30 per cent up lift to increase the qualifying expenditure can also be permitted by jurisdictions, subject to the overall expenditure. The intention of providing the up lift is to ensure that taxpayers who have acquired IP or outsourced R&D activities to related parties are not penalized, still ensuring that taxpayers only receive benefits if they themselves undertook R&D activities.

Overall expenditure to develop IP assets

Overall expenditure should be defined to include all qualifying expenditure, expenditure for acquiring IP and expenditure for outsourcing R&D to related parties, which are not part of qualifying expenditure.

Thus the only difference between qualifying expenditure and overall expenditure is the expenditure on acquiring IP asset and that incurred for related party outsourcing. Therefore, a taxpayer who incurred all the expenditure in developing an IP asset, without acquisition or outsourcing, should be able to apply the preferential regime to 100% of the IP income under the nexus approach.

Both the qualifying and overall expenditures are to be considered in the year in which they are incurred irrespective of the treatment in the books of account.

Unsuccessful R&D, general and speculative R&D expenditures

It is recommended that unsuccessful R&D expenditure should not form part of the nexus ratio as they do not contribute to the IP income, unless such R&D is connected to a larger project that has produced an income generating asset.

General or speculative R&D expenditures should be included in qualifying or overall expenditure if they have a direct link to an IP asset and where link can be established to an asset or product, these costs may be divided on a *pro rata* basis.

Overall income from IP asset

Like for expenditure, it has been left to jurisdictions to define what could constitute overall income from IP asset that may be eligible for benefits under the preferential regime. However broad principles for defining IP income have been suggested.

The overall income qualifying for benefits during a year should be net of the expenditure allocable to IP income incurred during that year. Further, the overall income should be that which is derived from the IP asset. This could include royalties, capital gains from sale of IP asset, other embedded income from sale of products and use of processes directly related to the IP asset.

Tracking of income and expenditure

The fundamental principle of the nexus approach is that a preferential regime should benefit only those taxpayers who have undertaken substantial activity – where expenditure is used to represent activity undertaken by the taxpayer.

Since the income that could qualify for preferential treatment under the nexus approach is dependent upon the amount of expenditure and the IP asset, it is recommended that jurisdictions mandate taxpayers to track expenditures, incomes and IP assets, making the tracking a condition to availing the preferential IP regime. The tracking mechanism designed should be able to provide the link between expenditure and IP income which can be traced to an IP asset.

Product based nexus approach

The nexus approach was designed to require a link between expenditures, IP assets, and IP income tracked to IP assets. Where it is not realistic to implement tracking to an IP asset, jurisdictions may allow application of the nexus approach so that there can be nexus between expenditure, products arising from IP assets and income.

This approach recognizes that R&D activities may not always be structured IP asset-by-IP asset, especially in cases where multiple IP assets are incorporated into one product. For using this approach jurisdictions would need to define products in such a manner that it is possible to track and trace the income and expenditures to the product.

Thus the application of the nexus approach, whether directly to IP asset or to products, will be based on the complexity of a taxpayer's business and its dependence on IP assets. Wherever the taxpayer chooses to adopt the product based nexus approach for quantifying the tax benefits, jurisdictions may insist maintenance of documentation to substantiate that the taxpayer is engaged in a complex IP-related business which may make tracking to individual IP asset unrealistic and arbitrary.

Transitioning and grandfathering

Application of the nexus approach will require information on the qualifying and overall expenditures which may not be traceable by the taxpayers. Accordingly, as a transitional measure, taxpayers may be permitted to use a three to five year average. Once appropriate tracking is in place, cumulative ratio may be applied.

The Action Plan also provides guidance on grandfathering of certain existing preferential IP regimes. However, it provides that new tax payers or new IP assets should not benefit from existing IP regimes which are not in accordance with the nexus approach after June 30, 2016. It has further been provided that benefits from an existing IP regime should not extend beyond June 30, 2021 in any case.

While the substantial activity requirement recommended by the OECD does address some of the BEPS concern regarding preferential tax regimes, it would require changes to the domestic laws of jurisdictions with preferential tax regimes.

Although the Action Plan provides guidance on the definition of expenditure and income, the approach will depend upon how different jurisdictions define these. The OECD and FHTP would need to closely review whether the changes by respective jurisdictions have the intended impact in addressing the BEPS concern.

Since the availability of the preferential regime would depend upon tracking of expenditures to IP assets or products or incomes by taxpayers, they could be burdened with maintenance of documentation which was uptill now not required. This may not deter taking up R&D activities but could deter taxpayers from opting for the preferential regime even where they satisfy the substantial activity test which could lead to restructuring of their operation or even moving away from the jurisdiction with the regime.

India perspective

Currently India gives tax benefit in the form of deduction or weighted deduction of the expenditure incurred on R&D activities, whether incurred on in-house R&D by self or outsourced to prescribed universities or research associations. The current tax regime does not provide any benefit to income from the IP generated.

Further, since India taxes payment of royalties at source, any payment to a jurisdiction with preferential regime is taxed in India. Accordingly, adoption of the nexus approach by India or other countries may not impact India's tax base.

However, taxpayers taking benefit of the IP regimes in offshore jurisdictions with R&D activities outsourced to Indian related parties, which are generally remunerated on a cost-plus basis, may need to reorganize their structures to align activities/expenditures with IP income.

In the total 43 regimes that were reviewed by FHTP, four tax incentives provided by India in relation to tonnage tax scheme, life insurance business, Special Economic Zones and offshore banking units and international financial services centre were also reviewed, but were considered non-harmful.

Improving transparency in relation to rulings by spontaneous exchange of information

Certain rulings given by a country to a taxpayer can result in base erosion or profit shifting of other countries, residents of which have transactions with the taxpayer that are subject matter of the ruling. For example where Country A passes a unilateral advance tax ruling which has an impact of reducing the income of the taxpayer which it receives from a related party resident of Country B. While the taxpayer receiving the income pays tax on the reduced income, the taxpayer resident of Country B avails higher expenditure deduction.

In the absence of information on the ruling, Country B will not be able to address the mismatch created by ruling on the transaction.

The second task of the FHTP in Action 5 is to improve transparency and require compulsory spontaneous exchange of information on certain rulings. This action recognizes that lack of transparency and exchange of information between countries with regard to certain rulings can give rise to BEPS concerns.

The objective of the spontaneous exchange of information is to ensure that all countries which could be impacted by a preferential ruling given by one country are able to analyze and address the BEPS impact, if any, by the ruling.

This task has been undertaken in three steps:

1. Developing a framework for compulsory spontaneous exchange of information on rulings in relation to preferential regimes.
2. Consideration of the ruling regimes in OECD and associate countries with a view to improve transparency and
3. Developing general best practices framework for designing and operating rulings regime

The Action Plan also provides guidance with regard to the rulings which are covered, countries with which information is to be exchanged, applicability to past and future rulings, etc. The framework for exchange of information is to be applicable only to taxpayer specific rulings and not proposed to apply to general rulings that apply to taxpayers at large.

The framework for compulsory and spontaneous exchange of information is applicable to the following six types of taxpayer specific rulings:

i. rulings relating to preferential regimes that meet the low or no effective tax criteria;

ii. unilateral APAs or other cross-border unilateral rulings in respect of transfer pricing which set a future transfer pricing methodology or a future pricing or profit apportionment structure and adjust profits both upwards and downwards from the starting position;

iii. cross-border rulings providing for unilateral downward adjustment to taxable profits that are not reflected in the accounts;

iv. permanent establishment (PE) rulings concerning existence or absence of PE and/or attribution of profits;

v. related party conduit rulings; and

vi. any other type of ruling that gives rise to BEPS concerns in the absence of spontaneous information exchange. This provides flexibility to FHTP to include other categories of rulings within the framework for spontaneous information exchange in future.

As a general rule, information on the above categories of rulings is required to be exchanged with the country of residence of related parties with whom transactions are entered and to which the rulings pertain and the country of residence of the ultimate and immediate parent company.

Parties will be considered related if one holds, directly or indirectly, 25% or more of voting rights or value of equity in the other.

In case of PE rulings, information would need to be exchanged with the country in which the head office of the PE is resident and for conduit rulings with the country of residence of the ultimate beneficial owner of the payments made to the conduit.

As a first step only basic information relating to the taxpayer, the ruling and reason for exchange of information in the format suggested by the FHTP is required to be shared by the country granting the ruling. Based on the information shared in the first step, the receiving country may request the ruling. Since the information sought to be exchanged is of sensitive nature, maintenance of confidentiality is of utmost importance. Although tax treaties and information exchange instruments contain confidentiality provisions, the domestic laws of recipient countries as well as other instruments may need to be appropriately amended to contain safeguards in case of breach in confidentiality.

The obligation to spontaneously exchange information applies both to future rulings and past rulings. In relation to past rulings it has been agreed that information with regard to rulings issued after January 1, 2010 which were in effect on January 1, 2014 must be exchanged before the end of 2016.

Where countries do not have information with regard to the countries of related parties/ parent/ultimate holding companies with which information of past rulings is to be exchanged, they can use best efforts to identify such countries without gathering such information from the taxpayer.

For future rulings countries may need to make necessary changes to their rulings regime to ensure that all information required to identify countries impacted by a ruling in line with the FHTP framework is available. Accordingly, rulings issued after April 1, 2016 are required to be spontaneously exchanged. It is recommended that such exchange be done as soon as the ruling is given but within 3 months from which it becomes available to the competent authority.

This may require further changes to the ruling process in countries to ensure that such rulings are shared with the competent authorities without undue delay.

Since exchange of information is subject to countries' legal framework, a reciprocal approach, though beneficial and anticipated may not always be practicable. Thus, lack of reciprocation from recipient country due to its legal framework should not be used as a pretext for not sharing information.

In a bid to counter tax evasion, the G20 countries along with the OECD have already taken measures for automatic exchange of information through the Common Reporting Standard ('CRS') which builds upon the US Foreign Account Tax Compliance Act ('FATCA') and the European Union ('EU') Savings Directive.

These measures require reporting by Financial Institutions to the tax authorities of their countries of the financial information of their customers which are tax residents of other countries. This information is then to be exchanged with the tax authorities of other countries which are signatory to the Multilateral Competent Authority Agreement ('MCAA'). While 96 countries had committed to implement the CRS, 79 countries, including India, have signed the MCAA as of January 2016.

Both the CRS and information exchange under Action 5 are expected to provide information to the tax authorities of the activities of its tax residents outside their jurisdiction which uptill now was not available. While the CRS contemplates automatic exchange of financial information to curb tax evasion and increase tax revenues of countries, Action 5 envisages exchange of information in relation to preferential rulings which could have BEPS impact.

India perspective

Currently in India taxpayer specific rulings are given in the form of APAs and ATRs, which are in line with the tax law and policies of India. While the administration of APAs and ATRs may not be effected by the reporting framework, taxpayers seeking such rulings and their related parties who are subject of these rulings may need to assess the impact in countries other than India as well, before approaching the authorities for a ruling.

Ongoing effort by FHTP

Since the tax laws and policies of countries are dynamic and subject to change, effective implementation of the Action 5 will require further work on part of the FHTP. The next steps identified for the FHTP are:

i. Monitoring of the ongoing work on IP regimes, non-IP regimes and application of the transparency framework as set out in the Action Plan

ii. Development of a strategy to include participation of non-OECD or non-G20 countries; and

iii. Revision or additions to the FHTP criteria as per the 1998 Report, which is currently limited to only two factors, i.e. substantial activity and transparency.

Action Plan 5 is a concerted effort by the OECD and G20 countries to align substantial activities for availing of a preferential regime and ringing in transparency by automatic exchange of information on rulings that may lead to BEPS. The successful implementation of the Action Plan is however dependent upon how countries adopt the frameworks designed by the FHTP in their domestic legislations.

Further, reporting to the FHTP to ensure smooth monitoring is also key to boosting the efforts to counter harmful tax practices.

Each work has to pass through these stages – ridicule, opposition, and then acceptance. Those who think ahead of their time are sure to be misunderstood.

— Swami Vivekananda

CA Paresh Parekh, CA Himanshu Tanna, CA Aparna Iyer[1]

Action Plan 6 – Preventing the granting of treaty benefits in inappropriate circumstances

Contents

1. Karan Kapoor assisted the authors in drafting this chapter

1. Introduction

International tax issues have never been as high on the political agenda as they are today. The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules, which were designed more than a century ago. Weaknesses in the current rules create opportunities for Base Erosion and Profit Shifting.

In the recent past, many Multi National Enterprises ('MNEs') have made news for their aggressive tax structures. Highly profitable MNEs are able to drastically reduce their tax burdens by shifting profits from high-tax to low-tax jurisdictions. One of the means of shifting profits includes situations wherein MNEs own intellectual property ('IP') and shift profits via intra-group licensing.

Furthermore, certain clauses in the tax treaties have triggered double non-taxation in a number of situations, thereby triggering policy makers to boost confidence in the system and ensure that profits are taxed where economic activities take place and value is created. Thus, it has become imperative to modify the existing domestic and international tax rules in order to closely align the allocation of income with the economic activity that generates income.

In light of the same, on October 5, 2015, the Organisation for Economic Co-operation and Development ('OECD') released the final report with recommendations for addressing treaty abuse under Action 6 of the Action Plan on Base Erosion and Profit Shifting ('BEPS'), being one of the 15 Action Plans proposed by OECD.

2. Overview of the OECD Final Report

The report on Action 6 of the Action Plan on BEPS titled **'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances'** ('2015 Final Report' or 'Final Report') identifies treaty abuse, and in particular treaty shopping as one of the most important sources of BEPS concerns and contains suggestions to the OECD Model Tax Convention to tackle such concerns.

It first addresses treaty shopping through alternative provisions that form part of a **minimum standard** that all countries participating in the BEPS Project have agreed to implement. It also includes specific treaty rules to address other forms of treaty abuse to ensure that tax treaties do not inadvertently prevent application of domestic anti-abuse rules. The report also includes changes to the OECD Model Convention that clarify that tax treaties are not intended to create opportunities for double non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping). It also identifies tax policy considerations that countries should consider before deciding to enter into a tax treaty with another country.

Final Report

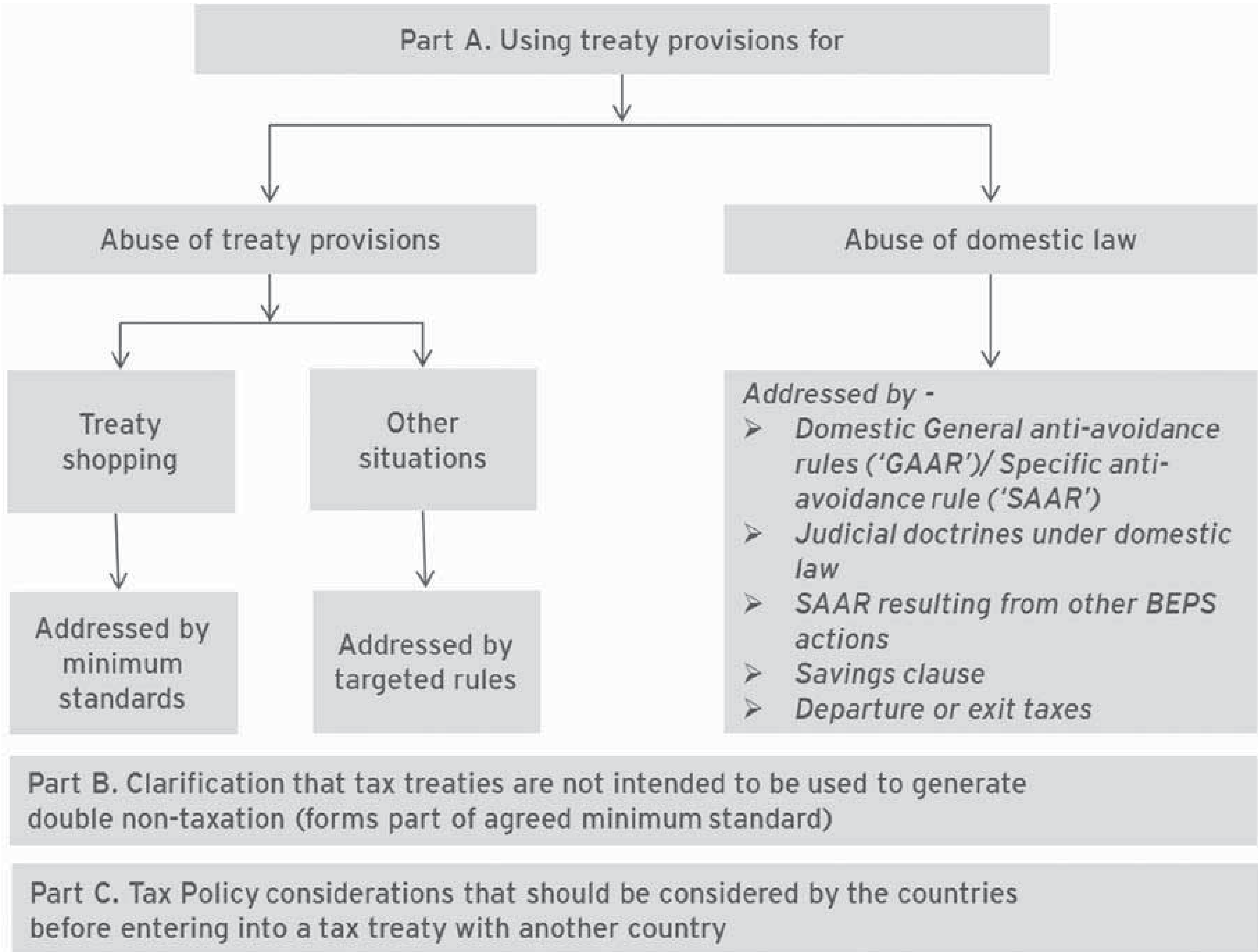
The 2015 Final Report is organised into three sections which align with the three different areas identified by Action 6:

(A) Treaty provisions and domestic rules to prevent granting of treaty benefits in inappropriate circumstances;

(B) Clarification that tax treaties are not intended to be used to generate double non-taxation; and

(C) Identification of tax policy considerations that countries should consider before deciding to enter into a tax treaty with another country.

Diagrammatic representation



2.1 Section A – Treaty provisions and domestic rules to prevent granting of treaty benefits in inappropriate circumstances

The Final Report notes that countries have committed to ensure a minimum level of protection against treaty shopping ('the minimum standard'). Section A of the Final Report contains details of how the minimum standard would be implemented. Countries will implement the minimum standard by including in their treaties one of the following:

(i) A combined approach consisting of a Limitation on Benefits ('LOB') and a principal purpose test ('PPT') rule (e.g. India's current treaties with Iceland, Sri Lanka, Romania etc.);

(ii) A PPT rule alone (e.g. India's current treaties with United Kingdom ('UK'), Finland, Norway etc.)

(iii) An LOB rule, supplemented by specific rules targeting conduit financing arrangements (e.g. India's current treaties with Switzerland has limited anti-conduit rule).

In order to determine the most appropriate method to prevent the granting of treaty benefits/ treaty abuse in inappropriate circumstances, the 2015 Final Report distinguishes two types of cases, viz; 1) Cases where a taxpayer circumvents limitations of the treaty itself; and 2) Cases where a taxpayer circumvents domestic law provisions by relying on tax treaty benefits.

2.1.1 Cases where a taxpayer circumvents limitations of the treaty itself

In cases where a person tries to circumvent limitations provided in the treaty itself, Section A of the 2015 Final Report, details the recommendations with respect to both the LOB and PPT rules in the context of the minimum standard, as well as other more targeted rules resulting from other situations that have been identified as prone to the inappropriate granting of treaty benefits.

2.1.1.1 Three-pronged approach to address treaty shopping

"Treaty shopping" generally refers to arrangements through which a person who is not a resident of one of the two states (that concluded a tax treaty) may attempt to obtain benefits that the treaty grants to the residents of these states.

Action 6 suggests a three pronged approach to address treaty shopping situations:

Title & Preamble	LOB Rule	PPT Rule
• A clear statement that the Contracting States intend to avoid creating opportunities for treaty shopping (Elaborated in Section B below)	• A specific anti-abuse rule based on the legal nature, ownership in, and general activities of residents of Contracting States (similar to those found in US, Indian treaties)	• General anti-abuse rule based on the principal purposes of transactions or arrangements to address other forms of abuse not covered by LOB rule (e.g., Conduit finance arrangements) (similar to the "main purpose" tests found in UK treaties)

It may be worthwhile to note that the LOB Rule is a specific and "objective" anti-avoidance rule which is aimed at addressing known treaty shopping situations but it does not address all forms of treaty abuses and treaty shopping arrangements involving conduit arrangements while the PPT rule is "subjective" as it requires case-by-case analysis (based on which the principal purposes of transactions or arrangements is determined).

(i) The LOB Rule

The 2015 Final Report notes that while it has been decided that such a rule will be included in the OECD Model, further work on the LOB rule is necessary. In particular, the Final Report refers to the proposals by the US to modify the LOB rule in the US Model Treaty. It is noted that the LOB rule, and Commentary related thereto, contained in the 2015 Final Report should be considered as draft (and is therefore bracketed) and is subject to change pending further review that will take into account the finalization of the LOB rule in the US Model Treaty. Final versions of the LOB rule and Commentary are expected to be completed in the first part of 2016.

Paragraphs 1 through 6 of a new Article 10 (Entitlement to Benefits) set forth the model treaty provisions for the LOB rule. In this regard, the objective tests are based on characteristics such as legal structure, ownership, or activities, ensuring a link between the person and the residence state.

Treaty benefits are available on satisfaction of **any** of the following requirements:

Qualified person ('QP') – Para 2	• Categories of "qualified person" detailed; (includes individuals, Government and Government owned entities, publicly traded companies / entities etc.)
Active trade or business test – Para 3	• Income is derived by a person engaged in active conduct of a trade or business in its residence country; and Income derived is in connection with or is incidental to that business
Derivative benefits rule – Para 4	• If at least more than an agreed proportion of that entity is owned by certain persons entitled to equivalent benefits
Discretionary relief by competent authority – Para 5	• Competent Authority can grant certain treaty benefits where benefits would otherwise be denied under the above rules

The Article further contains model treaty provisions for an alternative, simplified LOB rule. The simplified LOB rule sets forth general standards that could be used to address the most obvious cases of treaty-shopping while relying on the PPT rule to cover cases not caught by such an LOB rule. The 2015 Final Report clarifies that the simplified LOB rule is only intended to be used if the countries agree to incorporate the combined approach of an LOB rule and a PPT rule.

Some of the key differences between detailed version and simplified version are as under:

Parameters	Detailed version	Simplified version
Time at which QP test is to be tested	A resident should be a QP at the time of according treaty benefit	Silent
Definition of QP	• Elaborate rules for company/ others; • Commercial Investment Vehicles ('CIVs'), Not for Profit Organisations ('NPO')/ charitable organizations and pension funds qualify to be QP under certain circumstances	• An entity other than company is a QP, if the beneficial interests are regularly traded on recognized stock exchanges • No specific mention about CIVs, NPO/ charitable organizations and pension funds
Active conduct of business	Engaged in active conduct of business in resident state	Carry on business in the resident State
Derivative benefits	• Ownership test has a threshold of 95%; • Additionally there is a base erosion test which restricts deductible tax expense to persons other than equivalent beneficiaries to < 50%	• Ownership test has a threshold of 75% • No base erosion test
Discretionary relief	Granted based on specific facts and circumstances	Granted based on general administrative practice and domestic law

As can be observed from the table above, the broad construction of the simplified version may leave certain open ends. Hence, mere adoption of the simplified version may not address abusive transactions and it would be imperative to adopt the simplified version only in combination with the PPT rule.

(ii) The PPT Rule

As noted above, the minimum standard to protect against treaty shopping that was agreed to by countries may be met by including in treaties a PPT rule alone or a PPT rule in conjunction with an LOB rule.

Paragraph 7 of the new Article 10 contains the PPT rule:

"Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is ***reasonable to conclude,*** *having regard to all relevant facts and circumstances, that obtaining that benefit was one of the* ***principal purposes*** *of any* ***arrangement*** *or transaction that resulted* ***directly or indirectly*** *in that* ***benefit****, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."*

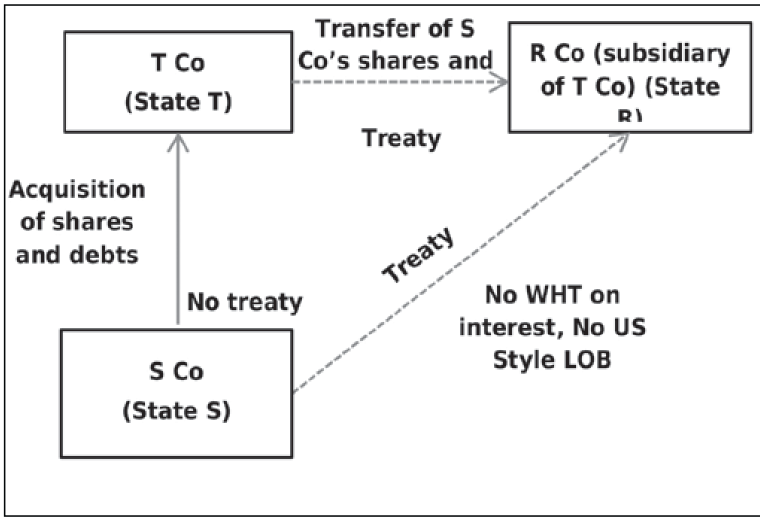
(Emphasis supplied)

The 2015 Final Report also includes commentary with respect to paragraph 7. The Commentary provides that to determine the principal purpose of an arrangement, it is necessary to undertake an objective analysis of the aims and objects of all persons involved in putting that arrangement or transaction in place. According to the Commentary, this requires consideration, on a case by case basis, of all circumstances surrounding the arrangement or event.

To illustrate, following are few examples from the Final Report on applicability of PPT rule:

Circumstances when the PPT rule is applicable

- Arrangements resulting in no/low taxation in source State by assigning debt/right to dividend etc. (Without any other objective)



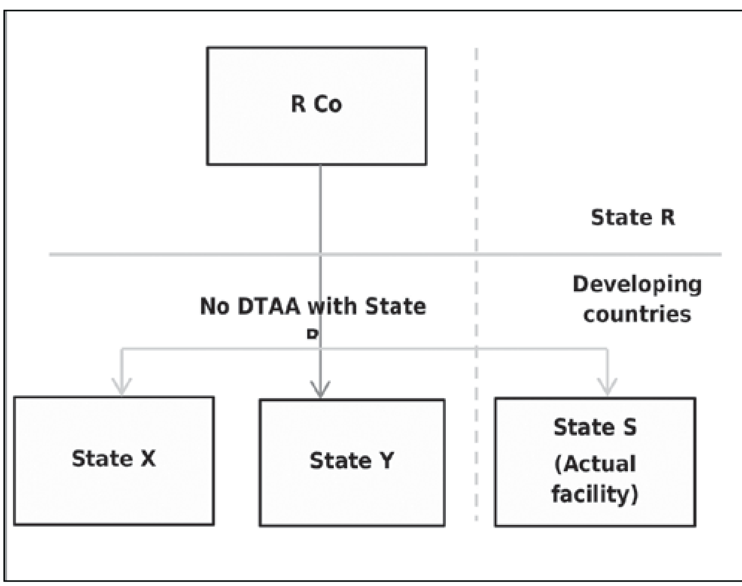
- Assignment of an existing debt carrying coupon rate of 4% by an entity in non-treaty favourable jurisdiction to another entity at 3.9% interest if the assignee is in treaty favourable jurisdictions
- While assignment is for valid commercial reasons, if it is established that one of the principal purposes of transfer of loan is to obtain benefit of treaty between the assignee country and the interest payer, PPT rule would be invoked

[para 8 of commentary]

Another example where PPT rule would be applicable could be in cases of splitting up of contracts in order to abuse the time threshold for PE and to avoid the existence of PE in source State

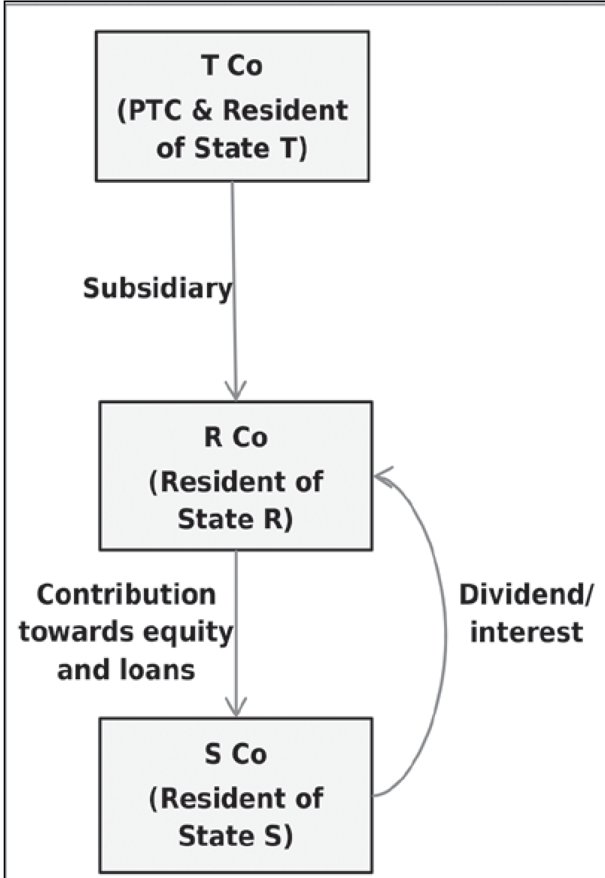
Circumstances when the PPT rule is not applicable

- Arrangements entered into for expanding the business or other business efficiency reasons (such as efficient management of large number small payments, withholding of tax at appropriate treaty rates etc.)



- Setting up a manufacturing facility in State S which was one of the three shortlisted locations for establishing manufacturing facility
- Though all three locations were comparable economically and politically, presence of treaty with State S tilted the choice
- Though tax is one of the principal factors in decision making, treaty benefit is to be granted
- Encouraging cross border investment and availing treaty benefit for actual plant set up in State S meets with object and purpose of the treaty.

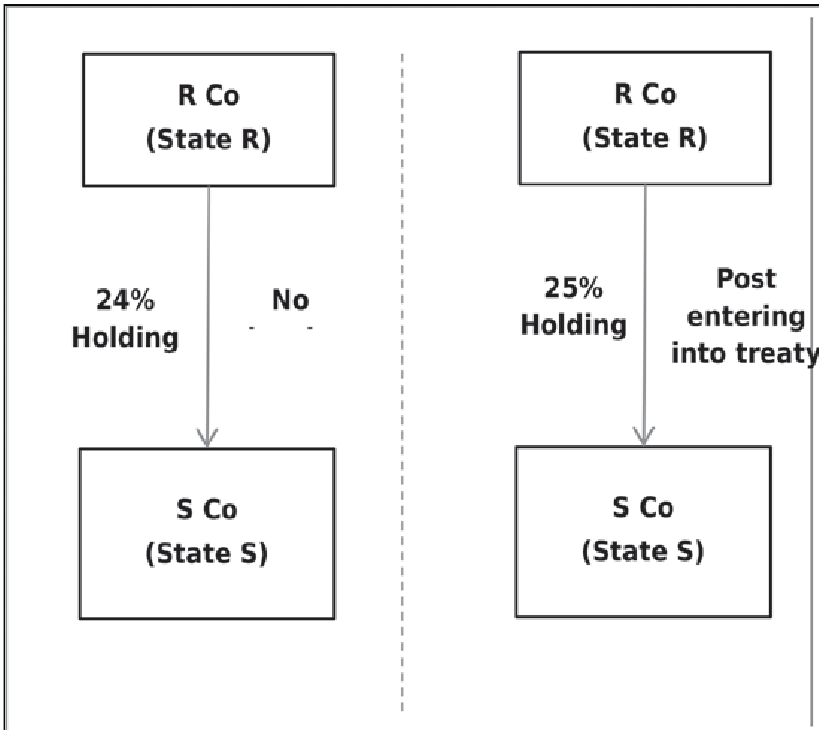
[Example C of Para 14 of the Commentary]



- RCO and SCO are subsidiaries of TCO
- TCO established RCO for developing foreign business activities and for business efficiency. Likewise RCO established SCO for actual business in State S.
- RCO and SCO are involved in active conduct of business (i.e. manufacturing) and possesses the human and financial resources that are necessary to perform business activities.
- Financing and investing into equity and loans of SCO forms part of active conduct of business of RCO
- Treaty benefits should not be denied on dividends/ interest received by RCO merely on the ground that such dividends are subject to lower WHT rate under the applicable treaty

(Example H of para 14 of the Commentary)

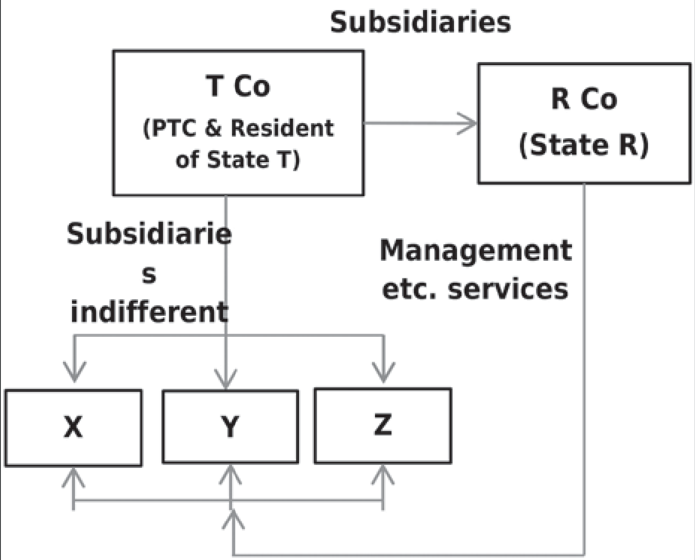
- Arrangements which results in obtaining treaty benefits in accordance with general objective of encouraging cross-border investment or obtaining that benefit legitimately



- Increasing ownership stake to 25% (from 24% stake) in order to avail concessional WHT rate of 5% on dividends
- The facts and circumstances reveal that one of the principal purposes for the transaction through which the additional shares are acquired is clearly to obtain the benefit the benefit of the lower WHT rate provided by Article 10(2)(a) of a treaty
- However, granting benefit under this Article is permitted to a taxpayer who genuinely increases its participation in a company in order to satisfy the arbitrary threshold of 25%.

(Example E of para 14 of the Commentary)

- Arrangements driven by commercial considerations and availability of requisite infrastructure, but does not include decisions made based on the effects of treaties on future payments/ Arrangements constitute a real business activity by exercising substantive economic functions, using real assets, assuming real risks, and carrying on the business through its own personnel located in resident State



- Establishing a regional company in State R for the purpose of providing managerial services to group companies.
- This decision is driven by the skilled labour force, reliable legal system, business friendly environment, and the comprehensive double taxation treaty network of State R which provide lower WHT rates.
- Merely reviewing the effects of the treaties on future payments by the subsidiaries to the regional company should not considered to be the purposes for the establishment of regional company.
- Treaty benefits should not be denied to the regional company provided it makes decisions necessary for the conduct of its business, constitute a real business, exercises substantive economic functions, uses real assets and assumes real risks, and carries on the business through its own personnel.

(Example G of para 14 of the Commentary)

It may be noted that while the LOB and the PPT enshrine the primary objective of treaty shopping, there are stark differences between the two approaches. As explained above, while the LOB rule is "objective" in nature leaving limited room for ambiguity, the PPT rule paves way to tax administrators to deny benefits for legitimate transactions where obtaining treaty benefits is "one of the principal purposes" for entering into a transaction/arrangement. The PPT is too wide scoped as the rule lacks guidance on various aspects, e.g. on how to differentiate between the main, principal and ancillary or subordinate purposes. Also, the PPT clause imposes serious concerns for *bona fide* business transactions (financing activities, IP management etc.) as it appears that the significant burden is on the taxpayers for proving the legitimacy of a transaction whereas the onus on the tax administrative is low ("reasonable to conclude", "one of the main purposes", "arrangement" etc.).

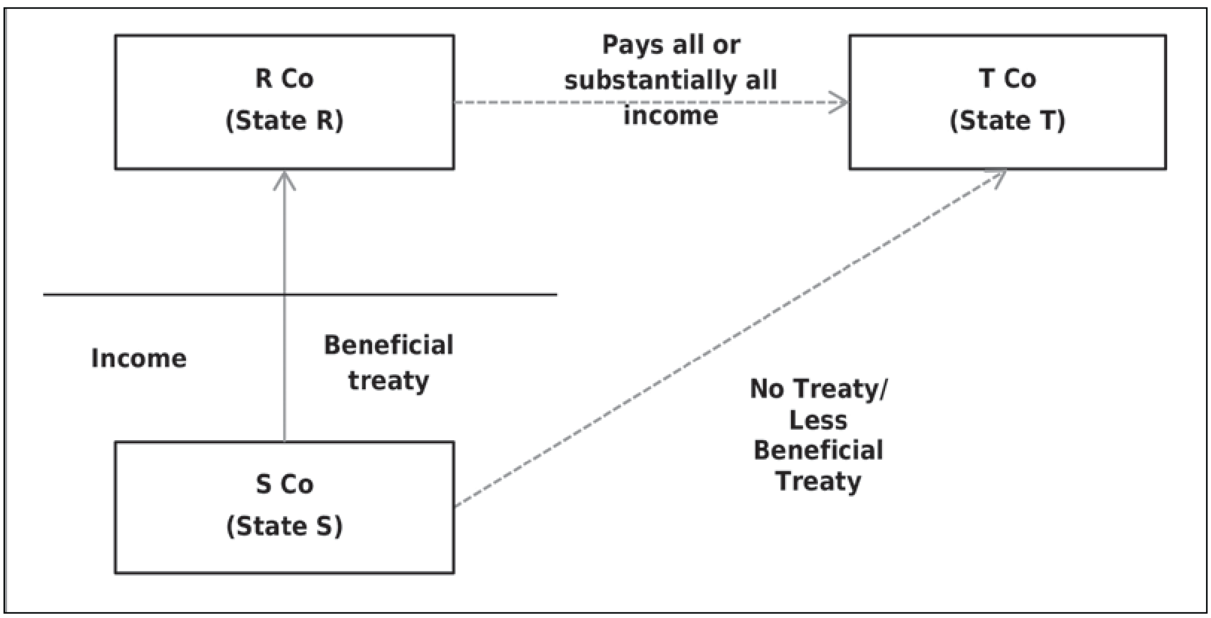
(iii) Conduit Arrangement Rule

As discussed above, countries may implement the minimum standard to protect against treaty shopping by including the simplified LOB rule supplemented by a mechanism that would address treaty-shopping strategies commonly referred to as "conduit arrangements" that would not be caught by the LOB rule. The Final Report notes that these rules would deal with such conduit arrangements by denying treaty benefits in respect of income obtained under, or as part of, a conduit arrangement. Further, they could take the form of domestic anti-abuse rules or judicial doctrines that would achieve a similar result.

The term "conduit arrangement" means a transaction or series of transactions:

a. Which is structured in such a way that a resident (R Co) of a Contracting State (State R), entitled to the benefits of a treaty, receives an item of income arising in the other Contracting State (State S) but that resident (R Co) pays, directly or indirectly, all or substantially all of that income (at any time or in any form) to one or more persons (T Co) who are not resident of either Contracting State (i.e. State R or State S) and who, if they received that item of income direct from the other Contracting State (State S), would not be entitled under a Treaty between the State of which those persons are resident (State T) and the Contracting State in which the income arises (State S), or otherwise, to benefits with respect to that item of income which are equivalent to, or more favourable than, those available under this Convention to a resident (R Co) of a Contracting State (State R); and

b. Which has as one of its principal purposes obtaining such increased benefits as are available under the Treaty



Further, the Final Report outlines a series of examples of conduit arrangements that would need to be addressed by such rules as well as transactions that would not be considered to be conduit arrangements. These examples are largely drawn from the exchange of letters between the United States and the United Kingdom in connection with the bilateral treaty between those two countries.

2.1.1.2 Addressing treaty abuse other than treaty shopping

In addition to the minimum standard to prevent treaty shopping, the 2015 Final Report includes recommendations for the targeted anti-abuse rules. The following are examples of situations with respect to which specific anti-abuse rules may be helpful and proposals for changes intended to address some of these situations:

- Splitting-up of contracts

  It refers to situations where the 12 month treaty threshold is utilised by splitting up of contracts, each covering a period of less than 12 months and attributing them to a different company which is owned by the same Group. The Final Report recommends that inclusion of the PPT rule and changes to the Commentary from Action 7 (Artificial Avoidance of Permanent Establishment) would help limit such situations.

- Hiring-out of labour cases

  It refers to cases wherein the taxpayers attempt to obtain inappropriately the benefits of the exemption from source taxation provided for in Article 15(2) (Income from Employment). The Final report notes that existing Commentary on that paragraph adequately addresses the issue.

- Transactions avoiding dividend characterisation that prevents source taxation

  It refers to transactions involving avoiding of domestic law rules that characterise an item of income as a dividend to benefit from a treaty characterisation of that income, (e.g. capital gain) to prevent source country taxation. In the context of the work being done on Action 2 (Hybrid Mismatch Arrangements), the Final Report recommends to examine the possibility of amending the treaty definitions of dividends and interest to permit the application of domestic law rules that characterise an item of income as mentioned above.

- Dividend Transfer Transaction to avail lower withholding rate

  Dividend transfer transactions are described in the 2015 Final Report as transactions where a person entitled to the 15% portfolio rate of Article 10(2)(b) (Dividends) seeks to obtain a lower rate (e.g., the 5% direct dividend rate) by engaging in transactions to increase the number of shares held at the time the dividend is legally available to the shareholder. In order to deal with such transactions, the 2015 Final Report notes that it was concluded that a minimum holding period of 365 days should be included in Article 10 of the OECD Model. The Final Report also concludes that additional anti-abuse rules need to be adopted to deal with cases where certain intermediary entities established in the country of source are used to take advantage of the treaty provisions that lower the source taxation of dividends. For example, the Final Report refers to an alternative provision provided in the Commentary to Article 10 to limit access to the 5% rate in cases of payments by domestic Real Estate Investment Trust ('REITs') to non-resident investors.

- Transactions that circumvent Article 13(4)

  In general, this provision allows the country in which immovable property is situated to tax capital gains realized by a resident of the other country on shares of companies that derive more than 50% of their value from such immovable property. The Final Report amends that article to ensure that the same treatment is extended to interests in other entities such as partnerships and trusts. The Final Report also outlines another revision to cover situations where assets are contributed to an entity shortly before the sale of shares or other interests in an entity in order to dilute the proportion of value that is derived from immoveable property. To address such a situation, a holding period has been added to preserve the ability of the country where the immovable property is located to tax the gain if, for example, at any time during the 365 days preceding the alienation, the shares derived more than 50% of their value directly or indirectly from immovable property in that country.

- Tie-breaker rule for determining the treaty residence of dual resident person other than individual

  To address situations in which a person is considered a resident of both contracting states, subparagraph 3 of Article 4 contains a tie-breaker rule to determine a single treaty residence for persons other than individuals. The Final Report recommends replacing Article 4(3) (Place of Effective Management ('POEM')) to provide that competent authorities of the two countries shall endeavour to determine on a case by case basis by mutual agreement the country of residence having regard to the POEM, the place where it was incorporated or otherwise constituted and any other relevant factors.

- Anti-abuse rule for PE in third State

  The 2015 Final Report notes that where the residence state exempts, or taxes at low rates, profits attributable to a PE situated in a third state, the source state should not be expected to grant treaty benefits with respect to that income. It was concluded that a specific anti-abuse rule with respect to such triangular cases should be included in the OECD Model. However, the Final Report also mentions that the provision and Commentary included in the Final Report will need to be reviewed and should be considered a draft, subject to change as it should be further examined once the United States has finalised the work to update the US Model Treaty. It is noted, however, that the final version of the provision is expected to be produced in the first part of 2016.

2.1.2 Cases where a person tries to abuse the provisions of domestic tax law using treaty benefits

Some of the examples wherein a person tries to abuse the provisions of domestic tax law using treaty benefits include the following:

- Thin capitalisation and other financing transactions that use tax deductions to lower borrowing costs
- Dual residence strategies (e.g. a company is resident for domestic tax but treaty non-resident)
- Transfer mispricing
- Arbitrage transactions related to mismatches between the domestic laws of one / two States and that are related to –
  - o Characterisation of income (e.g. by transforming business profits into capital gain) or payments (e.g. by transforming dividends into interest)
  - o Treatment of taxpayers (e.g. by transferring income to tax-exempt entities or entities that have accumulated tax losses; by transferring income from non-residents to residents)
- Timing differences (e.g. by delaying taxation or advancing deductions).
- Transactions that abuse relief of double taxation mechanisms (by producing income that is not taxable in the State of source but must be exempted by the State of residence or by abusing foreign tax credit mechanisms)

The Action 6 notes that the work on other aspects of the Action Plan, in particular Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing has addressed many of these transactions.

The Final Report has also recommended draft changes to rules vis-à-vis application of tax treaties to restrict a country to tax its own residents and application of tax treaties in relation to "exit" or "departure" taxes ("exit" or "departure" taxes are generally taxes imposed on certain types of income that is triggered in the event of a resident of a country ceasing to be a resident) and the double taxation issues that might arise in that context.

2.2 Section B – Clarify that tax treaties are not intended to be used to generate double non-taxation

The 2015 Final Report recommends the inclusion of specific language clarifying that tax treaties are not intended to be used to generate double non-taxation.

The Final Report recommends stating clearly in the title of treaties that the prevention of tax evasion and avoidance is a purpose of tax treaties. Furthermore, the Final Report also recommends the inclusion of wording in the preamble that expressly provides that the countries entering into the treaty intend to conclude a treaty for the elimination of double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.

Lastly, the Commentary to the OECD Model includes specific language referring to the BEPS project and the intention to address BEPS concerns arising from treaty shopping arrangements.

2.3 Section C – Tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country

The 2015 Final Report discusses tax policy considerations relevant to a country's decision whether to enter into, modify, or terminate a tax treaty with another country. The Final Report notes that a clear articulation of these considerations would be useful for countries in justifying their decisions not to enter into tax treaties with certain low or no-tax jurisdictions. Some of the tax policy considerations recommended in the Final Report include existence of risks of double taxation resulting from the interaction of the tax systems of the two States, risk of double taxation actually exists in cross border situations, risk of excessive taxation (that may result from high withholding taxes in the source State), benefits for cross-border trade and investment, benefits from provisions on administrative assistance.

In this connection, the Final Report recommends changes to the "Introduction" section of OECD Model Tax Convention for inclusion of the tax policy considerations. The recommended inclusion would aid to justify a decision of not entering into a tax treaty with a low or no-tax jurisdiction and also help to decide whether a treaty previously concluded should be maintained, changed or terminated, especially where there are changes to domestic law of a treaty partner in future.

Further, the Final Report recognises that there are many non-tax factors that can lead to the conclusion of a tax treaty between two countries and that a country has a sovereign right to decide to enter into tax treaties with any jurisdiction.

3. Global Scenario

With the BEPS reports now open for respective government's consideration, the focus on BEPS moves to a more localised one, focusing on the needs of the country and the approach that may be adopted among the many recommendations. Various countries have embarked on their first step towards preventing the abuse of treaty provisions. Some of them include countries like Mexico, Vietnam etc. which include strict documentation requirements to apply for treaty benefits or countries like France, Germany etc. which contain specific treaty-overriding anti-treaty shopping rules etc.

Further, incorporating many of the recommendations laid down in Action Plans, Australia- Germany signed a new tax treaty post BEPS. The treaty incorporates recommendation for Actions 6, 7 and 14 and could serve as a sketch for the other agreements. Also, Chile-Japan inked their first tax treaty reflecting the provisions in the current OECD Model Convention as well as recommendations in the OECD Final Reports in its Action Plan.

Further, more and more jurisdictions have started showing inclination to implement / include Action 6 in their legislation and many more countries are expected to follow suit and amend their treaties in order to fall in line with the BEPS Action Plans.

4. Indian landscape

In India, various mechanisms are already in place to prevent treaty abuse. Some of them are listed below:

Mechanisms present under the Income-tax Act, 1961 ('Act')

- Requirement to obtain Tax Residency Certificate ('TRC')/ Form 10F to be eligible to claim treaty benefits. TRC / Form 10F is the only first of the many tests before applying treaty benefits (e.g. beneficial ownership, LOB clauses if applicable);
- Reporting requirement at withholding stage for payer – currently, reporting under Section 195 of the Act read with Rule 37BB of the Income-tax Rules, 1962 ('Rules'), is under Forms 15CA / CB;
- Section 285BA of the Act lays down mechanism for exchange of financial information on automatic basis to combat offshore tax evasion/ avoidance and stashing of unaccounted money abroad;
- Domestic GAAR is in place (with main purpose test), but its application was deferred to April 1, 2017 as the Government awaited recommendations on OECD *vide* its BEPS reports before further amending the GAAR provisions.

Mechanisms present in various Indian tax treaties/multilateral treaties

- US, Singapore, UK, etc. treaties contain prevention of fiscal evasion as one of its objectives
- Switzerland treaty contain provisions of anti-conduit rule
- Sri Lanka, Iceland, Romania etc. treaties contain combination of LOB and PPT rules

Judicial precedents to address abusive transactions

So far, Indian Courts have applied general principles of tax avoidance (e.g. substance over form, lifting of corporate veil) to examine abusive arrangements. Illustratively:

- In case of *McDowell & Co. Ltd. vs. CTO (1985) (154 ITR 148),* the Hon'ble Supreme Court ('SC') laid down the distinction between tax planning and tax avoidance and held that while the former is legitimate, latter shall not be permissible.
- In the case of *Union of India and Anr vs. Azadi Bachao Andolan And Anr. (2003) [263 ITR 706 (SC)]* while Hon'ble Supreme court validated treaty shopping, it observed that colourable device, dubious method or subterfuge clothed with apparent dignity is not acceptable.
- In another landmark ruling of *Vodafone International Holdings B.V. vs. UoI (2012) (341 ITR 1),* the Hon'ble SC reiterated that use of artificial or colourable device for achieving tax benefits leads to tax avoidance which cannot be allowed. According to Hon'ble SC, to determine whether a scheme is a tax avoidance scheme or not, one should look at legal nature of the transaction as a whole and not in isolation of context to which it

belongs. SC advocated application of 'look through' approach where the corporate structure is found to be fake or sham.

While the above indicates that India's treaties/ domestic legislations are already in line with the recommendations suggested by Action 6, it would be essential for India to revisit the same in the wake of these developments. Striking a fine balance between anti avoidance measures and promoting tax certainty and at the same time ensuring encouragement of cross border investments is the need of the hour.

The OECD BEPS project proposes transformation of domestic tax rules to cater to many tax avoidance arrangements. Moreover, domestic measures in the Act like POEM, indirect transfer rules, wider source rules, moderate rate of tax also play a key role in protecting the tax base in India. In such backdrop, GAAR may be useful in targeting only limited cases (e.g. domestic avoidance schemes).

However, there exist certain provisions under GAAR [like Section 90(2A) of the Act] which override treaty benefits, and accordingly overlap with Action Plan 6 of the 2015 Final Report. Such over-reaching application of domestic GAAR to prevail over a treaty, need to be addressed by the Indian Government in the upcoming Budget 2016. In view of the above, it may have to be seen whether the omnibus GAAR provisions continues post implementation of the BEPS action plans.

5. Conclusion

The 2015 Final Report indicates that further work will be required under Action 6, in particular with respect to the LOB rule, which is expected to be finalized in the first part of 2016. In addition, the 2015 Final Report specifies that further work is needed with respect to the treaty entitlement of non-CIVs and pension funds and indicates that such work would benefit from consultation with stakeholders.

In order to enable swift implementation of the tax treaty-based measures developed during the course of the BEPS project, the OECD has also released another report, "Developing a Multilateral Instrument to Modify Bilateral Tax Treaties" (Action 15) for the same. Due to the time required to renegotiate each treaty, the treaty network may not be well-synchronized with treaty models and a change in treaty models would not satisfy the political imperative to address BEPS in a reasonable time frame. A multilateral instrument would however implement agreed treaty measures in a reasonably short time frame and at the same time would preserve the bilateral nature of tax treaties. Having said the above, the various anti abuse rules included in the 2015 Final Report will be among the changes proposed for inclusion in the multilateral instrument. With approximately 90 countries participating, work on the multilateral instrument is already underway with the goal of concluding the work and opening the multilateral instrument for signature by December 31, 2016. Any further work under Action 6 would need to be completed in the first part of 2016 in order to be relevant for the negotiation of the multilateral instrument.

As this work continues, it would be imperative for tax payers/ MNEs to evaluate their existing structures and arrangements and if required re-look at their structures/ arrangements. Further, tax payers/ MNEs should continue to monitor the latest developments with respect to Action 6, evaluate how any proposed changes may impact them, and stay informed about developments in the OECD and in the countries where they operate or invest, and consider participating in the process to provide stakeholder input.

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OECD Base Erosion and Profit Shifting Project Preventing the artificial avoidance of Permanent Establishment status – BEPS Action Plan 7 Final Report – A Study

Prelude

Under the double taxation avoidance agreements (DTAA's / Tax Treaties), the right to tax business profits earned by a resident of a contracting State in the other contracting State rests with the State of residence of the taxpayer. The State of source gets the right to tax only if the business profits are attributable to the permanent establishment (PE) situated therein. The term 'permanent establishment' is defined in the tax treaties under Article 5. The definition in its present form outlines the general rule as to when an enterprise would be said to have a PE. It also enumerates specific situations where an enterprise is said to have a PE. The definition also provides for situations where an agent or a subsidiary could be regarded as a PE. The definition also sets out situations whereunder a foreign enterprise is not regarded to have a PE in the State of source.

The G 20 countries noticed that the existing definition of PE is being circumvented by multinational enterprises (MNE) by taking advantage of the gaps in the definition and particularly the para dealing with situations as PE is not said to exist. One such instance could be replacing a typical distributorship arrangement with a commissionaire arrangement with the subsidiary company whereby the subsidiary cannot be regarded as an "agency PE" under the existing definition under Article 5. This, in view of the G 20 countries, resulted in shifting of the business profits from the State of source causing a BEPS concern.

Having regard to the above, the G 20 countries requested the OECD to work on the changes which are required to be made to the existing definition of PE with a view to prevent the aforesaid abuses. The OECD constituted a committee to work, among others, on the changes to the existing definition of the PE under the 'BEPS Action Plan'. The OECD published its final report in October 2015. Action Plan 7 therein deals with the proposed changes in the definition of PE contained in Article 5 of the OECD Model Tax Convention.

In this article an attempt has been made to discuss the recommendations and changes proposed in the final report on Action Plan 7.

Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status:

The final report on Action 7 is divided into the following four parts:

Part A: Artificial avoidance of PE status through commissionaire arrangements and similar strategies - Changes in Article 5(5) of the OECD Model Convention and changes to related Model Commentary.

Part B: Artificial avoidance of PE status through the specific activity exemptions – Changes in Article 5(4) of the OECD Model Convention and changes to related Model Commentary.

Part C: Other strategies for the artificial avoidance of PE status – Article 5(3).

Part D: Profit attribution to PEs and interaction with action points on transfer pricing.

PART A

This part of the BEPS final report deals with review of the existing definition of PE in view of certain common tax avoidance strategies. One of such strategies is known as a 'commissionaire arrangement'. The report defines this as *an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products.* The report notes that the enterprise (say UB Co.) entering into a commissionaire arrangement with another enterprise (say RS Co.) is able to establish before the courts that the goods have been sold by RS Co. in its own name. One of the conditions of attracting Article 5(5) is that the goods should be sold by a person in the name of the enterprise. Since this condition is apparently not satisfied in commissionaire arrangement between UB Co. and RS Co., the latter could not be deemed as a PE under Article 5(5). The profits derived are therefore held as not taxable in the State of sales in the hands of UB Co. On the other hand RS Co. pays tax only on the remuneration for services rendered in the State of sales. An example has been given in the report illustrating as to how the group entities are entering into a commissionaire arrangement for reducing the taxable profits of the entity selling goods in a foreign State.

The report also mentions the following two strategies seeking to avoid application of Article 5(5):

(i) The contracts are substantially negotiated in one State but finalized or authorized in another State.

(ii) A closely related person of a foreign enterprise acting on its behalf exercises an authority to conclude contracts but cannot be regarded as a PE for the reason that the said person takes shelter under Article 5(6).

The OECD countries view the above strategies as a tool to erode the tax base of the State where sales take place (as it is not getting its fair share of taxes). Having noted so, the OECD has reiterated the objective of Articles 5(5) and 5(6) in the following words in para 9 of the Report and stated that the proposed changes in Article 5(5) and 5(6) are aimed to achieve the same:

"As a matter of policy, 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 should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business. The changes to Art. 5(5) and 5(6) and the detailed Commentary that appear below will address commissionaire arrangements and similar strategies by ensuring that the wording of these provisions better reflect this policy."

The report also clarifies that the proposed changes in Articles 5(5) and 5(6) would not apply to low risk distributor arrangements where risks are transferred between related parties.

I. Changes in Articles 5(5) and 5(6):

The proposed Article 5(5) reads as under:

"Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a personis acting in a Contracting State on behalf ofan enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are

routinely concluded without material modification by the enterprise, and these contracts are

a) In the name of the enterprise, or

b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use,

or

c) or the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph."

The phrases which have proposed to be deleted from existing Article 5(5) are '*other than an agent of an independent status to whom paragraph 6 applies*' and '*has, and habitually exercises, in a Contracting State, an authority to conclude contracts*'.

As per the proposed Article 5(5), a person would constitute a PE of an enterprise if the following conditions are <u>cumulatively</u> satisfied:

(i) A person should act on behalf of an enterprise in a Contracting State;

(ii) While acting on behalf of the enterprise, he should habitually conclude contracts,

or

<u>habitually play the principal role leading to the conclusion</u> of contracts;

(iii) The contracts should be concluded <u>without material modification by the enterprise</u>;

(iv) The contracts should be concluded in the name of the enterprise,

Or,

The contracts should be concluded for the transfer of the ownership of or for the granting of the right to use property owned by the enterprise,

Or,

The contracts should be concluded for the granting of the right to use property on which the enterprise has the right to use,

Or,

The contracts should be concluded for the provision of services by that enterprise.

One could notice that the scope of Article 5(5) has been expanded. Under the existing Article 5(5), a person acting on behalf of an enterprise should habitually exercise an authority to conclude contracts to be deemed as a PE of that enterprise. This condition is modified in the proposed Article 5(5). ***A person acting on behalf of the enterprise would be deemed as a PE if he either concludes contract or plays the principal role in concluding a contract.*** Under the proposed dispensation, it would be difficult to argue that a contract though negotiated in a State by a person acting on behalf of an enterprise and formally concluded in that State would not lead to creation of a PE in the State where the negotiations took place.

Article 5(5) in its proposed form would also include contracts negotiated or concluded by a person in a foreign State on behalf of an enterprise for the provision of services by that enterprise or for transfer of ownership or for granting of the right to use the property owned by that enterprise.

The mandate in Article 5(5) is subject to the provisions of Article 5(4) and Article 5(6). If the activities undertaken by a person acting on behalf of an enterprise satisfy the ingredients of Article 5(4) or Article 5(6), the said person would not be deemed as a PE of the enterprise.

Under the Action Plan Article 5(6) has been completely recast. The proposed Article 5(6) reads as under:

"6.a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

b) For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise." (emphasis supplied)

The first limb of paragraph (a) of the proposed Article 5(6) is similar to the existing Article 5(6) except for the fact that the phrase *'a broker, general commission agent or any other agent of'* has been proposed to be deleted. Para 5(6) in its new form states that a person acting on behalf of an enterprise in the status of an 'independent agent' would not be covered under the ambit of Article 5(5). The second limb carves out an exception to the said stipulation. It provides that a person who is closely related to an enterprise or enterprises would not be characterized as an independent agent if he acts exclusively or almost exclusively on behalf of such enterprise.

Paragraph (b) of Article 5(6) defines rules under which a person would be regarded as closely related to an enterprise. The first limb outline a general rule that a person would be regarded as closely related to an enterprise if one has control of the other or both are under the control of the same persons or enterprises. For determining the aspect of control, one should consider all the relevant facts and circumstances [Refer para 38.10 of the Proposed Commentary, dealt hereinafter]. The second limb of Article 5(6) prescribes a test on satisfaction of which a person would be automatically regarded as closely related to an enterprise. As per the test prescribed, a person would be deemed as closely related to an enterprise under the following circumstances:

(i) If the person possesses directly or indirectly more than 50 per cent of the beneficial interest in the enterprise or *vice versa*.

(ii) If a third person possesses directly or indirectly more than 50 per cent of the beneficial interest in the person and the enterprise.

The phrase '50 per cent of the beneficial interest' in context of a company would mean 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company.

OECD Commentary on Article 5(5) – Proposed Changes

The OECD has proposed changes in paragraph 31 to 36 of the existing OECD Commentary on Article 5(5).

- Under the existing Commentary, a person whose activities create a PE for the enterprise is referred as a 'dependent agent'. The BEPS report proposes that the term 'dependent agent' should be removed. In its place, the phrase 'persons who act on behalf of the enterprise' should be used.

- Para 32 is proposed to be changed to clarify that a person's activities on behalf of the enterprise leading to conclusion of contracts indicate that the enterprise participates in business activities in the State concerned. Para 32 emphasizes that the PE envisaged in Article 5(5) presupposes conclusion of contracts (and not merely exercise of authority) resulting from the repeated actions of a person acting on behalf of the enterprise. Para 32 also indicates that conclusion of contracts resulting from isolated actions of the person in other State may not create a PE.

- Para 32.1 list out conditions which are required to be met for deeming a PE under Article 5(5). These conditions are same as outlined earlier.

- Para 32.2 clarifies that satisfaction of all the conditions listed out in para 32.1 would not lead to creation of a PE if the activities of the person acting on behalf of the enterprise are covered under Article 5(4) or Article 5(6) [dealt in detail infra]. An example has been given in para 32.2 of the Commentary illustrating that an independent agent of an enterprise who habitually concludes purchase contracts in the name of the enterprise would not be deemed as a PE under Article 5(5) if the enterprise is able to demonstrate that the activities undertaken by the independent agent is of a preparatory or auxiliary character under Article 5(4).

- Para 32.3 outlines the meaning of the phrase '*a person is acting in a Contracting Stateon behalf of an enterprise*' employed in Article 5(5). It is stated that a person is 'acting on behalf of' an enterprise if that person <u>involves the enterprise</u> to a particular extent in business activities in the State concerned. 'Involvement' of the enterprise in business activities in a foreign State is a condition precedent for demonstrating that a person acted on its behalf.

- A partner acting for a partnership, a director acting for a company, an employee acting for his employer are quoted in the proposed Commentary as examples of persons acting on behalf of an enterprise. Para 32.12 clarifies the meaning of the phrase 'on behalf of' by way of an example. As per the example, a person engaged in pure distributorship of goods could not be characterised as a person acting on behalf of the enterprise. The reason is that the goods sold by the distributor to third parties are not sold on behalf of the enterprise. The ownership passes from the distributor to the third party.

- The Commentary also clarifies that a company can act on behalf of an enterprise. Under such a case, the actions of the employees and director of the company acting as an agent would have to be measured together for determining to what extent the said company is acting on behalf of the enterprise.

- The Commentary is not clear as to what extent the enterprise should get involved in the business. Under such circumstances, the extent of involvement would vary from business to business.

- Para 32.3 states that a person cannot be regarded as acting on behalf of an enterprise if the enterprise is not affected (directly or indirectly) by the activities undertaken by such person. The meaning of the phrase 'not affected' is however not clear in the Commentary. How the enterprise should prove that it is affected or not affected by the actions / activities of the person is an issue which the countries would have to deliberate before accepting the proposed changes to the Article 5(5).

- Para 32.4 defines the phrase 'concludes contracts' to mean "situations where, under the relevant law governing contracts, a contract is considered to have been concluded by a person". As per the definition, a contract would be considered as 'concluded' if the same is regarded as concluded under the Contract law of a State. There is however no comment about which State's Contract law would have to be considered for determining the conclusion of a contract. Some indications are however forthcoming from the instances of conclusion of contracts contained in para 32.4 of the Commentary.

- Para 32.4 contains the following three instances where a contract is regarded as concluded under the relevant Contract law of a State:

  (i) A contract may be concluded without negotiation of the terms of that contract by the person acting on behalf of the enterprise. This happens where the relevant law of a State treats acceptance of offer by an agent on behalf of his principal as conclusion of a contract.

  (ii) A contract may be concluded under a contract law of a State if the same has been signed outside that State. An example has been given illustrating this situation. Under the example, acceptance of an offer by an agent in a foreign State results in conclusion of a contract under the relevant law of that State irrespective of the fact that the same has been signed outside that State.

  (iii) A contract may be concluded in a State if all the elements and details of that contract have been negotiated in that State and such terms are binding on the enterprise. This would be irrespective of the fact that contract has been signed by another person outside the State where negotiations took place.

- Para 32.5 deals with the meaning and scope of the phrase *"or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise".* This phrase is not there in the existing Article 5(5). The OECD supports the introduction of this phrase in Article 5(5) with a reason that the same would take within its ambit a situation where in substance contracts are concluded because of the substantive activities undertaken by a person acting on behalf of an enterprise in a foreign State. In other words, as per this new test, substantive activities of an agent resulting in conclusion of contracts would create a PE of the enterprise. The fact that the contract would be actually concluded under the relevant law in the State of residence of enterprise would be inconsequential.

- The Commentary also clarifies that the aforementioned phrase should be interpreted in the light of the object of Article 5(5). The object of Article 5(5) is outlined in the following words: *"Which is to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, i.e. where that person acts as the sales force of the enterprise".* The Commentary states that the phrase 'principal role leading to conclusion of contracts' would mean <u>actions of a person convincing third parties to enter into a contract with the enterprise.</u> An example given suggests that a person soliciting and receiving orders (without formally finalizing the order) would be characterized as a person playing the principal role in concluding contracts. A person sending e-mails, making calls or visiting organizations in order to convince the third parties to buy products and services of an enterprise of a foreign State is to be regarded as a person playing the principal role leading to conclusion of contract.

- Para 32.5 in its last limb clarifies that a person who merely promotes and markets goods on behalf of an enterprise in a foreign State (for example representatives of a pharmaceutical company) could not be characterized as a person playing the principal role in concluding the contract under the new test under Article 5(5).
- Para 32.6 further explains the new test in Article 5(5) [a person playing the principal role] with an illustration. The OECD has retained the proposition stated in existing para 33 of the Commentary that a person who merely takes part in the negotiations between the enterprise and the client could not be treated as conclusion of a contract by such person or playing of the principal role in conclusion of contracts by such a person.
- Paras 32.7 and 32.8 state that Article 5(5) in its proposed form would also cover a case where the enterprise is bound to perform obligations created in favour of a third party by virtue of actions of a person acting on behalf of such enterprise. This would be despite the fact that (i) there would not be any formal contract between the enterprise and the third party and (ii) contract would be between the person acting on behalf of the enterprise and the third party.
- The import of the phrase 'material modification' is not outlined in Article 5(5). The Commentary is also silent about circumstances under which a modification could be regarded as material. Whether a change in price or change in payment terms could be regarded as material modification? Non availability of answers to such questions may infuse subjectivity in interpretation of this phrase; which may in turn give unwarranted results.
- Para 32.9 clarifies that the expression '*in the name of*' in sub-paragraph (a) of Article 5(5) would cover a situation where the name of the enterprise is not disclosed in the name of the written contract but create rights and obligations that are legally binding on the enterprise.
- Para 32.10 outlines the scope of sub-paragraphs (b) and (c) of Article 5(5). As per this para, the condition precedent for attracting these sub-paragraphs is that a person acting on behalf of the enterprise must conclude the contract with a third party in such a manner that the obligation to perform activities of transfer of ownership or use of property or provision of services rest with the enterprise.
- Para 32.11 clarifies that sub-paragraph (b) would also cover contracts in respect of properties which never existed at the time of conclusion of the contract. Putting it differently, a person entering into a contract with a third party in the name of the enterprise for transfer of goods which would be produced subsequently by the enterprise would constitute a PE. Para 32.11 further states that the term 'property' in sub-paragraph (b) covers any type of tangible or intangible property.
- There are consequential changes in paras 33.1 and 34 of the existing Commentary which explain the meaning of the term 'habitually'.
- Para 35.1 reiterates that the State, where PE is created under Article 5(5), will have

right to tax profits which are attributable to such PE. The rules regarding attribution of profits are contained in Article 7.

OECD Commentary on Article 5(6) – Proposed Changes

- Para 36 of the proposed Commentary outlines the scope of Article 5(6). It states that an enterprise carrying on business dealing through an independent agent in another State would not be deemed to have a PE in such State. The condition precedent is that the independent agent must undertake activities on behalf of other persons in the ordinary course of his business. An employee acting on behalf of the employer or partner acting on behalf of the firm would therefore not assume the character of an independent agent.
- Para 37 of the existing commentary has been proposed to be replaced. Under the existing para 37, two general conditions are outlined; on satisfaction of which a person is regarded as an independent agent.
- The proposed para 37 outlines the scope of the second limb of Article 5(6). The second limb of Article 5(6) provides that a person acting on behalf of an enterprise in the course of carrying on his business could yet not be regarded as an independent agent if such a person performs activities exclusively or almost exclusively on behalf of an enterprise or closely related enterprises. Para 38.7 however clarifies that a person would not fall in the second limb of Article 5(6) if
    - o He acts exclusively or almost exclusively for an enterprise for a short period of time and
    - o Such enterprise is not a closely related enterprise.
- There are no substantial changes in the existing paragraphs 38.2 to 38.5 except the same have been renumbered as 38.1 to 38.6. These paragraphs set out factors to be borne in mind while determining when a person could be considered as an independent agent.
- A company could also act as an independent agent of its holding company or other related enterprises provided it does not act exclusively or almost exclusively for such enterprises. This is clarified in para 38.1 of the proposed Commentary.
- Para 38.6 illustrates with an example as to when an independent agent is said to act in the ordinary course of its business. The test is to determine whether the independent agent is performing activities that are unrelated to the business of an agent.
- The import of the phrase 'exclusively or almost exclusively' is not clear from the proposed Article 5(6) and the related Commentary. An indication is however forthcoming from the example given in para 38.8. Going by the example, a person would be regarded as acting exclusively or almost exclusively for the closely related enterprise if he concludes 90% of the sales for such enterprise.
- Paras 38.9 to 38.12 explains the scope of the expression 'closely related enterprise'. Para 38.9 clarifies that the concept of 'associated enterprises' is not equivalent to the concept of 'closely related enterprise'.
- The first part of Article 5(6)(b) contains a general test under which a person is to held as closely related to an enterprise. Para 38.10 gives an example illustrating the application of the said test. As per the example, where there is a special arrangement through which a person can exercise rights similar to those having 50

per cent beneficial interest, such person will be considered as person closely related to the enterprise.

PART B

Part B is divided into two segments. The first segment deals with changes in paragraph 4 of Article 5 of the OECD Model Tax Convention and paragraphs 21 to 30 of the existing OECD Commentary on Article 5. The second segment deals with introduction of a new paragraph 4.1 in Article 5 of the OECD Model Tax Convention.

I. Changes in Article 5(4)

The existing paragraph 4 of Article 5 of OECD Model Convention reads as under:

"4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character."

It is proposed in the OECD report that the above definition should be modified in the following manner:

(i) The phrase *'of a preparatory or auxiliary character'* in the last limb of clause (e) should be deleted.

(ii) The phrase *'provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character'* should be deleted from clause (f).

(iii) The following proviso should be added after clause (f):

"Provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character".

The modification has been proposed to provide for a stipulation that each of the exceptions under Article 5(4) should be subject to satisfaction of a condition that the activities providing for exception are in the nature of a "preparatory or auxiliary" activities. The existing Article 5(4) has been interpreted to mean that undertaking of activities mentioned in sub-paragraphs (a) to (d) would not lead to establishment of a PE irrespective of the fact whether such activities are of a 'preparatory or auxiliary' character. This is evident from para 12 of the OECD final report:

"It is therefore agreed to modify Art. 5(4) as indicated below so that each of the exceptions included in that provision is restricted to activities that are otherwise of a "preparatory or auxiliary" character."

With the proposed modification, the OECD is seeking to introduce a regime where an enterprise would not qualify for exemption under section 5(4) if the activities enumerated therein constitute essential and significant part of the business of the enterprise. The enterprise would have to demonstrate and establish that the activities carried out in a foreign State are of a preparatory or auxiliary character.

OECD Commentary – proposed changes

The OECD has proposed changes in paragraphs 21 to 30 of the OECD Commentary. A reference to such changes would indicate that the thrust is on the meaning of the expression 'preparatory or auxiliary'. The following highlight the proposed changes to the existing Commentary:

- Para 21 in its proposed form clarifies that the last limb of Article 5(4) applies to all the listed activities. This would mean that any activity answering the description of any of the listed activities undertaken by an enterprise in the foreign country would qualify for exception only if such activity has a preparatory or auxiliary character. The activities should complement the cohesive business of the enterprise. Para 21 has also been changed to recognize that Article 5(4) limits the definition of a PE contained in Article 5(1).

- Para 21.2 outlines the general rule as to when an activity could be regarded to have a preparatory or auxiliary character. The first limb of the paragraph states that an activity has a preparatory character if the same is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. A preparatory activity precedes the main activity and is carried out for a short period of time. What could be regarded as a short period depends upon the nature of business. An instance of preparatory activity given is the training of employees engaged in construction business prior to deputation at construction site located in various countries.

- The last limb of para 21.2 outlines the attributes of an auxiliary activity. It states that an activity which is carried on to support the essential and significant part of the activity of the enterprise as a whole is in the nature of an auxiliary activity. Thereafter the commentary clarifies that **an activity which requires significant proportion of the assets or employees of the enterprise could not be characterised as an auxiliary activity.**

- Para 21.3 clarifies that the activities enumerated in Article 5(4) should be carried on for the enterprise itself. It further clarifies that a PE would be established if the activities mentioned in the Article 5(4) are carried on behalf of other enterprises in the other State.

- Para 22 outlines the scope and intent of subparagraph (a) of the Article 5(4). It clarifies that use of facilities by an enterprise for storing, displaying or delivering its own goods or merchandise results in creation of fixed place of business. The same, however, do not result in creation of a PE as the activities undertaken (viz., storing, displaying and delivering) are of a preparatory or auxiliary character.

- Para 22 clarifies that it cannot be generalized that activities of storing, displaying or delivering goods would always be of a preparatory or auxiliary character. One should determine the character of an activity in the light of the overall circumstances and nature of the business.

Article 5(4)(a)

- An example has been included in para 22 illustrating as to when an enterprise could be regarded as falling outside the ambit of subparagraph (a) despite having been engaged in the activity of storing and delivering the goods in the foreign country. As per the example the benefit under Article 5(4)(a) would not be available if a very large warehouse is used and significant number of employees are used by an enterprise for storing and delivering the goods in a foreign country. The OECD reasons that use of a very large warehouse and significant number of employees shows that the activity of storing and delivering is not of a preparatory or auxiliary character.

- The first limb of para 22.1 contain following two instances where exception provided in sub-paragraph (a) would be attracted:

    (i) Maintenance of a warehouse in a foreign country for the sole purpose of storing fruit during custom clearance in the said country.

    (ii) Maintenance of a fixed place of business in a foreign country for the sole purpose of delivery of spare parts to customers for machinery sold.

- The second part of para 22.1 contains a situation where the exception under Article 5(4)(a) would not be attracted in relation to instance (ii) above. It is clarified that maintenance of a fixed place of business for delivery of spare parts coupled with post sales service cannot be characterised as a preparatory or auxiliary activity. Consequently, the fixed place of business would be regarded as a PE.

Article 5(4)(b)

- Para 22.3 has been inserted to elucidate the scope of subparagraph (b) of Article 5(4). As per this para, Article 5(4)(b) is not attracted if the stock of goods or merchandise belonging to an enterprise (say AB Co) is maintained in a foreign country by another enterprise (say CD Co). For falling within the ambit of Article 5(4)(b), it is imperative that the stock of goods or merchandise should be maintained by AB Co in the foreign country. The place or facility where the stock of goods or merchandise is maintained should be at the disposal of AB Co to constitute a fixed place of business.

- Para 22.3 further clarifies that AB Co. would be said to have a fixed place of business if CD Co. allows unlimited access to AB Co. to a part of the facility for the purpose of inspecting and maintaining the goods or merchandise belonging to AB Co. Whether such a fixed place of business constitutes a PE of AB Co. depends upon satisfaction of the condition whether activities of inspection and maintenance of goods or merchandise constitute a preparatory or auxiliary activity.

- The OECD has not outlined any situations [unlike commentary related to Article 5(4)(a)] where it could be concluded that the activity of maintenance of goods or merchandise constitute a preparatory or auxiliary activity. The said question could be answered in the light of the test outlined in para 21.2 viz., **whether an activity require significant proportion of the assets or employees of the enterprise.**

Article 5(4)(c)

- Para 22.4 outlines the scope of Article 5(4)(c). It has been reiterated in this para that the facility or place where a stock of goods or merchandise is maintained should be at disposal of the enterprise to create a fixed place of business. Additionally the stock of goods or merchandise should be maintained for processing by another enterprise on behalf of or for the account of the first-mentioned enterprise. On satisfaction of these primary conditions, the provisions of Article 5(4)(c) would be applicable.

- It is clarified by way of an example that maintenance of a stock of goods or merchandise belonging to a resident of one State (say JD Co.) in another State at a facility at disposal of a different enterprise (say KM Co.) could create a fixed place of business if KM Co. allows JD Co. to have unlimited access to a separate part of the facility for inspection and maintaining the goods. The example indicates that the key elements for attracting Article 5(4)(c) under such a situation are (i) unlimited access to facility (ii) inspection and maintenance of goods. JD Co would have to establish that the activities of inspection and maintenance of goods is of a preparatory or auxiliary character.

- It has been clarified in the last limb of para 22.4 that a distributor who merely maintains goods in a foreign State for processing of such goods by another enterprise satisfy all the ingredients of Article 5(4)(c) as the said activities constitute auxiliary activity for the distributor.

Article 5(4)(d)

- Para 22.5 of the Commentary outlines the scope of Article 5(4)(d). Article 5(4)(d) contains two parts. The first part stipulates that the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise by an enterprise would not lead to creation of a PE. The commentary clarifies that the exception envisaged under this part of Article 5(4)(d) would not be available to a fixed place of business used for the purchase of goods or merchandise if the following two conditions are satisfied.

  (i) Overall activity of the enterprise is to sell the goods purchased

  (ii) Purchasing of goods is the core function in the business of the enterprise.

- The fact that the purchase of goods is the only activity carried out in a foreign State by the enterprise would be immaterial if the above two conditions are satisfied. The commentary explains the prescription of Article 5(4)(d) by way of two examples. The first example deals with a situation where purchasing of goods by a fixed place of business in a foreign State constitutes a PE for the reason that two conditions enumerated in the example given above are satisfied. The second example contains a situation where the exception under Article 5(4)(d) is attracted for the reason that the purchasing function is not the core function of the enterprise. The goods were purchased occasionally by the fixed base in the foreign State towards its supplies and not for selling the same.

- The second part of Article 5(4)(d) relates to a fixed place of business that is used solely to collect information for the enterprise. The proposed commentary recommends that one should determine whether collection of information by the fixed base is a preparatory or auxiliary activity. Only on satisfaction of this condition, the exception under Article 5(4)(d) would be applicable. No such requirement is there in the existing Article 5(4)(d) of the OECD Model Convention.

- Following examples have been given in the proposed commentary where collection of information has been regarded as a preparatory activity:

  o An investment fund setting up an office in a foreign State solely for the purpose of collecting information through that office.

  o An insurance enterprise setting up an office solely for the collection of information such as statistics on risks in a particular market.

- o A newspaper bureau collecting information on news stories in a foreign State sans engaging in any advertising activities.

Article 5(4)(e)

- Para 23 deals with the scope of Article 5(4)(e). Article 5(4)(e) applies to a fixed place of business maintained by an enterprise in a foreign State solely for the purpose of carrying on any other activity which is of a preparatory or auxiliary character.
- Paras 24 to 29 of the proposed commentary contains discussion about situations which would be covered within the ambit of Article 5(4)(e) and vice versa. The examples given are broadly similar to the examples contained in the existing commentary except certain aesthetic changes.
- Para 30 states that a fixed place of business used by an enterprise for carrying out activities listed in Article 5(4) as well as other activities which are not of preparatory or auxiliary character would constitute a single PE. The profits attributable to the PE qua both the activities may be taxed in the State where the PE is situated.
- Para 30.1 of the proposed commentary recognizes that some of the States are unwilling to accept that all the activities mentioned in Article 5(4) should be subject preparatory or auxiliary character test. It is suggested that such States are free to adopt Article 5(4) outlined in the last limb of para 30.1; which is broadly in line with the existing Article 5(4).

II. Introduction of paragraph 4.1 in Article 5

It has been recommended in the final report that a new paragraph 4.1 should be added to existing Article 5. As per this paragraph, the exceptions under Article 5(4) should not apply if a cohesive business operation has been fragmented into smaller operations by an enterprise and each of such small operations is carried out at fixed places of business maintained <u>by such enterprise or by closely related enterprise.</u> The other conditions which are required to be met are as under:

(i) The different places of business could be maintained at the same place or at different places in the same contracting State.

(ii) The activities carried out by the enterprise and closely related enterprise at fixed places of business must be complementary functions.

(iii) At least one of the fixed places where these activities are carried out must constitute a PE under Article 5(1).

(iv) The overall activity resulting from the combination of activities carried out by the enterprise and the closely related enterprise should not be of a preparatory or auxiliary character.

The conditions mentioned in points (i) and (ii) above are to be mandatorily satisfied. In addition, any one of the conditions in (iii) or (iv) should be satisfied to attract the application of paragraph 4.1.

OECD Commentary related to new paragraph 4.1 to Article 5:

Under the current OECD Model Convention, para 27.1 clarifies that the scope of Article 5(4)(f) cannot be extended to an enterprise which fragments a cohesive business into smaller operations which are carried out at separate fixed places of business maintained by such enterprise in a foreign State. The existing commentary clarifies that it is impermissible for an enterprise to argue that each of the fixed places of business is merely engaged in a preparatory or auxiliary activity.

Para 15 of the final report on Action Plan 7 notes that the paragraph 4.1 would not only take care of the prescription under existing 27.1 but would also tackle a situation where enterprises were carrying out fragmented activities carried out by related parties at the same place or at different places.

It has been proposed that the existing commentary in para 27.1 should be modified and new paragraphs 30.2 to 30.4 should be added. Para 30.2 outline the intent and scope of the new paragraph. Para 30.3 states the phrase 'closely related enterprises' is defined in Article 5(6) [discussed earlier]. Para 30.4 contains certain examples which illustrate the application of the new paragraph.

PART C

This part of BEPS final report on Action Plan 7 deals with other strategies which are being used to avoid the PE status. Two strategies have been discussed in this part of the report. The first strategy dealt in the report concerns with the abuse of Article 5(3). Article 5(3) provides that a building site or construction or installation project constitutes a PE only if it lasts more than 12 months.

The OECD in its existing commentary has noted that the threshold of 12 months has been abused by enterprises mainly contractors or subcontractors working on the continental shelf. The usual strategy adopted by such enterprises is of splitting of contracts into several parts covering less than 12 months among closely related parties.

The OECD noted that the existing commentary is silent as to how such abuses should be prevented. It only states that the countries may address the same through anti avoidance rules or through bilateral negotiations. In view of the same, the OECD has recommended that a **'Principal Purposes Test (PPT)'** rule must be added to the OECD Model Tax Convention. An example has been given explaining as to how PPT rule would prevent abuse of Article 5(3).

The final report has also recommended changes in para 18 of the Commentary on Article 5(3). It has been stated in the proposed Commentary that the issue of abuse of PE status through splitting contracts could be addressed through anti-abuse rule contained in treaties. The report also suggests an alternate provision for States which do not have anti abuse provisions in their treaties for addressing the issue of contract splitting.

As per the alternate provision, for determining whether the 12 month period referred to in Article 5(3) has been exceeded, the connected activities carried on by closely related enterprises of an enterprise should also be reckoned. The conditions which are required to be met are as follows:

(i) The closely related enterprises should undertake activities at the same building site, construction or installation project where the first mentioned enterprise carried on activities

(ii) The activities carried on by the closely related enterprises should exceed 30 days.

The report also outlines certain factors that need to be considered while determining whether the activities carried on by the closely related enterprises are connected. The phrase 'closely related party' is to be understood in the light of the definition contained in Article 5(6).

The second strategy dealt in the report relates to selling of insurance in a foreign State without having a PE therein. The report concludes that the BEPS concerns in relation to insurance business should also be dealt by referring to changes proposed to Articles 5(5) and 5(6) of the OECD Model Tax Convention [discussed earlier].

PART D

The OECD in this part of the report has dealt with attribution of profits to a PE. The OECD concludes that the rules and guidance available in the existing Model Convention along with the Commentary do not require substantive modifications. The OECD also states that follow-up work needs to be done qua attribution of profits in the light of changes suggested to the definition of PE in this report and BEPS work related to transfer pricing.

Concluding Remarks

- Action Plan 7 has proposed certain changes in the understanding of 'PE'. A co-ordinated reading of such changes along with recommendations in Action Plan 1 dealing with Addressing the Tax Challenges of the Digital Economy and Action Plan 6 Prevent Treaty Abuse is required for a complete understanding of the changes to the concept of PE under BEPS Project.

- The objectives of Action Plan 7 are (i) to ensure that profits are taxed where economic activities take place and value is created (ii) introducing coherence in the domestic rules that affect cross-border activities (iii) reinforcing substance requirements in the existing standards and improving transparency and certainty. These objectives are sought to be achieved by modifying Article 5(4), Article 5(5) and Article 5(6).

- In view of the growth of digital economy, the activities which were earlier of a preparatory or auxiliary character may now correspond to the core business activities of an enterprise. An attempt has been made by modifying Article 5(4) to ensure that an enterprise should pay taxes on core activities in the State in which such activities are undertaken.

- A new rule to curb fragmentation of a cohesive business activity has been proposed by inserting para 4.1 in Article 5.

- Articles 5(5) and 5(6) have been proposed to be modified in order to deal with a situation where enterprises are able to demonstrate that no PE is created where an intermediary functioning in a foreign State (under a commissionaire arrangement or any other similar arrangement) concludes contract.

- The above could be achieved only if the proposed changes are accepted and implemented by the countries concerned. The OECD has noted in the report that there are countries which are unwilling to accept all the proposed changes or have reservations on the extent of change sought to be achieved.

- Current rules are inadequate to ensure a fair allocation of taxing rights to countries in relation to business profits derived by a non-resident taxpayer from activities undertaken in a foreign State. BEPS recommendation may have to be universally adopted by countries across the globe in order to achieve a successful implementation. Implementation is the key in ensuring that the purported objectives are achieved. The journey of BEPS from blueprint to action would be critical.

- Uniformity / consistency in understanding and execution of BEPS recommendations by the countries appear to be a herculean task. We would have to wait for the actual unfolding of the events to judge the success of the BEPS Project.



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BEPS Action Plan 8 – Guidance on Intangibles

"Uber, the world's largest taxi company, owns no vehicle. Alibaba, the most valuable retailer, has no inventory. Airbnb, the world's largest accommodation provider, owns no real estate[1]."

Over the years, intangibles have become crucial source of value, competitive distinctiveness and increasingly play a dominant role in determining a company's valuation and profitability. The role of intangibles in transfer pricing matters has perhaps become one of the most contentious issues internationally.

The ownership and pricing of valuable and unique intangibles are areas which have garnered growing interest and are facing considerable challenges. Increasingly, complicated business structures and policies being adopted by multinational enterprises (MNEs) in order to efficiently manage their global businesses has contributed in fair measure to this trend.

In emerging markets such as India, the issue assumes particular relevance as many MNEs have set up their manufacturing base, captive research and development centers and sales and distribution entities to reap benefits of the location saving, vast pool of skilled workforce and tap the huge consumer base.

A number of difficulties arise while dealing with intangibles. Some of the key issues revolve around determination of the arm's length price for the transfer and use of intangibles, ownership of intangibles, remuneration for development of intangibles, transfer pricing of cobranding etc.

Recently, a slew of measures have been announced by the OECD[2] in the form of BEPS[3] Action Plans with the objective to counter tax-evasion /aggressive tax-planning and equipping tax authorities with holistic view of business to prevent 'unilateral taxation'.

The Action plan 8 provides guidance to prevent BEPS by moving intangibles among group members by:

(i) adopting a broad and clearly delineated definition of intangibles;

(ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than separated from) value creation;

(iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles."

1. http://techcrunch.com/2015/03/03/in-the-age-of-disintermediation-the-battle-is-all-for-the-customer-interface/#.n7jzsan:0sCd

2. Organization for Economic Cooperation and Development

3. Base Erosion and Profit Shifting

Under this action plan, the OECD released several discussion drafts specifically, the OECD released i) initial report on intangibles – September 2014, ii) discussion draft on hard-to-value intangibles ("HTVI") – June 2015, (iii) final guidance on intangibles including HTVI on October 5, 2015.

This article specifically focus on the guidance provided by the OECD under Action plan 8 on intangibles and it relevance from an Indian transfer pricing perspective.

As per the guidance provided under this Action plan, the word "intangible" is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.

It is important to distinguish intangibles from market conditions or local market circumstances. Features of a local market, such as the level of disposable income of households in that market or the size or relative competitiveness of the market are not capable of being owned or controlled. While in some circumstances they may affect the determination of an arm's length price for a particular transaction and should be taken into account in a comparability analysis, they are not intangibles.

It is pertinent to note that not all intangibles deserve compensation separate from the required payment for goods or services in all circumstances, and not all intangibles give rise to premium returns in all circumstances.

For example, consider a situation in which an enterprise performs a service using non-unique know-how, where other comparable service providers have comparable know-how. In that case, even though know-how constitutes an intangible, it may be determined under the facts and circumstances that the know-how does not justify allocating a premium return to the enterprise, over and above normal returns earned by comparable independent providers of similar services that use comparable non unique know-how.

In summary, the guidance contained in this Chapter provides as follows:

- *Legal ownership of intangibles by an associated enterprise alone does not determine entitlement to returns from the exploitation of intangibles.*

  Legal rights and contractual arrangements form the starting point for any transfer pricing analysis of transactions involving intangibles. The legal ownership by itself, does not confer any right to retain returns derived by the MNE group from exploiting the intangible.

  For example, in the case of an internally developed intangible, if the legal owner performs no relevant functions, uses no relevant assets, and assumes no relevant risks, but acts solely as a title holding entity, the legal owner will not ultimately be entitled to any portion of the return derived by the MNE group from the exploitation of the intangible other than arm's length compensation, if any, for holding title.

- *Associated enterprises performing important value-creating functions related to the development, maintenance, enhancement, protection and exploitation of the intangibles can expect appropriate remuneration*

  The MNE group member(s) making the more significant contributions in a particular case should receive relatively greater remuneration. For self-developed or acquired intangibles that serve as a platform for further development activities, the important functions may include:

- design and control of research and marketing programmes;
- direction of and establishing priorities for creative undertakings including determining the course of "bluesky" research;
- control over strategic decisions regarding intangible development programmes;
- management and control of budgets;
- defence and protection of intangibles; and
- on-going quality control etc.

The legal owner may outsource most of all important functions to associated enterprises. In such scenario, although the legal owner of an intangible may receive the proceeds from exploitation of the intangible, as per the arm's length principle, the associated enterprises should be entitled to greater return.

- *An associated enterprise assuming risk in relation to the development, maintenance, enhancement, protection and exploitation of the intangibles must exercise control over the risks and have the financial capacity to assume the risks and control.*

Risk is inherent in business activities. The assumption of risks associated with a commercial opportunity affects the profit potential of that opportunity in the open market. Risk assumption means taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises.

Control over risk means

(i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function; and

(ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision making function.

Financial capacity to assume risk can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises. Access to funding by the party assuming the risk takes into account the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialise. This assessment should be made on the basis that the party assuming the risk is operating as an unrelated party in the same circumstances as the associated enterprise, as accurately delineated under the principles of this section.

- *An associated enterprise providing funding and assuming the related financial risks, but not performing any functions relating to the intangible, could generally only expect a risk-adjusted return on its funding;*

One member of an MNE group may fund the development, enhancement, maintenance, and protection of an intangible, while one or more other members perform all of the relevant functions. Where a party that provides funding, but does not control the risks or perform other functions associated with the funded activity or asset, generally could expect only a risk-adjusted return on its funding.

Such return can be determined, for example, based on the cost of capital or the return of a realistic alternative investment with comparable economic characteristics. In determining an appropriate return for the funding activities, it is important to consider the financing options realistically available to the party receiving the funds.

Entitlement of any member of the MNE group to profit or loss relating to differences between actual and expected profits will depend on which entity or entities assume(s) the risks that caused these differences and whether the entity or entities are performing the important functions in relation to the development, enhancement, maintenance, protection or exploitation of the intangibles or contributing to the control over the economically significant risks and it is determined that arm's length remuneration of these functions would include a profit sharing element;

It is quite common that actual *(ex post)* profitability is different than anticipated (ex ante) profitability. This may result from risks materialising in a different way to what was anticipated through the occurrence of unforeseeable developments. For example, it may happen that a competitive product is removed from the market, a natural disaster takes place in a key market, a key asset malfunctions for unforeseeable reasons, or that a breakthrough technological development by a competitor will have the effect of making products based on the intangible in question obsolete or less desirable.

It may also happen that the financial projections, on which calculations of ex ante returns and compensation arrangements are based, properly took into account risks and the probability of reasonably foreseeable events occurring and that the differences between actual and anticipated profitability reflects the playing out of those risks. Finally, it may happen that financial projections, on which calculations of ex ante returns and compensation arrangements are based, did not adequately take into account the risks of different outcomes occurring and therefore led to an overestimation or an underestimation of the anticipated profits. The question arises in such circumstances whether, and if so, how the profits or losses should be shared among members of an MNE group that have contributed to the development, enhancement, maintenance, protection, and exploitation of the intangible in question.

Resolution of this question requires a careful analysis of which entity or entities in the MNE group in fact assume the economically significant risks as identified when delineating the actual transaction. As this analytical framework indicates, the party actually assuming the economically significant risks may or may not be the associated enterprise contractually assuming these risks, such as the legal owner of the intangible, or may or may not be the funder of the investment.

The entitlement of any member of the MNE group to profit or loss relating to differences between actual (ex post) and a proper estimation of anticipated (ex ante) profitability will depend on which entity or entities in the MNE group in fact assumes the risks as identified when delineating the actual transaction. It will also depend on the entity or entities which are performing the important functions or contributing to the control over the economically significant risks, and for which it is determined that an arm's length remuneration of these functions would include a profit sharing element.

A rigorous transfer pricing analysis by taxpayers is required to ensure that transfers of hard-to-value intangibles are priced at arm's length.

The term hard-to-value intangibles (HTVI) covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.

For such intangibles, information asymmetry between taxpayer and tax administrations, including what information the taxpayer took into account in determining the pricing of the transaction, may be acute and may exacerbate the difficulty encountered by tax administrations in verifying the arm's length basis on which pricing was determined.

In these circumstances, the tax administration can consider ex post outcomes as presumptive evidence about the appropriateness of the ex ante pricing arrangements.

In evaluating the ex ante pricing arrangements, the tax administration is entitled to use the ex post evidence about financial outcomes to inform the determination of the arm's length pricing arrangements, including any contingent pricing arrangements, that would have been made between independent enterprises at the time of the transaction. Depending on the facts and circumstances of the case, a multi-year analysis of the information for the application of this approach may be appropriate.

This approach will not apply to transactions involving the transfer or use of HTVI in following situations:

Reliable evidence that any significant difference between the financial projections and actual outcomes is due to:

a) unforeseeable developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction; or

b) the playing out of probability of occurrence of foreseeable outcomes, and that these probabilities were not significantly overestimated or underestimated at the time of the transaction;

ii) The transfer of the HTVI is covered by a bilateral or multilateral advance pricing arrangement in effect for the period in question between the countries of the transferee and the transferor.

iii) Any significant difference between the financial projections and actual outcomes does not have the effect of reducing or increasing the compensation for the HTVI by more than 20% of the compensation determined at the time of the transaction.

iv) A commercialization period of five years has passed following the year in which the HTVI first generated unrelated party revenues

Let's know examine the above guidance in the context of following practical scenarios from an Indian transfer pricing perspective.

Contract Research and Development

Many MNCs have set up their contract Research and Development Centre (R & D Centre) in India to take advantage of low cost economy and skilled workforce. The contract R & D centres typically operate under the supervision and guidance of the overseas parent and are compensated based on cost plus arm's length mark-up. It is typically claimed that such contract R & D centres operate in a limited risk environment.

The guidance provided by the aforesaid BEPS Action plan would require an Indian contract R & D centre to demonstrate with the support of robust documentation, the critical functions for the research and development such as design, quality control, ongoing monitoring, strategic direction etc. are performed by overseas group entity (AE).

Further, the AE that has been funding the research and development process has:

- sufficient and capable personnel to oversee the work performed by an Indian contract R & D centre; and
- Wherewithal to assume and control financial risks.

In order to ascertain the wherewithal, the AE's net worth, employees, operations, past history etc. could be considered.

In case an Indian contract R & D centre is not able to satisfy above requirements then the mere cost plus mark-up compensation received from the AE may be challenged by the Indian Revenue Authorities and there could be potential for attributing higher compensation based on the activities performed by contract R & D centre. Depending on the relative intensity of the functions performed, assets employed and risks assumed (FAR), it is possible that the application of residual profit split method may provide the most optimal solution. In case the AE provides funding but does not exercise control over the associated risks, then the AE is entitled to no more than a risk-free return for its funding activities.

It may be pertinent to draw reference to the Circular 6/2013 in the context of contract R & D centres, wherein the Central Board of Direct Taxes ('CBDT') has directed the Revenue Authorities to examine the functional and risk characterization of the contract R & D Centres based on the conduct of the parties. In essence, the guidance provided by the CBDT is largely line with BEPS action plan 8.

Marketing Intangible

Let us assume a scenario wherein an Indian entity acts as full risk distributor of the products manufactured by the AE. The AE (registered owner of the brand) sells its products in several countries including India and the brand is well known in all countries except India. The Indian distributor incurs substantial advertisement, marketing and promotion (AMP) expenses to create awareness about the brand in India. It may be assumed that the Indian distributor has incurred spends that are higher than what a similarly placed distributor would be expected to incur. Based on the functional and risk profile, the Indian distributor is eligible to retain premium profit earned from sales made in India.

After several years the AE decides to sell the brand to a third party. The AE is clearly legal owner of the brand. However, the Indian distributor who has made significant investments as aforesaid in creating awareness of the brand may be regarded as having an economic ownership in the brand so far as it pertains to Indian market. In a third party situation, a distributor would not be willing to make such investments in the absence of a long-term 'right' to use the brand. Based on the BEPS guidance, the Indian distributor has contributed to the development, maintenance, enhancement, and exploitation of the intangibles in India by virtue of substantial AMP spends made in India and hence may be considered as a joint owner of the brand in India.

In such a scenario, it would be appropriate for the Indian distributor to receive a compensation from the AE, which could *inter alia* be the proportionate sale consideration resulting from the sale of brand.

Broadcast Rights

In the year 1, an overseas Parent (Foreign Telecasting Company) entity bids and wins a right to broadcast sports event in 3 countries (for example, India, Sri Lanka and Bangladesh) for 3 years by paying ` 1,000 crores. While bidding it was anticipated that viewership spread in these countries will be India – 70 %, Sri Lanka 30% and Bangladesh 10%. Based on the same, the AE attributes, 70% of bid cost to India i.e. ` 700 crores.

At the end of 3 year period, the collective revenue earned by 3 entities is ` 1400 Crores. However, there was a mismatch in the actual and anticipate viewership and consequent revenue earned by these 3 countries. The actual viewership in India - 50 %, Srilanka - 40% and

Bangladesh - 10%. The revenue earned by these 3 countries was also in the same ratio.

The critical issue will be whether the Revenue Authorities would be inclined to disallow the portion of broadcast cost attributed to India i.e. ` 200 crores (i.e. ` 700 crores attributed to India based on anticipated 70% viewership minus ` 500 crores based on actual 50% viewership)

As per BEPS HTVI guidance mentioned above, the Indian entity would be able to substantiate claim for original broadcast cost in the following scenarios:

- if the Indian entity is able to establish that the variation between *ex ante* estimate and *ex post* result is on account of unforeseen events;
- if the difference between the financial projections and actual outcomes does not exceed more than 20% of the broadcast cost determined at the time of the transaction; or
- the aforesaid transaction is covered by a bilateral or multilateral advance pricing arrangement

Based on above guidance, the Indian entity would need to demonstrate following with support of robust documentary evidences:

- the basis on which the original estimate of viewership and revenue projections were undertaken; and
- there is a credible explanation for the variation between *ex ante* estimate and *ex post* result due to unforeseeable developments or unanticipated events.

Following events could possible qualify as unforeseen development or unanticipated events:

1) Due to political turmoil, the Indian team could not participate in an important sports event leading to a drastic (unforeseen) drop in viewership in India; or

2) Change in government regulation, which mandated the transmission of the sports event via free to air TV channel (like Doordarshan) which drastically reduced viewership.

In the instant case, if Indian entity is able to demonstrate that the variation between the estimated viewership and actual viewership is on account of unforeseen events, such as those mentioned above, then it would be able to substantiate the claim for the original broadcast cost i.e. ` 700 Crores.

Conclusion

The BEPS Action plan 8 lays emphasis on substance and functions rather than contractual allocation of risks and rewards. In this regard, it would be crucial for MNE groups to map the FAR of entities operating in India in terms of the overall value chain to demonstrate that a fair remuneration is earned by Indian entity commensurate with its activities. This exercise is equally relevant for an Indian arm of any MNE operating as a captive service provider, distributor, licence manufacturer or franchise, as well as for an Indian headquartered MNE group with overseas affiliates.

It would be of utmost importance for MNEs to formulate an appropriate strategy and structure for effective compliance. This would broadly include review of existing transfer pricing structure and policies, building rationale for business transactions and robust justification with documentation to demonstrate substance at each entity-level. It would also include undertaking restructuring / corrective action to align business models in line with actual conduct and establishing the infrastructure to support data retrieval in appropriate formats for timely reporting.

While it remains to be seen whether the courts would permit the Indian Revenue authorities to rewrite intra-group transactions / arrangements in the absence of General Anti Avoidance Rules, it is clear that tax authorities worldwide will give more credence to the economic substance rather than legal form, and it would be advisable to plan accordingly.


CA Rohan Phatarphekar & CA Devendra Gulati

Action Plan 9 – Aligning substance and form in a Transfer Pricing Analysis

In October 2015, the OECD released its final reports on the Base Erosion and Profit Shifting (BEPS) Project after two years of comprehensive research and public consultations. The BEPS project is based on the three main pillars of coherence, substance, and transparency coupled with certainty. These Action Plans were focused on a large number of important issues including those pertaining to alignment of taxation with the location of economic activity and value creation, application of transfer pricing (TP) guidelines, taxation of digital enterprises like those engaged in e-commerce, strengthening of Controlled Foreign Company (CFC) Rules, making dispute resolution mechanisms more effective etc.

Under Actions 8, 9, and 10 of the BEPS Action Plan, OECD had released quite a few discussion drafts. In October 2015, OECD released its final guidance under Actions 8, 9, and 10 in one report which actually takes the form of guidance incorporated in the form of amendments to various chapters of the OECD TP Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines). Section D of Chapter I of the revised report deals with allocation and assumption of risk in a related party scenario. In this article we have discussed the guidance on accurately delineating the functions performed and risks assumed in a related party scenario, arising out of Action 9.

The most important aspect in any transfer pricing analysis is to obtain an understanding of the functions performed, assets employed and risks assumed by the associated enterprises transacting with each other. Correct understanding of the functions, assets and risk would assist in appropriately characterising the transacting entities, which in turn would form the basis of comparison of the transaction with economically relevant characteristics between independent enterprises. Any written contract between associated enterprises is generally the initiation point for obtaining the understanding of functions performed and risks assumed. OECD stresses upon the fact that while for the purpose of transfer pricing analysis, the process commences by examining the contractual terms of the transaction between parties, the next step should be to examine the actual conduct of the transacting entities. While in case of independent enterprises, the divergence of interests ensures that the parties' hold each other to the terms of the contract, the same divergence of interest may not exist in case of associated enterprises. Thus, it is important to examine the actual conduct of the parties on ground to ensure that the same is consistent with the written contract.

In case the actual conduct of the parties is not aligned to the terms of the contract, it shall be the conduct of the parties which shall be given regard to for transfer pricing purposes. To explain it better by way of an example, Company A has a wholly owned subsidiary Company B, to which the former has granted an exclusive licence to use intangible property for the purpose of its business for which Company B pays a royalty. However, on undertaking the functional analysis, it is determined that Company A also assists its subsidiary in obtaining customers, formulating business strategies and providing required technical support. The formulation of strategies and approval of budgets is undertaken by Company A. Further, Company A seconds its experienced staff to Company B for efficient management of the business. In such a situation, it may not be appropriate to characterise Company A as a mere licensor by merely placing reliance on the contract, as based on the conduct it is actually functioning as a principal.

Functional analysis cannot be completed unless the risks assumed by each of the parties have been identified, as the same would influence the pricing of transaction. Identification of risks in a related party scenario poses significant practical challenges and is much difficult vis-a-vis identification of functions and assets. Considering the same, a six step process has been laid down in the Action Plan for accurately delineating the material risks associated with a transaction in a related party scenario. The process as laid down for appropriate allocation of risk in a related party scenario has been discussed below:

Identification of economically significant risks and analysing contractual allocation of risk

The first step in the process is identification of economically significant risks in the business. One way to identify risks is to consider the various sources of uncertainty which may impact the objective of business. The guidelines mention an indicative list of risk in the business which includes market risk, operational risk, financial risk, transaction risks, hazard risk etc. It is noteworthy that while a business may encounter number of internally as well externally driven risks, for transfer pricing purposes the focus should only be on those risks which are economically significant to the business. One way to assess the economic significance of risk is to analyse the effect which the risk may have on the pricing of a transaction.

The next step in the process is to analyse the contractual allocation of risk between the parties. If there is a written contract between the associated enterprises, it may explicitly set out the assumption of risk between the parties. Risks which are not explicitly assigned may be implicitly assumed in the terms of contract.

Functional analysis in relation to risk

The third step in the process is to undertake functional analysis to verify whether the contractual allocation of risk is reflected in the conduct of associated enterprises. An entity which has been allocated a particular risk should be undertaking decisions to control the risk and have the financial capacity to bear the result in case the risk materialises. Financial capacity to bear the risk would mean access to the funding to take on the risk to pay for risk mitigation functions and to bear the consequence if the risk materialises. Control over the risk refers to the performance of risk management functions in the business.

Risk management functions comprises capability to undertake decisions in relation to a risk bearing opportunity, together with actual performance of the function. It is not necessary for the party controlling the risk to perform day -to-day routine functions in order to mitigate the risk. While these functions can be outsourced to a third party, what is more important is that the party assuming risk should have the capability to determine the objective of outsourced activity, undertake assessment of the performance of the service provider and undertake decisions to appoint or terminate the service provider.

Thus, the risk bearing entity would require both capability as well as performance of the necessary strategic functions discussed above in order to exercise control over risk. In nutshell, while the entity assuming the risk can outsource certain risk mitigation functions, strategic decisions in relation to management of risk cannot be outsourced.

To discuss the same by way of an example, Contract R&D centres operating in India have been facing severe litigation wherein Revenue authorities challenge the characterisation of the Indian entity, alleging that the functions performed are not in the nature of a contract service provider and hence the entity cannot be remunerated on a routine cost plus basis but by way of application of profit split method. Applying the guidance provided in Action Plan 9, in order to characterise Indian entity as a contract service provider, the foreign principal should not only provide funds / capital required to conduct the R&D, but should have the capacity to perform the economically significant functions, and have the capability to control and supervise the R&D functions through its strategic decisions to perform core functions. However, if the foreign principal lacks substance required to perform the necessary functions, then it would not be appropriate to characterize Indian as a contract R&D centre.

Allocation of risk based on conduct

If after taking into consideration the above discussed factors, it is concluded that the party which is contractually assuming the risk, lacks the financial capability or does not perform the functions to control risk, and is only providing capital required for the purpose of operations, then the risks and rewards associated with transaction needs to be reallocated to the entity controlling the risk. In such a case, the former entity would only be entitled to rewards for the funding activities. In the above discussed example, if it is concluded that while the contract states Indian entity as a contract R&D service provider, the foreign principal is only providing funds for R&D and lacks substance to perform strategic function to control and supervise the R&D, in such case the foreign principal should only be entitled to investment return and not the operational return in the business.

Pricing the transaction taking into account risk allocation

The delineated transaction should be priced after taking into account the financial and other consequences of risk assumption. Assumption of increased or higher risks would ideally be accompanied by an increase in expected returns, although the actual return may or may not increase depending upon the degree to which risks are actually realised. This clearly demonstrates the fact that the Revenue cannot expect a taxpayer assuming higher risks to automatically make premium returns, if the risks had actually materialised in the market or economy in a manner against the taxpayer.

Let's understand the application of above guidance on risk allocation in the Action Plan by way of an example. Company A has a wholly owned subsidiary Company B which acts as a contract manufacturer for the parent company. At the initiation, it is identified that capacity utilisation risk, supply chain management risk are economically significant. Further, based on the contract it is identified that capacity utilisation as well as supply chain management risk is borne by Company A. Once the risk is identified and contractual allocation is analysed, one would undertake the functional analysis to ensure that the conduct of parties is in confirmation with the contractual allocation of risk. As per the functional analysis, Company B has built the plant as per Company A's specification, products are manufactured as per technical designs provided by Company A. Volume of production, supply chain management and quality control functions are also controlled by Company A. Based on the functional analysis, while significant risk associated with generating returns in the business are controlled by Company A, service delivery risk is borne by Company B. Further, each party has the financial capacity to bear the risks allocated to them. Once the allocation of risk is finalised, pricing of the transaction shall be undertaken keeping in mind the allocation of risk. As significant risks are controlled by Company A, the upside and downside consequences of those risks should be allocated to Company A. Company B should be remunerated with routine return for service delivery, however the remuneration model should account for the fact that Company B has incurred the cost for acquisition of assets. However, if in the same example, during the functional analysis it is observed that there was a failure by Company A in appropriately determining the production levels, however the loss arising out of the same was borne by Company B, it would indicate that contractual allocation of risk requires further consideration. The same would also have to be factored while pricing the transaction.

While each of the transacting entity should be remunerated taking into account the risk assumed, the more complex scenarios would be those where the party which is controlling the risk does not contractually assume the same. In such circumstances, the party which controls the risk should also be sharing the potential upside or downside, commensurate with the contribution towards control.

To explain the above scenario by way of an example, Company X is the owner of a tangible asset and leases the same for use to unrelated third parties. Company X has a contract with a group entity Company Y for provision of services in relation to the leasing of asset. The significant risk as identified in the business is utilisation risk (loss which may arise to the owner on account of non-utilisation of asset) and service delivery risk. On analysing the contractual arrangement for service between Company X and Y, it is observed that the same does not address as to which entity would bear the utilisation risk. As a next step, functional analysis is undertaken in which it is observed that Company Y performs the functions of identifying potential customers, communicating the features of assets, undertaking the negotiation with customer, finalisation of the terms of agreement and provision of after sale services to customers. However, the lease arrangement is formally entered between Company X and the customer. Further, the functional analysis reveals that another group Company Z undertakes market analysis to identify the possible investment opportunities and decides whether investing in such a tangible asset would be appropriate or not. Company Z finalises the design and specifications of the tangible asset and places the order for requisition of asset, however the asset is purchased by Company X.

Clearly in the above case Company X does not have the capability to either control the utilisation risk or service delivery risk in the business. In the above case, service delivery risk and utilisation risk shall be allocated to Company Y and Company Z respectively, as these entities have the capacity to control the risk. Further, Company X would not be entitled to return higher than the risk free return as it is acting merely as an investor providing capital. In this case, it has been assumed that each party has the financial capacity to assume the respective risk.

The guidance as laid down in the action plan would help in accurately delineating the controlled transaction. Once the controlled transaction is accurately delineated, efforts should be made to determine the actual pricing of the transaction keeping in mind factors such as, characteristics of the property transferred, economic circumstances of the market, and business strategies being pursued by the parties. Non-recognition of a controlled transaction should be avoided and only be undertaken in extreme circumstances where there is no possibility of such transaction being undertaken by independent third parties. For better understanding let's discuss one example where the transaction can be de-recognised. Company A has its assets situated in a country which is currently a war zone. Company A is willing to obtain insurance on the assets, however no third party is willing to undertake the insurance. Considering the same, Company B which is a group company, provides insurance on the assets with a premium of 50% of the value of assets. In this example, the controlled transaction of provision of insurance may be de-recognised by Revenue authorities as the transaction is commercially irrational and there is no third party willing to undertake the transaction.

Takeaway for the taxpayers

The crux of the revised transfer pricing guidelines being that transfer pricing analysis has to be based on actual conduct of the entities on ground rather than allocation of functions and risks on paper. An entity cannot be allocated the significant risks and rewards in the business merely on account of the fact that it has infused the capital necessary for the operation and has been characterised as an entrepreneur in the contract. The performance of key strategic business functions are equally important. Thus, an entity cannot be acting as a principal, if it lacks substance to control and supervise the functions of the service provider. The guidelines are also important for service providers were the characterisation and allocation of risk was undertaken based on a certain set of functions, which have gone up the scale over period of time due to development in the technical expertise of personnel. It would be advisable that the taxpayers revisit the functions being performed on ground to ensure that contractual allocation of risk is appropriate.

In the Indian context, some of the guidance provided in the Action Plan is in line with the position being adopted by Revenue authorities. There has been significant litigation over the characterisation of R&D service providers in India, with Revenue authorities contending that for an Indian entity to be contract R&D centre, foreign entity must have the necessary substance to function as a principal. In this context, Central Board of Direct Taxes had issued Circular 5 / 2013 and Circular 6/ 2013 dated 29th June 2013, which laid down the guidelines for identifying R&D centre as a contract service provider. The circular provided that for the foreign entity to be principal, it should actually control and supervise the research and development functions. The foreign principal should have the capability to undertake strategic decisions, and supervise the activities of service provider on a regular basis. As per the circular, the significant functions of the foreign principal would include conceptualisation and designing of the product and providing strategic direction and framework to the research. The intent of the circular was exactly similar to the guidance under the Action Plan. It warranted actual substance in the foreign entity to be characterised as principal. The guidance in the Action Plan thus strengthens the point of view adopted by Indian Revenue authorities in such cases.

As far as the recommendations under Action Plan 9 is concerned, the OECD has only re-stated the fundamental principles which should be followed while applying transfer pricing regulations in dealing between related parties. This being in the nature of guidance would not require any legislative amendment in the regulations. Considering the recommendations, the onus would be on the taxpayers to align the conduct on ground with the contractual arrangement to avoid transfer pricing disputes going forward.

Sanjay Kumar & Chhavi Poddar*

Action Plan 10 : Other High Risk Areas in TP

Publication of 15 Action items out of the G20/ OECD Project on Base Erosion and Profit Shifting (BEPS) and its acceptance by the G20 Finance Ministers has brought focus on implementation of the BEPS recommendations. Many countries have started the process of implementing them through legislative actions, India is likely to move on to the implementation phase with the budget pronouncements for FY 2016-17. No doubt, BEPS has been a significant work by the international tax community to forge a consensus on issues such as preventing treaty shopping, fighting harmful tax practices, tackling hybrid instruments and developing a regime of acceptable interest deductibility, putting in place a new transfer pricing approach based on risk analysis and value creation, and improving dispute resolution – setting some minimum standards, some reinforced standards and some best practices. But as stated above, while the first step has been a matter of rejoice and hope, its implementation will require similar international political understanding so as to bring the desired change.

In this chapter, we will discuss Action 10 recommendations in the context of cost contribution arrangements, commodity transactions and transactional profit spilt method. The other two important recommendations, under Action 10, on low-value adding intra-group services and hard to value intangibles will be dealt in other chapters.

Aligning value with the activity

The arm's length principle has been the bedrock of transfer pricing rules around the country (with the notable exception of Brazil), with the principles also being embedded in tax treaties (appearing as Article 9(1) of the OECD and UN Model Tax Conventions). While the arm's length principle has been useful in preventing economic double taxation, its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also been seen to be vulnerable to manipulation, leading to outcomes which do not correspond to the appropriate value attribution to the underlying economic activity. BEPS Action 8-10 recommends to ensure alignment of returns with value creation, bringing out close relationship between the economic activity and the contractual terms - functions, assets and risks (FAR). Overall, this will prevent allocating excessive profit or inappropriate returns to members of the MNEs on the primary basis of their contractual terms or capital contributions. To achieve that, the BEPS guidance proposes "accurate delineation of the actual transaction". This basically means that a contractual allocation of risk and associated returns to an enterprise of an MNE group will be respected if and only

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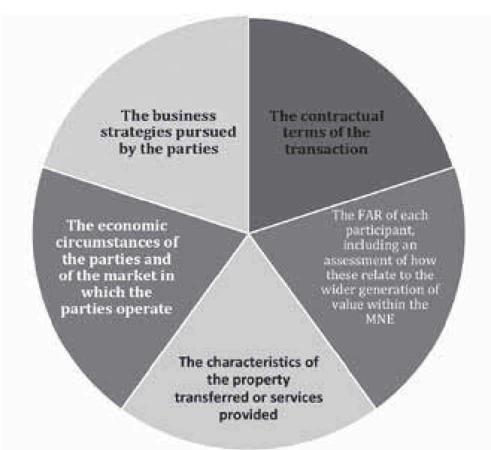
if these entities have the capacity to control the risk as well as financial capacity to bear the risk. Accordingly, the contractual allocation of risk needs to be in line with the actual conduct of the enterprise. Based on this premise, BEPS provides a revised interpretation of the arm's length principle predicated on an expanded view and analysis of the economic substance of a controlled transaction, requiring a significantly granular FAR analysis. Through the accurate delineation, the transfer pricing exercise will aim at pricing the real deal as compared to pricing a written contract which may not reflect the true contribution of the entities in the value creation. This in simpler understanding will mean carrying out value chain analysis, which will basically ask questions such as what is actually happening, and where; who sets strategy, etc. with proper understanding of key functions, assets and risks at each point of the chain for the MNE. The challenge for businesses, however, will be in ensuring that risks are identified and analysed in accordance with the framework set out. This will be a considerable compliance exercise. From a practical standpoints the taxpayers will have to separately identify the various risks involved in their controlled transactions and analyse and document the actual party making the decision to take, lay off and mitigate the risk. The new guidance provides a five-step process for accurate delineation of the transactions between the AEs of an MNE group, as shown in Figure 1.

Figure1: Five-step process for accurate delineation of transactions



Whilst the contractual assumption of risk is the starting point, the agreement needs to be made in advance of the risk outcomes (i.e. *ex ante*). The parties in the contract are required to have both capability (competence) and functional performance (decision-making) in order to exercise control over the risk. Where a party does not assume a risk, nor contribute to the control of the risk, it will not be entitled to any unanticipated profits or required to bear unanticipated losses arising from that risk. Financial capacity to assume a risk is included as a criterion that ranks equally with control when analyzing the assumption of risk. The test of 'financial capacity to bear risk' looks at access to funding (assuming the company is independent) to take on or lay off risk, to pay for risk mitigation functions and to bear the consequences of risk if the risk materializes.

Cash-boxes

Another important aspect of the new guidance is the distinction between the operational risk and financial risk. The guidance provides that an enterprise controlling the funding risk is entitled only to a risk-adjusted financial return rather than a residual return and the entity undertaking the operational risk is entitled to the residual returns. Financial risks refers to the ability to assess the investment opportunity as a provider of financial capital and undertaking such investment decisions as well as funding risk mitigation strategies. On the other hand, the operational risk refers to the ability to assess the implications of the various operational decisions and the capacity to undertake such operational decisions as well as the risk mitigating strategies. The guidance makes it clear in unequivocal terms that if the associated enterprise does not actually control the financial risks associated with its funding, then it will not be allocated the profits associated with the financial risks and will only be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational. This will bring in the guidance on non-recognition. But, what is worth highlighting from the operational point of view that this new guidance may provide results in many intra-group transactions, opposite to the hitherto practice, where the operational entities have been receiving returns under transactional net margin method (TNMM) and the funding entities have been receiving all the residual returns.

Though the work on risk and non-recognition has focused on clarifying and refining proposals that received broad agreement in consultations (such as delineating the actual transaction undertaken), but that has also been supplemented by improvements or clarifications, such as how the 'commercial rationality' test for recognition of transactions will actually be undertaken work, making clear that the financial capacity to bear risk is as important as exercising control over risk. For taxpayers, it will be imperative to document the commercial rationality for entering into the transactions with AEs, especially in respect of transactions that have no comparable transactions in the open market. This also puts onus on the tax authorities to appreciate the concepts like commercial rationality in recognizing the transactions between the associated enterprises, and adopt a broader view in scrutiny of the transactions. Hopefully, the access to additional information on the MNE group through master file and CbC reporting (under BEPS Action 13) and automatic exchange of critical information would be of help to the tax authorities in considering the commercial rationality and thereby ensuring that BEPS recommendation is implemented in spirit. It is hoped that holistic approach to BEPS implementation will ensure that eventually the role of capital-rich, low-functioning entities in BEPS planning will become less relevant. Also, the development of transfer pricing rules to achieve the overall BEPS effect is achieved without the need to develop special measures outside the arm's length principle.

Commodity transactions

BEPS Action 10 outlines transfer pricing rules to provide protection against common types of base eroding payments. Under this mandate, BEPS report has examined the cross-border commodity transactions between associated enterprises, and recommends an improved framework for the analysis of commodity transactions from a transfer pricing perspective which should lead to greater consistency in method for determining arm's length price for commodity transactions and also ensure the BEPS underlying principle of value creation.

It was generally perceived that certain types of transactions such as commodity transactions, intra group transactions, etc., often results in inconsistent pricing methodologies and insufficient documentary evidences. The new BEPS guidance states that for commodity transactions between associated enterprises, comparable uncontrolled price (CUP) method may generally be used as the most appropriate transfer pricing method, but what is important to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable before quoted prices can be used as arm's length price. The guidance also mentions that taxpayers should provide reliable evidence and document to the tax administration, as part of their transfer pricing documentation, so as to help them carry out an informed examination of the taxpayer's transfer pricing practices. The information needed to justify arm's length price would be the quoted price and any other relevant information, such as pricing formulas used, third party end-customer agreements, premia or discounts applied, pricing date, supply chain information, and also information prepared for non-tax purposes. The new guidance also states that the pricing date for commodity transactions should be the date agreed between the parties at the time of pricing the transaction. However, in the absence of such evidence, the tax administrations can adopt any other reliable date that may be adopted in uncontrolled circumstances such as the shipment date subject to the comparability adjustments. This will prevent taxpayers from using pricing dates in contracts that enable the adoption of the most advantageous quoted price. It will also allow tax authorities to impute, under certain conditions, the shipment date (or any other date for which evidence is available) as the pricing date for the commodity transaction. The rules for commodity transactions have been developed based on the experiences of the countries that have introduced domestic rules for pricing commodity transactions.

Transactional profit split method

Transactional profit split method has been one of the least used of the five OECD transfer pricing methods. Not surprising, as both taxpayers and tax administrations find it difficult to apply in an acceptable manner. BEPS guidance on the use of the profit split method, including practical commercial examples, is likely to be of help for both businesses and tax authorities. The work on the transfer pricing guidance on transactions profit split is still going on. However, as a part of the 2015 output, the OECD has issued only a short summary of the status of the on-going work on the use of the method, and further work on the method will be undertaken during 2016-17. It is sincerely hoped that the guidance will be clear on the principles to be taken into account, though it is understood that it may not be possible to provide examples for every situation that may arise given the inherent variety in commercial value chains. The scope of the work on profit split should be to provide clarity and practical examples on the applicability of the basic principles of profit split as provided in the existing OECD transfer pricing guidelines. Consideration of integration of business models and the digital economy will be key elements of the work.

The usefulness of the profit split method is due to the BEPS emphasis on value creation in the highly integrated MNE groups, and for those reasons it notes that the profit split method may be the most appropriate method to align profits with value creation in accordance with the arm's length principle, particularly where the facts of the case make other transfer pricing methodologies problematic. Considering that, the scope of the BEPS work sets out that the revised guidance will be based on the existing OECD transfer pricing guidance (in Chapter II of the Guidelines), but will clarify and supplement it with practical application being illustrated through examples; the starting point of that will, however, remain a robust functional analysis. In selecting the most appropriate method, attention would require to be given to the consequences of greater integration of business models as a result of the digitized economy, and the potential role of profit splits to account for such integration. In addition, the work will develop approaches to transfer pricing in situations where the availability of comparables is limited.

Given the inherent features of the method and divergent views on what constitutes “value”, the application and evaluation of profit split method has so far been a subjective exercise. The guidance is expected to bring more coherence across various jurisdictions on the way ‘value’ and ‘contribution’ is understood and thereby reducing any probable litigation. Also, with introduction of CbC reporting requirement and availability of financial attributes of the MNE group with tax authorities, it is vital to provide appropriate guidance on where and how to apply the profit split method in order to safeguard against the misapplication of such data.

The sharing of profits or losses under a profit split, it needs to be appreciated, reflects a fundamentally different commercial relationship, in particular concerning risk allocation, to the paying of a fee for goods and services. Where a sharing of profits is unlikely to represent an arm's length outcome, the revised guidance should emphasize the need to use and adjust the best available comparables rather than a profit split method. This will be more reliable than an inappropriate use of a profit split method. This work is similar to that of the G20 Development Working Group on toolkits to help low income countries address the challenge of the lack of comparables.

Additional guidance will be provided on dealing with scenarios with significant group synergies and, if appropriate, how profit split methods could be applied to them. The guidance, it is understood, will focus on the need for a strong correlation between profit allocation factors and the creation of value in order to ensure an outcome that is consistent with the arm's length principle. The sensitivities and practical application of various mechanisms for allocation, including the capability to independently verify underlying data, will be included.

Further, the guidance will also provide an evaluation on whether a transactional profit split method can be used to support results under a transactional net margin method, or to determine royalty rates or otherwise help simplify pricing outcomes. This is a welcome move by the OECD to undertake further work for providing guidance on the selection and application of transactional profit split method, as an appropriate use of such method could be very potent in aligning the transfer pricing outcomes with value created by the parties to the transaction.

Discussing profit split method under its different aspects for its proper implementation will be of value, particularly because this is of particular importance to the developing countries like India where the tax authorities believe that the Indian group companies of MNEs perform economically significant functions and also bear risks. But, in the absence of reliable comparable data in the public domain to benchmark such arrangements often results in arbitrary application of the method. Though at present, the instances of the Indian tax authorities resorting to the application of PSM are scarce, but with the increased disclosure by the taxpayers and access to information by the tax authorities, the application of PSM may become more widespread.

Cost contribution arrangement

Cost contribution arrangements (CCAs) are special contractual arrangements among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or to execute services with an expectation that the parties will enjoy the anticipated benefits to be derived from their contributions equitably. The new guidelines address both the asset development CCAs and the service CCA – primary difference being the timing of the expected benefits and the level of risks undertaken in the two arrangements. An asset development CCA is expected to provide ongoing future benefits and entails more risk, while the service provision CCA is expected to provide current benefits with lesser risk. The valuation of CCA is dependent on the substance of the transaction rather than on the contractual form – ultimate valuation being based on the actual risks, responsibilities and expected beneficial interest of the CCA parties.

BEPS guidance places significant importance on the risks borne by the parties since the assumption of risks would influence the prices and other conditions of the transaction. For delineating the transaction, understanding the contractual arrangement between the parties will be considered the first step though importance needs to be also placed on the conduct of the parties based on a detailed analysis of functions performed, assets employed and risks borne by the parties to the transaction. But absence of such appropriate valuations of the contributions and benefits of the CCA will lead to profits being shifted away from the location where the value is created, resulting in BEPS. The BEPS guidance correcting such valuation anomalies intends to work through the "substance over form" of such arrangements, thereby significantly changing the valuation of such CCA arrangements in many cases. The guidelines also require that all the participants to CCA should have the capacity and capability to control the risk. In most of the current CCAs, one party is primarily involved in development and control over CCA risk and the other participants only participate in funding. Therefore, such a requirement of all the participants controlling the risk would pose practical challenges if all the participants do not have senior technical resources. If a participant's role is only that of a funder, the new guidelines limits the return for such participant to only risk free return on capital. The BEPS guidelines, therefore, provide valuation method of CCA based on expected return and periodic reassessment of the CCA to make necessary prospective adjustments. This may eventually change the business arrangements of CCA development.

For the recognition of the transaction, the BEPS guidance has placed importance on the commercial rationale or the business reasons of the transaction. The guidance provides that the actual transactions between the associated enterprises may be disregarded by the tax authorities for transfer pricing purposes, if the arrangement between the associated enterprises, viewed in its totality, differs from what would have been entered into between two unrelated parties behaving in a commercially rational manner. In recognizing the transaction, the tax authorities should also consider the alternatives that are realistically available to the parties. An analysis of whether the MNE group would be worse off on a pre-tax basis due to the transaction / arrangement can be used as an indicator that the transaction viewed in its entirety lacks the commercial rationality. In this context, the guidance cautions the tax authorities on the re-characterization / replacement of the transactions, as it can be a source of double taxation and dispute. In the guidance recommends that 'every effort' should be made to determine the actual nature of the transaction (taking into account contractual arrangements and the conduct) and apply arm's length pricing to it.

The guidance echoes what India has been holding on the identification and allocation of risks based on the conduct of the parties and attributing appropriate return for such allocation / assumption of risks. In fact, specifically for the information technology sector, the Central Board of Direct Taxes through Circular No. 6 / 2013 dated 29th June, 2013 had set out a framework for identifying research and development (R&D) entities that can be considered as bearing insignificant risks in connection with rendering R&D services to the group companies. The circular was issued to clarify the circumstance in which transactional net margin method can be applied as the most appropriate method to justify the R&D services rendered by a taxpayer.

The framework in the Circular resonates the principles provided in the OECD for accurately delineating the controlled transaction by considering the conduct of the parties and the risks assumed. In the referred Circular, importance is given to identifying the party performing the economically significant functions, identifying the party providing economically significant assets including funding of the activities, party exercising control over the functions performed by the other party and finally identification of assumption of risks by the parties through a detailed analysis of conduct of the parties and not based on the contractual arrangement between the parties.

Summary

To summarize, the implementation of BEPS recommendations would witness structural changes in the business transactions, contractual arrangements and mergers and acquisitions along with an appropriate group transfer pricing policies based on detailed value chain analysis of the group. The MNEs would be required to maintain detailed documentation evidencing the actual conduct of parties to substantiate its returns from the arm's length perspective. From a survey of tax executives of MNEs, it is gathered that majority of the respondents believe that sufficient time is necessary for businesses to adapt to the changes anticipated as a result of BEPS. Thus, the law makers should adopt a co-ordinated, slow and steady approach in implementing these guidance. Indian law makers so far have not tried to bring in the laws implementing the BEPS in hurry, but the coming budget should see the BEPS-enabling changes.

CA Vispi T. Patel & CA Bhavya Haria

Action Plan 8-10 Aligning Transfer Pricing Outcomes with Value Creation – Focus on Low Value – Adding Intra-Group Services

Taxation is at the core of countries' sovereignty and fiscal policy, but the interaction of domestic tax rules in some cases leads to gaps and frictions. When designing their domestic tax rules, sovereign states may not sufficiently take into account the effect of other countries' rules. Transfer pricing rules are used by the countries to attribute fair share of revenue of multinational enterprises (MNEs), in the respective jurisdictions. However, the Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan, OECD[1], 2013), has clearly identified that these existing rules, may not always plug the loopholes for such fair attribution. The Action 8-10 of the BEPS Actions Plan aims to provide guidance to align these rules, such that each jurisdiction taxes on an arm's length basis (i.e. a fair basis) the value created by various entities in an MNE group.

Intra-group services have in reality emanated from the strategic imperatives of MNEs to operate globally in a seamless manner, but is sometimes perceived by tax authorities as a tax planning tool used by MNEs for effectively lowering taxable income in a particular tax jurisdiction. The tax authorities look at this transaction as a profit shifting technique and scrutinise the inter-company affairs strictly to determine if any profits are shifted from a high tax country to a low tax country.

OECD BEPS project on value creation

OECD has issued Actions 8-10 of the BEPS Action Plan in order to address the issue of mis-alignment between the outcomes of allocation of profits and the economic activity that produced such profits. The work under Actions 8-10 of the BEPS Action Plan has targeted this issue, to ensure that the transfer pricing outcomes are aligned with value creation, as existing international standards for transfer pricing can be misapplied and may result in allocation of profits not in sync with the economic activity of the enterprise in the MNE group.

Risks are defined as the effect of uncertainty on the objectives of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return. This economic notion that higher risks warrant higher anticipated returns made MNE groups pursue tax planning strategies based on contractual re-allocations of risks, sometimes without any change in the business operations. In order to address this, the Actions 8-10 provide that risks contractually assumed by a party that cannot in fact exercise meaningful

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and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks. The guidance ensures that pricing methods will allocate profits to the most important activities, the aim being to allocate benefits to the ones contributing to such benefits.

Summary

a. The guidance ensures that:

   o Actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality;

   o Contractual allocations of risk are respected only when they are supported by actual decision-making, and ability of the enterprise to control and bear the risk;

   o Capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to 'cash boxes' i.e. cash rich entities without relevant substance;

   o Tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply.

b. The guidance helps to accurately determine the actual contributions made by an associated enterprise that solely provides capital. Where the capital provider does not exercise control over the investment risks that may give rise to premium returns, that associated enterprise should expect no more than a risk-free return.

Contractual Arrangement vs. Conduct of Enterprises

The revised guidance ensures that a transfer pricing analysis is based on an accurate delineation of what the associated enterprises actually contribute in the transaction, not on contractual terms, including contractual assumption of risk, that are not in practice performed.

The conduct will supplement or replace the contractual arrangements if the contracts are incomplete or are not supported by the conduct. In combination with the proper application of pricing methods in a way that prevents the allocation of profits to locations where no contributions are made to these profits, this will lead to the allocation of profits to the enterprises that conduct the corresponding business activities. Where there are material differences between contractual terms and the conduct of the associated enterprises in their relations with one another, the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, should ultimately determine the factual substance and accurately delineate the actual transaction.

The guidance thus, provides a basis for any transfer pricing analysis, as also, it addresses some of the key BEPS challenges: allocating risks on paper does not in itself shift profits. Further, the need for transparency requirements coupled with the alignment of attribution of value and the creation of value will provide a holistic approach to tackling BEPS behaviour.

Basic concept of intra-group services

Intra-group services play an important part in the allocation of costs across the jurisdictions. An intra-group service is a service performed by one member of a multinational group for the benefit of one or more related members of the same group. The OECD Transfer Pricing Guidelines state that generally every MNE provides a range of services to its affiliates in order to benefit from economies of scale or to avoid duplication of services, or both. Typically, these intra-group services are technical, financial, administrative and commercial in nature. However, they may also include management, co-ordination and control functions within the group. Intra-group services typically strategically allow the MNE group to operate globally in a seamless fashion.

There can also be group-servicing centres, such as a shared service centres or a centralised management, central auditing, or financing advice that provide these services across the group. In a transfer pricing context, such intra-group services become significant when they are rendered to related parties located in different tax jurisdictions.

The transfer pricing methodology of such MNE groups needs to be analysed so as to be consistent with international standards regarding the allocation of income and costs among related parties.

There is no specific mention of intra-group services (though there is for cost sharing arrangements) in Indian transfer pricing provisions [i.e. sections 92 to 92F of the Income-tax Act, 1961 or Income-tax Rules, 1962]. The law is still evolving in India and therefore reliance is placed on, and useful inferences have been drawn from international tax practices followed in some other developed countries, along with the OECD Transfer Pricing Guidelines, 2010.

Intra-group service activities may vary considerably among MNE groups, as does the extent to which those activities provide a benefit, or expected benefit, to one or more group members. Each case is dependent upon its own facts and circumstances and the arrangements within the group. For example, in a decentralised group, the parent may limit its intra-group activity to monitoring its investments in its subsidiaries in its capacity as a shareholder. In contrast, in a centralised or integrated group, the board of directors and senior management of the parent company may make all important decisions concerning the affairs of its subsidiaries and the parent company may carry out all marketing, training and treasury functions.

OECD has identified two fundamental issues:

a. Whether intra-group services have in fact been provided

b. Whether any charge is required for the same? If yes, what?

Divergent practices are observed on this issue from country to country.

Low value-adding intra-group services

The OECD *vide* its edition of BEPS in 2015 has introduced a new section on intra-group services. Part D of this section provides specific guidance on 'low value-adding intra-group services'. The primary focus of this chapter is to arrive at an arm's length charge to be made within the MNE group with regards to low value-adding intra-group services. The intention of the OECD is to bridge the gap between the risk analysis conducted by the MNE group with respect to allocation of costs for intra-group services.

The purpose of introducing this new section is to:

a. Simplify the classification of intra-group services which command a very limited profit mark-up on costs;

b. Assist in allocation of such costs;

c. Authenticate the same with robust documentation;

d. Provide a simplified approach for determining arm's length price for such low value services, including a simplified benefits test.

OECD has addressed this issue as a number of countries have indicated that excessive charges for intra-group management services and head office expenses constitute a challenge. Primarily, the countries considering the implementing the approach may do so in combination with the introduction of a threshold. Further, if the payments for low value-adding intra-group services exceed this threshold, then the tax administrations may perform a full transfer pricing analysis to identify the benefit test.

In an MNE group, it is not uncommon that one group entity may provide 'Non-integral services' to another group entity. These services are activities or services which are not the principal business activities of the group entity providing and receiving such services. The 'non-integral services' could be in the form of provision of administrative assistance such as developing accounting or business function manuals and guidelines, assistance in legal, taxation, regulatory compliances, etc. provided by one group entity to another group entity; such activities not being the principal business activity for both these entities.

These guidelines propose an elective, simplified approach which:

- Specifies a wide category of common intra-group services which command a very limited profit mark-up on costs, as in essence these are low value-adding intra-group services;
- Applies a consistent allocation key for all recipients for those intra-group services; and
- Provides greater transparency through specific reporting requirements including documentation showing the determination of the specific cost pool.

The approach aims to guarantee payer countries that the system through which the costs are allocated leads to an equal treatment for all associated enterprises that are operating in similar circumstances. Moreover, the approach aims to guarantee that no overpricing takes place due to general agreement on the categories of costs included in the cost base and general agreement on the moderate mark-up of 5% that should be charged. Finally, the transparency of the approach makes clear to payer countries whether intermediary companies, that may have no or low functionality and may aim to inflate the intra-group service charges, have been interposed.

Definition

Low value-adding intra-group services are:

- Of a supportive nature
- Not part of the core business of the MNE group (i.e. not creating the profit-earning activities or contributing to economically significant activities of the MNE group)
- Do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles, and
- Do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

Following services are excluded from its ambit:

- Services constituting the core business of the MNE group
- Research and development services
- Manufacturing, production, sales, marketing and distribution activities
- Financial transactions
- Services of corporate senior management

The above-mentioned services may not qualify as low value-adding intra-group services because in their specific context they create significant risk or unique and valuable intangibles.

The key elements or principles of the approach developed in this guidance are depicted below:

STEPS OF A SIMPLIFIED APPROACH

STEP 1: DETERMINING POOLING OF COSTS

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STEP 2: ELIMINATING ENTITY–SPECIFIC COSTS

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STEP 3: ALLOCATION OF COSTS

Benefits of a simplified approach

The simplified approach proposed by OECD is premised on the proposition that all low value-adding service costs incurred in supporting the business of MNE group members should be allocated to all the members. The revenue authorities prefer a benefit test for allocation of costs to the matching revenue w.r.t. to the services provided. The simplified approach may lead to reduction in compliance effort for determining arm's length services. It shall also lead to increased certainty of the tax liability in the respective jurisdictions for the MNE group. Further, the certainty will help to reduce compliance risks to a greater extent. MNE groups may elect to adopt the simplified method at the level of a sub-holding company and apply it on a consistent basis across all subsidiaries of that sub-holding company.

Allocation of pool of costs

The direct and indirect operating costs for rendering the service, as well as wherever relevant, the appropriate part of the overheads (e.g. general and administrative costs, etc.) should be pooled according to category of services, on an annual basis, i.e. aggregating a pool of all costs incurred by all members of the group in performing each category of low value-adding intra-group services. However, while pooling the costs together, certain costs like pass-through costs or in-house activity costs which are incurred solely for the entity and not for the MNE group as a whole, need to be excluded. All the costs incurred by various members of the MNE group are pooled together, so that a member of the group can eliminate those costs which are incurred only for the benefit of one of the members of the MNE group. Further, it can also be ensured that no costs are left out from the pooling of costs, before allocation.

The guidance under the simplified approach states that the taxpayer will select one or more allocation keys, depending on the nature of the service, to allocate costs among members of the group. The allocation of the costs in the cost pool should be such that it must benefit multiple members of the group. A consistent approach needs to be followed for identifying the allocation keys.

The simplified approach advocates that the same reasonable allocation key will be used from year to year, unless the facts and analysis justifies a change of such key. The aim being to simplify the determination of an arm's length charge for such services year to year, as a change in the allocation key may lead to complexities.

The OECD has provided certain allocation keys for illustration purpose only:

Type of services	Allocation Key
Services related to people	Share of total group headcount
IT services	Share of total users
Fleet Management services	Share of total vehicles
Accounting support services	Share of total transactions / total assets
General cases	Share of total turnover

The guidance provides that a mark-up equal to 5% of the relevant cost as a standard charge may be charged for all low value-adding intra-group services. The simplified approach envisages a standard set of mark-up for all the low value adding intra-group services falling within the ambit of the definition of the category of services. Each of the group members shall levy/charge the same standard set of mark-up, leaving all the complexities of benchmarking out of the ambit of controversy and further analysis.

Concept of threshold

Another proposal by the OECD is adoption of a threshold limit in order to further analyse and scrutinise the intra-group services wherever the threshold is exceeded. The revenue authorities may arrive at a reasonable threshold, transactions below which may not be analysed in detail. A threshold may be set based on not absolute monetary value but on fixed financial ratios, i.e. percentage of intra-group services to total costs/turnover, etc. which can be a more scientific factor for adoption of simplified approach. The threshold probably provides a check on any erosion of tax base.

Documentation

Documentation is the key for demonstrating adherence to the arm's length principle. Preparation and maintenance of the evidences for demonstrating that the intra-group services are primarily low value-adding would be the basis for adopting the simplified approach. The next stage would be to document the benefits derived from such service and quantify the same in terms of value.

The MNE group electing for application of this simplified methodology needs to prepare and maintain the following information and documentation within the group:

Low value-adding services:

– Description of the categories of low value-adding intra-group services provided to dovetail the same within the definition;
– Identity of the beneficiaries
– Commercial rationale for the provision of services
– Benefit test

Allocation Key

– Description and selection of an allocation key with the reasonable rationale
– Calculations showing the determination of the cost pool and mark-up
– Calculations showing the application of the specified allocation keys

Formal Agreements

– Written contracts or agreements for the provision of services and any modifications to those contracts and agreements reflecting the agreement of the various members of the group to be bound by the allocation rules of this section;
– Such written contracts or agreements could take the form of a contemporaneous document identifying the entities involved, the nature of the services, and the terms and conditions under which the services are provided.

Country-by-Country reporting

In order to give effect to Actions 8-10, under Action Plan 13[2], a three-tiered standardised approach to transfer pricing documentation has been recommended.

Tier 1 – Master File

The MNE group shall provide the tax administrations with high-level information regarding their global business operations and transfer pricing policies in a "master file". It is the aim of the guidance that such data shall be available to all relevant tax administrations.

2. Transfer Pricing Documentation and Country-by-Country Reporting, 2015

Tier 2 – Local file

Further, a detailed transactional transfer pricing documentation shall be provided in a "local file" specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.

Tier 3 – Aggregation of information

Further, large MNEs will need to file a Country-by-Country Report that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.

Taken together, these three documents (master file, local file and Country-by-Country Report) will require taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing 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.

Conclusion

This holistic approach to tackle BEPS behaviour of MNEs is supported by the transparency requirements agreed under Action 13. Transfer pricing analysis depends on access to relevant information. The access to transparent documentation provided by Action 13 will enable Actions 8-10 to be applied in practice, based on relevant information on global and local operations in the master file and local file. In addition, the Country-by-Country Report will enable better risk assessment practices by providing information about the global allocation of the MNE groups' revenues, profits, taxes, and economic activity.

The work under Actions 8-10 of the BEPS Action Plan will ensure that transfer pricing outcomes are better aligned with value creation of the MNE group. Moreover, the holistic nature of the BEPS Action Plan will ensure that the role of capital-rich, low-functioning entities in BEPS planning will become less relevant. As a consequence, the goals set by the BEPS Action Plan in relation to the development of transfer pricing rules are intended to be achieved without the need to develop special measures outside the arm's length principle. Finally, the interaction with Action 14 on dispute resolution will ensure that the transfer pricing measures included in this guidance will not result in double taxation.

The implementation of the guidance is required to be made diligently so as to maintain the level of confidentiality and revelation of trade secrets, etc. and at the same time, also make suitable disclosures in law to avoid erosion of tax base.

In summary, the revisions respond to the mandate to prevent inappropriate returns to capital and misallocation of risk by encouraging thoroughness in determining the actual arrangements between the associated enterprises so that pricing takes into account the actual contributions of those parties, including risks actually assumed, and by authorising the non-recognition of transactions which make no commercial sense. Though India is a part of G20 countries, how far this guidance shall be actually implemented and adopted; and whether it will assist India in protecting its share of taxes, only time will tell; and one also needs to factor in how other countries respond to this guidance.

In essence, transfer pricing needs to be viewed from an end-to-end perspective throughout the value-chain, to correctly attribute value and correspondingly attribute revenue and cost, to the various legal entities involved in the complete value-chain, to bring harmony in such attribution.

 

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BEPS – Action Plan 12 – Mandatory Disclosure Rules

I. Introduction

The integration of national economies and markets has increased substantially in recent years. The current international tax rules have revealed weaknesses that potentially create opportunities for Base Erosion and Profit Shifting (‘BEPS’), which led G 20 policy makers to take steps for ensuring that profits are taxed where economic activities take place and value is created. In September 2013, G 20 leaders endorsed the ambitious and comprehensive Action Plan on BEPS.

On 5th October 2015, the Organisation for Economic Co-operation and Development (OECD) released final reports on all 15 focus areas in its Action Plan on BEPS. The 15-point Action Plan presented by the OECD is around three core principles – coherence, substance and transparency. Substance actions seek to align taxing rights with the relevant value-adding activity. Coherence actions aim to remove unintended gaps in the existing laws. Transparency actions look to provide significant disclosure.

Action Plan 12 of the Base Erosion and Profit Shifting (BEPS) which is Mandatory Disclosure Rules (‘MDR’) forms part of the transparency pillar. The lack of timely, comprehensive and relevant information on aggressive tax planning strategies is one of the main challenges faced by tax authorities worldwide. Early access to such information provides the opportunity to tax authorities to quickly respond to tax risks through informed risk assessment, audits, or changes to legislation or regulations. For example: where information is provided by both taxpayers and advisors (or promoters), tax authorities can potentially influence the behaviour of those that design tax avoidance/ planning schemes (advisor), and also those that implement them (taxpayer). Action Plan 12 Report provides 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

II. Background

OECD issued draft report on Action Plan 12 on 11th May 2015, for public discussion. After receiving inputs and comments from corporate, consulting firms and public at large, OECD issued final report on 5th October 2015.

The recommendation has been drafted based on the experiences of the various countries (like US, UK, Korea, South Africa, Canada, etc.) that have such rules. The recommendations in the report of Action Plan 12 do not represent a minimum standard. Countries are free to choose whether or not to introduce mandatory disclosure regimes. Where a country wishes to adopt mandatory disclosure rules, the recommendations provide the necessary flexibility to balance a country's need for better and timely information with the compliance burdens for taxpayers.

The Action Plan 12 Report makes a series of recommendations about the design of mandatory disclosure regimes intended to allow maximum consistency between countries while also being sensitive to local needs and to compliance costs. The Action Plan 12 Report focuses in particular on international tax schemes, which are viewed as an area of special concern and the primary focus of the BEPS project. It states that disclosure schemes that are intended to address domestic avoidance might not be sufficient to capture cross-border arrangements and provides recommendations for an alternative approach.

Action Plan 12 Report provides three key outputs

(i) Recommendations for the modular design of mandatory disclosure rules;

(ii) Focus on international tax schemes and consideration of a wide definition of tax benefit to capture relevant transactions; and

(iii) Designing and putting in place enhanced models of information sharing for international tax schemes;

III. Key design principles of MDR

Action Plan 12 Report recommends that countries should strive to achieve following objective while designing mandatory disclosure regime:

- MDR should be drafted as clearly as possible to provide taxpayers with certainty about what is required by the regime;
- MDR should balance additional compliance costs to taxpayers with the benefits obtained by the tax administration;
- MDR should be effective in achieving the intended policy objectives and accurately identify relevant schemes to be reported;
- A tax administration needs to implement effective procedures for making best use of the information disclosed by taxpayers.

IV. Recommendation for designing key elements of MDR

Action Plan 12 Report acknowledges that in order to successfully obtain early information about tax planning schemes from the users and promoters of those schemes, certain design features need to be considered when constructing a mandatory disclosure regime. These include: who should report, what information they should report and when they should report. The recommendations under Action Plan 12 are as under:

a) Who should report

Taking guidance from existing mandatory disclosure regimes, the Action Plan 12 Report has recommended two different approaches (1) to impose the primary obligation to disclose on the promoter or advisor; or (2) to impose an obligation on both the promoter and the taxpayer.

[The Report defines promoter or advisor means any person responsible for or involved in designing, marketing, organising or managing the tax advantage element of any reportable scheme in the course of providing services relating to taxation. This definition can include any person who provides any material aid, assistance or advice with respect to designing, marketing, organising or managing the tax aspects of a transaction that causes the transaction to be a reportable transaction.]

Option A: Both the promoter and the taxpayer have the obligation to disclose separately

This approach has been adopted by Canada and the United States wherein detailed information about the transaction and its expected tax benefits will be required to file. This approach would have strong deterrence effect on supply (i.e. advisor/promoters) as well as demand (i.e. taxpayer/client side) of avoidance scheme.

Option B: Either the promoter or the taxpayer has the obligation to disclose

Under this approach promoters have the primary obligation to disclose and if such disclosure is made then users are not, as a general rule, required to provide details of the scheme to the tax administration. This is based on the premise that advisors have better understanding of the scheme and tax benefits as compared to the taxpayers. However, in the following circumstances, report recommends to place the primary disclosure obligation on the user, the way it is in United Kingdom, Portugal, Ireland and South Africa:

- Where the promoter is offshore
- Where there is no promoter i.e. scheme is developed inhouse
- Where the promoter asserts legal professional privilege

b) Which transactions/schemes should be reported

Mandatory disclosure regimes often have a threshold condition. The Action Plan 12 Report acknowledges that threshold conditions can be appropriate because they help keep the number of disclosures to a manageable level. Action Plan 12 Report provides two options to defining the scope of a disclosure regime:

1) Single-step approach which excludes threshold conditions and may generate large number of disclosures. In this scenario, the amount of disclosures can be controlled by other means such as having narrower or more tightly defined hallmarks and/or by filtering disclosures by reference to a monetary limit. For instance the US adopts single step approach however, uses monetary filters in respect of loss transactions.

2) Adopt a multi-step or threshold approach which uses threshold condition of main benefit test (i.e. tax benefit is the primary reason for any arrangement) and/or monetary filter before assessing against specified hallmarks.

Hallmarks act as tools to identify the features of schemes that tax administrations are interested in. In existing disclosure regimes, disclosure is often triggered by an arrangement that includes certain hallmark characteristics. Hallmarks are generally divided into two categories: generic and specific hallmarks.

- Generic hallmarks target common schemes or widely marketed schemes. For example schemes where promoters desire to keep the arrangement confidential or require for premium fee. The Action Plan 12 Report indicates that a country may also adopt additional generic hallmarks (which are less frequently used) which include "contractual protection" where the parties agree an allocation of risk in respect of a failure of the tax consequences of the scheme and "standardised tax product" intended to capture widely-marketed schemes.

- Specific hallmarks reflect the particular or current concerns of tax authorities, and can therefore target areas of perceived high risk. The Action Plan 12 Report recommends that countries may design specific hallmarks considering their local circumstances and may attach a *deminimis* filter to individual specific hallmarks. Under specific hallmarks, the disclosure obligation is triggered by describing certain potentially aggressive or abusive transactions and including them as a hallmark. Examples of specific hallmarks used in existing regimes are:

    - Loss schemes (UK, US : Schemes designed in such a way so as to provide losses to taxpayer that will be used to reduce their income tax and capital gain tax)

- Leasing arrangements – aim to capture benefits derived from leasing arrangement
- Transactions with significant book-tax differences

Thus, Action Plan 12 Report recommends where countries introduce a mandatory disclosure regime they have the option to use a single-step approach or a multi-step/threshold approach with mixture of generic and specific hallmarks. The Action Plan 12 Report indicates that it may be appropriate to use a main benefit test as a pre-condition, with the monetary filters attached to specific hallmarks, so as to ease the administrative burden.

c) Information to report

The Action Plan 12 Report recommends that once a transaction is reportable, the person who is obliged to disclose must provide the tax authorities with particular information about how the transaction works and how the expected tax benefit arises along with details of the promoter and scheme user. The Action Plan 12 Report recommends disclosure of following information:

- Identificaiton of advisors and users which includes the full name, address, phone number and tax reference or identification number;
- Details of hallmark/provision that make the scheme reportable;
- A description of the arrangements and the name by which they are known;
- Details of the statutory provisions on which tax advantage is based;
- Description of tax benefit or advantage;
- A list of clients (which is applicable only to promoters);
- Amount of expected tax benefits

The Action Plan 12 Report also recommends that countries may also want to incorporate provisions which provide necessary powers to tax authorities to enable them to 1) enquire into the reasons for a failure to disclose; 2) inquire into the identity of promoters and intermediaries; and 3) request further follow up information in response to a disclosure.

d) When it should be reported

The main objectives of MDR are to obtain early information on avoidance schemes/transactions and to deter those schemes/transactions and hence, time frame within which tax authorities can obtain information, become extremely critical. The Action Plan 12 Report recommends that where the promoter has the obligation to disclose then the time frame for disclosure should be linked to the availability of the scheme. This is on the premise that at this point the scheme will be sufficiently well-developed to be marketable and all the necessary information on how the scheme works must be available if it is being promoted and sold.

Where a taxpayer has to disclose it is recommended that the disclosure is triggered by implementation rather than availability of a scheme. This is on the premise that at this point it is more likely that there is a real tax loss. However, as the information would be received much later, it would impact the tax administration's ability to react quickly which could potentially lead to greater revenue loss.

e) Consequences of non-disclosure

According to the Action Plan 12 Report, mandatory disclosure regimes should be enforced through financial penalties for non-compliance. The Action Plan 12 Report notes that countries may also implement other types of penalties (including non-monetary penalties) that are coherent with their general domestic law provisions. In addition, the Action Plan 12 Report recommends that domestic law to be explicit about the consequences of reporting under a disclosure regime (e.g., disclosure does not mean that the tax administration agrees with the proposed tax consequences of the arrangement).

f) Use of the information collected

Once a mandatory disclosure regime is introduced there are several ways in which tax authorities can use the information collected to change behaviour and to counteract tax avoidance schemes. These include legislative changes through risk assessment and audit and through communication strategies.

V. International tax Schemes

The above rules do not generally discriminate between schemes that are wholly domestic and those that have a cross-border component. However, as per several countries' experiences with respect to mandatory disclosure regimes, in practice, that countries receive comparatively fewer disclosures of cross-border schemes. The Action Plan 12 Report mentions that the reason for this lower number of disclosures appears to be that the way international schemes are structured, they do not meet the formal threshold condition for disclosure. Thus, the Action Plan 12 Report acknowledges that an alternative approach is recommended for the design of a disclosure regime for "international tax schemes" as it may not always be clear in one jurisdiction whether a tax advantage has been obtained in another jurisdiction.

a) Who should report

The Action Plan 12 Report suggests that MDR should only apply to domestic taxpayers or their advisors or both and only in respect of schemes that have a material impact on domestic tax outcomes in the reporting jurisdiction. Thus, this helps avoiding disclosure obligations on persons that are not subject to tax in the reporting jurisdiction or on advisors that do not provide any advice or assistance in respect of domestic taxpayers or transactions.

Domestic taxpayer includes resident as well as non-resident (to the extent he is subject to a tax reporting obligation on income that has a source or nexus in the reporting jurisdiction). Advisor includes all those persons who can be reasonably expected to have the knowledge of cross-border outcome of the arrangement.

b) Schemes and transaction to be reported

The Action Plan 12 Report recommends that threshold conditions, such as the main benefit test, should not apply to arrangements with cross-border outcomes. This is because the recommended hallmarks would target only arrangements of particular concern to the tax administration. The Action Plan 12 Report recommends that the most direct way of targeting cross-border schemes for the tax administration is to develop hallmarks that focus on the kinds of base erosion and profit shifting techniques that are known to give rise to tax policy or revenue concerns and should be broad enough to capture different and innovative planning techniques.

The Action Plan 12 Report recommends that the definition of reportable scheme in the international context should be broad and should include any arrangement that incorporates a material transaction with a domestic taxpayer and that gives rise to a "cross-border outcome."

c) What type of information to report

The information to be submitted in respect of international tax schemes is largely similar to the information required for domestic tax schemes. Such information should include information about the arrangement so far as it is relevant to the tax impacts in the reporting jurisdiction and should include key provisions of foreign law that are relevant to the cross-border outcome. Taxpayers are required to disclose information that is within their knowledge, possession or control.

VI. Information sharing

The Action Plan 12 Report concludes with a brief discussion of information sharing developments generally and under the BEPS Action Plan. It includes cross-references to the Action Plan 5 requirement of compulsory spontaneous exchange of information on rulings and the Action Plan 13 requirement of a three-tier approach to transfer pricing documentation (including a master file, a local file and a country-by-country report). Further, the Action Plan 12 Report provides an update on the Joint International Tax Shelter Information and Collaboration (JITSIC) Network. It notes that the information to be spontaneously exchanged within the JITSIC Network could include information obtained under a mandatory disclosure regime and that the JITSIC Network provides a forum for co-operation among tax administrations with respect to emerging issues that are identified through such disclosure and exchange.

VII. Benefits of MDR

The Action Plan 12 Report recognises that most of the countries have some kind of disclosure requirements which is in addition to or instead of having a mandatory disclosure regime. However, OECD believes that MDR have edge over other types of disclosure initiatives due to following benefits to tax authorities:

a. Mandatory disclosure applies to a broader range of persons

MDR also include third parties involved in the design, marketing, or implementation of tax planning schemes unlike most of the other disclosure regimes wherein only taxpayer is required to disclose tax planning arrangements.

b. Mandatory disclosure provides information early in the tax compliance process

Early warning allows tax administrations to respond more quickly to tax policy and revenue risks through operational, legislative or regulatory changes. Other disclosure initiatives do not generally provide tax administrations with the same degree of advanced warning.

c. Mandatory disclosure provides specific information on the scheme, users and suppliers

Many countries impose reporting obligations on their taxpayers in relation to particular transactions or require taxpayers to specifically disclose the application of the particular regime. These additional reporting obligations enable tax authorities to improve audit efficiency through better data collection and analysis. However, in contrast to mandatory disclosure regimes, other reporting obligations do not focus on tax avoidance and typically do not directly provide tax administrations with information on tax planning techniques.

VIII. International experiences[1]

The comparative international experience of few countries on MDR has been tabulated below:

Country	UK	South Africa	Canada	USA
MDR	Yes	Yes	Yes	Yes
Who reports	Promoter or user	Promoter or user	Promoter and user	Promoter and user
Which Schemes to be reported	Schemes where main benefit or one of the main benefit test is satisfied	Schemes where main benefit or one of the main benefit test is	Schemes where condition of main benefit test is satisfied along with	Single-step approach where the domestic tax

1. These are not exhaustive provisions and based on secondary sources

Country	UK	South Africa	Canada	USA
	along with generic hallamrks (i.e. confidentiality or premium fee or standardised tax product) and specified hallmarks (i.e. loss transaction, leasing transaction employment income)	satisfied. It excludes arrangements/ schemes where the tax benefit is not the main or one of the main benefits unless the arrangement is listed (i.e. equivalent to specific hallmarks), in which case it is reportable, regardless of whether it satisfies the main benefit test.	generic hallmarks and specified hallmarks. Generic hallmark are confidentiality, premium fee and contractual protection (Any 2 out of 3 hallmarks need to be satisfied). Specified hallmarks are loss transactions, etc.	benefit does not need to be identified. US regime uses monetary filters and other filter for schemes to be reportable
When to be reported	Within 5 days of scheme made available to clients	Within 45 days after an amount first accrues or is received or paid	By 30 June of the calendar year in which transaction becomes reportable	Last day of the month following the end of the quarter in which an advisor becomes a material advisor
Conse-quences of non-compliances	Minimum – GBP 100 per day Maximum-GBP million	Monthly penalty of ZAR 50,000/100,000 and may be doubled or tripled if anticipated tax benefits exceed specific threshold	Tax benefit from a reportable transaction is disallowed until properly disclosed Total of all tax-result oriented fees and contractual protection fees to which promoters/ advisors are entitled in respect of a reportable transaction	Minimum 5000 USD Maximum higher of 200000 USD or 75% of tax benefit

IX. India Landscape

Indian tax regime is supported by an extensive reporting framework like tax audit, income tax returns requiring disclosure of foreign assets, incentives, transfer pricing documentation etc. Further, India already has many SAARs in place which target loss generation scheme, sale and leaseback transaction, gift taxation, etc. Further, tax authorities have wide powers to conduct survey, obtain information including from third parties. An important aspect to note is that most of these existing reporting and tax administration structure is *post facto,* wherein, a taxpayer is required to report transactions at the end of the year. The tax administration also undertakes review once the reporting has been done.

The Indian tax administration provides *pre-facto* measures as well – such as Advance Rulings, Nil / Lower Withholding tax certification etc.; However, these are limited and constitute a minor portion of the existing tax administration framework.

Further, GAAR would be in place with effect from 1st April, 2017 which indicates that Indian judiciary has not favoured aggressive tax planning with no commercial purpose. With BEPS and many Exchange of Information (EOI) treaties including Automatic EOI and CbCR, there will be marked improvement in transparency. It is highly expected that Indian Government would introduce recommendation of Action Plan 13 i.e. CBCR and Master file. Further, Senior Competent Authority of India had mentioned in one of the interview that report on MDR would be viewed independently of GAAR. MDR is a preventive measure which aimed at greater transparency whereas GAAR is something which is *post facto*[2]. Hence, India may consider implementing some disclosure regime which targets early disclosure of tax avoidance schemes.

India is presently promoting the 'Make in India' campaign under which it is attracting foreign investors to invest in manufacturing activities in India. One of the main challenges to this campaign is the ease of doing business in India. Where India seeks to implement the mandatory disclosure regime, it is imperative to ensure that it balances the need for information *vis-a vis* reporting burden and does not impose onerous compliance requirements on tax payers.

X. Conclusion

The OECD's final recommendations under Action Plan 12 are in the form of best practices for countries to consider if they are interested in developing a mandatory disclosure regime. It is important that companies stay informed about any developments with respect to mandatory disclosure in the countries where they operate or invest. In addition to timing and effective dates, jurisdictions considering implementation of a mandatory disclosure regime may vary other key factors, including:

- Whether to place the onus for reporting on promoters or to employ a dual-reporting obligation that includes reporting by the taxpayer as well;
- The type of threshold condition *(de minimis* level or main benefit test) for reporting; and
- Whether to include additional general hallmarks and which specific hallmarks to include.

Apart from cost and compliance burden, over-reporting may not help tax authorities to have qualitative information of really meaningful / aggressive schemes. Thus, it is important that tax authorities take care while designing MDR to avoid vagueness and subjectivity and genuine interests of taxpayers must be safeguarded.

CA Sudhir Nayak* CA Sunil Nayak**

Action Plan 13 – Transfer Pricing Documentation – Country-by-Country Reporting Template and Guidance

Background

Action 13 of the Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan, OECD, 2013) required the development of "rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNEs 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".

In response to the above requirements, the OECD has developed revised standards for Transfer Pricing (TP) documentation and has issued the following interim reports:

a. On 16th September, 2014 – OECD issued a report, which provided a framework of three-tiered standardised approach to the TP documentation i.e., Master File, Local File and Template for Country-by-Country (CbC) reporting.

b. On 6th February, 2015 – OECD issued implementation guidelines for CbC reporting which addressed the matters such as timing of preparation & filing of CbC reports, category of MNE groups required to file CbC reports, conditions for obtaining & use of CbC reports by jurisdictions, etc.

c. On 8th June, 2015 – OECD issued additional guidance on implementation package for CbC reporting. This report included model legislation that countries can use to implement CbC reporting requirements and model competent authority agreements that countries can adopt to facilitate implementation of information exchange between tax authorities.

In October 2015, OECD issued the Final Report on Action 13 merging all the above interim report/guidelines. *This Final report substituted the existing guidelines on the 'Documentation' as contained in Chapter V of OECD Transfer Pricing Guidelines, 2010 by providing revised standards for TP documentation and a template for CbC reporting of income, taxes paid and certain measures of economic activities.*

What was the need for replacing the existing Chapter V on Documentation?

- *When Chapter V of the OECD Guidelines was adopted in 1995, the tax administrations and the taxpayers had less experience in creating and using transfer pricing documentation.*
- *The language used in the said Chapter V put an emphasis on the need for reasonableness in the documentation process from the perspective of both taxpayers and tax administrations,*

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as well as on the desire for a greater level of co-operation between tax administrations and taxpayers in addressing documentation issues in order to avoid excessive documentation compliance burdens while at the same time providing for adequate information to apply the arm's length principle reliably.

- *The language of Chapter V did not provide for a list of documents to be included in a transfer pricing documentation package nor did it provide clear guidance with respect to the link between the process for documenting transfer pricing, the administration of penalties and the burden of proof.*

Therefore, many countries since then have adopted aggressive TP documentation rules. Further, the increase in volume and complexity of international intra-group transactions and the aggressive scrutiny/audits by tax administrations have resulted in significant increase in compliance costs for the taxpayers. The tax administrations also often feels that TP documentation is less than fully informative and not adequate for their tax enforcement and risk assessment needs.

What are the objectives of the revised/new TP documentation requirements?

The three objectives of maintaining TP documentation are:

- *To ensure that taxpayers give appropriate consideration to the transfer pricing requirements in establishing the prices and other conditions for the transactions undertaken with the associated enterprises (AEs) and reporting the income derived from such transactions in their tax returns;*
- *To provide tax administrations with the information necessary to conduct an informed risk based audits; and*
- *To provide tax administrations with useful information to conduct thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction, along with additional information required as the audit progress.*

The final reports also suggest that the above objectives shall be considered in designing the appropriate domestic TP documentation requirements and that the taxpayers are required to carefully evaluate, at or before the time of filing a tax return, their own compliance with the applicable TP rules.

The final reports also suggest countries to adopt documentation requirements reasonable and focused on material transactions in order to ensure mindful attention to the most important matters, keeping in mind the above-mentioned objectives and compliance burden/costs for the taxpayers.

The "Three tiered approach" to the TP documentation

In order to achieve the objectives mentioned above, the OECD has developed/prescribed a 'three-tiered' standardised approach to the TP documentation and have requested the participating countries to adopt the same. The three-tiered framework consists of maintaining the following:

i. *Master File* – containing standardised information relevant for all MNE group members;

ii. *Local File* – containing information on the material transactions entered by the local taxpayers; and

iii. *Country-by-Country reporting* – containing certain information relating to the global allocation of MNE's income and taxes paid together with certain indicators of location of economic activity.

According to the Action 13 Final report, above stated approach to TP documentation will provide tax administrations with relevant and reliable information to perform an efficient and robust transfer pricing risk assessment analysis. As per the report, above stated approach will also provide a platform for the taxpayer to consider the information necessary for an audit and describe their compliance with the arm's length principle for the material transactions.

i. Master File contents in detail

As per the Action 13 final report, the 'Master file' provides a "blueprint" of the MNE group and the information required to be maintained in the master file can be grouped in five categories. Same are as under:

• **Organisational structure** *i.e., chart illustrating legal/ ownership structure, geographical locations*
• **Description of MNE's Business** *i.e., important drivers for business profits, Supply chain chart for five largest products and service offerings plus other products or services amounting to more than 5% of a group sales, Description of geographic markets for the groups products/services, Functional analysis, etc.*
• **MNE's Intangibles** *i.e., List of intangibles and their legal owner, Description of MNEs overall strategy for development, Ownership and exploitation of intangibles, Description of TP policies related to R&D and other intangibles, etc.*
• **Inter-company Financial Activities** *i.e., Description as to how the group is financed including important financial arrangement with third party, Member company which provides central financing function for the group, Description of TP policies related to financial arrangements between group entities.*
• **Financial and Tax Position** *i.e., details of Unilateral APAs and other tax rulings etc.*

As per the final report, the taxpayers shall present the information in the master file for the MNE as a whole. The final report also permits organisation of the information to be presented in the master file by different business lines. Further, the report suggests that, even where the line of business presentation is selected, the entire master file consisting of all business lines should be available to each country in order to ensure that an appropriate overview of the MNE group's global business is provided.

ii. Local File contents in detail

As per the final report, the Local file provides detailed information relating to the specific inter-company transactions. Such information would include relevant financial information regarding specific transactions, a comparability analysis, selection and application of the most appropriate transfer pricing method, etc. The information required to be maintained in the Local file can be grouped in three broad categories, as stated below :

• **Relating to Local entity** *i.e., description of the management structure, organisational chart, description of the business operations and business strategy, key competitors, description of the individuals to whom local management reports and countries in which such individuals maintain their principal offices.*
• **Details of material controlled transactions** *i.e.,*
a. Description of the material controlled transactions (e.g., procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees, licenses of intangibles, etc.) *b. Amount of intra-group payments and receipts for each category of controlled transactions involving the local entity and broken down by tax jurisdiction of the foreign payer or recipient;* *c. Identification of AEs involved in each category of controlled transactions, and relationship amongst them;* *d. Copies of all material inter-company agreements;*

e. Detailed comparability and functional analysis of the taxpayer and relevant AEs (*if the same is already covered in the Master file, cross reference to the master file is sufficient*);

f. Most appropriate TP method selected for each category of transactions and reasons for selecting that method;

g. An indication of which AE is selected as the tested party, if applicable, and an explanation of the reasons for this selection;

h. A summary of the important assumptions made in applying the transfer pricing methodology;

i. If relevant, an explanation of the reasons for performing a multi-year analysis;

j. A list and description of selected comparable uncontrolled transactions/ companies with their financial indicators, search methodology & sources, etc;

k. A description of comparability adjustments performed and an indication of whether adjustments have been made to the results of the tested party or comparable uncontrolled transactions or both;

l. A summary of financial information used in applying the transfer pricing methodology;

m. A copy of existing unilateral and bilateral/multilateral APAs and other tax rulings to which local tax jurisdiction is not a party, and which are rel ted to controlled transactions described above.

- ***Financial information** i.e., Annual financial statements, Summary schedules of relevant financial data for comparable used in the TP analysis and the source of financial data of the comparable.*

The report also suggest that, where a requirement of the local file can be fully satisfied by a specific cross-reference to information contained in the master file, such a cross-reference should suffice.

iii. CbC Report

As per the final report, the CbC report requires aggregate tax jurisdiction-wide information relating to the global allocation of the income, the taxes paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE group operates. The report also requires reporting a listing of all the Constituent Entities and their financial information, including the tax jurisdiction of incorporation, where different from the tax jurisdiction of residence, as well as the nature of the main business activities carried out by that Constituent Entity.

Are there any compliance issues?

The Final report also addresses some of the compliance issues, which are summarized as under:

a. Contemporaneous documentation

- *The report recommends that taxpayer shall give due consideration as to whether its TP is appropriate for tax purposes before the pricing is established and should confirm the arm's length nature of its financial results at the time of filing its tax returns.*
- *As per the said report, the taxpayer is not expected to incur disproportionately high costs and burdens in producing documentation and hence, the tax administration should balance the requests for documentation against the expected cost and administrative burden to taxpayer of creating it/ providing it.*
- *The report also recommends that, where a taxpayer reasonably demonstrates, having regard to the principles of the guidelines suggested, that either no comparable data exists or that the cost*

of locating the comparable data would be disproportionately high relative to the amounts involved in the issue, taxpayer is not required to incur costs in searching for such data.

b. *Timeframe*

- *The report takes cognisance of the fact that, some countries require documentation to be finalised by the time of filing the tax returns and some countries require the documentation to be ready when the audit commences.*

- *The report also mentions that, the time given by tax administrations to taxpayers to respond/ file specific details/documentation requested, differs from country to country.*

Hence, as per the report, the above differences can add to taxpayer's difficulties in setting priorities and in providing the right information to the tax administrations at the right time. Therefore, the report recommends as under:

a. *Local file – shall be finalised by the taxpayer on or before filing of the tax return for a fiscal year.*

b. *Master file – shall be finalised by the due date for filing the tax return of the ultimate parent company. As per the report, in countries pursuing policies of auditing transactions as they occur under co-operative compliance programmes, the information of the master file is necessarily to be provided in advance of the filing of the tax return.*

c. *CbC report – Report recognises that final statutory financial statements and other financial information that may be relevant for reporting may not be finalised until the due date for tax returns in some countries for a given fiscal year. Under such circumstances, the report states that, the date for completion of the CbC report will be extended to one year following the last day of the fiscal year of the ultimate parent of the MNE group.*

c. *Materiality*

The report recognises that the measures of materiality may be considered in relative terms (e.g. transactions not exceeding a percentage of revenue or a percentage of cost measure) or in absolute amount terms (e.g. transactions not exceeding a certain fixed amount). Therefore, the report recommends to the individual member countries to establish their own materiality standards for the Local file purpose and include the same in their TP documentation requirements, based on the size and nature of local economy, size and nature of the entity, etc.

The report also mentions that the CbC report shall include all tax jurisdictions in which the MNE group has an entity resident for tax purposes, regardless of the size of business operations in that tax jurisdiction.

d. *Retention of documents*

The report suggests that, taxpayers should not be obliged to retain documents beyond a reasonable period consistent with the requirements of domestic law at either the parent company or local entity level. The report also mentions that, the way the documentation shall be stored/ maintained (i.e., paper form or electronic form or in any other system) should be at the discretion of the taxpayer and taxpayer shall promptly make available the necessary information to the tax administrations in the required form specified by the local laws & practices.

e. *Frequency of documentation updates*

The report recommends reviewing the TP documentation periodically, in order to determine whether functional and economic analyses are still accurate/ relevant and conform to the applied transfer pricing methodology. The report recognises that, in many situations, business descriptions, functional analyses, and descriptions of comparable may not change significantly from year to year. Therefore, *the report recommends that the searches in databases for comparable, supporting part of the local file, be updated every three years rather than annually, as long as the operating conditions remain unchanged. However, the financial data for the comparable be updated every year in order to apply the arm's length principle reliably.*

f. Language

The language in which TP documentation are to be submitted should be established under local laws. The report recommends countries to permit filing of TP documentation in commonly used languages where it will not compromise the usefulness of the documents. If tax administrations believe that translation of documents is necessary, they should make specific requests for translation and provide sufficient time to make such translation as comfortable a burden as possible.

g. Penalties

- o *The report recognises that, many countries have adopted documentation related penalties to ensure efficient operation of TP documentation requirements and that the country practices with regard to TP documentation related penalties vary widely.*
- o *The report recommends for levying penalty by the tax administrations for non-compliance with the documentation requirements.*
- o *The report also suggests non-imposition of a documentation-related penalty on a taxpayer for failing to submit data to which the MNE group did not have access.*
- o *However, the report also clarifies that, an assertion by a local entity that other group members are responsible for TP compliance is not a sufficient reason for that entity to fail to provide required documentation, nor should such an assertion prevent the imposition of documentation-related penalties for failure to comply with documentation rules where the necessary information is not forthcoming.*

h. Confidentiality

The report recommends that the tax administrations should take all reasonable steps to ensure that there is no public disclosure of confidential information (trade secrets, scientific secrets, etc.) and other commercially sensitive information contained in the documentation package (master file, local file and Country-by-Country Report). Tax administrations should also assure taxpayers that the information presented in TP documentation will remain confidential except such disclosure is required by the country's courts.

Implementation mechanism for Master File, Local File and CbC Reporting

In order to ensure that the Guidance provided are implemented effectively and consistently, the countries participating in OECD/G20 BEPS Project have developed the guidance on implementation of TP documentation and CbC Reporting.

1. Master File and Local File

- *The report recommends that, the implementation of the Master File and Local File elements of the TP documentation shall be through local country legislations or administrative procedures. Therefore, the Master file and Local file shall have to be filed directly by the local entity with its tax administration.*
- *As per the report, countries participating in the OECD/G20 BEPS Project have agreed the adoption and consistent use of the standards prescribed for master file and local file when introducing these elements in the local country legislations.*

2. CbC Reporting

What is a CbC Report? Why a such report is required?

CbC report is part of a three-tiered documentation framework together with Master File and Local File represent a standardised approach to the new/revised TP documentation. CbC report requires the disclosure of the aggregate tax jurisdiction vide information relating to global allocation of the income, taxes paid, and certain other financial indicators of the tax jurisdictions in which MNE group operates and a listing of all constituent entities for which financial information is reported as well as the nature of the main business activities carried out by that constituent entity.

As per the Action 13 report, the CbC report will be helpful for high level transfer pricing risk assessment purposes by the tax administrations. It may also be used by tax administrations in evaluating other BEPS related risks and also for economic and statistical analysis. Thus, information contained in CbC report is expected to enable tax administrations to perform an efficient transfer pricing risk assessment analysis for the purposes of selecting the appropriate cases for detailed scrutiny.

The Action 13 report, however, clarifies that, the information in the CbC report should not be used by the tax administrations as a substitute for a detailed transfer pricing analysis of individual transactions. The Action 13 report also states that the information in the CbC report on its own does not constitute conclusive evidence that transfer prices are or are not appropriate. The Action 13 report further states that CbC report should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income.

When CbC reporting would start?

- *As per the Action 13 report, the first CbC reports are required to be filed for MNE fiscal years beginning on or after 1st January 2016. The first CbC report will be due by 31st December 2017 for the MNE which follows calendar year as its fiscal year.*
- *The CbC report shall be filed within 12 months from the end of the fiscal year.*
- *The Action 13 report also states that the MNE's with fiscal year ending other than 31st December, shall file its first CbC report within 12 months from the close of its fiscal year.*
- *The Action 13 report also clarifies that the MNE's fiscal year relates to the consolidated reporting period for the financial statement purposes and not for the taxable years or to the financial reporting periods of individual subsidiaries.*

Which MNE group is required to file CbC report? Is there any threshold limit?

- *As per the Action 13 report, all the MNE groups with annual consolidated groups revenue equal to or exceeding EUR 750 million or equivalent amount in domestic currency in the immediately preceding fiscal year, shall file the CbC report.*
- *The Action 13 report states that the prescribed threshold of EUR 750 million will exclude approx. 85 to 90 per cent of MNC groups from the requirement of filing the CbC report, but the CbC report will nevertheless be filed by MNE groups controlling approx. 90 per cent of corporate revenues.*
- *As per the Action 13 report, the participating countries will review the threshold set above in the year 2020 to retain or include additional/ different data for threshold.*
- *The Action 13 report mentions that, other than the threshold limit for filing, no other exemption (such as special industry exemption or exemption for non-corporate entities etc.) will be provided.*

Are there any underlying conditions for obtaining and use of CbC report?

As per the Action 13 report, the countries *participating in the BEPS project have agreed to the following conditions for obtaining and using the CbC report:*

- *Confidentiality – The country/jurisdictions should have in place and enforce legal protections of the confidentiality of the reported information.*
- *Consistency – The countries/jurisdictions should use their best efforts to adopt a legal requirement that MNE groups' ultimate parent entities resident in their jurisdiction prepare and file the CbC report and shall use the model template prescribed.*
- *Appropriate use* – The Action 13 report particularly states that:
  - *i. The jurisdictions/tax administrations shall commit to use the CbC report for assessing high level transfer pricing risk only.*
  - *ii. Jurisdictions may also use the CbC report for assessing other BEPS related risks.*
  - *iii. Jurisdictions should not propose adjustments to the income of any taxpayer on the basis of an income allocation formula based on the data contained in the CbC report.*
  - *iv. Jurisdictions are not prevented from using the CbC report information as a basis for making further enquiries into MNE's transfer pricing arrangements or into other tax matters in the course of scrutiny/ audits.*

OECD's Implementation package for Government-to-Government exchange of CbC report

- *The Model legislation contained in OECD's Implementation Package requires the Ultimate Parent Entity of an MNE group to file the CbC report in its jurisdiction of tax residence.*
- *The said model legislation also states that the member countries shall have to enact these model legislations into their own domestic laws.*
- *The model legislation provides for back up mechanism/secondary mechanism for filing of CbC report wherein the CbC report will be filed by a "surrogate parent" (surrogate parent means an entity of the MNE group that has been appointed by the MNE group, as a sole substitute for the Ultimate Parent Entity, to file the CbC report) in situations where:*
  - *i. Ultimate Parent Entity is not required/ obliged to file CbC report in its jurisdiction;*
  - *ii. Jurisdiction in which the Ultimate Parent Entity is resident for tax purposes, has not signed up the relevant information exchange agreements; and*
  - *iii. There has been a failure to exchange the information with jurisdiction after agreeing with that jurisdictions to do so.*
- *The surrogate parent shall file the CbC report in its tax jurisdiction.*
- *As per the model legislation, where no entity of the MNE group is appointed as 'surrogate parent', then the 'local subsidiary/entity' will have to directly file the CbC report in its tax jurisdiction.*
- *As per the Action 13 report, arrangements for automatic exchange of CbC report under the international agreements have been developed which include competent authority agreements based on existing international agreements (Multilateral Convention, Bilateral tax treaties and Tax Information Exchange Agreement). As per the report, the member countries are encouraged to expand the coverage of their international agreements for exchange of information.*
- *The Action 13 report mentions that the implementation of the package will be monitored on an ongoing basis and the outcomes of the monitoring will be taken into consideration in year 2020 review.*

What kind of information is required to be stated in CbC Report Template?

The model templates for the CbC Report recommended by the OECD is given below:

Transfer pricing documentation - Country-by-Country Report

A. Model template for the Country-by-Country Report

Table 1: Overview of allocation of income, taxes and business activities by tax jurisdiction

Name of the MNE group:

Fiscal year concerned:

Currency used:

Tax Jurisdiction	Revenue			Profit (Loss) before Income Tax	Income Tax paid (on cash basis)	Income Tax accrued - current year	Stated Capital	Accumulated Earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

Table 2: List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction

Name of the MNE group:

Fiscal year concerned:

Tax Jurisdiction	Constituent Entities Resident in the Tax Jurisdiction	Tax Jurisdiction of Organisation or Incorporation if different from Tax Jurisdiction of Resident	Research and Development	Holding or Managing Intellectual Property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management or Support Services	Provision of Services to Unrelated Parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding Shares or Other Equity Instruments	Other (note 1)

1. Please specify the nature of the activity of the Constituent Entity in the 'Additional Information' section.

Table 3: Additional Information

Name of the MNE group:
Fiscal year concerned:
Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in the Country-by-Country Report.

Source of data for the above template – The report states that:

- Reporting MNE should consistently use same source of data form year-to-year.
- Reporting MNE may choose to use data from its consolidation reporting packages, from separate entity statutory financial statements, regulatory financial statements, or internal management accounts.
- It is not necessary to reconcile the revenue, profit and tax reporting in the template to the consolidated financial statements.
- If statutory financial statements are used as the basis for preparing the template, then the amounts shall be reported in the functional currency of the reporting MNE. Translation from one currency to other shall be made at the average exchange rate.
- Adjustments are not required for differences in the accounting principles.
- If a change is made in the source of data used from year-to-year, the reporting MNE should explain the reasons for such change and its consequences in the Additional Information section of the template.

Important terms defined and other instructions to the above templates as provided in Action 13 report:

Terms	**Meaning / particulars / explanations**
Reporting MNE	Reporting MNE is the ultimate parent entity of an MNE group
Constituent Entity	Constituent Entity of MNE group is: i. Any separate business unit of an MNE group that is included in Consolidated Financial Statements (CFS) of MNE group, or would be so included if equity interests in such business unit of MNE group were traded on a public securities exchange; ii. Any such business unit that is excluded from MNE group's CFS solely on size or materiality grounds; and iii. Any Permanent Establishment (PE) of any separate business unit of MNE group included in (i) or (ii) above, provided the business unit prepares a separate financial statement for such PE for financial reporting, regulatory, tax reporting, or internal management control purposes.
Treatment of Branches and PEs	The data for PE should be reported by reference to tax jurisdiction in which it is situated and not by reference to tax jurisdiction of residence of business unit of which the PE is a part. Consequently, residence tax jurisdiction reporting for the business unit of which the PE is a part should exclude financial data related to PE.
Consolidated Financial Statements (CFS)	CFS are the financial statements of an MNE group in which, assets, liabilities, income, expenses and cash flows of the ultimate parent entity & Constituent Entities are presented as a single economic entity.
Period covered	The CbC template should cover the fiscal year of the reporting MNE.
Tax Jurisdiction	• A tax jurisdiction is defined as a state as well as a non-state jurisdiction which has fiscal autonomy. • Where a constituent entity is resident in more than one tax jurisdiction, the applicable tax treaty tie breaker should be applied to determine tax jurisdiction of residence. • Where no applicable tax treaty exists, constituent entity should be reported in the tax jurisdiction of the constituent entity's place of effective management (POEM).

Terms	Meaning / particulars / explanations
	• POEM should be determined in accordance with the provisions of Article 4 of the OECD Model Tax Convention.
Revenues	• Reporting MNE should report the sum of revenues of all constituent entities of the MNE group in the relevant tax jurisdiction generated from transactions with associated enterprises & Independent parties. • Revenues should include revenues from sales of inventory and properties, services, royalties, interest, premiums and any other amounts. • Revenues should exclude payments received from other constituent entities that are treated as dividends in the payer's tax jurisdiction.
Profit (Loss) before Income Tax	• Reporting MNE should report the sum of the profit (loss) before income tax for all the constituent entities resident for tax purposes in the relevant tax jurisdiction. • The profit (loss) before income tax should include all extraordinary income and expense items.
Income Tax Paid (on Cash basis)	• Reporting MNE should report total amount of income tax actually paid during the relevant fiscal year by all the constituent entities resident for tax purposes in the relevant tax jurisdiction. • Taxes paid should include withholding taxes paid by other entities (AE and independent enterprises) with respect to payments to the constituent entity.
Income Tax Accrued (Current Year)	The current tax expense should reflect only operations in the current year and should not include deferred taxes or provisions for uncertain tax liabilities.
Stated Capital	With regard to PE, the stated capital should be reported by the legal entity of which it is a PE, unless there is a defined capital requirement in the PE tax jurisdiction for regulatory purposes.
Accumulated Earnings	The information to be reported is as of the end of the year. With regard to PEs, accumulated earnings should be reported by the legal entity of which it is a PE.
Number of Employees	• Reporting MNE should report the total number of employees on a full-time equivalent (FTE) basis of all constituent entities resident for tax purposes in the relevant tax jurisdiction. • Number of employees may be reported as of the year-end, on the basis of average employment levels for the year, or on any other basis, consistently applied across tax jurisdictions and from year-to-year. • Independent contractors participating in the ordinary operating activities of the constituent entity may be reported as employees.
Tangible Assets other than Cash & Cash equivalents	• Reporting MNE should report the sum of the net book values of tangible assets of all the constituent entities resident for tax purposes in the relevant tax jurisdiction. • With regard to PE, assets should be reported by reference to the tax jurisdiction in which the PE is situated. • Tangible assets for this purpose do not include cash or cash equivalents, intangibles, or financial assets.

Terms	**Meaning / particulars / explanations**
Main Business Activities	Reporting MNE should determine the nature of the main business activities carried out by the constituent entity in the relevant tax jurisdiction, by ticking one or more of the appropriate boxes.

Guidance under Action Plan 13 and the Indian context

India being a part of the G-20 group of countries has apparently agreed to adhere to the guidance provided under various Action Plans of the OECD and hence, in order to implement the guidance recommended, India shall have to make necessary amendment to its legislations. There is a reasonable expectation that, there will be many changes in the forthcoming budget 2016 as regard existing TP regulations are concerned. The particular Action Plan 13 will have a far reaching effect on the Indian TP regulations.

Let us now have a look at the nuances of the elements of the Master File and Local File prescribed under the BEPS Action Plan 13 *vis-a-vis* the existing Rule 10D of Income-tax Rules, 1962 (Rules) which deal with the TP documentation.

<table>
<tr><td colspan="2">• Nuances of Master File with Rule 10D of the Rules:</td></tr>
<tr><td>Elements of the Master File</td><td>Presence in Rule 10D of the Rules</td></tr>
<tr><td>Organisational structure of the MNE</td><td rowspan="2">Most of the information suggested are broadly covered under Rule 10D(1)(a), (1)(b) and (1)(c) of the Rules. Specific information not covered includes the important profit drivers of the business and supply chain chart for 5 largest products or service offerings more than 5% of group's sales.</td></tr>
<tr><td>Description of MNE's business</td></tr>
<tr><td>MNE's intangible</td><td>At present, not covered under Rules</td></tr>
<tr><td>MNE's inter-company financial activities</td><td>At present, not covered under Rules</td></tr>
<tr><td>MNE's financial and tax position</td><td>At present, not covered under Rules</td></tr>
<tr><td colspan="2">• Nuances of Local File with Rule 10D of the Rules:</td></tr>
<tr><td>Elements of the Local File</td><td>Presence in Rule 10D of the Rules</td></tr>
<tr><td>Information relating to local entity</td><td>Most of the information suggested are broadly covered under Rules 10D(1)(a), (1)(b) and (1)(c) of the Rules. Specific information not covered include business strategy pursued by the local entity, key competitors and description of the individuals to whom the management of the local entity reports & countries in which such individuals maintain their principal officers.</td></tr>
<tr><td>Information relating to controlled transactions of the local entity</td><td rowspan="2">Most of the information suggested are covered under Rules 10D (1)(d) to Rule 10D (1)(m) of the Rules, except for the details relating to unilateral/ bilateral APAs and similar rulings.</td></tr>
<tr><td>Financial information of the local entity and comparable</td></tr>
</table>

CbC Reporting in Indian context

The existing Indian transfer pricing regulations do not provide for filing of Master file and CbC report. As India is a part of G-20 and BEPS project, it is reasonably expected that India would soon adopt the OECD's three-tiered transfer pricing documentations in the forthcoming Budget 2016.

As per the Action 13 report, the CbC report is required to be filed by the MNE with annual consolidated group revenue equal to or exceeding EUR 750 million (i.e., INR 5,300 crores approx.) in the immediately preceding fiscal year and said report also states that OECD has taken cognizance of the fact that, such threshold would exclude almost 85% to 90% of the MNEs. Most of the large MNEs in India are already subjected to detailed tax assessments under the existing tax provisions. Therefore, considering the purpose of CbC report (assessing the transfer pricing risk for selecting the case for scrutiny), it may be said that CbC reporting has very limited use to the Indian tax authorities in selecting the cases for detailed scrutiny, based on transfer pricing risk assessment.

Nevertheless, Indian outbound MNE groups having consolidated annual revenue exceeding EUR 750 million (i.e., INR 5,300 crores approx.), shall have to prepare and file CbC report. Given the global level of information to be provided in the Master file and CbC report, the Indian MNE shall have to re-assess its business operations, functional and risk analysis to check if there is mismatch between the risks and rewards, possible exposures and accordingly take appropriate measures.

While Action Plan 13 states that the information in the CbC reporting template "may be useful in risk assessment purposes" and "should not be used as a substitute for a detailed transfer pricing analysis", the challenge for the taxpayers could be in defending before the tax authorities the use of such information. The Action 13 also states that the accounting differences are not required to be adjusted while reporting the required information in the CbC report and therefore, the different accounting principles and conventions followed by the entities in different tax jurisdictions, may lead to the distortion of results stated in the CbC report.

CbC related updates around the world

- **On implementation of CbC reporting**

After the OECD released its final Action Plans on 5th October 2015, various countries have started adopting these guidelines. Countries which have already taken initiative in implementing the said new reporting requirements are Spain, United Kingdom, Australia, Germany, Netherlands, United States, Brazil, Denmark and Italy.

Australia

Australia is one of the first country to implement some of the BEPS Action Plans. The law passed by the Australian revenue authorities in December 2015 have focused on foreign MNEs without a permanent establishment and applies to MNEs having a global income of AUD 1 billion (USD 703 million). The limit seems lower than what the OECD has stipulated. The TP documentations including CbC reporting are effective from 1 January, 2016. It is expected that the revenue authorities are going to be more aggressive with enhanced powers to overcome a historically unfavourable record in anti-avoidance court.

USA

USA has proposed regulations in December 2015 which are in general in line with the model CbC reporting template and instructions set forth in Action 13 of the OECD/G-20 BEPS project. However, some aspects of the proposed regulations represent a more detailed or slightly different approach from the approach delineated in Action 13. The threshold proposed to set for CbC filing requirement is USD 850 million and is effective from the year 2017.

Netherlands

The Netherlands amended its legislation to incorporate BEPS on 22nd December, 2015. With this legislation, the Netherlands has implemented recommendations from the OECD's BEPS under Action Plan 13. Companies that have a consolidated turnover of Euro 750 million must file a notification with the Dutch revenue authorities by 31st December, *2016. Further the companies will have to file their CbC reporting by 31st December, 2017 for fiscal year starting from 1st January, 2016. Further, penalties will be imposed for intentional non-compliance or serious misconduct with a potential maximum penalty of Euro 20,250 and criminal prosecution.*

France

An amendment to the Finance Bill 2015, to make CbC reporting by the French Government was rejected by the Senate after the Government resorted to a special procedure to block it. Despite the rejection, the Finance Bill for 2016 has been approved which implements CbC reporting in line with OECD BEPS recommendations in Action 13.

Brazil

The implementation of Action Plan 13 is under discussions. Brazil is going to select the action plans that will suit them.

Japan – *In December 2015, Japan has released draft proposal on Country-by-Country reporting in line with BEPS recommendations.*

Finland

On 21st December, 2015, the Finnish Ministry of Finance sent a draft bill for introduction of Country-by-Country reporting rules for public consultation. The proposal reflects the recommendations issued by OECD's BEPS on Action 13.

Norway

The Norwegian Ministry of Finance published a public consultation paper regarding Country-by Country reporting for tax purposes. The proposal suggests that multinational groups, when the ultimate parent company is a resident in Norway would be required to submit Country-by-Country reports. The reporting requirements could also affect foreign group entities that are resident in Norway if certain conditions are met. The public consultation ends on 25th January, 2016.

Said proposal is in line with OECD's BEPS Action 13.

- **On Exchange of information**

The OECD announced the first signing ceremony of Multilateral Competent Authority Agreement ("MCAA") on Wednesday 27th January, 2016, marking a major milestone towards implementation of OECD/G20 BEPS Project. The representatives from more than 30 countries will sign the MCAA, which will facilitate automatic exchange of Country-by-Country reporting. As per OECD, adherence to the MCAA will enable consistent and swift implementation of the new transfer pricing reporting standards developed under BEPS Action 13, ensuring that tax administrations obtain complete understanding of operational structure of MNEs while also ensuring that the confidentiality of such information is safeguarded.

Conclusion

It is evident from the reading of the Action 13 report that, the OECD has made a concerted effort to balance the requirements both from a tax administration and from a taxpayer perspective. The documentation rules and compliance of the said rules will change how global TP documentations will be maintained and scrutinized going forward. However, one will have to "Wait and Watch" how the taxpayers and the tax administrations/authorities will adopt this complete turnaround in maintaining of the detailed documentation methodology.

It is also important for MNE's operating in India and Indian head quartered companies having international operations to evaluate their existing contracts and operating structures to ensure they are in line with the tax regulations in various jurisdictions and adhere to documentation compliance obligations as required under the Action 13 report.

As the exchange of information between tax administrations or countries worldwide will be shared more proactively, it is expected that "Transparency will be the best policy" going forward. Let's hope that the guidance to be implemented based on the BEPS action plan recommendations, do not become a burden for the taxpayers in complying with it.

 

Kuntal Kumar Sen, Ex-IRS Officer & CA Anand Kankani

Action Plan 14 – Making Dispute Resolution Mechanisms More Effective

Introduction

The credibility of the tax Administration of a country depends to a great extent upon the ability of its system to resolve disputes in a quick, consistent, transparent and fair manner. Besides it is also significant that countries make their alternate dispute resolution mechanism more robust in times to come because of the complexities of Tax Administration and the manner in which business is conducted. To this effect it is necessary that the law, rules and procedures are simple, accessible and non-adverserial.

Action Plan 14 is timely and appropriate towards achieving the above objectives. Action Plan 14 – 'Making Dispute Resolution Mechanisms More Effective', lays down the basic structure, principles and objectives for avoiding double taxation and strengthening the effectiveness and efficiency of Mutual Agreement Procedure. As per the Plan, countries have agreed to recognize the importance of removing double taxation as an obstacle to cross-border trade and investment and accordingly they have committed to develop a minimum standard with respect to the resolution of treaty-related disputes.

Importance of Action Plan 14

- Allows countries to build an investor friendly environment and send a positive message that the country is open to resolve disputes in current complex business setting.
- Implementing this Plan as per the guided principles offers an opportunity to countries to balance out positions adopted in implementing other Action Plans.
- Considering the fact that Base Erosion and Profit Shifting ('BEPS') is in its inception stage where different countries could adopt different positions, this Plan gains importance to resolve disputes till the time the system gets matured enough to handle the complexities which may arise in implementing the other Plans.
- With the expectation that countries are expected to consistently implement this Plan, certain minimum standards have been laid by a set of best practices.
- It is important that the Action Plans which lay down certain minimum standards should be aligned together so that they can be implemented together from a procedural standpoint.

Action Plan 14 has been considered by many stakeholders as important to instil confidence in a dispute resolution system that avoids double taxation and achieves the fair allocation of rights between jurisdictions so that taxpayers do not pay more than their fair share of tax.

Overall, following are the positive developments that reflect significant steps forward in preventing and resolving treaty-related disputes in a post-BEPS environment:

- the commitment to the minimum standard,
- the recommended best practices,
- the peer monitoring mechanism, and
- the support for mandatory binding arbitration.

The report reflects a deep understanding of the complex problems faced by, and potentially created by, Tax administrations as they implement the BEPS initiatives, and recognizes that these issues can only be addressed on a multilateral basis with full transparency.

Independent of the domestic law, Article 25 of the OECD Model Tax Convention provides a mechanism under which the Competent Authorities of two countries may resolve disputes which result in double taxation. This mechanism – the Mutual Agreement Procedure ('MAP') – is accordingly of prime importance to ensure that taxpayers are not subject to taxation by both of the Contracting States on the same income.

India perspective for Dispute Resolution

India has an elaborate structure of Tax Administration, including, in particular, administrative practices for dealing with disputes. The need for efficacy of the system has become more significant in the wake of the ever-growing size and quantum of cross-border transactions, frequent disputes emanating from interpretational uncertainties, and the rapidly emerging convergence between international tax policies across nations.

As far as India is concerned, implementing the Action Plan 14 would be in line with the Indian Government's commitment to provide a non-adverserial tax regime. To make the Action Plan 14 successful from India perspective, certain steps at ground level will be important to ensure that this Action Plan is implemented in its true spirit.

To this end, following recommendations from Tax Administration Reform Commission ('TARC') would serve as a guidance in formulating Action Plan 14 strategy:

- *Taxpayers appear to have lost confidence in the procedure and usually apply for the Mutual Agreement Procedure ('MAP') as a last resort when all other remedies under the Income-tax Act or Constitutional remedies have been exhausted. More often than not, bureaucratic overhang comes in the way of successful negotiation of MAP outcomes between the competent authorities of the two negotiating countries.*
- *Lack of transparency and lack of taxpayers' trust in the functioning of MAP authorities is another key challenge. The present MAP is not sufficiently transparent. The record of discussions in the MAP is not made public. Taxpayers are often circumspect as to the degree of confidential information that they could share with MAP authorities.*
- *Another limitation that constrains the success of the MAP process is the time limit prescribed in Article 25 of the Model Convention (i.e., 3 years) for invoking the MAP remedy.*

In the above backdrop, certain thoughts which will assist India in aligning with the objective of implementing Action Plan 14 with respect to minimum standards are discussed below:

Minimum Standard 1 - Ensure that Treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner

- ***Insertion of Article 9(2) in the Tax Treaties, where it is absent***
  Paragraph 2 of Article 9, where it exists provides that the second country shall

make an appropriate adjustment to the amount of the tax charged on the profits in respect of the profits so adjusted in the first country. Article 9(2) of the OECD Model Tax Convention as well as UN Model Tax Convention also provides for an adjustment to the taxpayer that complies with arm's length standard and these adjustments are referred to as "corresponding adjustments".

Though the OECD Transfer Pricing Guidelines provide for initiating a MAP under Article 25 to determine corresponding adjustments, India has expressed its inability to accept cases under MAP where Article 9(2) does not exist[1,2] . In addition to above, India has also expressed inability to accept bilateral Advance Pricing Agreement applications from countries with which it has a DTAA but the said DTAA does not contain Article 9(2).

Absence of such a path (i.e., denial of MAP option in cases of adjustment in one country) would result in economic double taxation, which would be against the spirit of the Tax Treaty to eliminate double taxation and at the same time to prevent fiscal evasion.

However, it is understood that it is under consideration by India for providing corresponding adjustment, where Article 9(2) is not present in the concerned Tax Treaty, as well as providing access to TP-MAP/bilateral Advance Pricing Agreements under such Tax Treaties. This is a very welcome move.

As per OECD and UN Model Commentaries MAP can be entertained by a country even in the absence of paragraph 2 to Article 9. The OECD Commentary states that the mere fact that Article 9, paragraph 1 is a part of the DTAA reflects the intention of the parties to the Agreement to have economic double taxation covered[3]. It is suggested that India either re-negotiates its Tax Treaties with countries where Article 9(2) is absent to include Article 9(2) or aligns its position with OECD MTC and UN MTC under which MAP can be entertained by a country even in the absence Article 9(2). It is worthwhile to mention that in the Tax Treaties signed by India in recent past (for e.g. Romania in 2014, Sri Lanka in 2014, Malaysia in 2012), India has included Article 9(2) in the Tax Treaties.

It is pertinent to note that inclusion of Article 9(2) in respective Tax Treaties is one of the best practices listed in the Action Plan.

- ***No parallel issues in litigation on MAP issue – non-MAP issues to move forward***
  In addition to the appellate route available under the domestic laws, in cases where the taxpayers have also opted for MAP route to resolve the disputes (for e.g. transfer pricing maters), these issues can be kept aside for disposal under the domestic laws till resolution is reached by the Competent Authorities. However, the non-MAP issues can move forward and adjudicated under the domestic laws. This shall ensure that no multiple views from different authorities on issues under MAP are taken to make the outcomes independent and consistent with the spirit of resolution.

1. Question no 19 on FAQs in India APA scheme issued by Indian Income tax department, TPI Series 43.
2. Some of the key countries with whom Indian Tax Treaties do not have Article 9(2) are Singapore, France, Germany, Belgium amongst some other countries.
3. Commentary on Article 25 concerning the Mutual Agreement Procedure, under the Commentaries on the Articles of the Model Tax Convention issued by OECD.

- ***Transparency***

  Lack of transparency and lack of taxpayers' trust in the functioning of MAP authorities was highlighted to be a key challenge under the TARC report. India will have to create a more open environment which creates confidence in the tax payers approaching this alternate route of dispute resolution. To this effect, the Tax Authorities can share the framework agreed between the Competent Authorities to resolve disputes. This shall serve as a guidance for other taxpayers who may want to pursue this alternate route if they fit within the prescribed framework. It would also be critical for the Government to share MAP data i.e. number of tax payers who have opted for MAP (year wise, country wise, issue wise) and corresponding resolution of MAP cases. As part of the Action Plan, countries are committed to provide their position on mandatory binding arbitration – another aspect to be transparent in its positions adopted. The Action Plan also outlines a number of requirements to provide greater transparency, including the publication of rules, guidelines, and procedures with respect to accessing and using MAP, something which India can consider positively.

  Additionally, an Annual Report can be devised and presented by the competent Authority summarizing the issues dealt with by them, average time taken to reach resolution, key learnings which can be leveraged by other taxpayers. This Annual Report can serve as a reference guide.

- ***Fix time frame***

  One of the disadvantages of MAP is that there are no prescribed time lines for conclusion of the proceedings. The Competent Authorities should typically provide an assurance that they would seek to resolve MAP cases within a given time frame. India should also adhere to these time frames set (24 months suggested in the Action Plan) and the progress of which shall be periodically monitored and reviewed as part of the peer-based monitoring mechanism.

- ***Roll back***

  To ensure that there is no double taxation, a mechanism should be provided which can have a window available for taxpayers which allows them to apply for MAP even if the three year time limit for filing of MAP application is missed. A proper framework around this can be worked out to ensure applicability of MAP resolutions for some of the years outside of the MAP timeline as well if the tax payer satisfies the prescribed criteria.

Ensure the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes

- ***Use of Technology***

  In many rapidly developing Tax Administrations, digital penetration is often comparatively high and this enables them to exploit this infrastructure by introducing technology based channels such as internet portals, and mobile payment options, which serve as powerful levers to improve taxpayer service levels.

  Technology allows for sharing and collaboration, which leads to efficiency and cost effectiveness. It offers scope for customization and personalisation because of which target delivery is made possible and remote access allows users to access services 24*7 from anywhere in the world.

  An elaborate digital architecture can be set up by India to leverage the advantages of technology. Internet portals can be used by the Indian Authorities to disseminate data relating to broad guidelines for applying MAP / alternate dispute resolution mechanism, status of MAP applications, key principles applied for reaching resolution which can serve as guide for tax payers. Tax Administration will have to put in place a system which can provide restricted access to applicants to this platform. Use of video conferencing by Competent Authorities will also serve as significant time and cost efficient tool. These measures would ensure speedy communication, cost efficient administration and easy accessibility irrespective of physical location.

India has started moving in this direction, but will need to speed up its pace to ensure that it has an adequate and appropriate infrastructure in place which enables it to meet the objectives of Action Plan 14.

- ***Administrative set up***

  India needs to ensure that adequate resources are provided to the MAP function and that those responsible for MAP resolutions are not evaluated according to the performance indicators that are based on the amount of adjustment ultimately sustained.

  It is important to note that Tax Administrations will be closely monitored by OECD as to whether they are devoting sufficient resources to run MAP programs.

- ***Adequately trained teams to resolve disputes***

  Indian Authorities need to create a workforce / team which is appropriately equipped to handle MAP cases. In this regard, many tax administrations around the world train their staff in the areas of commercial awareness, risk management and financial management. While undertaking staff development in the area of commercial awareness, the tax administrations often utilize their networks with external organizations including legal and accounting firms. There is also an increasing trend among Tax Administrations to partner with educational bodies for training purposes, with some working with universities to develop externally accredited training programmes. Indian Authorities have taken several steps towards capacity building of their teams. These efforts have to be sustained and made more creative to keep pace with similar capacity building initiatives by other countries.

Ensure that taxpayers can access the MAP when eligible

- ***Amending Article 25(1) to enhance coverage***

  The Action Plan clearly emphasizes that both Competent Authorities should be made aware of MAP requests so as to provide their respective views on whether the request would be accepted or rejected. This is to be achieved by either amending paragraph 1 of Article 25 that permits a request be made to "**either**" Contracting State, or in the absence of such, implementing a bilateral notification or consultation process when the competent authority to which a MAP case is presented does not consider the tax payer's objection to be justified. This is a welcome move and India Authorities should positively consider this for resolving disputes.

- ***Access to rulings***

  At present, there is no mechanism to disseminate any ruling given by the tax authorities in Competent Authority proceedings. For proper guidance and awareness of tax payers, Authorities can publish on a no name basis, grounds and issues of MAP resolution with adequate safeguards. This can be made part of Annual Report which can be put on the portal.

Mandatory binding arbitration

Following the release of the Discussion Draft, a number of stake holders expressed the need for consensus on mandatory binding arbitration as the best way to guarantee that Treaty related disputes are effectively and efficiently resolved through MAP. OECD has been unable to achieve full agreement on mandatory binding arbitration, but in addition to the minimum standard, a group of 20 countries have committed to the inclusion of such provisions in their bilateral Tax Treaties. It is pertinent to note that India is not part of these 20 countries. To ensure non-double taxation, accord certainty to taxpayers, and align our dispute resolution mechanism with international best practices, it is critical that India agrees to adopt mandatory binding arbitration. It is pertinent to note that India recently promulgated the Arbitration and Conciliation (Amendment) Ordinance 2015, which marks a significant change in the arbitration landscape of India. Most significantly, this Ordinance seeks to restrain judicial intervention in arbitration and tackle inordinate delay with arbitration-related court actions. India should align the aforesaid Ordinance to the Action Plan 14. Time has also come, when India includes the arbitration process in the Income-tax Act, 1961 and adds this as an alternate and effective dispute resolution mechanism. Suitable amendments would be required to be made in the Income-tax Act laying down the procedure and guidelines for resolving disputes through the independent arbitration model. Appropriate changes would have to be carried out to include the arbitration process in the Tax Treaties which India has entered into.

Conclusion

Companies are spending a significant amount of time and effort on managing the tax risks by putting up complex structure. Further, the change over the last decade in the manner MNCs conduct their businesses globally adds up to this complexity and poses difficult questions, which one did not anticipate when the rules were initially drafted. As tax authorities around the globe are resorting to positions to ensure that they have their fair right of tax, MNCs face a large number of disputes which they need to manage.

Under this backdrop, it is important to recognize the importance of resolving disputes through the alternate mechanism as there has been an increase in the number of disputes. This will support the broader objective of creating image of investor friendly jurisdiction and ease of doing business. India is no exception to this rule and implementing Action Plan 14 would be a stepping stone to achieve this objective. The Indian Authorities will have to invest time and resources to ensure that India achieves this objective.

As the MAP procedure is typically a special treaty-based procedure falling outside domestic law, the tax administration has to recognize that the competent authority has sufficient legal authority to enter into mutual agreements and to ensure they are implemented. The role of the competent authority, therefore, needs to be clearly recognized and understood in this context.

As regards implementation of the Action Plan is concerned, the starting point could be that the G20 countries agree and sign a multilateral agreement with standard clauses in their respective Tax Treaties. This would save, to a large extent, the need for individual countries to amend their Tax Treaties individually and result in consistency across the table.

Hariharan Gangadharan, *B.Com. LL.M.*

Action Plan 15 – Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

Background

The BEPS package of measures released last year marks the successful completion of a two year long process of identifying strategies for reforming the international tax system. While the debate over the merits of these substantive proposals continues, the focus is now shifting to the process of implementation of these measures. Although the final reports are stated as representing the consensus view of the participants to the BEPS project, it is only in the course of the actual implementation that the success or otherwise of this initiative will become apparent.

Various measures proposed as part of the final package of BEPS are designed to be implemented through changes in domestic law or practice and changes in treaties. While changes in domestic law based on the BEPS measures are relatively simpler to implement, the issue of making changes to the thousands of multilateral treaties is far more challenging. For instance, it has been noted that even when changes are made to the OECD Model Convention by consensus, it takes several years before these changes are actually incorporated in treaties through bilateral negotiations.

Recognizing that a process of gradual modification of thousands of bilateral treaties to bring them in line with the BEPS measures could take years, if not decades, the feasibility of a multilateral instrument that would have the same effect as a simultaneous renegotiation of multiple bilateral treaties was explored as one of the Actions in the BEPS project.

This was undertaken as Action 15, which aimed at streamlining the implementation of tax treaty related BEPS measures. The Report noted that such an approach had no exact precedent in the tax world, but drawing on various other areas in public international law, it concluded that such a multilateral instrument was both desirable as well as feasible. An *ad hoc* Group was also set up and tasked with developing such a multilateral instrument with a view to opening the instrument for signature by 31st December 2016.

What is the need for a multilateral instrument?

Saving of time and effort

As mentioned above, renegotiation of treaties is often a long drawn process that may take years, if not decades in some cases. For instance, the India-Mauritius treaty has been reported as being in the process of renegotiation for several years now and there is no clarity on when, and indeed if, any amendment will take place. There are several reasons for this phenomenon. Treaty negotiations and re-negotiations are specialised functions and most Governments lack the skilled manpower required to pursue multiple negotiations and re-negotiations simultaneously. While this problem is by no means limited to the developing world, it is particularly acute in their cases. As a result, one often sees this process drag on for years due to infrequent negotiation meetings – with no more than one or two meetings taking place a year.

In fact, the Report notes that in many cases, actual treaties are often not in sync with the model tax conventions due to delays in the bilateral negotiation process. It is therefore felt that the agreed changes to treaties as part of the BEPS measures could take as much as a generation to fully implement, if countries were to try and accomplish this through the usual bilateral process. Since this could potentially undermine the political objective of tackling BEPS on a priority basis, a multilateral instrument is seen as critical in ensuring the successful roll-out of BEPS.

Most importantly, there would be an exponential savings of time and effort that would otherwise be required to negotiate multiple bilateral treaties. For instance, if 20 countries, each having bilateral treaties with each other, joined in a multilateral agreement, the need to enter into 190 bilateral agreements among them would be avoided! Naturally, the larger the number of countries who sign on to such a multilateral instrument, the bigger the savings.

Negotiation expertise

As opposed to bilateral treaty negotiations, in a multilateral context, similarly minded countries (particularly from the developing world) can co-operate and pool their limited tax treaty negotiation expertise in the multilateral process.

Efficiency gains

Current bilateral treaties, even though modelled largely on the OECD or UN Model Conventions, still differ from each other on several small aspects. These variations, in particular, lead to conflicting interpretations and end up occupying significant time and attention of treaty negotiators, taxpayers as well as the Courts. In the BEPS context, if anti-BEPS measures were to be incorporated through a bilateral negotiating process, there could be similar variations from treaty to treaty, which in turn could lead to inconsistent interpretations. It is felt that a single multilateral instrument will be preferable to thousands of similar but slightly varying texts since this can help obviate these concerns and produce consistent outcomes.

Specific benefits of a multilateral instrument

The existing treaty network is not geared up to address specific issues that arise in the context of modern business such as global value chains and multi-country structures (e.g. in triangular cases). A multilateral instrument will help address some issues such as a multilateral Mutual Agreement Procedure (MAP) process, which may otherwise be difficult to accomplish through a traditional bilateral process.

What will be the scope of the multilateral instrument?

Changes to the model tax conventions as well as modifications of existing bilateral treaties are seen as essential to address BEPS related challenges. The key substantive issues (set out in multiple Actions of the Final BEPS measures) which are likely to form part of the multilateral instrument are summarised below:

Action 2: Neutralising the scope of Hybrid mismatch arrangements

In the context of Action 2, in addition to various domestic law rules that are proposed to counter hybrid arrangements, changes to treaties are also proposed to provide for new rules to determine the tie-breaker residency of dual-resident entities. Additionally, changes are also proposed to deal with the issue of the applicability of tax treaties to hybrid entities.

Action 6: Preventing the granting of treaty benefits in inappropriate circumstances

The prevention of treaty abuse is among the most important objectives of the BEPS exercise. In this regard, a three-fold change is proposed to tax treaties to limit its applicability in inappropriate circumstances. These are:

– Inclusion in tax treaties of a clear statement/preamble that treaties are entered to avoid creating opportunities for non-taxation or reduced taxation through evasion or avoidance including treaty shopping arrangements

– A specific anti-abuse rule in the form of a comprehensive Limitation on Benefits ('LOB') Article which will comprise of various conditions based on factors such as legal nature, ownership, general activities etc.

– In order to address other forms of treaty abuse that would not be covered within the LOB clause, a more general anti-abuse rule based on a 'Principal Purpose Test' or a PPT rule to be included in the OECD Model Convention

Given India's long standing concerns on treaty abuse, particularly as regards the exemption for capital gains under the Mauritius, Cyprus and Singapore treaties, the inclusion of strong anti-abuse provisions in its bilateral treaties will have a significant impact on Indian inbound structures.

Action 7: Preventing the artificial avoidance of PE status

As regards this article, four specific changes are proposed to ensure that artificial avoidance of PE status is prevented. These include:

– Widening of the scope of the PE definition to cover selling of goods in another State through 'Commissionaire' arrangements or similar strategies;

– Blocking the artificial avoidance of PE status through specific activity exemptions (preparatory and auxiliary clause)

– Dealing with avoidance of PE status arising from a fragmentation of activities between closely related parties:

– Splitting-up of contracts amongst group entities to avoid a PE

Action 14: Making dispute resolutions mechanisms more effective

In addition to administrative steps to strengthen the MAP process, a provision is also proposed to be made in respect of a mandatory binding MAP arbitration in bilateral tax treaties as a mechanism to guarantee that treaty-related disputes will be resolved within a specified timeframe.

How will a multilateral agreement work in practice?

Relationship with existing treaties

The principle of *lex posterior derogate legi priori* (the latter in time prevails) will ordinarily apply to clarify that existing bilateral treaties will continue to apply only to the extent their provisions are compatible with a lateral multilateral treaty. Despite this, it is envisaged that, with a view to ensure certainty, it would be advisable to specifically provide for a 'compatibility clause' in the multilateral instrument which will expressly govern its relationship with the bilateral treaty.

At a practical level, it is expected that the relationship of a multilateral treaty with bilateral treaties will be similar to that of a protocol to an existing treaty. Just as treaty provisions are read subject to provisions contained in a protocol, a bilateral treaty will have to be read subject to modifications contained in the multilateral instrument. A multilateral instrument will:

a) Modify specific provisions contained in most bilateral treaties (e.g. the definition of Permanent Establishment, tie-breaker test for dual-resident corporations etc.)

b) Add new provisions that are specifically designed to counter BEPS (e.g. LOB clauses, the Principal Purpose test etc.)

c) Clarify the compatibility of tax treaties with other BEPS related measures proposed as part of the BEPS project.

Thus, the objective is to achieve a concurrent and integrated application of the multilateral instrument to bilateral treaties.

In an Indian context, the language of section 90 appears to contemplate only bilateral agreements. Hence, prior to any multilateral agreement coming into force, it is possible that amendments may need to be carried out to:

a) Enable the Central Government to enter into an multilateral agreement (i.e. in section 90(1)); and

b) Define the relationship between a multilateral instrument, bilateral treaties and domestic law (in section 90(2))

Applicability of the multilateral instrument when there is no bilateral treaty

The Report clarifies that a multilateral instrument will only govern the relationship between parties who have concluded bilateral treaties amongst themselves. Hence, it would have no impact as between countries who do not have any bilateral treaty relationships.

However, one exception to this rule that could be carved out relates to the multilateral dispute resolution mechanism. It is possible that such a dispute resolution mechanism could operate among all parties to the instrument, including in cases where certain parties do not have bilateral treaty relationships between themselves.

Relationship between the multilateral instrument and bilateral treaties concluded after the multilateral instrument comes into force

It is recognized that to ensure that the multilateral instrument is not undermined through later bilateral treaties, certain parameters may have to be set out to govern future treaty making powers of the parties. While no formal recommendations have been made, it is possible that such parameters will take the form of a forward looking 'compatibility clause' or an 'obedience clause'. These clauses typically stipulate that parties to the multilateral instrument will not conclude subsequent agreements amongst themselves that contradict the provisions of the multilateral instrument. However, these do not necessarily limit the parties' power to extend, amplify or supplement the provisions of the multilateral instrument by bilateral treaties.

There are several examples of such 'compatibility' or 'obedience' clauses existing in public international law today, including in the European Convention on Extradition, Vienna Convention on Consular Relations, the Chicago Convention on International Civil Aviation, the UN Convention on the law of the Sea etc.

Since these clauses impose significant restrictions on a country's sovereign treaty making powers, one could expect some significant debate on the language and structure of such clauses during the course of the negotiation of the multilateral instrument.

Relationship between signatories to the multilateral instrument and non-signatories

It is a basic principle of international law that treaties are binding only on the signatories thereto. Hence, a multilateral instrument will have no legal force whatsoever as regards countries who are not signatories thereto. Hence, a signatory to a multilateral instrument and a non-signatory will be governed by the provisions of a bilateral treaty between them (if any) or by provisions of their domestic laws.

This factor is a crucial one, and may have a significant bearing on the overall success of the BEPS project.

Consistency in interpretation and implementation

In order to ensure consistency in interpretation and implementation, it is proposed that the multilateral instrument could be accompanied by interpretative guidance in the form of an Explanatory Report or a Commentary thereon. The relationship between the instrument and the commentary could also be defined in the multilateral instrument itself.

Will there be flexibility in the level of a country's commitment to the multilateral instrument?

It is acknowledged that if the objective of the multilateral instrument is to be achieved, the commitments undertaken by the parties must be closely aligned. As in any area of international law, full alignment of commitments by parties is a distant, and possibly unrealistic goal. Hence, if a viable multilateral instrument is to see the light of day, it is essential that countries are given some flexibility to tailor their commitments under the instrument.

Such flexibility can either be vis-à-vis the substance of specific provisions (for example by a country excluding the applicability of mandatory arbitration in MAP disputes), or it can be vis-à-vis specific parties (for example by a country varying its level of commitment to a particular country). The mechanisms for building in flexibility in the multilateral agreement are briefly discussed below:

Flexibility in the level of substantive commitments

As regards substantive commitments, there are three broad ways in which flexibility can be built into the multilateral instrument. This will take the form of the parties undertaking to commit to a core set of provisions in the multilateral instrument with the possibility of either:

a) opting out of certain measures; or

b) making a choice between alternative measures; or

c) opting in to additional measures

Opt-out mechanisms

An opt-out mechanism is the most common means of providing flexibility in international treaties. This involves a country excluding or modifying the effect of certain specific provisions under a specific mechanism provided for such a purpose under a treaty.

For instance, Article 124 of the Statute of the International Criminal Court expressly permits parties to declare that "for a period of seven years after the entry into force of this Statute for the State concerned, it does not accept the jurisdiction of the Court with respect to the category of crimes referred to in Article 8 when a crime is alleged to have been committed by its nationals or on its territory" (emphasis supplied)

Even in cases where there is no express opt-out mechanism under a treaty, it may still be possible for a country under customary international law to make a reservation at the time of signing or ratifying a treaty whereby it excludes or modifies the legal effect of certain provisions. However, such reservations will have no legal effect if they are specifically prohibited under a treaty, or if they are incompatible with the treaty's object and purpose.

Hence, with a view to ensuring that the use of indiscriminate reservations do not render the multilateral instrument unworkable, it is stated that the instrument could allow for reservations only for certain provisions by setting out an exhaustive list of permitted reservations. A similar approach has been followed in the Convention on Mutual Administrative Assistance in Tax Matters, which permits signatories to make reservations, but only as regards six specific areas. It is also expressly provided that no other reservations can be made.

A similar approach could be adopted in the multilateral instrument.

India too, has made reservations in several of its treaty obligations. For instance, reservations have been made by India in respect of its adherence to the jurisdiction of the International Court of Justice, Convention on the Elimination of all Forms of Discrimination against Women, the Convention for the Suppression of Terrorist Bombings 1997 etc.

Given India's strong opposition in respect of binding arbitrations in relation to MAP matters, one could expect that a reservation on this issue will be made.

Choice between alternative measures

Another means of building in flexibility is to provide for alternative measures and offer contracting states a choice between them. Such a choice may have to be exercised at the time of acceding to the treaty.

In the context of the BEPS measures, Action 6 (dealing with treaty abuse) provides for a Limitation on Benefits Article that may form part of the multilateral instrument. Two variants – a detailed version and a simplified version are proposed in the Report, and it is possible that a choice may be given to countries as to which option they would accede to.

Such a choice, while not uncommon in public international law, may be somewhat difficult to administer in the context of the proposed multilateral instrument. This is because, unlike in the case of pure multilateral obligations, the proposed multilateral instrument is intended to operate bilaterally. Hence, there could be complications in cases where treaty partners exercise conflicting choices. The instrument will have to address such situations and provide for resolving such inconsistencies.

Opt-in mechanisms

Opt-in mechanisms are intended to enable participants to accept obligations, which in the absence of an express acceptance would not be applicable to them. For instance, if the proposals for binding arbitration in MAP matters does not find widespread acceptance, instead of requiring dissenting countries from making a reservation in respect thereof, it could be structured as an opt-in provision that would apply only to those countries that specifically opt for its application.

Mechanics

In terms of the implementation, the negotiation of the multilateral instrument is to take place within an *ad hoc* non-permanent Group set up in February 2015 which is convened under the aegis of the OECD and the G20. Various technical sub-groups could be established as necessary in this regard. Membership of the Group is open to all interested States and all members of the Group participate on an equal footing. Over 80 countries have joined the group, including India.

The group has been tasked with preparing the multilateral instrument such that it is open for signature by December 2016.

Conclusion

The proposed use of a multilateral instrument as a means to implement treaty related BEPS measures is a novel idea. The Report identifies several precedents in public international law, which could serve as a useful basis for its drafting. Thus, in theory, this could resolve many of the challenges associated with the implementation of BEPS.

From a practical perspective though, this still remains uncharted territory. Taking recourse to a multilateral instrument while applying a bilateral treaty by itself is a workable proposition. However, given the large number of treaty parties, the task of forging a workable consensus could prove difficult. For instance, evolving a consensus amongst a large and diverse group of countries with conflicting objectives could require:

a) Adopting broad and non-specific language in the agreement itself; or

b) Preparing for a large number of reservations, declarations etc. by countries seeking to tailor the language of the instrument to address their specific requirements and concerns.

These problems are all too obvious in public international law and are often cited as the reasons for its general ineffectiveness. However, in the case of public international law, the affected parties are often nation-states, who do not frequently seek judicial redress through international fora. In the context of the proposed multilateral instrument though, taxpayers across countries are directly involved and recourse to local courts and Tribunals is inevitable. This could magnify these challenges and lead to uncertainty for taxpayers.

  

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BEPS and The Multilateral Instrument

The avoidance of juridical double taxation has till date been addressed by countries entering into bilateral tax treaties. The framework for these treaties has evolved since the 1920's based mainly on the work of the League of Nations Tax Committees, the Organisation for Economic Co-Operation and Development ("OECD") and UN Model Tax Conventions. Supported by the development of these conventions, the international tax framework developed around a vast network of bilateral tax treaties following the so-called "classification and assignment of sources" method, in which different types of income are subject to different distributive rules. This schedular nature of distributive rules entails a preliminary step, whereby the income subject to conflicting claims is first classified into one of the categories of income defined by the treaty. Where an item of income falls under more than one category of income, double tax treaties resolve the conflict through ordering rules. Once the income is characterised for treaty purposes, the treaty provides distributive rules that generally either grant one contracting state the exclusive right to exercise domestic taxing rights or grant one contracting state priority to exercise its domestic taxing right while reserving a residual taxing right to the other contracting state.

The Vienna Convention on the Law of Treaties provides in Article 26 "*Pacta Sunt Servanda*" that every treaty in force is binding upon the parties to it and must be performed in good faith. Article 27 on Internal law and Observance of Treaties provides that a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.

Over the years and hastened by globalisation, bilateral treaties contracted between countries have created a complex network (in excess of 3,000) of such treaties. Despite the general principles of treaty interpretation set out in the Vienna Convention, taxpayers, tax administrations, lawyers and courts spend considerable time, energy and resources in interpreting the interface between bilateral tax treaties and domestic law and the differences between these treaties as each treaty represents a different agreement between sovereign countries. The amendment to an existing bilateral tax treaty is undertaken through the two countries agreeing to a new protocol to amend the treaty which takes up considerable time and resources of both. A number of Base Erosion and Profit Shifting ("BEPS") issues arise on account of gaps in the existing bilateral tax treaty structure of the international tax regime.

The BEPS Action 15 Report recognises that even if a large number of countries multilaterally agree to a change in the model tax conventions and their respective tax treaties, if such consensus is attempted to be reflected through numerous protocols to existing bilateral tax treaties, it would add another layer to an already complex structure. The Report concludes that only a Multilateral Instrument can overcome the practical difficulties associated with trying to rapidly modify all the existing bilateral tax treaties and would also save on time and resources besides giving better clarity to the anti-BEPS related modifications of the treaties.

The BEPS Action 15 Report further narrows down the structure of such a Multilateral Instrument to one that coexists with and modifies bilateral tax treaties. *("The most promising approach for pursuing the goal of a multilateral instrument to consistently modify the existing, varied, 3000+ tax treaty architecture involves developing a multilateral instrument that would co-exist with bilateral tax treaties"- Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, ACTION 15-2015 Final Report.)*

The 'co-existence' approach has been preferred over the other two options – a 'self-standing' instrument which supersedes bilateral tax treaties might impinge tax sovereignty while a bundle of 'amending protocols' to existing treaties would be technically complex and less efficient than the 'co-existence' approach.

The Report suggests examples of the different anti-BEPS Actions which would envisage changes or modifications to bilateral tax treaties through a Multilateral Instrument. These are –

a) Multilateral Mutual Agreement Procedure ("MAP") to resolve multi-country disputes by consultation between the competent authorities of all parties that are concerned with a taxpayer operating across all their jurisdictions (Action 14);

b) Countering dual resident company structures (Action 2);

c) Avoiding 'double non-taxation' situations through hybrid arrangements by consistently modifying existing tax treaties so that the eligibility of tax benefits of payments made to entities in another jurisdiction is based on looking across jurisdictions to determine whether the corresponding income actually accrues for taxation in the hands of the recipient entity (Action 2);

d) "Triangular" cases involving Permanent Establishments in third states (Action 7); and

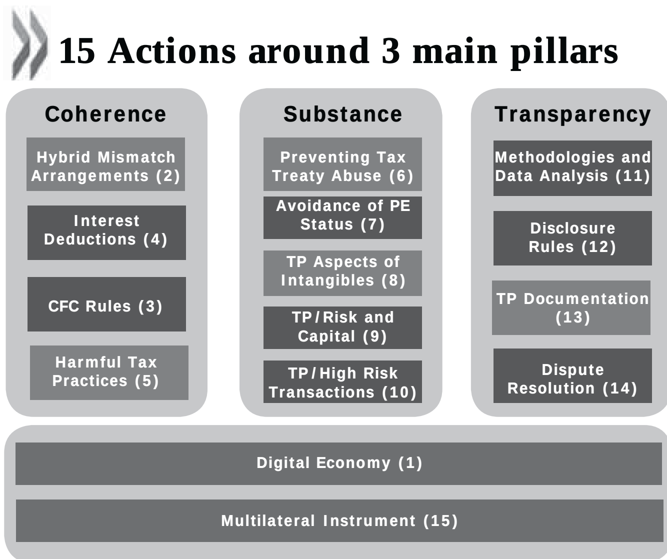
e) Treaty abuse (Action 6).

To this end, Action 15 was conceived as follows on developing a Multilateral Instrument ("MI"):

"Analyse the tax and public international law issues related to development of a multilateral instrument to enable jurisdictions which wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral treaties. On the basis of this analysis, interested parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to quickly adapt to this evolution."

The final BEPS actions are developed on three pillars – coherence, substance and transparency. And they rest on two bedrocks – the digital economy, that forms the frame of reference around which the actions are based; and the multilateral instrument, that will bring these actions to life (refer slide[1] below).

1. BEPS: The final Package by OECD Centre for Tax Policy and Administration presented by Grace Perez-Navarro, Deputy Director, in the Taxsutra Conclave, New Delhi, October 2015



BEPS represents the most transformational revolution in the tax landscape in our generation and not least because it was initially the brainchild of the 34-member OECD and G20, but more importantly, presently practically the whole world has signed up to BEPS – over 90 countries, that have expressed an interest in being a participant to the multilateral instrument when it will be opened up to signature in December 2016, and counting. Such broad-based consensus is unprecedented in a tax world riven by differences, evidenced by the OECD Model Convention applying to developed countries, the UN Model Convention applying to developing countries and the US having its own model convention. The BEPS Actions represent a new world order in international tax law and public international law, because the project is not limited by membership (OECD or G20), but is instead purposive in its intent, and countries would eventually find themselves singled out and be conspicuous by their absence if they did not accede to the BEPS Actions (and thereby become a signatory of the multilateral instrument) in some form or the other.

The unique nature of the multilateral instrument

The OECD model that endorsed residence-based taxation and the UN model that espoused source-based taxation served as templates around which countries formulated their respective tax treaties. Such bilateral tax treaties were country-to-country and were intended to mostly serve the following:

- Avoidance of double taxation
- Prevention of fiscal evasion
- Incentivise cross-border trade and commerce
- Exchange of information
- Dispute resolution

For instance, Singapore states that its DTAs serve the following purposes[2]:

"DTAs help to widen Singapore's economic space and strengthen its position as a hub for business. Currently, Singapore has 60 comprehensive DTAs and 7 limited DTAs in force. The main objective of a DTA is to minimise tax barriers to the cross-border flows of trade, investment, technical know-how and expertise between two treaty countries. Through the provisions of a DTA, taxpayers engaged in cross-border business can enjoy certainty on the taxing rights of either country, benefit from the elimination of double taxation, and gain access to a platform to settle tax disputes.

A DTA is a bilateral agreement which provides clarity on the taxing rights of each country on all forms of income flows between two countries. The DTA also eliminates instances of double taxation which can arise from cross-border trade and investment activities. Usually, there would be provisions in the DTA for reduction or exemption of tax at source on certain types of cross-border incomes such as interest and royalties."

Therefore, the DTAs are sovereign charters that exist between countries, and amount to fiscal legislations of their own accord, that typically override domestic law. Specifically, Section 90 of the Indian Income-tax Act, 1961 ("Act") deals with Agreement with foreign countries or specified territories and provides as follows:

2. http://www.mof.gov.sg/MOF-For/Businesses/Tax-Treaties-Double-Taxation

***90.** (1) The Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—*

*(a) for the **granting of relief** in respect of—*

(i) income on which have been paid both income-tax under this Act and income-tax in that country or specified territory, as the case may be, or

(ii) income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory, as the case may be, to promote mutual economic relations, trade and investment, or

*(b) for the **avoidance of double taxation of income** under this Act and under the corresponding law in force in that country or specified territory, as the case may be, or*

*(c) for **exchange of information for the prevention of evasion or avoidance of income-tax** chargeable under this Act or under the corresponding law in force in that country or specified territory, as the case may be, or investigation of cases of such evasion or avoidance, or*

*(d) for **recovery of income-tax** under this Act and under the corresponding law in force in that country or specified territory, as the case may be,*

and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.

*(2) Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the **provisions of this Act shall apply to the extent they are more beneficial to that assessee.***

(Emphasis supplied)

The Supreme Court, in the case of *UoI vs. Aazadi Bachao Andolan*[3], explained the interplay between the Act and the Treaty as follows:

Quote

Every country seeks to tax the income generated within its territory on the basis of one or more connecting factors such as location of the source, residence of the taxable entity, maintenance of a permanent establishment, and so on. A country might choose to emphasise one or the other of the aforesaid factors for exercising fiscal jurisdiction to tax the entity. Depending on which of the factors is considered to be the connecting factor in different countries, the same income of the same entity might become liable to taxation in different countries. This would give rise to harsh consequences and impair economic development. In order to avoid such an anomalous and incongruous situation, the Governments of different countries enter into bilateral treaties, Conventions or agreements for granting relief against double taxation. Such treaties, conventions or agreements are called double taxation avoidance treaties, conventions or agreements.

The power of entering into a treaty is an inherent part of the sovereign power of the State. By Article 73, subject to the provisions of the Constitution, the executive power of the Union extends to the matters with respect to which the Parliament has power to make laws. Our Constitution makes no provision making legislation a condition for the entry into an international treaty in time either of war or peace. The executive power of the Union is vested in the President and is exercisable in

3. 263 ITR 706

accordance with the Constitution. The Executive is *qua* the State competent to represent the State in all matters international and may by agreement, convention or treaty incur obligations which in international law are binding upon the State. But the obligations arising under the agreement or treaties are not by their own force binding upon Indian nationals. The power to legislate in respect of treaties lies with the Parliament under Entries 10 and 14 of List I of the Seventh Schedule. But making of law under that authority is necessary when the treaty or agreement operates to restrict the rights of citizens or others or modifies the law of the State. If the rights of the citizens or others which are justiciable are not affected, no legislative measure is needed to give effect to the agreement or treaty.

A survey of the (aforesaid) cases makes it clear that **the judicial consensus in India has been that section 90 is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a double taxation avoidance agreement. When that happens, the provisions of such an agreement, with respect to cases to which where they apply, would operate even if inconsistent with the provisions of the Income-tax Act.**

Unquote

(Emphasis supplied)

The multilateral instrument now promises to change the unilateral or bilateral nature of tax legislation and treaty. Currently, the bilateral tax treaties that exist all represent a one-to-one agreement between countries. At most, a bilateral treaty may be bound by an article such as most-favoured-nation clause, that looks to another treaty that defines the scope of a certain type of income to be more restricted, or a rate lower, in which case such beneficial treatment would apply (the protocol to the India-Netherlands treaty is a case in point). Giving effect to the BEPS actions would have ordinarily meant renegotiating the network of thousands of bilateral treaties, which would put an enormous strain on worldwide governmental resources that are all veering around a common objective.

The multilateral instrument is therefore a watershed in international tax law and public international law, by providing a common ground for countries to sign up to all or parts of the BEPS actions. The MI is not without precedence, although the scope and inclusivity of the document make it distinctive. The Multilateral Convention on Administrative Assistance ("MAC") which India has signed in 2012 is a precedent (for tax matters) though it is a much simpler document. The MAC seeks to improve the effectiveness of exchange of information and provides for co-operation between the countries in the assessment and collection of taxes, with a view to combating tax avoidance and evasion.

At a very basic level, the MI is intended to serve as a plug-and-play model for countries, that could choose to opt in or out for various of the BEPS actions. One could almost equate it to signing a many-to-many country agreement instead of the bilaterals that have prevailed so far. By virtue of it being a co-existing document, it would rank *pari-passu* with the treaties the India has signed under section 90. The benefits of a having a multilateral instrument stems from the premise that it can help in:

– addressing treaty-based BEPS issues while respecting sovereign autonomy;

– providing flexibility, respecting bilateral relations, and a targeted scope; and

– facilitating speedy action and innovation.

Interestingly, the multilateral instrument appears to pose more operational challenges than diplomatic ones. For instance, how does one deal with the possibility of India and Hong Kong being parties to the multilateral agreement when the two countries do not have a treaty? Or how would the existing India-Mauritius treaty, India-Netherlands treaty (both of which do not have a Limitation of Benefit ("LOB") clause), or India Singapore treaty (that has a quantum-based LOB clause) change if the countries decide to sign up the multilateral instrument? How does one reconcile the existing limitation of benefits article in the India-Luxembourg treaty that stresses on the main purpose, or one of the main purpose tests applicable to an enterprise (i.e. the creation of such enterprise was to obtain the benefits under this Agreement that would not otherwise be available), if the two countries also sign up to the Principal Purpose Test ("PPT")?

Incidentally, the Indian Competent Authority has gone on record to say that India's preference is for a combination of the limitation of benefits and the principal purpose test, with the latter applying where the objective measures laid down by the limitation of benefits are not captured by situations of treaty abuse. These and other operational difficulties are addressed variously by Action 15.

GAAR, PPT, LOB and the MI

Consider that India already has General Anti-Avoidance Rule ("GAAR") provisions in its domestic tax law under Chapter XA of the Income-tax Act, 1961, which regard an arrangement as an Impermissible Avoidance Arrangement, when its main purpose is to obtain a tax benefit and it contains any of the following tainted elements —

- the arrangement is not at arm's length;
- results in misuse or abuse of provisions of tax laws;
- lacks commercial substance;
- is carried out in a manner not ordinarily employed for *bona fide* purposes.

The GAAR provisions in the Indian tax law thus focus on the main purpose test – i.e. the essential purpose of an arrangement should not be to obtain a tax benefit.

Under Action Plan 6 which deals with Preventing the Grant of Treaty benefits in Inappropriate Circumstances, the OECD and G-20 countries have agreed to implement the minimum standard by including in their treaties one of the following:

i. a combined approach consisting of an LOB and a principal purpose test (PPT) rule;

ii. a PPT rule alone; or

iii. an LOB rule, supplemented by specific rules targeting conduit financing arrangements.

However, the PPT is more onerous than the GAAR under the Income-tax Act – a benefit under the Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude that obtaining the benefit was ***one of the principal purposes*** of any arrangement or transaction, that resulted directly or indirectly in such benefit.

Ordinarily, where the domestic law provisions are onerous on a resident of a contracting state and the tax treaty provides a beneficial provision, the taxpayer can opt for the beneficial provision under the tax treaty. Although the minimum standard provisions need to be enacted by the respective countries, it should not result in a situation where the treaty provisions become more onerous compared to the domestic tax law of a country. This issue is accentuated by the fact that section 90A(2) of the Income-tax Act provides for a treaty override. A possible solution could be that India sticks to the current domestic legislation on GAAR and gets concurrence from treaty partners on its application to treaties rather than a stricter PPT version under the treaty which would create its own complications. Alternatively, India could elect to carve out an exception from the PPT in preference for main purpose test in MI and negotiate this exception in the International Conference.

Accordingly, unlike the other Actions, that are focused on solutions to the BEPS Action Plan, and are therefore substantive and prescriptive, Action 15 is about the form that has to incorporate the substance that the other Actions provide. Hence, now that the treaty based action plans have been finalized, the form and content of the multilateral instrument should take into account the action plans as finalised. Action 15 does not layout the template of the multilateral instrument, that is a work-in-process to be readied by December 2016, but rather provides the legal mechanisms available to achieve a balanced instrument that is capable of addressing political and technical challenges and supplements it with a toolkit that borrows from similar analogies that exist in public international law.

The International Conference

The forum to negotiate and operationalize the multilateral instrument is the international conference. The international conference would enable countries to determine what portions of the multilateral instrument they would opt for, what they would opt out of, and to what extent they would express reservations or carve out exceptions from the terms of the multilateral instrument. Whereas presently countries have expressed their willingness to adopt substantial parts of the BEPS actions and incorporate them into their domestic law or treaties, the international conference is actually "where the rubber hits the road". At the least, the minimum common standards will certainly be acceded to by the OECD and G20 and other willing countries. Then, there are recommendations that go to update guidance, such as transfer pricing actions, that may not be necessarily included in the MI, as they anyway find a place in the revised OECD guidelines and could be included in the UN transfer pricing manual. And finally, there are best practices, that countries could choose to include or opt for in the MI, without any compulsions.

Opportunities and challenges

The MI presents opportunities of a distinctive kind. The Action 15 recognises that the bilateral treaty architecture was not originally designed to address high levels of factor mobility and global value chains. And therefore, examples of the low hanging fruit which should be easily doable through the MI are multi country MAP. Also specific to India, Article 9(2) for allowing correlative relief or bilateral APAs would be possible for bilateral treaties which do not have the provision without having to wait for full-fledged re-negotiation of the bilateral treaty.

That said, there are challenges too. The hard-to-deal-with issues are those such as India specific issues like Limitation of Benefits in treaties (Mauritius, as discussed earlier), PPT in treaties (the 'main purpose test' in domestic GAAR versus 'one of the principal purposes' test in the PPT) ; and its interface with domestic GAAR. We could also speculate whether the Instrument would apply where both countries do not already have a bilateral treaty- India & Hong Kong - it may not, except for multilateral dispute resolution.

In all, the MI presents a new world order, one that allows countries to come together on a common platform to curb BEPS via an orchestrated mechanism and facilitate dispute resolution all at once. And India can benefit from the MI by aligning with the world, and yet differentiating itself positively.

Ashesh Safi & Nilesh Bhagat*

How will countries implement the BEPS Action Plan

A. Backdrop

Under the current tax framework (domestic tax laws and tax treaties), it is possible to plan the business affairs of multinational enterprises [MNEs] in a manner that the effective tax outgo is minimised. This minimum tax position is achieved by allocating higher profits in a low or no tax jurisdiction and lower profits in a high tax jurisdiction. Essentially, this involves taking advantage of gaps and mismatches in tax rules and bilateral tax treaties. This is referred to by governments as Base Erosion and Profit Shifting [BEPS]. BEPS is the most significant aspect of international tax currently being discussed globally.

Is 'tax planning' legitimate?

Tax planning within the four corners of law is not considered as illegal; rather the Supreme Court of India has consistently held such practices as legitimate, legal and rightful by tax-payers, unless it is a colourable device.

The tax rules in most countries, including bilateral tax treaties, have generally been framed for conventional business arrangements and do not match up with ever changing business practices adopted globally in today's digital world. As a result, tax rules provide scope for legally arranging business arrangements in a manner that results in minimum taxation or double non-taxation for MNEs i.e. create opportunities for BEPS.

Is BEPS a cause of worry?

Governments in most countries believe that they are not getting their 'fair' share of taxes on account of BEPS. There has been a significant amount of discussions around this globally over the past several years and social organisations are also expressing their concerns on account of BEPS.

BEPS could be regarded as disadvantageous for local companies vis-à-vis MNEs, as MNEs may have a lower tax bill on account of BEPS, and consequently higher profits and cash. This would give MNEs an edge over local companies and it would not be a level playing field for local companies and MNEs.

How to combat BEPS?

The G20 group of nations[1], in a combined effort with the Organisation for Economic Cooperation and Development [OCED], has been trying to address the issues around BEPS. Pursuant to this, a 15 point action plan was formulated under the BEPS project. The final BEPS action plans were released on 5th October 2015.

1. Including countries like US, UK, France, Germany, China, India etc.

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B. Implementation of BEPS actions – A key factor

With the release of the final BEPS action plan in October 2015, the focus is now on its effective implementation. The BEPS package is designed to be implemented through changes in domestic law and amendment to tax treaty provisions. Some of the actions are also to be implemented by way of amending the OECD transfer pricing guidelines.

The OECD and G20 countries have agreed to continue to work together to ensure a consistent and co-ordinated implementation of the BEPS recommendations. In this regard, the OECD and G20 countries have taken various steps for supporting BEPS implementation.

A summary of the BEPS actions and the mode of implementation of these measures is summarised in the table below.

Changes to domestic tax law	Amendment of bilateral tax treaties (multilateral instrument)	Amendments to the OECD transfer pricing guidelines
Action 1: Addressing the tax challenges of the digital economy (CFC rules)	Action 1: Addressing the tax challenges of the digital economy (permanent establishment)	**Action 1:** Addressing the tax challenges of the digital economy (intangibles)
Action 2: Neutralising the effects of hybrid mismatch arrangements	Action 2: Neutralising the effects of hybrid mismatch arrangements	**Action 8-10:** Aligning transfer pricing outcomes with value creation
Action 3: Designing effective controlled foreign company [CFC] rules	Action 5: Countering harmful tax practices	
Action 4: Limiting base erosion involving interest deductions and other financials payments	Action 6: Preventing the granting of treaty benefits in inappropriate circumstances	
Action 5: Countering harmful tax practices	Action 7: Preventing the artificial avoidance of PE status	
Action 12: Mandatory disclosure rules	Action 14: Making dispute resolution mechanisms more effective	
Action 13: Transfer pricing documentation and Country-by-Country reporting	Action 15: Developing a multilateral instrument to modify bilateral tax treaties	

C. Treaty implementation of BEPS measures

Action 15 of the BEPS action plan deals with developing a multilateral instrument to modify bilateral tax treaties. The report indicates that globalisation has aggravated the impact of gaps and frictions among tax systems of different counties. Consequently, some features of the current bilateral tax treaty system facilitate BEPS and need to be addressed. Beyond the challenges faced by the current tax treaty system, the sheer number of bilateral treaties make updating the current tax treaty network highly burdensome. Even though there is a consensus on making changes to the OECD Model Tax Convention, it will involve substantial amount of time and resources to introduce the same to most bilateral tax treaties. As a result, the current network is not well-aligned with the model tax conventions and issues that arise over time cannot be addressed swiftly.

The report also mentions that in absence of a mechanism to swiftly implement the recommendations, changes to models only make the gap between content of the models and the content of the treaties wider. This is contradictory to political objective of strengthening the current systems by putting an end to BEPS, in part by modifying the bilateral treaty network. Doing so is necessary to not only tackle BEPS, but also to ensure the sustainability of the consensual framework to eliminate double taxation. For this reason, governments have joined hands to explore the feasibility of a multilateral instrument that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.

Action 15 of the BEPS project analyses the possibility of developing a multilateral instrument in order to allow countries to swiftly amend their tax treaties to implement the tax treaty-related BEPS recommendations. The report on Action 15 concludes that such a multilateral instrument is not only feasible but also desirable, and that negotiations for the instrument should be convened quickly. A mandate to set up the *ad hoc* group for the development of a multilateral instrument was approved by the OECD and endorsed by the G20 Finance Ministers and Central Bank Governors at their February 2015 meeting.

Work on the development of the multilateral instrument to implement the tax-treaty related BEPS action plan began on 27th May, 2015 in Paris. As per the OECD / G20 mandate, the *ad hoc* group that will complete the work under Action 15 was established with over 80 countries participating[2]. Thereafter, the inaugural meeting of the *ad hoc* group for the development of a Multilateral Instrument was held on 5-6 November 2015. The membership of the *ad hoc* group in that meeting increased to 94 members from OECD and G20 countries, developing countries and non-OECD/non-G20 economies, all participating in the work on an equal footing. At its inaugural meeting, the *ad hoc* group decided on issues relating to the organisation of the work on the multilateral Instrument, as well as approaches for addressing key substantive issues such as the relationship between the multilateral Instrument and the existing bilateral treaty network. This will enable the group to swiftly develop the multilateral instrument.

The report on Action 15 recognises that this is an innovative approach with no precedent in the tax world, but such precedents are available in arenas of public international law. The goal of Action 15 is to streamline the implementation of the tax treaty related BEPS measures. The key to transferring these efforts from paper to practice is the 'multilateral instrument'.

The report acknowledges specific reasons that push ahead the need of a multilateral instrument. Further, the report recognises the wide network of over 3,000 treaties currently in existence, and also the fact that any change to these could take decades to implement. The need of the hour being to eliminate BEPS with utmost urgency, the report puts forth that multilateral instruments are innovative and a unique opportunity and would facilitate speedy action. The report also states that the bilateral

2. Members as of 28 May 2015: Andorra, Argentina, Australia, Austria, Azerbaijan. Bangladesh, Barbados, Belgium, Brazil, Bulgaria, Burkina Faso, Canada, China, Colombia, Costa Rica, Croatia, Cyprus, Czech Republic, Denmark, Dominican Republic, Fiji, Finland, France, Georgia, Germany, Greece, Guatemala, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Korea, Latvia, Lebanon, Liberia, Liechtenstein, Lithuania, Luxembourg, Malaysia, Malta, Marshall Islands, Mauritius, Mexico, Moldova, Morocco, Netherlands, New Zealand, Nigeria, Norway, Philippines, Poland, Portugal, Qatar, Romania, Russia, San Marino, Saudi Arabia, Senegal, Serbia, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sri Lanka, Swaziland, Sweden, Switzerland, Tanzania, Thailand, Tunisia, Turkey, United Kingdom, Uruguay, Viet Nam and Zambia.

tax treaty network will continue to co-exist along with the multilateral instrument and the manner in which the same would function.

The report indicates that the aim is to conclude the work and open the multilateral instrument for signature by 31st December, 2016.

Some of the benefits of the proposed multilateral instrument as indicated in the report are highlighted below.

– Overcoming the hurdle of cumbersome bilateral negotiations

– Providing an opportunity for developing countries to fully benefit from the BEPS project

– Addressing some issues in a better manner than a bilateral instrument (see below)

– Providing increased consistency and continued reliability of the international tax treaty network providing certainty for businesses

It is pertinent to note that the scope of the multilateral instrument goes beyond merely being a substitute for bilateral treaty negotiations. The report identifies some important areas/issues that are multilateral in nature and would be best addressed through a multilateral instrument:

– Multilateral MAP to address multi-country disputes (Action 14)

– Dual residence structures to be decided on a case-to-case basis (Action 6)

– Transparent entities in the context of hybrid mismatch arrangements (Action 2)

– Triangular cases involving permanent establishments in third states (Action 7)

– Treaty abuse (Action 6)

To sum up, for the BEPS actions to be implemented consistently and in a timely manner, the multilateral instrument is a practical way to address treaty related measures. It is an important aspect of the BEPS project, as it allows for an efficient implementation of the BEPS project requiring amendment to bilateral tax treaties. This unprecedented, hugely complicated and very ambitious initiative, if successful, could revolutionise the way bilateral treaties are updated in the future.

D. India: Perspective and impact

India has been an active participant in the BEPS project and is also a member of the *ad hoc* group constituted for the development of the multilateral instrument. As a member of G20 and an active participant, India is committed to its outcome. An important point to be noted here is that the 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.

In relation to implementation, it is pertinent to note that section 90 of the Indian Income-tax Act, 1961, which enables the signing of bilateral tax treaties, does not expressly enable signing a multilateral instrument. Hence, legislative changes may be required for the multilateral instrument to have effect.

As regards changes to domestic tax law, it is interesting to note that India has introduced a general anti-avoidance rule [GAAR] to deal with tax treaty abuse and other forms of tax avoidance measures. It is pertinent to note that the GAAR has been deferred financial year 2017-18 to ensure that it is implemented in line with Action 6 of BEPS dealing with the concept of principal purposes test.

The Indian Finance Ministry has hinted towards prioritising implementation of the BEPS measures. It is understood that internal groups have been formed in order to study measures that can be implemented currently and ones which could be postponed.

The existing Indian transfer pricing regulations call for maintenance of prescribed information/

documents for substantiating the arm's length price of its transactions with the related parties. While the aforesaid documentation requirements broadly cover most of the contents of a local file, the Indian transfer pricing regulations explicitly do not provide for maintenance of the information contemplated as per BEPS action 13 in the master file and Country-by-Country template. Accordingly, a need to frame additional rules under the Indian regulations would arise for implementation of the transfer pricing documentation.

It is interesting to note that India has been ahead of the curve in trying to protect its corporate tax base, asserting principles similar to some of the BEPS recommendations. The Indian revenue authorities have been taking an aggressive approach in tax policy and assessment, while looking at existence of permanent establishment and making transfer pricing adjustments on the basis of perceived value creation.

In relation to expectations from the 2016 Budget, the government is likely to make amendments for the transfer pricing documentation. As regards other actions in relation to CFC rules, hybrid mismatch arrangements, cap on deductibility of interest, etc., we will need to see how the government will go ahead with their implementation.

E. Global update on implementation

As a result of BEPS recommendations, several countries have adopted consistent measures with BEPS recommendations. The recent examples in this regard, are France and Japan which has proposed to take action relating to certain hybrid financing arrangements. Further, UK has introduced draft legislation to facilitate Country-by-Country reporting. Some of the important steps being taken by the countries are outlined in the table below.

Country	**Recent developments in line with the BEPS recommendations**
Netherlands	The Netherland parliament on 22nd December, 2015 approved the Other Fiscal Measures Bill, which also includes supplementary transfer pricing requirements which is in line with the three tiered approach of Action 13 of the OECD BEPS project. It is applicable for qualifying MNES for fiscal years beginning on or after 1st January, 2016. Also in the Government Gazette on 30th December, 2015, a ministerial regulation containing further rules relating to form and content of the CbC report, master file and local file has been published. On 30th December, 2015, a bill was introduced providing directive for implementing changes to the parent-subsidiary hybrid instruments and anti-abuse measures.
Germany and Japan	The representatives of Germany and Japan signed a revised income tax treaty and a protocol on 17th December, 2015 that replaces the erstwhile 1966 treaty. The new signed treaty and protocol include some of the OECD recommendations relating to BEPS Actions 2 and 6 such as: (i) Rule determining the treatment of income from transparent entities or arrangements; (ii) Tie-breaker rule requiring the competent authorities of the contracting states to determine the treaty residence of dual residents; and (iii) A combination of limitation of benefits provision and a principal purpose test provision. The new treaty also allows for a mandatory binding arbitration.

Country	Recent developments in line with the BEPS recommendations
Portugal	The Portuguese Council of Ministers on 17th December, 2015, published a draft law to implement a recent amendment to the European Union Parent Subsidiary Directive. The draft law provides for anti-abuse provisions relating to the below situations: (i) the withholding tax exemption regime dealing with payment of dividends from a Portuguese subsidiary to its non-resident parent company; and (ii) the participation exemption regime providing that the profits and reserves distributed by qualified subsidiaries to a Portuguese parent company will be excluded from taxation at the parent level. Further, the draft law provides for the concept of 'non-genuine arrangements' i.e. arrangements that lacks substance or do not reflect economic reality.
United States	The US Treasury Department and the Internal Revenue Service on 23rd December 2015 have issued proposed regulation in line with BEPS which will require annual CbC reporting by the US persons that are the ultimate parent entity of MNE group. The US Treasury Department has also introduced a new requirement for specific US persons being the ultimate parent entity of the US MNE Group to file an annual report provided the US MNE group had revenues of approximately USD 850 million for the preceding annual accounting period.
Australia	The Australian Parliament on 3rd December, 2015 passed the multinational anti-avoidance rule and the CbC reporting regime. Further, the Australian Tax Office on 17th December, 2015 released guidelines that addresses CbC reporting. This Guideline explains the way the ATO will apply the new Sub-division 815-E of the Income Tax Assessment Act 1997, concerning the implementation of Country-by-Country reporting, including transfer pricing documentation (CbC reporting). The new law will apply to all multinationals with an Australian presence (i.e. Australian resident entities or business operations conducted through an Australian permanent establishment) with annual global income of A $ 1 billion or more.

Some of the other countries which have introduced the CbC reporting as suggested by the BEPS action plan are Italy, Sweden, Denmark, France, Ireland, Japan, Korea, Poland, Finland etc.

Further, the European Commission on 28th January, 2016 released an anti-tax avoidance package that contains proposed measures to prevent aggressive tax planning, boost tax transparency and create a level playing field for all businesses in the EU.

The draft package among others, contains – 1) Amendments to the administrative co-operation directive to implement country-by-country (CbC) reporting; 2) A draft anti-tax avoidance directive.

It is worth to mention that, the EU draft anti-tax avoidance directive reflect some of the actions in the OECD's BEPS project including rules addressing hybrid mismatches, limits on the deductibility of interest and controlled foreign company (CFC) rules, however the directive is slightly in variance with the actions adopted by the G20 and OECD member countries in respect of these items.

F. Conclusion

The BEPS plan is structured around the following fundamental pillars:

- Introducing **coherence** in the local laws affecting cross-border activities;
- Emphasising on **substance** requirements in the existing international standards for ensuring alignment of taxation with the location where economic activity takes place; and
- Increasing **transparency**, as well as certainty for Investors and governments.

Although the G20 Finance Ministers have welcomed the recommendations, the ultimate success of BEPS will be dependent on each country implementing them. Each country's tax rules will need to change to align with the BEPS recommendations and while doing so the political considerations of each country will have a significant role to play.

It may also be noted that not all OECD recommendations have been accepted as minimum standards. This implies that not all countries fully accept all the recommendations. The report also outlines the on-going/follow up work that is needed. The recommendations therefore remain a continuing work-in-progress even after implementation by respective countries.

The OECD suggests the following measures at the domestic level of implementation:

- Assess and analyse the BEPS measures that present recommendations, best practices and other options to help improving both domestic tax systems and international tax rules
- Adapt them to the domestic context and peculiarities
- Implement them in a consistent manner and according to existing treaty obligations
- Provide legal certainty for both tax administrations and taxpayers

To sum up, the BEPS framework is now in place and countries need to go ahead and implement the measures – as always, this is going to be interesting in view of different positions adopted by different countries. One thing is however certain – BEPS is going to change the way taxpayers approach tax – there is going to be a paradigm shift from 'tax planning' to 'tax risk management'.

There is no help for you outside of yourself; you are the creator of the universe. Like the silkworm you have built a cocoon around yourself.... Burst your own cocoon and come out the beautiful butterfly, as the free soul. Then alone you will see Truth.

— *Swami Vivekananda*

 

Daksha Baxi and Anvita Mishra[1]

Implications of BEPS vis-à-vis the present provisions of the Income-tax Act

"In an increasingly interconnected world, national tax laws have not always kept pace with global corporations, fluid movement of capital, and the rise of the digital economy, leaving gaps and mismatches that can be exploited to generate double non-taxation. This undermines the fairness and integrity of tax systems."[2]

Introduction – Base Erosion and Profit Shifting

Aggressive international tax planning by corporate houses, employing complex strategies to exploit loopholes in laws relating to cross-border taxation, leading to double non-taxation or negligible taxation has received significant attention the world over. One of the recent controversies that captured global attention and outrage was over the miniscule taxes paid by certain multinational enterprises (MNEs), like Amazon, Starbucks, Google, etc. These MNEs successfully diverted their profits to other low-tax jurisdictions, and consequently reduced their overall tax liability in the jurisdiction where they earned revenue. A public uproar followed, including boycott of Starbucks, which successfully pressurised them to pay taxes in the UK. The strategies adopted by these MNEs to lower their tax exposure along with the aggressive stand taken by the G20 nations to arrest their tax bases being eroded, became instrumental in persuading the Organisation for Economic Co-operation and Development (OECD) to initiate the base erosion and profit shifting (BEPS) programme. Clearly, the intention was to examine the various ways in which complex structures and strategies have been adopted by MNEs to sharply reduce their taxation, by shifting profits away from the jurisdictions where value is created or income is sourced, resulting in loss of revenue.

Concern over BEPS

The BEPS Action Plan is thus collaboration between the G20 and the OECD. As per the initial road map laid down with time table, a 15-point action plan, formulated on the basis of consultations with developed and developing countries have now been rolled out. India has actively participated in this consultation process. The BEPS Action Plan deals with key concerns in the international tax sphere, identifying strategies adopted by MNEs to successfully shift their profits (such as avoiding permanent establishment through different arrangements, treaty shopping, hybrid mismatch arrangements, interest deductions, etc.) and measures to

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2. About BEPS Project, OECD, seen at http://www.oecd.org/ctp/beps-about.htm

counter them (such as country-by-country reporting, re-negotiations of bilateral treaties, etc.). The Report aims in achieving coherence in the domestic taxation regimes dealing with cross-border activities, realigning relevant substance in international standards to keep with changing times, and to improve transparency and certainty for businesses and governments.[3]

The OECD published its final set of recommendations on 5th October 2015. In this article we briefly discuss these recommendations, and their interplay with the current provisions of the Income-tax Act, 1961 (IT Act).

Implications of BEPS vis-à-vis the present provisions of the Income-tax Act

Action 1 – Digital Economy

The advent of the digital boom has revolutionised the ways of conducting business around the world, simultaneously raising complexities around taxation of such businesses internationally. E-commerce is the product of digital boom. There is significant litigation surrounding e-commerce transactions. Needless to say, neither domestic nor international tax laws have been able to keep pace with the complexities presented by the digital economy and the way business is conducted under it. With the intention to address the above challenges, the OECD in Action 1 has provided guidance on identifying business models and key features of the digital economy which aggravate base erosion risks, such as developing nexus rules to bring to taxation of profits attributable to the entity, based on its digital presence in the jurisdiction, and not on the location of its servers/ headquarters. The Action Plan also addresses challenges of nexus, data, and characterisation for income tax purpose, along with challenges for levy of VAT for consumers having acquired goods & services online from suppliers located in other jurisdictions, which may not even be known! It further recommends to modify the definition of permanent establishment (PE) such as to bring the artificial arrangements for sale of goods or services within the ambit of PE even where the contracts are effectively concluded by dependent agents but signed by the non-resident principal outside the sale jurisdiction. The exclusion of PE for preparatory and auxiliary activities has been further sought to be restricted by requiring each of the activities of the place of business to be in fact preparatory and auxiliary in nature. It is expected that this will reduce the ability to gain exclusion from PE by claiming omnibus exemption for a host of activities which collectively may appear to be preparatory but individually do not satisfy this test in the context of the nature of business of the foreign entity.

India perspective

While Indian tax laws do not specifically deal with the taxation of digital economy, the provisions in the IT Act relating to taxation of intangibles (being royalty payments, fees for technical services, etc.) are fairly broad to encompass within its ambit transactions relating to technology transfer or transactions in the digital space. The typical example is that of payment for shrink wrapped software. While most jurisdictions treat this payment as business income which cannot be taxed in source country in absence of PE of the seller, Indian authorities have officially departed from this line and treat this payment as 'royalty' or 'licence fee', to be taxed in India since it is sourced in India. Similar is the situation for certain other digitised services.

In the digital economy sphere also, India has time and again emphasised on source-based taxation, rather than residence-based taxation. However, the courts have held that e-commerce websites, which do not host a server in India,

3. OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing. Seen at http://dx.doi.org/10.1787/9789264202719-en

do not create a taxable presence. In *ITO vs. Right Florists Pvt. Ltd. (ITAT Kolkata, 2013)* it was held that payments received by Google and Yahoo for online advertising by an Indian florist company, were not taxable in India as the servers on which the websites were hosted, were not located in India. Similarly, MNEs like Amazon, Google, pay little or no taxes associated with their revenues generated in India, as their servers are located offshore. It is expected that the upcoming budget will address some of the issues surrounding taxation of such websites which generate revenues in India, irrespective of their server location.

Action 2 – Neutralising the effects of hybrid mismatch arrangements

Action Plan 2 aims to curtail the lacuna surrounding taxation of hybrid instruments (i.e. instruments which are treated as debt in one jurisdiction, but as equity in another) and hybrid entities (i.e. entities which are not treated as taxpayers in either or both the jurisdictions that have entered into a tax treaty) collectively, hybrid arrangements, which are being exploited by MNEs to gain undue benefits. To neutralise the effect of such arrangements, the recommendations are set out in two parts – Part I covers recommendations for amending domestic laws and Part II recommends changes to the OECD Model Tax Convention.

Part I recommends measures to neutralise hybrid mismatches, by disallowing: a) multiple deductions for a single expense; or b) deductions without corresponding taxation in the hands of recipient; or c) generation of multiple foreign tax credits for single amount of tax paid.

Part II is aimed at ensuring that hybrid arrangements are not used to unduly obtain benefits of tax treaties and that tax treaties do not prevent the application of the amended domestic laws recommended in Part I. Part II recommends resolving the issue of dual resident entities, on a case by- case basis, by an agreement of the competent authorities rather than on current rule based on the place of effective management of entities. Part II also deals with application of tax treaties to hybrid arrangements. It recommends that benefits of tax treaties should be granted in appropriate cases, however, carves out an exception where neither state treats the income of such an entity as the income of its residents.

India perspective

India's domestic tax laws do not currently envisage measures to curb and neutralise the effects of hybrid mismatch arrangements. It could be argued that these hybrid arrangements may fall under the extensive and wide ambit of General Anti Avoidance Rules (GAAR) scheduled to come into force in 2017. If so, then MNEs structuring any hybrid financial instruments or arrangements may lose the effective zero or low taxation they enjoyed so far. India has also remained largely unaffected by these arrangements due to the fact that debt investment in Indian entities is restricted by exchange control regulations. India has no concept of a tax pass through business entity. Partnerships, limited liability companies and unincorporated joint ventures are taxed at entity level, whether they are located in India or outside India. Also, the rule for establishing residence for partnerships and unincorporated joint ventures make it difficult for such foreign entities to avoid Indian residence and thereby avoid Indian entity level taxation. Most treaties also permit India to deny any benefit to an entity in another jurisdiction which does not levy entity level taxation. The participants in those entities therefore would not benefit from favourable treaty with India unless their home jurisdiction also has a beneficial treaty with India.

Action 3 – Designing Effective Controlled Foreign Company (CFC) Rules

Under Action 3, the OECD aims to develop recommendations on the design of controlled foreign company rules. The report sets these recommendations in the form of six "building blocks", which include –

- **Definition of CFC** – CFC rules should apply to foreign companies controlled by shareholders in the parent jurisdiction;
- **CFC exemptions and threshold requirements** – should only apply to those controlled foreign companies, subjected to a considerably lower tax rate than applicable in the parent jurisdiction;
- **Definition of income** – CFC income should only be attributed to the shareholders in the parent jurisdiction;
- **Computation of income** – Apply rules governing the parent jurisdiction to compute the CFC income;
- **Attribution of income** – tying of the attribution threshold with the control threshold;
- **Prevention and elimination of double taxation** – participating countries should allow for foreign tax credit; dividend income, and capital gains should be relieved from double taxation, if tax has already been paid in the parent jurisdiction following the CFC regime.

Due to different policies implemented by the countries, relaxations have been provided to comply with CFC recommendations which are best suited and consistent with the policy objectives of their respective tax systems.

India perspective

India had envisaged provisions similar to the CFC rules in its Direct Taxes Code, 2013. Since, the Direct Taxes Code is no longer to be implemented, it is not clear if the CFC rules would be revived. In the meantime, India has introduced a stricter and narrower regime i.e. the Place of Effective Management (POEM) of a company. The Central Board of Direct Taxes recently issued draft guidelines on determination of POEM. The test for residency of a company has been enhanced now to where "key management and commercial decisions" necessary for the conduct of entity's business as a whole are made "in substance". The approach is based on substance rather than form. The guiding principles require the company to ascertain whether the foreign company is engaged in 'active business outside India'[4]; thresholds relating to assets, income and expenses have been set. A two-stage process, where the company is not engaged in active business, is also provided – a) identify persons making key decisions, and b) determine where these decisions are taken. These Guidelines are meant to benefit taxpayers, and the revenue, by ensuring that any attempt to evade or defer tax liability in India while controlling a foreign company from India can be successfully addressed. The official communication from the government seems to indicate that they want to assess the impact of POEM and then consider if CFC is required and in what form.

Action 4 – Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

Action Point 4 recognises scenarios where MNEs, within their group entities often resort to multiplying and adjusting their debts through financial instruments, to achieve favourable tax rates. These instruments are economically equivalent to interest, but have a different legal form, and thus avoid restrictions on deduction of interest. These scenarios include:

- Reducing tax liability by placing high level debts in high tax jurisdictions,

4. The Draft Guidelines provide that where a company is engaged in 'active business outside India', the POEM shall be presumed to be outside India if the majority of the meetings of the Board of Directors of the company are held outside India.

- Using intra-group debts to generate interest deductions in excess of third party cost, and
- Using third party or intra-group financing fund the generation of tax exempt income.

To address these risks, Action 4 recommends prescribing a fixed debt to equity ratio for limiting net deductions for interest and payments within the range of 10% to 30% to prevent base erosion, based on country-specific factors prescribed in the Report. For groups which are highly leveraged, for non- tax reasons, the recommended approach is to use a group ratio rule, along with the fixed ratio rule. Further, the countries may supplement these rules with other provisions that reduce the impact of the rules on entities or situations which pose less BEPS risks.

India perspective

While, there are no formal thin capitalisation rules under Indian laws, the Finance Act, 2001 had introduced Section 14A in the IT Act to disallow deduction of any expenditure incurred in relation to earning an exempt income. Introduction of domestic transfer pricing for 'specified transactions' has further enhanced the ability of the Assessing Officer to disallow expense under between related parties.

As mentioned above, introduction of GAAR coupled with the restriction under exchange control regulations help address the issue of thin capitalisation, and structures incorporated for the sole purpose of avoiding taxes, which are in essence also lacking any commercial substance. India is also in favour of the fixed ratio rule, its implementation, however, it remains to be seen how this moves ahead.

Action 5 – Countering harmful Tax Practices more effectively, taking into account Transparency and Substance

Action Point 5 is dedicated to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. It proposes to address concerns relating to the practice of artificial profit shifting to preferential regimes and lack of transparency in relation to low tax through negotiated rulings. To address this, a 'substantial activity test' for preferential regimes is recommended. Further, to improve transparency between tax administrations relating to existence and mechanics of preferential regimes, a compulsory spontaneous exchange of information on rulings, is recommended.

- **Nexus approach:** The 'nexus approach' is regarded to be the most appropriate in determination of substantial activity, which would depend on research and development activities carried out in the jurisdiction which has low tax regime.
- **Transparency:** A framework for compulsory information exchange by tax administrations on tax rulings (also including Advance Pricing Arrangements) has been developed.
- A continuing monitoring and review mechanism for preferential regimes, including IP regimes, and the transparency framework has been settled and shall be put in place.

India perspective

India has continuously focused on a fair regime of transparency and disclosure. It is a signatory to the multilateral treaty on automatic exchange of information relating to taxation, as well as FATCA. It has also adopted the Common Reporting Standards to determine the tax residency of entities, its controlling persons and individuals, all with the aim of curbing tax avoidance across jurisdictions.

India, recently blacklisted Cyprus, upon its refusal to share details of Indian accounts in its jurisdiction. India has been swift to recognise tax havens, and aggressive structuring surrounding those regimes. India has also been struggling to arrest the exodus of its start-ups with IPs to jurisdictions which have IP box or patent box regimes (such as UK, Ireland, Netherlands, Switzerland, Luxembourg) or to low tax regimes such as Singapore. India therefore faces a challenge that while it is committed to support BEPS measures to abolish harmful tax competition, it also needs to prevent its tax base by offering tax sops to the creation of IP for which the activities are essentially carried on in India.

With respect to the use of harmful tax practices, India has been pursuing rigorous transfer pricing regime, seeking to allocate higher revenue to the actual IP creation activities in India. This has created huge transfer pricing litigation, leading to uproar in relation to Indian transfer pricing. With the introduction of the advance pricing agreements regime, these disputes are expected to reduce. Further, if the BEPS proposition of Nexus Approach is implemented, it would vindicate India's stand and enable India to arrest the erosion of its tax base.

Action 6 – Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Action 6 identifies treaty abuse, and in particular treaty shopping, as one of the most important causes of BEPS concerns. It is seen that this practice undermines the tax sovereignty and depletes revenues, by MNEs claiming treaty benefits, which were not intended to be granted. The Report includes new and flexible anti-abuse rules to curb treaty shopping:

- States entering in to a treaty must clearly lay out that they intend to avoid opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.
- A specific anti-abuse rule being the limitation-on-benefits (LOB) that limits the availability of treaty benefits to entities that meet certain conditions will be included in the OECD Model Tax Convention. These conditions seek to ensure that there is a sufficient link between the entity and its State of residence. *(India already has an LOB clause with jurisdictions like the US, UK, Luxembourg, Singapore, etc. and is also seeking to negotiate one in the Mauritius tax treaty).*
- A general anti-abuse rule based on the principal purpose for transactions or arrangements (i.e. the principal purposes test) will be included in the OECD Model Tax Convention. if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.

India perspective

The Indian tax laws have evolved several provisions to protect the object and spirit of tax treaties, such as furnishing of a tax residency certificate, to require MNEs to obtain a Permanent Account Number (PAN) in India if tax benefits in India is sought as well as requiring the foreign entity claiming any treaty benefit to submit some details regarding its eligibility to treaty benefit in the country where it claims to be resident. Strict withholding tax obligations are also in place, the rates of which would be higher if foreign recipients of income from India do not have a PAN in India. These have to be regularly reported in the prescribed form, which requires the payer to have undertaken reasonable due diligence before determining the rate of withholding. Further, furnishing incorrect information or withholding taxes at a rate lower than prescribed could also lead to imposition of considerable penalties. Significant amount of litigation has taken place for lower withholding or no withholding of taxes due to claiming treaty benefits which Indian tax authorities have denied. Though, where no LOB exists or where the settled legal position is to grant treaty protection upon satisfying tax residency criteria (e.g., under India-Mauritius tax treaty), the higher courts have upheld the law and granted the benefits. Currently there is no treaty override provision under the IT Act. The proposed GAAR provisions which have a treaty-override clause in circumstances where thresholds triggering GAAR are met are also expected to reduce instances where undue and unintended benefit of the beneficial treaty provisions are given to MNEs.

Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status

Tax treaties generally provide that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has a PE in that State to which the profits are attributable[5]. The definition of PE, as well as its determination is the sine qua non for taxability of a non-resident enterprise in the source State. Action Plan 6 recommends revision of the definition of PE in Article 5 of the OECD Model Tax Convention, which is highly negotiated in tax treaties.

Broadly, the following recommendations have been made:

- Transactions involving commissionaire agents - where activities carried out by an intermediary in the Source country are intended to result in the regular conclusion of contracts to be performed by a foreign company, then such company should be considered to have a taxable presence in the Source country.
- An anti-fragmentation rule is proposed to plug the practice of fragmenting various activities in the Source State to avoid PE status by taking advantage of exceptions to the PE rule.

India perspective

Determination of PE in India is a complex and contentious exercise, involving interplay between the law, facts and circumstances of each case. Indian authorities take a tough stance, on scope of activities undertaken in determination of PE. Unlike the OECD Convention, India has several clauses in its PE article which make it difficult for a foreign enterprise to avoid constitution of PE in India. To begin with, many of the treaties India has entered into contain service PE clause under which, a presence of employees or personnel of the foreign entity in India beyond threshold number of days for furnishing services would create a PE. In case of related parties (which an Indian wholly owned subsidiary or joint venture of the foreign enterprise would be) a single day's presence of employee or personnel for furnishing of services would trigger PE of the foreign enterprise in India. India has well developed jurisprudence pertaining to preparatory and auxiliary activities, whereby the exclusion from triggering PE could be denied. While, India does not have the concept of commissionaire arrangements, under the Agency PE clause, India seeks to attribute income to the PE even where the agent has facilitated conclusion of contracts. Under the domestic law, there is the concept of business connection, which is far wider than the PE concept. Therefore, where treaty benefit is not available, a foreign enterprise is likely to be taxed on its business income in India for triggering business connection.

Action 8-10 Aligning Transfer Pricing (TP) Outcomes with Value Creation

The increase in the number and volumes of intra-group trades has necessitated consequent amendments to the TP rules. These Action Plans intend on preventing misapplication of TP rules to ensure that transfer pricing outcomes are aligned with value creation. The Report focuses on the fact that TP analysis is dependent on access to relevant information, thus relating it to the requirements in Action 13 to create appropriate TP documentation. Special attention is given to the needs of developing countries. The Report is focused on three key areas:

5. Article 7 of the OECD Model Tax Convention.

- Action Plan 8 focuses on transfer pricing issues involving intangibles, since misallocation of profits generated by valuable intangibles has contributed to BEPS. For intangibles, it is clarified that legal ownership alone will not necessarily generate a right to all (or indeed any) of the return from exploitation of the intangible. Returns will be determined on the basis of the group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction. Specific guidance will ensure that the analysis is not weakened by information asymmetries between the tax administration and the taxpayer in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement.

- Action Plan 9 considers the contractual allocation of risks, and resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. These Reports also address the amount 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. It recommends that if the associated enterprise does not control the financial risks associated with its funding, then it will not be allocated the profits, and nor will it be entitled to a risk-free return.

- Action Plan 10 focuses on other high-risk areas, such as profit allocations in transactions which are not commercially rational (recharacterisation), targeting the use of transfer pricing methods in diverting profits from the most economically important activities of the MNE group, and neutralising the use of certain types of payments within the group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.

India perspective

While India has a robust TP audit system, it has acknowledged in the comments to the BEPS that shifting profits out of India through aggressive transfer pricing by MNEs is one of the major ways in which BEPS operates in India.[6] Perhaps this is at the base of India being in the eye of storm for witnessing significant TP litigation especially in case of intangibles, such as software licences, outsourcing of R&D work, outsourcing of creation of software and other IP etc. The authorities often examine the value created and attributed to transactions between related parties. Stringent penalties have been prescribed for failing to adhere to the TP regulations. In relation to Action Plan 10, which permits recharacterisation, the same is being covered under the proposed GAAR. However, the interplay between GAAR and transfer pricing (being a SAAR) remains to be seen.

Action 11 – Measuring and monitoring BEPS

Action Plan 11 recognises that BEPS causes 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.

The Report makes a number of recommendations to improve analysis of available data. Some of the information required for the measurement and monitoring of BEPS is already collected by tax administrations, but not analysed or made available for analysis. The focus is on improved access to and enhanced analysis of existing data, and new data proposed to be collected under some other Actions of the BEPS Project. The Report recommends that the OECD work with governments to report and analyse more corporate tax statistics and to present them in an internationally consistent way.

6. India's comments to the BEPS questionnaire. Seen at http://www.un.org/esa/ffd/tax/Beps/CommentsIndia_BEPS.pdf

Action 12 – Mandatory disclosure rules

Consistent with the overall objective of achieving transparency in the business models to counter abusive arrangements, this Action Plan aims at providing a framework for countries to design a disclosure regime that fits their need to obtain timely information on potentially aggressive or abusive tax planning schemes. The Report provides a modular framework that enables countries without mandatory disclosure rules to design a regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes. However, for countries adopting mandatory disclosure regimes, the following has been recommended:

- Impose a disclosure obligation on both the promoter and the taxpayer, or impose the primary obligation to disclose on either the promoter or the taxpayer;
- Include a mixture of specific and generic hallmarks, the existence of each of them triggering a requirement for disclosure[7];
- Establish a mechanism to track disclosures from promoters and clients and link them;
- Introduce penalties (including non-monetary penalties) to ensure compliance.

India perspective

India already has in place an extensive disclosure regime where mechanisms for disclosure of financial statements, audit reports, valuations, etc. exist. However, there are no rules governing identification or reporting of transactions structures or aggressive schemes. The proposed implementation of GAAR could be effective in order to curb the tax avoidance strategies. However, even under GAAR no specific disclosure regime has been prescribed.

Action 13 – Transfer pricing documentation and country-by-country reporting

Action 13 aims to develop rules relating to transfer pricing documentation to enhance transparency for tax administration. The OECD has adopted a three-tiered approach to require the following disclosures in the context of transfer pricing documentation:

a) High level information regarding global business and transfer pricing policies in a 'master file';

b) Country-specific transfer pricing documentation to be provided in a 'local file';

c) Country-by-country report to provide key financial information (including amount of revenue, profit before taxes, taxes paid, number of employees, tangible assets, etc. in each jurisdiction) annually.

Countries are required to keep these objectives in mind while designing their transfer pricing documentation requirements.

Country-by-country report [CbC]: Country-by-country reporting is scheduled to be implemented from 1st January 2016, and aim to apply to MNEs with annual consolidated group revenue equal to or exceeding EUR 750 million. This is subject to review in 2020. An implementation package for reporting standards consisting of model legislation has been developed. Mechanisms to monitor compliances are also in the offing. The first CbC report would be filed by 31st December 2017, which then would be shared with other relevant tax authorities by 30th June 2018.

India perspective

India has a robust transfer pricing regime which requires every person who has entered into an international transaction or deemed international transaction, to maintain prescribed information / documents for substantiating the arm's length price (ALP) of its transactions with the related parties, which would be consistent with the requirements of keeping a 'local file'. These are continuous obligations imposed on the taxpayer. However, the present regulations do not contemplate the requirements of a master file, or

7. Generic hallmarks target features that are common to promoted schemes, such as the requirement for confidentiality or the payment of a premium fee. Specific hallmarks target particular areas of concern such as losses

a CbC reporting format. It is expected that these requirements will be brought on statute book through the Finance Bill, 2016.

Action 14 – Making Dispute Resolution Mechanisms More Effective

There is consensus that introduction of counter-measures to BEPS should not lead to any uncertainty, or to unintended double taxation. There must be consistent and proper operation of the tax treaties to avoid unnecessary hassles to honest taxpayers. To address this effectively, improving dispute resolution mechanisms is considered essential.

Article 14 aims to strengthen the *effectiveness and efficiency* of the Mutual Agreement Procedure (MAP)[8] under the tax treaties. The countries adopting this Action Plan are expected to adhere to a minimum standard, with respect to dispute resolution of treaty-related disputes, by establishing a peer-based monitoring mechanism that will report through the Committee on Fiscal Affairs to the G20. The minimum standard so prescribed is aimed at:

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

The monitoring of the implementation of these standards will be carried out by setting up an assessment methodology in the context of the BEPS Project in 2016.

India perspective

India does not favour this recommendation to make arbitration mechanism to be binding and mandatory under the MAP to resolve disputes in tax treaties, as it considers that mandatory MAP will affect the sovereign rights of taxation, as well as limit application of domestic laws for taxing non-residents.[9]

The success of a dispute resolution system depends on the efficacy and timeliness of obtaining results. In that light, it is pertinent to point out that MAP processes, except under the UK and US Treaty, do not have a time limit specified for dispute resolution. Litigation in India is often time consuming. By way of amendments to Arbitration and Conciliation Act, time limit for concluding arbitration is prescribed; this is a welcome step, and should be helpful in expediting the MAP procedures, provided India agrees to include arbitration in the MAP process.

Action 15 – Developing a multilateral instrument to modify bilateral tax treaties

Action 15 requires framing of a multilateral instrument for implementing BEPS measures, designed to provide an innovative approach to modify the existing bilateral tax treaties. Action 15 analyses the legal, administrative, and technical feasibility in undertaking this mammoth exercise of negotiating the multilateral agreement, and to simultaneously amend the existing bilateral treaties to address BEPS measures. This Action Point derives its substance and value from the political support from various governments intending to curb base erosion in their jurisdictions. To achieve this, an ad hoc group was constituted in May 2015 to develop a multilateral instrument to tackle BEPS which aims to conclude this exercise and open the instrument to signatures by 31st December, 2016.

8. Mutual agreement procedure contained in Article 25 of the OECD Model Tax Convention provides a mechanism, independent from the ordinary legal remedies available under domestic law, through which the competent authorities of the Contracting States may resolve differences or difficulties regarding the interpretation or application of the Convention on a mutually-agreed basis.
9. India's comments to the BEPS questionnaire. Seen at http://www.un.org/esa/ffd/tax/Beps/CommentsIndia_BEPS.pdf

India perspective

India, being a member of the ad hoc group, is expected to expedite the negotiations and implementation of the multilateral agreement. What remains to be seen is whether the IT Act will be amended to expressly cover multilateral agreements (Section 90 only deals with the ability to enter into bilateral agreements) to avoid double taxation. The success of this measure will also be dependent on the negotiating power of the countries in question, to either re-negotiate, or revamp the existing treaties in favour of a multilateral agreement.

Conclusion – BEPS' Score Card

Since, the measures under BEPS Action Plan intend to revamp international taxation laws, the success of these measures will depend on the co-operation and implementation of these Action Plans by countries in their domestic legislations as well as in successfully renegotiating certain provisions of their bilateral treaties and / or successfully entering into the proposed multilateral agreement. The BEPS Action Plans are soft law instruments, with no legal sanction behind them, unless adopted by legislative bodies of the different states. UK has already legislated on taxing diverted profits; Australia is committed to take action on BEPS under its current budget. India too is expected to introduce measures countering BEPS, in line with the Action Plan, in the coming budget. Other jurisdictions too have committed to adopt these measures as a key priority to check base erosion in their respective jurisdictions. This will have significant impact globally on MNEs who have indulged in aggressive tax schemes to reduce their liability.

Measuring BEPS – India's Score Card

India, having a well-developed judicial system, already has a number of measures to counter and tackle BEPS. It boasts of an aggressive TP regime, with focus on value creation. However, there is a significant amount of avoidable litigation resulting from absence of clearly formulated rules and provisions. This leaves room for administrative and judicial discretion. Therefore, it is recommended that India formulate clear reporting standards for international TP consistent with the CbC Reporting standards, and clearly articulate principles of value creation.

Another leading cause of BEPS is avoidance of PE creation. In terms of activities constituting PE, the existence of service PE clause in most of the treaties that India has entered into, make it difficult to avoid PE creation in India. The Courts have extensively interpreted "preparatory and auxiliary" activities. However, taxation regime for digital economy is still awaited. India has also released guidelines on determination of POEM – a concept more stringent than the CFC Rules. Additionally, there are numerous specific anti avoidance rules, to attempt to catch tax avoidance instances, including for transfer of assets (IP) outside India. The proposed implementation of GAAR is being seen as an important step towards addressing the measures recommended in the Action Plans. The success of GAAR in relation to countering BEPS remains to be seen.

Given India's commitment to the BEPS Action Plans, modifications to the existing laws may be in the offing. One may expect to see the thus-far missing Action Plans and more clarity in respect of the Action Plans to be adopted and implemented through changes to be brought about by Budget 2016.

Disclaimer*: The views and discussion in this article are personal. They are neither intended to be accurate legal analysis nor to be taken as legal opinion of the authors or Khaitan & Co. None of the contents of this article should be quoted or relied upon for the purposes of decision making without taking legal advice from the authors or otherwise.*

 

Sunil Shah & Geeta Ramrakhiani*

Summary of BEPS measures requiring changes in treaty law

The OECD Secretariat on 5 October 2015 published 13 final reports and an explanatory statement outlining consensus on 15 Actions under the base erosion and profit shifting (BEPS) project. Sixty-two countries have collaborated in the G20/OECD-led BEPS project, and they have agreed to continue working together until at least 2020. There will be some more policy developments in 2016 and 2017, but the main activity now will be to monitor adoption of the BEPS measures.

In these 15 Action plans, OECD has provided a package of measures ranging from new minimum standards to revision of existing standards, common approaches which will restore taxation in a number of instances where income would otherwise go untaxed. Minimum standards were agreed in particular to tackle issues in cases where no action by some countries would have created negative spillovers (including adverse impacts of competitiveness) on other countries. Preventing treaty shopping, Country-by-Country Reporting, fighting harmful tax practices and improving dispute resolution are the examples of minimum standards. Depending on the planning structure used, one or more of 15 Action Plans may have an impact and ensure that income is taxed at least one time and not more than once. The aim of the measures is to realign taxation with economic substance and value creation, while preventing double taxation.

The Action Plans are not legally binding but there is an expectation that they will be implemented by countries that are part of the consensus. 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 and the multilateral instrument is expected to be open for signature in 2016. Finally, other measures require domestic law implementation.

Actions requiring amendments to double tax treaties

The areas to be covered by tax treaty changes are treaty abuse, permanent establishments (PEs) and dispute resolution.

Treaty abuse (Action Plan 6)

The treaty abuse and in particular treaty shopping is one of the most important BEPS concerns. The treaty abuse Action springs from

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concern that double tax treaties could be used to make available treaty benefits in circumstances not intended by the treaty signatories. Countries have agreed to include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping viz. routing payments via a treaty country to reduce taxes. They also agree that some flexibility in the implementation of the minimum standard is required, since these provisions need to be adapted to each country's specificities and to the circumstances of the negotiation of bilateral conventions.

To implement this Action Plan, the approaches put forward in relation to tax treaties are limitation on benefits rules (LOB rule) (currently used by Japan, US and India) and principal purpose tests (PPT rule) (currently used by many other countries, including the UK). There also will be optional specific measures. Within LOB rule, the report contains simplified version and detailed version.

The final report provides different options to countries with regard to adoption of LOB rule and PPT rule in their countries:

- Option 1: The countries may choose to adopt only PPT rule; or

- Option 2: The countries may choose to adopt a detailed LOB rule and a mechanism to address specific conduit arrangements; or

- Option 3: The countries may choose PPT rule together with the either simplified LOB rule or a variation of detailed LOB rule.

Option 2 may be adopted where domestic tax law includes strong anti-abuse rules that are sufficient to deal with various forms of treaty abuses. The final report recommends Option 3 as it prevents a large number of abusive transactions. The rationale here is that the LOB rule is aimed at addressing treaty shopping situations and the PPT may help in addressing other form of treaty abuses such as conduit financing arrangement, etc. It is however clarified that countries having domestic anti-abuse rules or having developed interpretative tools such as economic substance or substance-over-form might not require a separate PPT rule.

Limitation on benefit rule (LOB rule)

The LOB rule as provided in the final report is as under:

i. The benefits of a tax treaty would be denied to a resident of a contracting state if such person is not a qualified person.

ii. The qualified person is defined to include individual, contracting state, its political subdivision, etc., publicly listed entities and their affiliates, charities and pension funds, certain collective investment vehicles, etc. and entities that meet certain ownership requirements.

iii. The treaty benefit may be provided to income derived by a resident who is a non-qualified person if such resident is engaged in the active conduct of business in its state of residence and the income derived is in connection with or is incidental to that business.

iv. Certain companies residents of a contracting state and owned by residents of third states are allowed to obtain treaty benefits of the said contracting state under derivative benefit rule if the owners were eligible for the benefits of the said contracting state if they had invested directly.

v. The competent authority may be allowed to grant treaty benefits where other provisions of the LOB rule deny the treaty benefit.

The test of qualified person is limited to the application in relation to treaty shopping and treaty abuse and will not act as a gateway for entitlement to various benefits contained in different clauses of a tax treaty.

Principal purpose tests (PPT rule)

Under the PPT rule, benefit of a tax treaty may be denied where having regard to all facts and circumstances, it is reasonable to conclude that one of the principal purposes of an arrangement is to obtain tax treaty benefit. The benefit of a tax treaty is available in respect of bonafide exchanges of goods and services and movements of capital and persons as opposed to arrangements whose principal objective is to secure a more favourable tax treatment. This requires an objective analysis of the aims and objects of all persons involved in putting that arrangement or transaction in place or being party to it. The final report provides certain examples with regard to application of the PPT rule. The principles that emerge from these examples are as follows:

i. Structures created to artificially transfer dividend or split contracts may result in application of PPT rule.

ii. Taking a business decision after considering various factors one of which being the favourable tax treaty regime will not be sufficient to trigger PPT rule.

iii. PPT rule will not be triggered if taxpayer genuinely increases its participation in a company to satisfy the requirement contained in a tax treaty.

iv. It would not be reasonable to deny treaty benefit to a company having a real business through which it exercises substantive economic functions, uses real assets and assumes real risk.

v. The setting up of subsidiary by intermediary holding company will not trigger PPT rule if subsidiary was established for business efficiency reasons and contribution of equity is a part of intermediate holding company's active business.

vi. Acquisition of business of a company whose is resident of a contracting state which has concluded many tax treaties providing for no or low source of taxation will not be considered as acquisition for availing treaty benefits and the PPT rule may not be triggered.

Other measures

The final report covers the following examples aimed at addressing treaty abuse:

i. Artificial splitting of contracts.

ii. Recharacterisation of dividend to prevent source taxation.

iii. Requirement to hold increased equity stake throughout a 365 day period where reduced rate of tax is provided for equity holding in excess of 25%.

iv. Gains on alienation of shares or comparable interest may be taxed if at any time during the 365 days preceding the alienation date these shares or comparable interest derived more than 50% of their value directly or indirectly from immovable properties.

v. The changes with respect to anti-abuse rules for PE in triangular cases may be carried out once US finalizes the work to update US Model Treaty.

Action Plan 6 also provides for change in title of and preamble of the tax treaty to provide that tax treaties do not intend to create opportunities for non-taxation or reduced taxation through tax evasion and avoidance. Also Action Plan 6 discusses the tax policy consideration each country should articulate before deciding to enter into tax treaty with another country. While the aspects suggested in this regard may undergo a change based on the US proposal on similar aspects, the final report suggests inclusion of definition of special tax regime, denial of benefits contained in Article 11, 12 and 21 of a tax treaty if resident is subject to special tax regime and turning off treaty provisions consequent to changes in domestic tax laws.

Permanent establishments (Action plan 7)

The final report in relation to preventing the artificial avoidance of permanent establishment (PE) status introduces following changes to the model treaty and commentary.

Artificial avoidance of PE establishment status through commissionnaire arrangements and similar strategies

The activities of a person will result in Agency PE if such person plays the principal role leading to the conclusion of contracts which are routinely concluded without material modification by the enterprise. Therefore, in a situation where employees of wholly owned subsidiary of a foreign parent use their relationship building skills to convince the customers to purchase product and services offered by their foreign parent, the subsidiary may constitute an agency PE when contract is concluded online for the quantity discussed with subsidiary's employee and in accordance with the price structure presented by that employee. The act of convincing the account holder to accept these standard terms leads to conclusion of contracts on behalf of the foreign parent. The fact that a person has attended or participated in negotiations may be a relevant factor but not a conclusive factor in determining whether person has played principal role leading to the conclusion of contracts.

As regards the determination of whether agent is an independent agent, the report provides following factors for consideration:

i. Independent status is less likely attached if activities are performed exclusively for one enterprise or closely related enterprise.

ii. Independent status may not be achieved if the activities performed for unrelated enterprise is not significant.

iii. Independent agent is not considered to be acting in ordinary course if activities performed are unrelated to its business.

Artificial avoidance of PE establishment status through specific activity exemptions

The work under this head reflects modern ways of doing business, where activities may represent a key part of a business' value chain (particularly relevant for supply chains involving digital sales). A number of examples together with limited guidance on the meaning of "preparatory or auxiliary" are included in the revised commentary as under:

i. Storing and delivering goods to fulfill online sales may not be considered preparatory or auxiliary in character if such activities forms essential part of the company's sales or distribution business, whereas storing of goods in a bonded warehouse during the custom clearance process would be considered preparatory and auxiliary.

ii. Use of warehousing facilities operated by an independent logistics company may not constitute a fixed place PE. However, if unlimited access is allowed to inspect and maintain goods, PE will depend on whether activities constitutes a preparatory or auxiliary activity. A similar analysis will equally apply to a case of stock of goods lying with a toll manufacturer.

iii. A company purchases goods from a country for selling in the other countries and has an office in the country where purchases are made. The employees working at that office are experienced buyers who visit producers to determine the type and quality of products. The activities of the company though limited to purchase of goods may constitute PE as purchasing activity is essential part of overall activity of such company.

iv. The activities of local office for two years for researching the local market and lobbying the government for the regulatory or other changes may be regarded as activities of preparatory and auxiliary character.

v. A branch of the bank which reviews loan applications submitted with other branches in the same country will constitute a PE as the activity of the said branch is complementary and part of cohesive business operations of the bank.

vi. A manufacturing company owns its warehouse in another country in which its subsidiary has a store which displays a few large items identical to the ones stored in the warehouse owned by the company. The goods stored in warehouse is transferred to subsidiary once goods leave the warehouse. The warehouse would constitute a PE as its function is complementary and part of a cohesive business operation.

Other strategies for the artificial avoidance of PE status

The report addresses the splitting up of contracts between the group companies to circumvent the specific 12-month time period for creating PEs for building sites and construction or installation projects by updating the commentary as follows:

i. Adding an example to illustrate the application of the principal purposes test for the prevention of treaty abuse (Action 6 of the BEPS Action Plans) to deal with splitting up of contracts; and

ii. Suggesting an alternative provision (for treaties that do not include the principal purposes test) to add connected activities (exceeding 30 days' duration) carried on by closely related enterprises to the period of time on site for the purposes of determining the 12-month period.

The factors relevant in considering the activities to be connected is as under:

i. Contracts covering different activities concluded with the same or related person.

ii. Additional contract is logical consequence of previous contract concluded with the same or related person.

iii. Absent tax planning consideration, activities would have been covered by a single contract.

iv. Nature of work involved in different contracts is same or similar.

v. Same employees are performing activities under the different contracts.

Insurance

The report confirms that there will be no specific PE threshold for insurance businesses in the model tax treaty. Instead, insurance businesses will be treated in the same way as any other industry (unless variations are negotiated in bilateral agreements between specific countries).

Profit attribution to PEs and interaction with action points on transfer pricing

Further guidance will be issued in respect of the attribution of profits to PEs. The report notes that, although substantive modifications are not required to the OECD's existing rules for determining the profits that should be allocated to PEs, additional guidance is necessary on how the rules will apply to new PEs resulting from the threshold changes. This guidance will focus on businesses outside the financial services sector and take into account BEPS revisions to transfer pricing guidelines on intangibles, risk and capital.

The work on the new guidance is expected to be completed by the end of 2016, in time for the multilateral instrument to implement changes to the PE threshold in tax treaties.

Dispute Resolution Action (Action Plan 14)

The explanatory statement notes: "Double taxation would harm multinationals which have contributed to boosting trade and investment around the world, supporting growth, creating jobs, fostering innovation and providing pathways out of poverty. Double taxation would also increase the cost of capital and could deter investment in the economies concerned."

The measures developed under Action 14 aim to strengthen the effectiveness and efficiency of the mutual agreement procedure (MAP) where cases are settled between countries. The OECD's statistics on the MAP show that there were over 4,600 cases at the end of 2013 between OECD members and four partner countries, including 1,900 new cases in the year.

The new minimum standard will ensure that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner, and also will ensure that taxpayers can access the MAP when eligible.

The three general objectives of minimum standard are complemented by eleven best practices. Unlike the elements of the minimum standard, best practices have a subjective or qualitative character and G20 countries are not willing to commit to these practices at this stage.

The best practices discussed in the final report are as under:

i. The countries should have the possibility to provide for adjustment unilaterally when other country make transfer pricing adjustment

ii. Without comprising the confidentiality of taxpayer information, countries should publish mutual agreements reached so as to provide guidance for future disputes.

iii. The Forum on Tax Administration (FTA), which was created in July 2002 by the Committee on Fiscal Affairs (CFA) with the aim of promoting dialogue between tax administrations and of identifying good tax administration practices, be entrusted with the task of delivering global awareness training module in relation to international tax matters for the benefit of tax administrators of each country

iv. Countries should implement bilateral APA programs as these programs increase certainty, lessen double taxation and prevent transfer pricing disputes

v. Countries should permit multiyear resolution of dispute through the MAP of recurring issues with respect to filed tax years, where the relevant facts and circumstances are the same and subject to the verification of such facts and circumstances on audit.

vi. Countries should suspend tax collections when MAP case is pending on similar lines as may apply to a person pursuing a domestic administrative or judicial remedy.

vii. It would be the choice of the taxpayer to take recourse to the MAP or judicial remedies available under the domestic law to resolve treaty-related disputes

viii. A public guidance should be made available to indicate whether competent authorities have the ability to deviate from the domestic court decisions

ix. Application for MAP relief in a country owing to bonafide tax payer-initiated adjustments in the other treaty partner country permitted under the domestic laws of that other country.

x. Consideration of interest and penalties in MAP

xi. Provide guidance on multilateral MAPs and APAs

Additionally, there will be a "robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20." This type of mechanism has worked well in the Global Forum on Transparency and Exchange of Information for Tax Purposes, and it is intended that this will help ensure consistent application of the MAP in the future.

Twenty countries, covering 90% of reported open MAP cases, have said that they will add mandatory binding arbitration to their tax treaties, using the "last best offer" approach. This requires the independent arbitrator to choose between one of the proposals put forward by the countries, rather than making his or her own decision. The mechanism for adding arbitration presumably would be the multilateral instrument, although the US (one of the 20) has not yet decided to participate in the negotiations.

Developing a Multilateral Instrument to Modify Bilateral Tax Treaties (Action Plan 15)

The multilateral instrument is intended to allow the effective modification of many treaties. In view of the practical difficulty associated with modifying 3000+ bilateral tax treaties, the final report on Action Plan 15 provides for execution of multilateral instrument so as to produce synchronized results. As base erosion and profit shifting results from the interactions of multiple countries' laws and treaties, governments need to collaborate more intensively through a hard law multilateral instrument both to prevent the tax treaty network from facilitating base erosion and profit shifting and to protect their tax sovereignty. This is an innovative approach with no exact precedent in the tax world, but precedents for modifying bilateral treaties with a multilateral instrument exist in various other areas of public international law.

The multilateral base erosion and profit shifting issues such as multilateral MAP, addressing of dual-residence structures, transparent entities in the context of hybrid mismatch arrangements, triangular cases and treaty abuse can be best implemented through a multilateral instrument.

The multilateral instrument will be negotiated during 2016. Over 90 countries and jurisdictions have indicated they will participate in the negotiation. The multilateral instrument must be completed by the end of 2016 and then will be available for countries to ratify. It is expected that there will be significant flexibility within the instrument, such that participating countries may make different choices.

The success of above measures depends upon whether the consensus is reached on the different measures, whether the measures are actually implemented and applied according to the consensus, and whether instances of base erosion and profit shifting still exist after implementation. 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.



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BEPS Minimum Standards – Streamlining the global transfer pricing methodology[1]

I. Introduction

1. The Organisation for Economic Co-operation and Development ('OECD') has undertaken significant efforts on Base Erosion and Profit Shifting ('BEPS') which has resulted into 15 separate action points which were published based on negotiations and active participation from member states.

2. The aim of the BEPS 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. This renovation is necessary not only to tackle BEPS, but also to ensure the sustainability of a consensus-based system aimed at eliminating double taxation.

3. The BEPS measures are not legally binding since the BEPS measures are soft law legal instruments. Accordingly, "minimum standards" were agreed by countries in particular to deal with concerns in cases where no action by some countries would have created negative spillovers, including adverse impacts of competitiveness, on other countries.

4. The Action Plans which can be considered as minimum standards are as follows:

- Fighting harmful tax practices (Action 5);
- Preventing treaty shopping (Action 6);
- Country-by-Country Reporting (Action 13); and
- Improving Dispute Resolution (Action 14).

These minimum standards are discussed as follows:

A. Action 5: Fighting Harmful Tax Practices

5. Action 5 of BEPS Project entails a revamp of the work on harmful tax practices, with a priority and renewed focus requiring substantial activity for any preferential regime and on improving transparency, including compulsory spontaneous exchange of information on certain tax rulings.

6. It is given to understand that the European Commission is seriously thinking on this aspect as they are participating in all the meetings of the Forum on Harmful Tax Practices ("FHTP") and have also adopted the same approaches, such as the nexus approach for IP regimes, in respect of requiring substantial activity in preferential regimes.

7. Additionally, attention is drawn to the fact that the lack of transparency in the operation of a preferential regime makes it harder for

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1. Inputs referred from www.oecd.org

other countries to take defensive measures. The 2014 Progress Report included an agreed framework on the compulsory spontaneous exchange of rulings related to preferential regimes. The framework set out in the 2015 Final Report includes all rulings that could give rise to BEPS concerns in the absence of compulsory spontaneous exchange.

8. While exchanging the information, it is to be noted that not all patent boxes are harmful. Fostering innovation can be an important element of growth strategies because intangibles such as patents have become one of the key value drivers of many business models. A preferential regime may therefore be useful in supporting growth and innovation in a country if it attracts real activity. However if a regime merely encourages companies to shift profits from the location in which the value was actually created to another location where they may be taxed at a lower rate if may indeed be harmful.

9. It does so by requiring that these regimes only grant preferential treatment to income derived from substantial activities effectively carried out by the taxpayer obtaining the benefit. This has been achieved through the adoption of the "nexus" approach which is used to assess whether or not there is substantial activity in Intangible Property ('IP') regimes.

10. The nexus approach uses expenditure as a proxy for substantial activity. More specifically, it is the proportion of expenditures directly related to development activities that demonstrates real value added by the taxpayer and acts as a proxy for how much substantial activity the taxpayer undertook.

11. The FHTP will continue to review and monitor preferential IP regimes and where necessary existing IP regimes will need to be amended to comply with the nexus approach. Future review and monitoring will also consider the introduction of new and amended regimes to ensure that they also comply with the agreed approach and agreed information reporting requirements.

12. An ongoing monitoring and review mechanism is being put in place to ensure countries' compliance with the obligation to spontaneously exchange information under the framework.

13. We understand that 16 Intangible Property regimes listed in the 2015 Final Report were found to be inconsistent, either in whole or in part, with the nexus approach. Countries with such regimes will now proceed with a review of possible amendments of the relevant features of their regimes.

14. From an Indian perspective, it is to be seen how this would be translated into the Indian laws. The nexus approach will also impact those groups, who have acquired IP holding companies or IPs in preferential tax regimes and have no employees in such entities holding the IPs but most of the development of IP, is *per se*, outsourced.

B. Action 6: Preventing Treaty Shopping

15. The term "Treaty shopping" generally refers to arrangements through which a person who is not a resident of one of the two States / Countries that concluded a tax treaty may attempt to obtain benefits that the treaty grants to residents of these States / Countries. These strategies are often implemented by establishing companies in States / Countries with desirable tax treaties that are often qualified as "letterboxes", "shell companies" or "conduits" because these companies exist on paper but have no or hardly any substance in reality. This can be addressed through changes to bilateral tax treaties in line with the minimum standard agreed in the context of the BEPS Project.

16. The minimum standard requires the adoption, at a minimum, of rules in bilateral tax treaties that effectively address treaty shopping. First, the treaties should include, in their title and preamble, a clear statement that the States / Countries that enter into a tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping.

Second, countries can implement this common intention by including in their treaties the following requirements:

(1) A combination of a "limitation-on-benefits" rule (LOB, which is a specific anti-abuse rule) and of a "principal purpose test" rule (PPT, a general anti-abuse rule);

(2) The inclusion of the PPT rule; or

(3) The inclusion of the LOB rule supplemented by a mechanism that deals with conduit arrangements, such as a restricted PPT rule applicable to conduit financing arrangements in which an entity otherwise entitled to treaty benefits acts as a conduit for payments to third-country investors.

17. Additionally, Treaty abuse, like the abuse of domestic law, can be addressed through a combination of:

(i) Specific anti-abuse rules, which provide greater certainty but can only deal with known abusive strategies; and

(ii) General anti-abuse rules or judicial doctrines, which are less certain but offer protection against abusive transactions that have not previously been identified or addressed.

18. Both of these approaches can be equally effective to address treaty abuse, but countries have different legal environments and policy preferences. Therefore, while the minimum standard guarantees that treaty abuse is targeted effectively, countries have some flexibility in deciding which rules to adopt.

19. Further, model provisions to curb tax treaty abuse have been developed for inclusion in bilateral tax treaties. Some, but not all, treaties already contain such provisions. About ninety countries have already started the negotiation of a multilateral instrument to implement the treaty-related BEPS measures and modify those bilateral tax treaties that do not yet include these measures in a synchronised and efficient manner. We understand that the multilateral instrument will be opened for signature in 2016.

20. Since the investment decisions of collective investment vehicles ("CIVs"), REITs and pension funds are typically not dictated by their beneficiaries, these investment vehicles do not raise the same treaty-shopping concerns as entities such as private companies. For that reason, special exceptions to the LOB rule have been developed for CIVs, and pension funds. Indeed some CIVs and pension funds are included in the list of "qualified persons" under the LOB rule (REITs fall under the definition CIVs as long as they are widely-held and regulated), e.g., pension funds that are residents of a Contracting State / Countries are entitled to treaty benefits if more than 50% of the beneficial interests in that pension fund are owned by individuals resident in either contracting State / Countries.

21. Another key impact of the said action plan is on use of the Mauritius or the Netherlands structures by US based shareholding companies to invest into India, which could now come under scrutiny from an Indian perspective. The Dutch holding structure (including the Dutch co-operative holding structure in recent times) have been extensively used having regard to zero dividend tax and withholding tax exemptions provided under the treaties with Netherlands for the US/European investors, which would come under the radar and may see LOB clauses included / strengthened under this action plan. On similar lines the equity infusion through Mauritius into India wherein there is no capital gains taxes on exit as well as debt infusion through Cyprus into India having regard to withholding tax benefits on interest payments will also now need to face restrictions, for which in any case Indian Government was seeking to renegotiate treaties with the said countries for a long time.

22. India has also in 2013 notified[2] Cyprus as a notified jurisdiction area under section 94A of the Income-tax Act, 1961 owing to lack of effective exchange of information. As a result

2. Notification No. 86/2013, dated 1 November, 2013 published in Official Gazette through SO 4625 GI/13

every person undertaking a transaction with a person based in Cyprus will be deemed to be considered as an associated enterprise and an arm's length price will have to be determined in accordance with the provisions of Indian transfer pricing regulations. It is to be noted that these transactions are being taxed at the rate of maximum marginal rate based on nature of transaction. Further, in 2014, owing to various negotiations, Cyprus has intimated that they have accepted some LOBs but no response has been received from India on this matter.

C. Action 13: Country-by-Country Reporting

23. The guidance on transfer pricing documentation requires Multi-National Enterprises ('MNEs') to provide tax administrations high-level global information regarding their global business operations and transfer pricing policies in a "master file" that would be available to all relevant country tax administrations. It also requires that more transactional transfer pricing documentation be provided in a "local file" in each country, identifying relevant related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.

24. Country-by-Country Reporting is a tool intended to allow tax administrations to perform high-level transfer pricing risk assessments, or to evaluate other BEPS-related risks. The Country-by-Country reporting template will require MNEs to provide annually and for each jurisdiction in which they do business, aggregate information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group, as well as information about which entities do business in a particular jurisdiction and the business activities each entity engages in.

25. The information must be provided to the relevant governments to protect the confidentiality of potentially sensitive information. Further care would be taken to ensure that it will not be made publicly available. Hence, this information is provided with the treatment of most other taxpayer information.

26. Thus in totality, the three documents (the Country-by-Country Report, TP master file and TP local file) will require taxpayers to articulate consistent transfer pricing positions, and will provide tax administrations with useful information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, commence and target audit enquiries.

27. A cause of concern may be that when appropriate safeguards are not in place or when there has been a breach in keeping the information confidential and the situation has not been appropriately resolved, information exchange partners may suspend the exchange of information and therefore deny the exchange of CbC information.

28. Effective implementation requires domestic law changes in many countries to align existing TP documentation requirement to the content and filing mechanisms agreed in the context of the BEPS Project. The report recommends that the first Country-by-Country Reports be required to be filed for MNE fiscal years beginning on or after 1 January 2016.

D. Action 14: Improving Dispute Resolution

29. Considering that the transfer pricing disputes are one of the largest matters globally, the need to do better in the area of dispute resolution was felt. Accordingly, the countries have agreed on a minimum standard and a number of best practices. The minimum standard will ensure that treaty obligations related to the mutual agreement procedure ('MAP') are fully implemented in good faith and that administrative processes promote the prevention and timely resolution of treaty-related disputes. A total of 11 best practices are also identified in this regards.

30. The minimum standard for dispute resolution provides that countries commit to seek

to resolve MAP cases within an average timeframe of 24 months. The countries' progress toward meeting that target will be periodically reviewed by the mechanism proposed to be set-up.

31. The implementation of the minimum standard will be evaluated through a monitoring mechanism in order to ensure that the commitments embodied in the minimum standard are effectively satisfied. The reviews will evaluate the legal framework provided by a jurisdiction's tax treaties and domestic law and regulations, the jurisdiction's MAP programme guidance and the implementation of the minimum standard in practice.

32. A large group of countries have committed to adopt and implement mandatory binding arbitration as a way to resolve disputes that otherwise prevent the resolution of cases through the mutual agreement procedure. We understand that a mandatory binding MAP arbitration provision will be developed as part of the negotiation of the multilateral instrument and included in there for countries willing to sign to it.

33. However, one of the key challenges in implementing this action remains the capacity of authorities to adhere to the 24 month's timeline for resolution of MAPs having regard to the plethora of other BEPS initiatives to be given effect to couple the already existing backlog, especially in the India – USA scenario. There are also other challenges on what are the measures to ensure both competent authorities are agreeable to a mutual resolution and what if one of them not agreeable to the position and how to resolve the possible deadlock in ensuring the above timelines are met, as was recently experienced between India and USA a few years back.

II. Future outlook

34. BEPS aims at streamlining the international tax rules to ensure the elimination of tax avoidance and also deal with double taxation. Consequently, to minimise the impact on SMEs, a number of measures have been crafted in a way that SMEs will have to face negligible BEPS risks, e.g. the measures on interest deductibility can exclude companies with interest below a certain de minimis threshold, while 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.

35. The existing standards have been updated and will be implemented by the participating countries. It is pertinent to note, however that not all BEPS participants have endorsed the underlying standards on tax treaties or transfer pricing. In other areas, such as recommendations on hybrid mismatch arrangements and best practices on interest deductibility, countries have agreed a general tax policy direction. In these areas, they are expected to converge over time through the implementation of the agreed common approaches, thus enabling further consideration of whether such measures should become minimum standards in the future.

III. Conclusion

36. We would like to conclude here with a thought that though the changes proposed in the BEPS package along with the measures provided in the minimum standards may take some time to be implemented into the current transfer pricing laws in India and other countries globally. However, it will go a long way in providing relief from the various arbitrations to the various MNEs if they maintain the necessary Country-by-Country documentation while avoiding harmful tax practices and preventing treaty shopping as also increasing transparency and limiting aggressive tax planning, thereby avoiding the negative publicity arising therefrom. More importantly, the above measures seek to bring more substance in the way MNEs deal with related parties and ensure that those states that are rightly entitled get their fair share of tax revenues having regard to substance of activity undertaken in the State, which brings transfer pricing concepts to the fore, going forward and a key and inevitable aspect of doing business by MNEs.

SS-V-206




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US Perspective on BEPS

Introduction

The Organisation for Economic Co-operation and Development (OECD) released its final reports on the G20/OECD Base Erosion and Profit Shifting (BEPS) Project on Monday October 5th, 2015. The BEPS Project is the most comprehensive reform of the international tax standards in decades. The changes recommended as part of the BEPS Project are likely to impact the way companies operate, and the extent to which their tax and financial affairs need to be disclosed. In response to the recent release of the BEPS final reports a U.S. Treasury Department official was quoted on October 5th as stating: "[Overall the United States is pleased with the final reports because the work of the BEPS project should make it easier to ensure that income is taxed where the functions, assets and risks that give rise to the income are located, and it will improve the dispute resolution mechanisms that are key to the elimination of double taxation."[5]

The final BEPS reports issued last fall comprise fifteen Actions generally intended to tax profits based on where the activities that give rise to those profits and to minimise revenue losses incurred on account of gaps in the taxation of the profits of multinational businesses. Four Actions address minimum standards: Action 5 on harmful tax practices, including proposals to address patent box regimes; Action 6 on treaty abuse; Action 13 on transfer pricing documentation; and Action 14 on dispute resolution. Two Actions reinforce and update international standards: Action 7, which updates the permanent establishment definition; and the consolidated Actions 8-10, which provide revised transfer pricing guidelines, including new provisions concerning intangibles. A further four Actions provide for model rules and best practices: Action 2 on hybrid entities and instruments; Action 4, providing for limitations on interest deductions; Action 3, which contains building blocks for CFC rules; and Action 12, which provides for mandatory disclosure rules to combat aggressive tax planning strategies. The other three Actions concern overarching issues and implementation: Action 1 addresses the challenges of the digital economy; Action 11

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5. http://www.bna.com/final-beps-reports-m57982059147

concerning the development of improved data collection and analysis; and Action 15, which recommends the use of a multilateral instrument to streamline the implementation of the BEPS provisions.

Even with the October release of the final BEPS deliverables, questions remain regarding how much of the recommended BEPS changes would be implemented in the United States. Because many of the recommendations require legislative changes or incorporation into income tax treaties and given that congress remains focused on other tax matters, it is thought that many of the OECD's recommendations changes may not be implemented any time soon in the United States. Many in Congress view the BEPS project as an effort by foreign governments to target U.S. multinationals.[6] In announcing recent Ways and Means committee hearings regarding BEPS, Rep. Charles Boustany stated:

> The direction of the OECD's BEPS project final reports has sent a troubling indication of a desire to target American companies, in an unprecedented attempt to erode the U.S. tax base. The effect on U.S. jobs and U.S.-based research and development activities will have dire consequences for our economy and for our continued ability to compete with foreign corporations. We must take swift action to fix our broken tax code so that American companies and their employees can continue to be leaders in the global marketplace.

Some of the OECD’s recommendations, however, may be implemented in the United States without legislative action. On December 21 the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (“IRS”) released proposed regulations to implement reporting in accordance with the OECD Country-by-Country (“CbyC”) template, which has been accepted as the international standard, in order to avoid “inconsistent and overlapping reporting obligations.” The proposed regulations will not be effective until finalized, however, and the IRS and Treasury recognise the possibility “that there may be areas where further clarification or refinement is warranted.” It remains unclear whether and to what extent the Administration or the U.S. congress will implement any of the other BEPS recommendations.

U.S. Legislative Process

The Constitution of the United States grants all legislative powers to the U.S. congress. In general, the legislative process may begin in either the lower chamber of the congress, the House of Representatives, or the upper chamber, the Senate. However, in the case of any bills for the raising of revenue, the Origination Clause of the Constitution requires that such bills originate in the House of Representatives. Thus, in general, tax laws must originate in the House of Representatives.

In brief, a new tax law starts when a representative sponsors a bill in the House. The bill is assigned to a committee for study. In the case of tax law, this is generally the House Ways and Means Committee. If the committee releases the bill it will go before the full House for debate and vote. If a majority vote to approve the bill, it moves on to the Senate.

In the Senate the process is generally the same as in the House. The bill will go to committee, the Senate Committee on Finance in the case of tax laws, and, if the committee approves the bill, it will then go to the full Senate for debate and vote. If the bill passes the Senate by a majority vote (although 60 votes is frequently required in order to break a filibuster) the House bill and the Senate bill are sent to a conference committee composed of both House and Senate members to resolve any difference between the two versions of the bill. The synthesized version of the bill returns to both the House and Senate for final approval and, if approved by a majority vote of

6. http://waysandmeans.house.gov/ryan-responds-to-oecd-beps-proposal/

both, is then sent to the President of the United States for signature or veto.

In the case of tax laws, the Joint Committee on Taxation, a non-partisan committee composed of members of both the House Ways and Means Committee and the Senate Finance Committee, is closely involved with all aspects of the legislative process.

Administration views in general

As an OECD and G20 member country, the United States has been a very active participant in the OECD's BEPS work. Discussing BEPS in October, Treasury Deputy Assistant Secretary for International Tax Affairs and lead U.S. delegate to the OECD's Committee on Fiscal Affairs, Robert B. Stack, maintained that the existing U.S. tax rules are, in general, consistent with the BEPS recommendations.[7] Despite the apprehension of many in the United States on the potential of BEPS-related legislative activity, in the near term it appears likely that U.S.-based multinationals will be affected by the BEPS changes primarily through actions that may be adopted through Treasury actions (such as country-by-country reporting) as well as by the adoption of the BEPS recommendations in the other jurisdictions in which they do business. We will examine what legislative actions the Administration might adopt concerning BEPS.

Country by Country Reporting

The U.S. administration has previously expressed support for CbyC reporting, referring to the results as an "extraordinarily successful effort"[8]. This past October, a spokesman for the U.S. Treasury Office of Tax Analysis said that temporary regulations implementing CbyC reporting would be released in the near future. One question raised is what authority the Treasury is relying on to issue regulations without congressional approval. In a letter to Treasury, Paul Ryan, then Chairman of the Ways and Means Committee (and now Speaker of the House), and Orrin Hatch, the Chairman of the Senate Finance Committee, questioned Treasury's ability to issue CbyC regulations without congressional approval. In the letter Ryan and Hatch stated the following:

"We are concerned about the country-by-country, or C-by-C, reporting standards that will contain sensitive information related to a U.S. multinational's group operations. Some recent press reports have indicated that the Treasury Department believes it currently has the authority under the Internal Revenue Code to require C-by-C reporting by certain U.S. companies, and that the IRS guidance on this reporting will be released later this year. We believe the authority to request, collect and share this information with foreign governments is questionable."

Treasury authorities have said that, based on the authority in existing legislation, Treasury has sufficient authority to collect the information that's being asked for in the CbyC report. In his October comments, Mr. Stack asserted that contrary to the position of many in Congress, in the Treasury Department's view there was no doubt that there is the authority to implement the CbyC reporting requirements under I.R.C. Ss. 6011, 6012, 6031, and 6038.

The preamble to the proposed regulations states that CbyC reports will merely serve as a "basis for making further inquiries into transfer pricing practices or other tax matters." That is to say, that the CbyC reports will not be used as a substitute for a full transfer pricing analysis under the current section 482 regulations.

However, Treasury has emphasised U.S. reservations concerning the misuse of CbyC reporting data by other countries, noting that the United States was willing and able to suspend

7. http://www.taxnotes.com/tax-notes-international/base-erosion-and-profit-shifting-beps/stack-gives-us-perspective-beps-recommendations/2015/10/19/16848641

8. http://www.taxanalysts.com/www/features.nsf/Features/3829CF4979DEBA9A85257E65005C5915

the exchange of information in the event of information use that the U.S, considered abusive. Concerns about confidentiality were also addressed in the proposed regulations, as the preamble states that the United States will only enter into information exchange agreements with jurisdictions deemed to offer the necessary legal safeguards to protect exchanged information. Even where such safeguards are in place and an information exchange agreement has been concluded, the United States "will not enter into a reciprocal automatic exchange of information relationship with a tax jurisdiction unless it has reviewed the tax jurisdiction's policies and procedures regarding confidential protections."

Furthermore, the IRS and Treasury have indicated that they are considering an exception for cases involving sensitive information relevant to national security concerns. If the exception is adopted, U.S. persons required to file the as-yet unnumbered CbyC form could request an exception for reasons of national security, at which point the U.S. person, Treasury, and other relevant federal agencies would evaluate whether said request is warranted. The IRS and Treasury have requested comments regarding the procedures that U.S. persons would be required to follow in such cases.

The proposed regulations would require annual CbyC reporting by U.S. persons that are the ultimate parent entity of a multinational enterprise group (MNE). The proposed regulations affect U.S. persons that are the ultimate parent entity of a MNE group that has annual revenue for the prior accounting period of $850,000,000 or more. The regulations generally are proposed to be applicable to tax years beginning on or after the date of publication of the final regulations. Final regulations are not expected until sometime during 2016, pushing the first reportable period for of calendar taxpayers to 2017.[9] Before the proposed regulations are finalized, consideration will be given to any comments that submitted by March 22, 2016, to the IRS.

In addition to the CbyC proposed regulations, could Treasury act on its own without congressional approval? Below we look at what other actions the administration could do without congressional approval.

Permanent Establishment

The proposed changes to the definition of a PE under Action 7 would expand the boundaries of what constitutes a PE. Action 7 significantly widens the circumstances in which a dependent agent PE can be created. For example, it will extend to situations where a person "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise." Additionally, under an option in the final report, the list of excepted activities could be subject to an overriding requirement that they be "preparatory or auxiliary" in nature under the proposed provisions.

In May of 2015, the U.S. Treasury released proposed revisions to the U.S. Model Tax Convention ("The Model). The Model serves as a template for future U.S. tax treaties and protocols. Accordingly, the Model helps articulate the U.S. treasury tax treaty position, Among the proposed revisions is a provision meant to address instances of double non-taxation, whereby taxpayers use a permanent establishment in a third country to significantly reduce taxes paid in both the taxpayer's country of residence, as well as the country where the PE is located. However, rather than address the issue through the PE provision, the proposed revision qualifies the use of treaty benefits based on a minimum level of tax on the profits of the PE. The Model is not self-executing, and Treasury must negotiate new treaties and protocols with its treaty partners before any provisions in the Model can become effective.

9. TaxNewsFlash-Transfer Pricing No. 2015-106: KPMG report: Country-by-country reporting, proposed regulations in United States (December 23, 2015)

Whether the United States will sign up for the multilateral instrument that will allow countries to amend their tax treaties is up for debate. We discuss the multilateral instrument below.

Multilateral Instrument

Action 15 calls for the development of a multilateral instrument ("MLI") that will allow countries to swiftly amend their existing tax treaties with other countries that are also a party to the MLI in order to implement the tax treaty-related BEPS recommendations by modifying a number of common tax treaty provisions. Action 15 recognises that more than 3,000 bilateral tax treaties exist which vary widely in their details. Updating them requires substantial resources and time since every single tax treaty would need to be renegotiated. The MLI is intended to modify a limited number of provisions common in most bilateral tax treaties. Tax treaties which do not have such provisions would be amended by the provisions designed to counter BEPS. It is not intended to draft a new complete tax treaty like the existing model tax convention or to replace it. Only the provisions related to bilateral treaties are intended to be addressed.

From the U.S. perspective, the issues to be addressed by the MLI, for example hybrid mismatches and treaty shopping, are already adequately addressed by the tax treaties the United States is a party to. However, if the MLI included terms providing for mandatory binding arbitration, something the United States has been hoping to obtain, then the Administration would be inclined to sign the agreement.[10]

The United States is now participating in the *ad hoc* OECD group of approximately 90 countries tasked with moving the MLI project forward. This group initially convened in November 2015. However, while the Administration may ultimately decide to sign the MLI, ratification would require the approval of the U.S. Senate by a two-thirds majority.

Intangibles

The United States is a member country to the OECD, and is an active contributor in the development of the OECD BEPS Guidelines. As such many of the ideas that appear in the 482 treasury regulations also appear in the OECD BEPS Guidelines. For example, the arm's length price standard in 482 treasury regulations closely resembles the arm's length charge standard in the OECD BEPS Guidelines. Similar to the S. 482 Treasury regulations, the OECD BEPS Guidelines include a chapter devoted to intangible property. The final report on transfer pricing under Actions 8 through 10 revises Chapter VI of the OECD Transfer Pricing Guidelines to address the use of transfers of intangibles to shift income to low-tax jurisdictions. In general the new guidelines define intangibles as an item that is not a physical asset or a financial assets, is capable of being owned or controlled for use in commercial activity, whose use or transfer would be compensated if it occurred in a transaction between independent parties in comparable circumstances.

In addition to adopting a clear definition of intangibles, Action 8 provides guidelines intended to ensure that the income associated with intangibles is allocated among parties according to value creation and guidance on the valuation of intangibles, including those intangibles considered to be subject to a high degree of valuation uncertainty, referred to as hard-to-value-intangibles (HTVI). The OECD's new valuation guidance generally deems one-aided transfer pricing methods to be inappropriate for valuing intangible assets, as they tend to result in an over-allocation of income to the owner of the intangible. The OECD guidelines recommend the comparable uncontrolled price (CUP) method for valuing intangibles. In the cast that an appropriate comparable is not available the profit split method may prove the most useful method for

10. http://www.taxanalysts.com/www/features.nsf/Features/3829CF4979DEBA9A85257E65005C5915

deriving an accurate valuation of intangibles transferred or licensed between related parties.

Similarly, prior to the final BEPS reports, the U.S. Treasury issued new regulations under I.R.C. S. 367 and S. 482 intended to achieve similar ends. The proposed § 367 regulations removes the provision from the temporary regulations which had made a specific exception to taxation under S. 367(d) for the outbound transfer of foreign goodwill and going concern value. The temporary S. 482 regulations provide for the aggregate valuation of interrelated transactions that are partially covered by S. 482 and partially covered by other I.R.C. sections, such as S. 367.

In general, the proposed and temporary regulations issued by Treasury indicate that the United States is moving in a direction that is similar to and consistent with the aims of the OECD BEPS actions concerning intangibles as contained in Action 8.

Conclusion

In its role as a member of the OECD and other international organisations the United States has been an active participant in developing the global standards on taxation, and the BEPS project is no exception to this pattern. With the final reports completed the United States remains engaged with the work of implementing the recommendations of the BEPS reports, as seen by its participation in the development of the MLI and the recent actions working toward the implementation of CbyC reporting. Additionally, in other areas the United States and the OECD have converged on similar approaches to address difficult taxation issues as demonstrated by the parallel guidance of the proposed S. 367 regulations and BEPS Action 8 concerning intangibles.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author or authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

ERRATA

In the January issue we had printed the Tribute to Chief Justice Kapadia authored by Mr. S. E. Dastur. In Paragraph 5 by mistake "or in the form of residential accommodation. He believed ...". The same has to be read after correction as "He never sought favours from the Government, either as a post retirement benefit or in the form of residential accommodation. He believed...".

We regret the omission and express sincere apologies for the same.

 

CA Ameya Kunte & CA Aishwaryaa V.

Overview of changes made by countries pursuant to BEPS

Base Erosion and Profit Shifting ('BEPS') has remained a mandatory topic of discussion in the tax world for the past two years. The Organization for Economic Co-operation and Development ('OECD') has kicked off the action on BEPS by releasing substantial recommendations and BEPS has also remained a topic of consideration in countries' annual tax budget. The motive behind commencement of this task by OECD is seen to be the huge uproar by political leaders, media outlets and civil societies' concerns over multinational companies' ('MNCs') sophisticated tax planning strategies. Three years since the beginning of concerted efforts of countries to counter BEPS, a lot of nations are already witness to the domino effect. During the course of the BEPS project, some countries, including India, indicated their preference to wait for the final outcome, while some other countries simultaneously commenced legislative changes unilaterally. With the release of the final action plans in October 2015, the next few years are going to be very crucial in shaping the tax world across the globe.

In this article, we bring out the major changes undertaken by countries to tackle BEPS. The changes have been grouped under the popular topics from the BEPS Action Plans for a much cohesive outlook[1].

A. Transfer Pricing

The transfer pricing related updates are contained in the Action Plans 8-10 and Action 13 pertaining to documentation and reporting. Several countries have enacted legislations introducing the new set of documentation and several other countries are in pipeline.

> *"Action 13: Guidance on transfer pricing documentation and Country-by-Country ('CbC') reporting" sets out a three-tiered standardized approach to transfer pricing documentation consisting of a master file, a local file and CbC reporting.*

Notable developments – CbC Reporting

- CbC reporting has been introduced in Australia, Mexico, Denmark, Netherlands, Spain, South Africa, Poland, Italy and France. The countries have retained the revenue limit of 750 million euros in their local currency. The reporting framework would require each subsidiary entity to submit a local file, identified groups to submit the master file. CbC reports filed in the jurisdiction of the ultimate parent entity would be shared under automatic exchange of information. It may be noted that in Italy, a secondary filing obligation

1. The other articles elsewhere in journal also deal US and Europe perspective on BEPS in detail.

is provided for Italian resident companies controlled by a foreign company that are required to submit group consolidated financial statements either in a country that does not require the filing of a CbC report or in a country that does not share the CbC report with Italy.

- UK released a technical consultation paper titled "The Taxes (Base Erosion and Profit Shifting) (Country-by-Country Reporting) Regulations 2015" for implementation of the new transfer pricing documentation requirement. The regulations propose CbC obligations for UK resident parent entities with a consolidated turnover of at least 586 million pounds in a 12 months accounting period. The regulations also provide for a UK resident company that is not an ultimate parent entity to voluntarily file the CbC report for the group as a surrogate parent entity.

The "OECD Action 7: Preventing the artificial avoidance of PE Status" majorly targeted commissionaire arrangements and fragmentation of activities which would avoid creation of a PE.

- US has also released discussion draft on December 21, 2015 on the proposed CbC regulations, that would apply to US entities that are the ultimate parent of a multinational group and have a consolidated revenue of $850 million or more for the preceding year. It may also be noted that there was also a bill introduced which prohibits the US Treasury Department, from obtaining or transmitting any CbC report covering taxable years on or before January 1, 2017.

- The Japanese 2016 tax reform outline also proposed to introduce CbC reporting for taxable years beginning from April 1, 2016. The reporting requirements apply to Japanese Parent entities, surrogate parent entities, Japanese companies and permanent establishments if the Japanese authorities are unable to obtain the report from the country of the ultimate parent/ surrogate parent in the group.

- Korea imposed new documentation requirement for certain MNCs pertaining to their international transactions. The qualifying companies are required to submit to the Korean tax authorities a comprehensive international transaction report containing management information on those companies and information on transfer pricing with related parties.

Notable Developments – Other transfer pricing action plans

- There has not been significant amendments in countries with respect to the other transfer pricing action plans i.e. Actions 8-10. In December 2015, the Swedish Tax Agency published on its website that the Actions 8-10 only clarify the arm's length principle and therefore are applicable in Sweden going forward as well as retroactively. It is also noted that the provisions are to be applied in parallel to the existing guidance. China had also released a draft circular dealing with transfer pricing specifically pertaining to intangibles, location savings, market premium etc. It largely follows the OECD BEPS proposals and in addition to traditional transfer pricing methods, the draft also provided for two other methods: value contribution allocation method for cases where comparables are difficult to find and the asset valuation method for valuation of equity shares and intangible property. The draft also introduced the three-tier documentation requirement with additional details on value chain analysis.

B. Permanent Establishment

Permanent Establishment ('PE') has always been the center point of international taxation. It is the decisive factor in determining the

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taxation of an entity vis-a-vis any country. The concept of PE has been ever evolving subject to interpretations by courts of various countries and requiring rediscovery with each new form of business operation. While countries continued to litigate on what constituted PE, some significant legislative changes pertaining to PE are as below.

Notable Developments

- One of the most discussed and debated provisions affecting the concept of PE is the UK diverted profits tax introduced in 2015. The tax at 25% is intended to apply to large MNCs with business activities in the UK who enter into contrived arrangements to divert profits from UK by avoiding a UK taxable PE or through other arrangements between related parties. The charge is impacted by the activity and substance outside of UK and is unlikely to arise in cases where there is sufficient substance in offshore asset owning entities, arm's length transactions in the value chain and presence of a UK PE. Similar provisions are also contained in the Australian multinational anti-avoidance law discussed above.

- The tax treaty between Australia and Germany had been modified to incorporate the proposals of the OECD BEPS Action Plan 7: Artificial Avoidance of Permanent Establishment. The PE definition therein has been modified to include the proposals with respect to the dependent and independent agent definitions, the anti-fragmentation rule under which the preparatory or auxiliary exemptions would not apply to a place of business maintained by the enterprise or a closely related enterprise in specific circumstances, and a new anti-splitting up of contracts provision.

- Inconsistent with the OECD/ UN Model conventions, the Kingdom of Saudi Arabia had introduced the concept of "virtual service permanent establishment ('PE')". Thus, a PE may be created in Saudi Arabia even when employees perform the services entirely offshore. Similar concept has also been introduced by Kuwait. Italy is also considering introduction of the concept of virtual PE targeting digital companies.

The last few years have witnessed several important changes in the taxation regime of the countries. With the BEPS project proceeding on one side, some countries had continued to unilaterally legislate measures to tackle tax issues. Several other countries had also held on to amendments waiting for completion of -the OECD BEPS project. Now that the final recommendations are released, countries are working on ways to legislate the changes into their tax framework, after carefully considering the economic impact. With such dynamic activity, it is imperative that businesses and tax professionals are on track with the updates so as to ensure continuity of business decisions.

C. Treaty Abuse & Hybrid mismatch

Treaty abuse is one of the major concerns in the tax world. Several countries have resolved to put an end to treaty abuse, treaty shopping through several measures such as the general anti-avoidance rule ('GAAR'), specific anti-avoidance rule ('SAAR'), additional taxes on unusual arrangements, enhanced disclosure requirements etc.

The recommendations of "Action 6: Preventing the granting of treaty benefits in inappropriate circumstances" include changes to the preamble, introduction of a limitation on benefits ('LOB') clause, introduction of principal purposes test ('PPT') rule.

Notable Developments

- The European council formally adopting a binding general anti-abuse rule to be included in the parent-subsidiary directive. This rule aims at denying benefits to arrangements that are not genuine and is formulated as a '*de-minims*' rule to be adopted by member States. Member States Bulgaria, Cyprus, France, Sweden, Denmark, Poland, Netherlands, Lithuania and Finland have amended their local legislations to give effect to the amendment.

- China had introduced GAAR provisions and also issued administrative guidance on GAAR, which defines the main characteristics of a tax avoidance arrangement and the manner of tax adjustments.
- Netherlands initiated renegotiation of its treaties with several developing countries to include the anti-abuse clauses. The revised treaty between Germany and Japan also contains a combination of a limitation on benefits provision and a principal purpose test provision.
- The US had initiated changes to its Model Convention. Some of the proposals deal with BEPS concerns. The proposed changes increases the scope of anti-treaty shopping provisions, limitation of benefits and also denies benefits to income subject to special tax regime. Finalisation of these changes is also being closely watched by the OECD BEPS Project group.
- Brazilian Government had called for disclosure of all transactions that leads to avoidance, reduction or deferral of tax, if it had no business or economic purpose or is in an unusual manner. However, later in the year, the proposal was rejected by the House of Representatives and is now awaiting further action.
- Australia introduced the "multinational tax avoidance legislation" towards the end of 2015 aimed at MNCs earning profits from Australian consumers without having an Australian permanent establishment. The law allows the Australian tax authorities to look through the scheme and cancel the tax benefits obtained by the foreign entity, and its related parties. Australia had also revised its tax treaty with Germany, comprehensively incorporating the proposals in the OECD Action Plan 6. The preamble of the treaty has been replaced to clarify that it is not intended to be used to generate non-taxation or reduced taxation through tax evasion or avoidance. Additionally a new limitation of benefits article is included which provides a more general way to address treaty avoidance cases including treaty shopping.
- UK has announced introduction of legislation to neutralise the effect of hybrid mismatch arrangements in accordance with the recommendations of the OECD's BEPS project. The aim is to tackle aggressive tax planning, typically involving multinational groups, where either one party gets a tax deduction for a payment while the other party does not pay tax on the receipt, or where there is more than one deduction for the same expense. The legislation will have effect from January 1, 2017.

D. Patent Box

"Action 5: Countering harmful tax practices" dealt with the taxation approach for patent box regimes. Several existing regimes were reviewed and found not compatible with the OECD proposal. Accordingly, the Action Plan proposed that countries adopt the modified nexus approach and existing regimes be repealed with adequate grandfathering provisions.

> *"Action 5: Countering harmful tax practices" proposed that the tax benefits for intellectual property be based on the research and development expenditure under the 'modified nexus approach'*

Notable Developments

- Italy introduced the patent box regime through the 2015 budget. The regime is an elective tax regime available to taxpayers engaged in research and development activities, providing up to 50% exemption in a phased manner for corporate income tax and local tax on income derived from licensing or exploitation of the intellectual property ('IP').

- Spain introduced the modified nexus approach as per the Action Plan 5 (counteracting harmful tax practices), allowing deductions in line with expenditures linked to generating the IP income.

- Irish Budget 2016 introduced the "knowledge development box" to encourage companies to develop IP in Ireland and thereby engage in substantial operations that have a high 'value-add' for the Irish economy. Corporation tax of 6.25% (as against the normal rate of 12.5% for trading income and 25% for other income) would apply to the profits arising from certain IP assets which are the result of qualifying research and development activity carried out in Ireland.

- As part of the Budget proposals, Luxembourg repealed its existing IP regime from the tax year 2016, although some grandfathering rules would apply, subject to fulfilment of certain conditions. A new regime is expected to be released in the near future which would be in line with the modified nexus approach of the OECD Action Plan.

- US has also proposed creation of an "innovation box". The proposal would result in a 10.15% effective tax rate on the portion of profits derived from qualifying IP and from the sale of products produced using such IP.

  UK had in place a patent box regime since 2013. The said regime is proposed to be modified for new entrants on or after July 1, 2016 and for some assets acquired on or after January 1, 2016. The change has been mandated in order to be compliant with the new international framework for preferential tax regimes for Intellectual property as set out by OECD. Accordingly, the amount of profit from IP assets which can qualify for the reduced 10% corporation tax will depend on the proportion of the asset's development expenditure incurred by the company. Detailed legislations are expected in the Finance Bill, 2016.

E. Tax on Digital Services

Contrary to wide expectations at the beginning of BEPS project, OECD has not suggested any specific solutions to tax digital economy transactions. However, BEPS report speaks about VAT on e-commerce transactions and states that countries should apply the principles of the OECD's International value-added tax/ goods and services tax and should consider introduction of the collection mechanisms included therein.

Digital companies in several countries are facing the wrath of the tax authorities for their disproportionate tax dues with respect to their huge incomes. The digital economy cannot be restricted to borders and hence requires a co-ordinated international response for effective taxation. Simultaneous with the BEPS Actions, several countries have also looked into this area of taxation and have attempted to secure their tax bases.

Notable Developments

- As early as 2013, the European Union ('EU') commenced discussions on taxation of the digital economy under the umbrella of the general Value Added Tax ('VAT') rules. Beginning from January 1, 2015, the EU VAT rules changed the point of taxation from the location of the seller to the location of the buyer, thus impacting e-commerce.

- In October 2015, Japan started imposing 8% consumption tax on digital services. For business-to-consumer transactions, the Foreign Service provider would be required to register as a taxable entity and file consumption tax returns. For business-to-business transactions, a reverse charge mechanism was introduced, which would require a Japanese service recipient to declare taxable sales and related tax due on its consumption tax return.

- In July 2015, a 10% tax on digital services came into effect in South Korea. However later an exemption was provided for services rendered to a domestic entrepreneur registered for VAT in Korea. VAT on digital services has been in place in South Africa since June 2014.

- Several other countries are in pipeline in putting into place a tax system for the digital economy. Russia introduced a draft law in the lines of the EU VAT rules, which is set to go onboard in 2017. Australian budget in 2015 proposed a 10% tax on digital goods and services. Similar is the case with New Zealand. Turkey has also indicated VAT on foreign companies by bringing in a concept of electronic taxpayer.

- The French Government's task force on digital economy has also proposed for taxing digital data and services through the concept of virtual permanent establishment and a short-term Data tax.

While digital service providers are faced with the new web of taxation across the user locations, what follows is also the additional burden of registrations and compliances.

While there seems to be an emerging consensus on VAT on digital economy transactions, the income tax implications are still not very clear. It is expected that countries may implement unilateral measures to tax such transactions, thereby leading to a possible double taxation, which may not be addressed by the language of the tax treaties.

F. Transparency and Exchange of Information

Improving transparency is one of the priority areas of the OECD BEPS project. In the last year, there has been substantial activity in the EU with the objective of improving transparency and exchange of information among the member states. The other parts of the world too has been witnessing developments fostering transparency and exchange of information such as FATCA, exchange of information agreements, common reporting standards etc.

In January 2016, around 31 countries signed the Multilateral Competent Authority Agreement on the Exchange of CbC reports. This execution is expected to enable the consistent and swift implementation of the Action Plan 13, establish the minimum standard, facilitate automatic exchange and ensure that confidential information is safeguarded.

Notable Developments

- The "Transparency package" was presented by the EU for adoption by the member states. The proposal contained provisions pertaining to automatic exchange of rulings, including

Advance Pricing Arrangements between member states. Following this, EU also introduced a communication titled "A Fairer Corporate Taxation System in the European Union: 5 Key Areas for Action". The 5 identified action areas were relaunching the common consolidated corporate tax base, ensuring fair taxation where profits are generated, creating a better business environment, increasing transparency and improving EU co-ordination. Further proposals relate to the modification of the EU accounting and transparency directive that would require large groups to include country-by-country information in the notes to their financial statements. In October 2015, the EU reached a political agreement on a directive regarding the mandatory automatic exchange of information on tax rulings. The member states will be required to communicate summaries of cross border tax rulings and advance pricing arrangements to all other EU member states, and to the European Commission. The Commission would develop a secured central directory for storage of such information. Later in the year 2015, the European Parliament adopted a report with recommendations such as EU wide implementation of public reporting of country based information for all MNCs by the first quarter of 2016, expanding the scope of automatic exchange of rulings including making certain information public, a mechanism of communication between member states before introducing measures that could potentially constitute harmful tax practices, revising definitions for hybrid arrangements, permanent establishment and economic substance.

- The Korean 2015 tax reform introduced huge administrative penalties of upto US$ 95,000 for failure to report a cross Border transaction with foreign related parties.

- Australian Board of Taxation released a consultation paper "A Tax Transparency Code" that would apply to large and medium enterprises and sets out minimum standards for disclosures. Compliance with the code is expected to be voluntary. The code is still in the process of consultation with Public and stakeholders.

- Moving a step ahead, the Israeli Parliament had enacted a legislation that requires disclosure of certain types of written tax advice received on or after January 1, 2016 and tax positions taken in 2016 and thereafter. Herein the taxpayer would be required to disclose the fact that a tax advice was obtained, the transaction or asset discussed in the advice and the type of tax issues involved. It is not required that the tax advice itself be disclosed. Further, a tax position will be considered reportable if it is inconsistent with the published tax position or results in significant tax advantage.

- UK published a draft legislation that requires large groups, companies and partnerships to publish on the internet the annual tax strategy in relation to UK taxation, which would be available free of charge to the Public. The provisions are said to be effective after the Royal Assent. The tax strategy to be published must among other things, set out the approach of the group, attitude towards tax planning, level of acceptable risk and must be published by the end of each financial year.

Snapshot of the Key Developments around the world

Region	Development
Asia	• Japan introduced 8% consumption tax on digital services
	• South Korea introduced 10% tax on digital goods and services. Also requires companies to submit international transaction report containing management information and related party transaction details to tax authorities.
	• China introduced GAAR.
	• Israel introduced legislation for disclosure of details on tax advice to tax authorities.
	• Saudi Arabia and Kuwait introduced 'virtual service PE'.
Africa	• CbC reporting introduced in South Africa.
Australia	• CbC reporting introduced.
	• Multinational tax avoidance legislation introduced.
America	• US proposed to introduce CbC reporting and patent box regime. Also proposed amendments to model tax convention.
Europe	• EU VAT rules amended the point of taxation from the seller to buyer. Also adopted GAAR rules in parent subsidiary directive. In order to promote transparency, EU introduced transparency package for improving co-ordination among the member states with provisions such as exchange of tax rulings, inclusion of CbC report in notes to accounts etc.
	• CbC reporting introduced in Denmark, Netherlands, Spain, Poland, Italy, France.
	• Patent box regime introduced in Italy, Ireland. Spain and UK modified patent box regime in line with OECD Action Plan 5. Luxembourg repealed its existing patent box regime.
	• UK announced diverted profits tax at the rate of 25% targeting contrived arrangements that avoid a PE. UK to introduce changes to neutralise the effects of hybrid mismatches from January 1, 2017.

Our duty is to encourage every one in his struggle to live up to his own highest idea, and strive at the same time to make the ideal as near as possible to the Truth.

— *Swami Vivekananda*

CA T. P. Ostwal

Should BRICS & Developing Countries – Fall in Line or Turn their Backs on the OECD?

On 5th October, 2015, the OECD presented the 'Base Erosion and Profit Shifting (BEPS) package', the 13 reports outlining recommendations on how loopholes in the current international tax system could be fixed. Some of it was good – such providing tools to address treaty abuse and requiring the world's biggest companies to report to tax authorities the global allocation of income and taxes paid, together with other indicators of the location of economic activity within the company – i.e. Country-by-Country reporting. Much of it was however underwhelming, including the inability to deal with tax giveaways through innovation boxes – such as the UK's patent box – and the failure to reach agreement on important anti-tax haven legislation (so called CFC rules). And even recommendations that looked promising turned out to provide plenty of scope for interpretation and tax planning.

The BEPS package was cooked up by 42 of the world's biggest economies with only limited consultation of other, poorer countries. However, the ambition is that these recommendations will become global standards. The rich making rules for the poor, in other words. The outcomes of the BEPS package – limited in scope and effect at best for rich countries – are even less likely to be a game changer for developing countries. Despite the OECD's ambitions to simplify international tax rules, the BEPS package is nearly 2,000 pages long and unlikely to make the lives of resource strapped tax authorities in developing countries much easier.

The BEPS package also ignores the problems of where profits are taxed (so called taxing rights) and definitely does nothing to address tax competition; both massive problems faced by developing countries when trying to collect corporate tax. If this was branded as a tax revolution it certainly wasn't developing countries' tax revolution.[1]

Let us examine the reactions/responses from BRICS and developing countries (in general) on their participation in the OECD's BEPS project as well as any unilateral action taken by them in order to safeguard their interest.

Brazil

Brazil has a long history of going its own way where international tax standards are concerned. Brazil is taking part in OECD working group meetings as a vocal observer but has not committed to adopting the BEPS project's results. However, there are signs that Brazil may be prepared to adjust its international tax rules in selected areas to bring the rules somewhat more in line with global norms.

Traditionally, Brazil has been unwilling to harmonise with OECD international taxation principles and its current versions of tax rules

1. http://www.actionaid.org/2015/10/lukewarm-beps-process-wrapping-whats-next-international-tax-rules

leave little scope for aggressive tax planning. Rather, they often expose companies to double taxation risk mainly because Brazilian transfer pricing requirements do not follow the arm's length principle thereby most companies face challenges in supporting their transfer pricing policies in Brazil.

Some recent changes suggest that Brazil is open to bringing its tax rules closer to OECD principles in cases where doing so serves the country's interests. For example, amendments to Brazil's CFC regime introduced in May 2014 appear to draw on OECD recommendations in this area.

Starting in 2015, Brazilian companies will be required to disclose their profits for tax purposes by country, including profits of all their foreign subsidiaries. The required report will be in essence similar to the type of report required under the OECD's Country-by-Country tax reporting proposals, but the information will be provided in the companies' accounting records.

Brazil has also signed up as a member of the Global Forum on Transparency and Exchange of Information for Tax Purposes. In the OECD's Phase 2 Review of Brazil's compliance, the OECD found the country's practice to be in line with the international standard for transparency and exchange of information for tax purposes.

In line with BEPS Action Plan 12, on July 21, 2015, Brazil enacted a Provisional Measure[2] creating the obligation for taxpayers to disclose aggressive tax planning and declare to Brazilian tax authorities, until the end of September of each year, the transactions performed in the previous calendar year that involve elimination, reduction or deferral of tax. Although this provisional measure has been suspended for the moment, Brazil will not shy away from taking such unilateral action in the near future.

Russia

Improving its tax legislation, Russia is already taking steps on a number of the Action Plan items. BEPS Action Plan 13 on Country-by Country Reporting presents a new format of TP documentation making taxpayers disclose the group structure and all important details of the business which will be available to the tax authorities of the involved countries. The Federal Tax Service of Russia have declared that similar forms will be implemented in Russia, too.

CFC rules effective in Russia since 2015 require that Russian shareholders disclose the ownership structure of their foreign assets and, in certain cases, pay Russian tax on the profit accumulated in such CFC if it was not distributed as dividends. Certain amendments to the new rules are already being prepared even though they have only been in place for a few months. There was a risk that introduction of CFC rules would force quite a number of Russian shareholders to restructure their business in order to move it offshore. To avoid this, an amnesty scheme was announced on repatriating capital.

To make CFC rules work, Russia also introduced two important concepts previously missing in the law: tax residence of companies based on the place of their day-to-day management and definition of beneficial owner of income.

In 2014, Russia ratified the OECD Convention on Mutual Administrative Assistance in Tax Matters which helps tax authorities exchange tax information, allows them to participate in tax audits abroad and collect tax arrears from taxpayer's assets located abroad.

Certain other issues remain unsolved in Russia, such as taxation of 'digital economy' and amendment of thin capitalisation rules. Given that digital commerce is rapidly growing and common tax rules are sometimes difficult to apply in this area, there seems to be a general understanding in Russia that something should be done in this respect.

Thus, the main anti-BEPS steps in Russia included introduction of transfer pricing rules, CFC rules, the concepts of companies' tax residence and beneficial ownership of income, as well as

2. MP No. 685

improvement of the international information exchange system. As OECD finalises its proposals on the BEPS Action Plan, Russia will probably continue further amending its tax legislation accordingly.

India

Being an emerging economy and part of G20, India has been participating in the BEPS right from the inception stage, when the plan was endorsed by the G20, and from the formulation of the action plans with a view to safeguarding India's interests in developing these recommendations.

At the G20 Finance Ministers meeting, on September 20, 2014, India's Ministry of Finance, while generally welcoming the OECD's proposals, urged that the needs and limitations of developing countries must be taken into due consideration while developing consensus on the underlying issues surrounding the BEPS project.

There are several issues in the BEPS action plan, which are relevant for India like anti-abuse provisions in treaties – there are a lot of other ways, besides abuse through certain jurisdictions, in which treaties can be misused to get benefits which are not intended. Similarly, the work related to action plan on transfer pricing promised to be far reaching and which will change the concepts of transfer pricing, especially in the area of valuation of intangibles and allocation of income on the basis of intangibles.

In spite of the huge market for the digital economy in emerging economies like India, digital enterprises face zero or no taxation because of the principle of residence-based taxation as against source-based taxation. Since the dominant players in the digital world like Amazon or Google are not tax residents in India, profits sourced from India are not offered for taxation. Thus, significant base erosion is caused by the inadequacy of existing international tax rules to allocate profits to countries from where these profits are sourced, and in particular, the irrelevance of physical presence as a criteria for allocating taxing rights to source countries in case of digital enterprises.

Substantial tax base erosion also results from artificial avoidance of PE status and treaty shopping including the use of techniques to obtain treaty benefits in situations where such benefits were not intended. Tax base erosion also takes place on account of incentives in the tax laws for attracting investment through offering tax incentives, Further, tax base erosion takes place by MNEs adopting strategies to avoid tax paid when assets situated in India are sold owned by companies located in low tax jurisdictions with no substance.

One of the major concerns from the point of view of developing countries is regarding the approach adopted for making dispute resolution mechanisms more effective which includes introduction of mandatory and binding arbitration in the Mutual Agreement Procedure under Tax Treaties. A view strongly expressed is that this may impact the sovereign rights of developing countries, which however is legally debatable and also limit the ability of the developing countries to apply their domestic laws for taxing non-residents and foreign companies. India has expressed reservations on mandatory and binding MAP arbitration and hence this might be a stumbling block on MAP disagreements.

In Budget 2015, the Government announced that it will defer the application of the GAAR for two years until the release of the OECD's final recommendations under the BEPS project so that India's domestic anti-avoidance rules are into line with international standards.

The Country-by-Country Reporting (Action Plan 13) implementation guidance from the OECD is most timely as it allows the Indian Revenue authorities to calibrate its prescription for CbCR to be consistent with the implementation guidance. The Indian MNEs can therefore expect a big bang reform on transfer pricing documentation in Budget 2016!

China

China has been actively involved in the BEPS Project to reform international tax rules in order to prevent MNCs from artificially shifting profits to low tax jurisdictions. China has already been active in pursuit of similar issues and has released general anti-avoidance procedural guidance, indirect transfer rules, and base-eroding payment rules.

On September 17, 2015, China's State Administration of Taxation (SAT) released the draft of "Implementation Measures of Special Tax Adjustment" for public comments. As a response to the deliverables of the BEPS, the Draft absorbs many recommendations in the BEPS Deliverables and represents the most prominent development in transfer pricing regime.

The Draft refines the definition of related party and provides a more concrete guideline for identifying related parties and also recognised some additional types of related party transactions (RPT). With reference to the BEPS Action Plan 13 Deliverable, the Draft creates a new TP documentation structure. The Draft provides two new TP methods, i.e. the Value Creation Attribution Method and the Asset Appraisal Methods. The new TP methods are likely to be used to deal with complex intangible transactions and situations where comparable transaction information is hard to locate. The Value Creation Attribution Method is a method to allocate combined profit of related parties by using one or several value contribution related allocation keys, by way of analysing and comparing the value contribution of each related party. The Asset Appraisal Methods, on the other hand, are consistent with the general practice of asset appraisal, including the cost approach, market approach and income approach. Considering that China market comparable information is generally limited, and the RPT by and among the MNCs frequently involves intangibles, these two new methods are likely to be used widely in practice.

Besides, the Draft introduces some new concepts as the factors to be considered and analysed for implementing the TP methods, such as special geographical factor i.e. location saving advantage, marketing intangibles, and intra-group synergistic effects, which have been heavily discussed in the last few years, especially in the United Nations Transfer Pricing Manual. It is expected that the Draft will be finalised and issued as a SAT Decree very soon.

South Africa

Both transfer pricing and the BEPS Project have been receiving attention in the South African media and Parliament for quite some time. On 19th November, 2014, a session on transfer pricing was held during a meeting of Parliament's mineral resources and finance committees. Presentations by the National Treasury and the South African Revenue Service (SARS) during this session provide insight into possible future transfer pricing legislation in South Africa – to maintain specific transfer pricing documentation (Country-by-Country reporting), advance pricing agreements on transfer pricing between taxpayers and SARS could alleviate the enforcement burden and encourage compliance.

November's Parliamentary session was followed shortly afterwards by the publication of the first interim draft report of South Africa's Davis Tax Review Committee on 23rd December, 2014. The report, prepared by tax experts appointed by the Minister of Finance, addresses issues associated with the digital economy, harmful tax practices, treaty abuse, transfer pricing, and the proposed multilateral instrument that would implement the BEPS recommendations.

The draft recommends that South Africa adopt new source rules to tax non-resident suppliers of goods and services via e-commerce based on where the consumption takes place. Also, new rules should be adopted that require non-resident companies with South Africa sourced income to submit income tax returns even if they do not have a permanent establishment in South Africa. The report suggests that South Africa renegotiate its tax treaties to include both a limitation on benefits provision and a principle purpose test to prevent treaty shopping.

Further, South Africa should adopt rules requiring large MNEs to disclose their transfer pricing in a master file, local file, and Country-by-Country report, as suggested in OECD recommendations. South Africa would prefer to receive more information in the Country-by-Country reports — including information on related party interest payments, royalty fees, and service fees. The report notes that South Africa and other developing nations' views on this issue will be taken into account when the Country-by-Country reporting system is reviewed in 2020. The report also suggests that South Africa simplify existing rules on hybrid equity, and it criticises a recently issued draft public notice listing some hybrid equity and debt instruments as reportable arrangements.

Just like Brazil, China & Russia, even South Africa may proceed for unilateral action to safeguard its interest and exacerbate more problems leading to double-taxation.

Developing Countries

United Nations Sub-Committee on BEPS had invited the developing countries to provide feedback by answering the UN Questionnaire[3] including 10 questions. The UN participates in the tax work of the OECD and will certainly provide useful insights regarding the particular concerns of developing countries.

The UN Sub-Committee is mandated to draw upon its own experience and engage with the OECD with a view to monitoring developments on BEPS issues and communicating on such issues with officials in developing countries (especially the less developed) directly and through regional and inter-regional organisations.

Many of these international taxation rules, which have been drawn to a large extent, on the basis of the preference of the developed states to allocate greater taxation rights to the state of residence and restrict the ability of the source states to enforce their sovereign right of administering the taxes allocated to them, have to be accepted by the developing countries and low-income countries, in view of their limited ability to bargain with developed countries. In view of the inherent vulnerability of these countries in their bilateral treaty negotiations with developed countries, the United Nations needs to take a position that protects the sovereign taxation rights of the developing countries and low-income countries and prevent the international taxation rules from getting unjustly skewed in favour of the developed countries. In particular, the United Nations needs to take the interest of the developing countries and the base erosion and profit shifting faced by them into account while carrying out work on BEPS.

Singapore tax officials said that it is important that BEPS recommendations not impede the growth of genuine substantive business activities. "In particular, tax incentives are a valuable tool for developing countries to spur investment in under-invested sectors and regions, and BEPS should not take away such tools as long as they are geared towards real development and substantial economic activities."

Singapore's officials also said they hoped the BEPS work would grow the "economic pie" for all countries, and not be "side-tracked by protectionism and development of rules for political expedience."

Further, the Singapore officials said that BEPS recommendations should not adopt a "one size fits all" approach. "Instead, there should be adequate flexibility for countries to choose what meets their unique needs best. We should not be aiming to achieve one universal tax system for the whole world – this would undermine sovereignty and development."

Thailand tax officials said that an action plan item to deal with business restructuring would be helpful to developing countries. The officials also said that insufficient legal infrastructure and limited information disclosure by MNEs of expenses such as royalties, pursuant to international accounting standards, were obstacles to preventing corporate tax avoidance.

3. http://www.un.org/esa/ffd/tax/BEPS_questionnaire.pdf

Officials from **Argentina** said lack of effective exchange of tax information and lack of specific rules related to the digital economy prevented enforcement of tax laws. The Revenue officials believe that the constant improvement of risk analysis tools to detect abusive practices is key to minimise the negative effects on the tax base

In its response to UN's BEPS questionnaire, **Bangladesh** concluded that BEPS has a detrimental effect on the economy because it reduces the tax revenues that could be collected in the absence of BEPS. In a developing economy like Bangladesh, tax revenues are crucial for reducing poverty and inequality. BEPS slows down the pace of development by lowering the fiscal spend of the country.

BEPS has significantly affected tax revenues in **Mexico**. The most common practices and structures detected in Mexico, are: a) Sales of companies in Mexico; when alienating holding companies located in jurisdictions with little or no access to exchange of information and where those sales are not taxed or taxed at low rates, b) Migration of intangibles developed in Mexico to jurisdictions with low or no taxation, c) Structures that do not recognise the existence of permanent establishments in Mexico because it is considered that the activities and risks are located abroad and d) Huge debts with no business reason.

As BEPS arrangement artificially shifts profit from **Malaysia** to other tax jurisdictions, it results in the erosion of tax revenue hence impact tax collection and undermine the credibility of the tax system due to negative public perception. The cause of profit shifting are mainly due to mis-pricing and excessive or unwarranted intra group payments such as interest on loans, management fees or technical services fees, or payment for intellectual properties. Action Plan By not properly compensating the local entities, Malaysia's tax base is eroded as taxes are not paid in jurisdiction where economic activities are generated. Profits are easily shifted to related parties in low tax jurisdiction where there are no/ minimal real economic activities.

The current legal framework of **Chile** to counteract BEPS situations is still narrow compared to other countries' legislation. The lack of a General Anti-avoidance Rule and CFC rules together with only limited specific anti-avoidance measures and abuse of transfer pricing, use of tax havens and harmful preferential regimes, intercompany transfers of unjustified costs (interest deductions, royalty payments, service payments) imply that Chilean tax administration faces more difficulties to address the complexity of international tax planning.

Conclusion

As it stands today, the G20/OECD's biggest challenge is "keeping the consensus" going on international tax principles amongst the countries participating in the BEPS project. If G20/OECD cannot secure the delicate balance between its members, most countries will introduce unilateral BEPS measures which will seriously impact the tax risks of MNCs – "the war scenario". As a consequence, the OECD will run the risk of losing its position of being the only "consensus platform".

OECD's BEPS has increased the complexity of the global tax system and thus made it more difficult to define what the rules actually say. Rather than providing solutions, OECD has started considering options for arbitration, something which risks undermining the ability of countries to apply their own tax laws even further.

I am convinced that the OECD's final BEPS recommendations isn't the biggest shake-up of international-tax rules like that in the 1920s. It is frustrating to see that the OECD has correctly diagnosed the tax dodging crisis but has not been able to prescribe the right cures. Instead it is a "sticking-plaster approach" which may provide limited improvement in some areas but is a long way from the comprehensive, effective solution that is required.

CA Uday Ved

Immediate areas of professional opportunities pursuant to BEPS

Background

International tax issues have never been high on political agenda as they are today. With growing international trade & business amongst various countries, globally international tax rules are changing. Countries are becoming more aggressive in protecting their own tax base and this is creating its own challenges.

Weaknesses in current domestic tax rules create opportunities for profit shifting and erode tax base. This required 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.

Following the release of the Report of Base Erosion and Profit Shifting (BEPS) in February 2013, OECD and G20 countries adopted a 15-point Action Plan to address BEPS. Final report of BEPS covering all 15 Action points was released on 5th October, 2015 and subsequently ratified. The report and action plans have reiterated principles that profits should be allocated and taxed where economic activities take place and value creation happens.

India is a significant contributor to this initiative and tax authorities at the highest level have accepted these recommendations and suggestions and there will be necessary changes in tax legislation soon – likely in Finance Bill, 2016 effective April 1, 2016. Also GAAR will become reality soon latest by April 2017, as planned.

As economies gear to accept and implement changes as per BEPS report, there will need to be an awareness to be created amongst corporate and business houses as well as professionals who would be advising them.

The objective of this article is to identify immediate professional opportunities arising out of BEPS report for professionals. Before diving into the same, it would be useful to understand what BEPS means to businesses at large and what are say Top 5 issues on their agenda so that we are in a better position to focus on the same.

The rest of the article is structured as below.

– What does BEPS mean to businesses at large?

– Creating awareness and knowledge amongst professionals

– Impact of BEPS

– What are Top 5 issues that a Tax Director or a Finance Director should look into?

– Opportunities for Professionals.

What does BEPS mean to businesses at large?

There are basically 15 Action Points suggested in BEPS report. These are broadly divided in 3 key pillars:

– Introducing coherence in domestic tax rules that affect cross-border activities;

– Reinforcing substance requirements in the existing international standards; and

– Improving transparency as well as certainty.

Above 3 pillars together with 15 Action points will mean that entire cross border trade and business models may undergo substantial change in many situations, particularly dealing between related parties and affiliates globally and including in India. Transfer pricing regulations are already in force in India over a decade and there are local documentation rules and requirements for both international and domestic transactions. For example, BEPS Action points 8-10 & 13 detail Country-by-Country (C-b-C) reporting of transactions and related profits and assets for global companies for turnover in excess of Euro 750 million (approx. ` 5,000 crore). This will increase substantial compliance for large companies and corresponding opportunities. Also TP authorities may look into local documentation more closely for other companies too.

Creating awareness and knowledge amongst professionals

Indian Government opened up Indian economy for attracting foreign investment mainly through New Industrial Policy in July 1991. Since then, the foreign investment policies have been significantly liberalized and now, a non-resident or a foreign company can invest up to 100% in almost all ventures and sectors except very few where there are sectoral caps or few negative list of strategic and national security importance sectors.

Also the entire concept of 'Regulatory' aspect of foreign exchange was replaced by 'Management' by RBI in 2000 when Foreign Exchange Regulation Act, 1973 (FERA) was replaced by Foreign Exchange Management Act, 2000 (FEMA). Under FEMA, even outbound investments regulations have been substantially liberalized and almost 100% equity as well as debt investment is permitted on an automatic basis (up to 400% of Net Worth). Also RBI announced Liberalized Remittance scheme in 2011 under which an individual and other residents can invest up to US$ 250,000 per person per financial year on an automatic basis (through authorized dealers). This has significantly expanded outbound investments both by individuals as well as Indian companies and residents all over the globe.

Above cross-border trades (both inbound as well as outbound) have provided significant opportunities for professionals on advising with respect to tax planning and structuring as well as implementation and compliance requirements. International tax planning through use of tax treaties has been a core area and transfer pricing regulations have added another opportunities in the past on advising on structuring as well as documentation and certification matters.

All these above will undergo a sea change in many aspects with BEPS action points focusing on substance over form requirements as well as bringing transparency and certainty measures. Also coherence and minimum standards agreed under few action points will bring consistency and suitable change in domestic tax rules, including India soon. Business structures and models will need to be aligned with new BEPS rules going forward.

Considering above proposed changes, it will be extremely important and relevant in the first instance to create awareness of new BEPS rules and action points and impart technical knowledge amongst professionals before one can advise corporate, foreign companies and individual investors. Also as part of transparency measures, India has already agreed on automatic exchange of information and has signed Agreement with USA under Foreign Account Tax Compliance Act (FATCA) which is already effective this year in 2015. There are certain disclosure requirements under FATCA and it provides some good opportunities to advice NRIs/POIs and Indian institutions investing in specified US investments. BEPS will bring many more opportunities under FATCA as well as similar Agreements signed by India with foreign countries.

In all 15 Action points are deliberated in the BEPS report spread over more than 3,000 pages – thus huge amount of effort has gone in covering these aspects with inputs and contributions of approx. 60 countries, including substantial contribution by Indian tax authorities as equal partner amongst all.

Briefly, Action points deal with different aspects of BEPS as below.

Action – 1	Addressing tax challenges of Digital economy
Action – 2	Neutralizing effects of hybrid mismatch arrangements
Action – 3	Designing effective Controlled Foreign Company rules
Action – 4	Limiting Base Erosion involving interest deductions and other financial assets
Action – 5	Countering harmful tax practices more effectively, taking into account transparency and substance
Action – 6	Preventing the granting of Treaty benefits in inappropriate circumstances
Action – 7	Preventing the artificial avoidance of permanent establishment status
Action – 8-10	Aligning transfer pricing outcomes with Value creation
Action – 11	Measuring and monitoring BEPS
Action – 12	Mandatory disclosure rules
Action – 13	Transfer pricing documentation and Country-by-Country reporting
Action – 14	Making Dispute Resolution more effective
Action – 15	Developing a Multilateral Instrument to modify bilateral treaties.

Impact of BEPS

The focus of BEPS would be to ensure that profits are taxed where economic activities take place and value is created.

This will have substantial impact on both Inbound and Outbound investments structures going forward.

Inbound investments into India

Over years, foreign companies have invested in Indian companies either directly or through holding structure. Similarly, numbers of technology transfers as well as technical services agreements have been executed. There are also secondments of technical and other personnel in manufacturing and capital intensive projects.

The concept of holding company structures and holding company structures will need to be reviewed and reworked in line with BEPS. Also with GAAR in force, substance over form will be a reality. For example, numbers of foreign investments in the past have been routed through Mauritius and Singapore. In these situations, BEPS Action points 5 & 6 will be attracted and Treaty shopping will be a matter of past. These structures without substance will be questioned and shell or post box companies will be disregarded.

In the context of royalties and technical services, transfer pricing regulations will be closely scrutinized and documentation rules including C-b-C wherever applicable will need to be adhered to. Interestingly, in the draft guidelines issued by CBDT on Place of

Effective Management (POEM) in the context of residential status under section 6 of Income-tax Act, royalty transactions between affiliates will be treated as creating a passive income and POEM may be scrutinized more closely on that count.

In addition to above, foreign companies will no longer be able to artificially avoid PE status through split of activities e.g. manufacturing, distribution, marketing by different entities and thus avoid threshold limit of 183 days (generally) for each activity. One would need to examine impact on outsourcing units operating in India – particularly high end back office operations will have higher value creation and higher allocation of profits. Thus shifting of profits to low/no tax jurisdiction or tax havens will have serious tax challenges.

Outbound investments from India

There have been number of outbound investments effected by Indian companies and non company entities (including individuals). Here too, holding company structures and POEM will need to be examined closely. Also Action point 3 in BEPS deals with CFC regulations and Indian legislature may introduce CFC regulations in local tax law in future. Like inbound investments, shifting of profits to low/no tax jurisdiction or tax havens will not be permissible. The Indian businesses with outbound investments will need to be suitably educated and awareness should be created.

What are Top 5 issues that a Tax Director or a Finance Director should look into?

Considering use of Tax treaties and treaty shopping in international tax planning over say last 2 decades, BEPS will bring major change in approach the way traditional tax planning is done. 15 Action points bring a whole gamut of coherence, substance over form, transparency and certainty measures.

A Tax Director or a Finance Director will need to immediately focus on some important and critical tax issues which may have a bearing on the business model and structures.

In this regard, following may be Top 5 issues that a Tax Director or a Finance Director may look into more closely.

- Build business substance in offshore business structures, especially those involving low or no tax jurisdictions
- Review the extent and nature of business presence in foreign jurisdictions in light of potential changes to existing permanent establishment concepts
- Develop a central approach to transfer pricing and prepared processes and tools to enable C-b-C tax reporting where necessary
- Consider threats to existing hybrid entities and structures in the group and investigate potential alternatives
- Prepare strategy for communicating tax position (e.g. impact of global effective tax rate – ETR) to various stakeholders and decide what to communicate, to whom, where and when.

Above are Top issues which a Tax Director or a Finance Director of a large conglomerate with multi country locations presence may need to keep in mind. Having said that some or all of above may also be relevant to medium and small sized businesses.

Opportunities for professionals

In light of above perspective and business rationale, let's now turn to various opportunities that BEPS can throw for professionals.

Obviously, the opportunities will depend upon the size of businesses, complexities that these businesses have and cross country presence of these entities. The needs of these businesses and entities will create opportunities at various levels for large firms, mid-size firms and individual practitioners.

The needs can be further divided as below.

- Large Foreign MNE companies operating in India
- Mid-size foreign companies operating in India
- Large Indian business houses with multi country presence for outbound investments
- Mid-size Indian companies with outbound focus in few countries
- Foreign Outsourcing companies operating in India.

There are also issues on Intangible creation and allocation of profits due to value creation. In addition for complex business models, supply chain will become more relevant. These can cut across all kinds of companies.

Large foreign MNE companies operating in India

With OECD releasing its final recommendations and Indian Govt. indicating that it would be implementing the same soon, it is crucial that MNEs will need to understand current tax environment in detail and anticipate any potential impact on their existing structures and future transactions. Upfront planning would help businesses to streamline their operations from BEPS perspective. Various companies having operations in other jurisdictions will need to address following and will accordingly need professional help to address the same:

- How are developing economies reacting to BEPS and what is India's position on the same? This is the first obvious question which will arise and answer to that is that India is committed to deliver recommendations on BEPS. Thus this will be a broad awareness exercise which will lead to analysis in further details.
- It will be important to know if profits in overseas jurisdictions are in alignment with operations in those jurisdictions. This is crucial to determine as profits allocation need to be aligned with value creation and operations. This will be a commercial and financial exercise.
- What is the commercial rationale behind setting up a holding or a subsidiary company in a particular overseas jurisdiction? This will need advice on building substance or if the same is not possible, review of the jurisdiction. Mauritius and Singapore structures will need review on this count.
- Funding options – What kind of financial instruments are used in funding various global operations. Action points 2 & 4 are relevant here. Also GAAR provisions will need to be examined to evaluate if debt will be characterized as equity or otherwise. There will also be transfer pricing impact due to respective functions vs. risks taken by different entities e.g. a mere financing entity (without taking commercial risk of lending, etc.) will now be entitled to a normal margin and not high profits allocation. Thus financing structures will need to be examined and re-evaluated in this light.
- How is overall supply chain management structured? One would need to look at backward and forward integration and impact of the same under BEPS – transfer pricing review will become very relevant and profits allocation will depend on value creation. This may need re-working of transfer pricing strategy and most appropriate method.
- How are various Intellectual Property Rights (IPRs, brands, etc. positioned)?

Whether all group companies contributing to development, enhancement, maintenance, protection and exploitation of intangibles being remunerated on arm's length? This can be a major transfer pricing exercise. Action point 5 dealing with Countering harmful practices and Action points 8-10 dealing with Transfer pricing are very relevant. This can also open opportunity for valuation of intangibles based on functions described above.

– Whether overseas group companies receiving royalty or fees for technical services from Indian group companies are beneficial owner of such receipts? This can have both transfer pricing and withholding tax implications. Global transfer pricing study and pricing mechanism may undergo change and review.

– Will commissionaire structures be questioned on account of creating a permanent establishment? These will need to be examined closely and re-worked as necessary.

– What impact BEPS will have on Global Effective Tax Rate (ETR)? Reallocation of profits, if any, due to BEPS can change ETR and have impact on bottom line – positive and negative, as the case may be. This can lead to opportunity on minimizing Global ETR and maximize global profits. Also considering substance over form concept, this can also lead to creating substance and commercial rationale in different entities. Not only this is tax opportunity but this can lead to re-drafting of legal agreements and create opportunities for legal profession on drafting various legal agreements.

Considering above, various opportunities can be summarized as below.

– Initial awareness of BEPS issues and conducting training for tax and business personnel within client organization

– Tax advice on BEPS

– Treaty related advice

– Transfer pricing including C-b-C reporting (for global revenues in excess of Euro 750 million or approx ` 5,000 crore)

– Supply chain and related matters and financial impact analysis – transfer pricing and profit allocation will be key.

– Review of holding company structures from tax perspective and liaisoning with global tax consultants, as required

– Review of various financial instruments to align with BEPS report

– Entire exercise on review of IPRs, brands and intangibles – This will have tax, transfer pricing, valuation, alignment with commercial and business objectives, review of legal documents and agreement. This can be a larger tax, finance and legal opportunity. Various professionals can work together or independently as permitted by their respective Regulators and Code of Conduct

– Review of Global TP study on account of royalty, technical service fees, management fees, etc.

– Review of Global ETR.

– 'Project management leader' for making sure that various constituents work in tandem and deliver optimal result

– Assist in implementing the suggested structure once the review is complete

– Tax compliance services (BEPS related), as may be required in future.

Number of above opportunities can happen immediately and some of them can happen post Finance Bill, 2016 once there is clarity.

One comment – there is general feeling that large MNEs can be serviced only by larger firms due to bandwidth, infrastructure and network reach. Though this may be true in overall sense, there is still a great opportunity for individual practitioners to be a bridge between senior management (where senior management trusts an individual) and different constituents – providing their own expert advice and working in a collaborative basis with relevant constituents/large firms to deliver results, as feasible. Also an individual can act as a 'project management leader'.

Mid size foreign companies operating in India

Depending on the size, some or all of the above aspects will be relevant for a mid size foreign company. If the global turnover is less than Euro 750 million (approx ` 5, 000 crore), then maintaining C-b-C Report will not be mandatory. However, there will still be need to perform local TP study, documentation and certification.

In fact, large MNEs have global in-house tax support and hence part of work can be done internally and only value added services may be outsourced. Compared to this, mid size foreign companies may not have much in-house support and generally outsource the entire tax function.

Considering the size, following opportunities may occur for professionals.

– Initial awareness advice and training their finance and business people – generally such companies may have more flatter organization with fewer hierarchies making it easier to reach various constituents.

– Individual practitioners have an opportunity to act as trusted business advisor here as management will generally discuss even non-tax matters that impact their business.

– Domestic Tax, Tax Treaty & Transfer pricing advice

– Review of holding company structures and liaisoning with tax advisors in foreign jurisdictions

– Liaisoning with tax advisors in foreign jurisdictions, where required

– Transfer pricing documentation and certification services

– Valuation of Intangibles, where required

– Financial impact analysis due to BEPS

– Effect of ETR and related tax planning services

– Review of relevant Agreements – tax and legal services

– Assist in implementation, as required

– Tax compliance services (BEPS related), as required in future

– Advice on account of disclosures under FATCA in USA for institutional and individual investors – in liaison with US tax experts. Similar opportunities will occur when India signs more such exchange of information agreements with other foreign countries.

Large Indian business houses with multi country presence for outbound investments

As discussed ahead, Govt. & RBI opened up Indian companies to invest outside of India and lot of outbound investments have happened in last decade or so.

Large Indian business houses with presence in multi country locations (i.e. Indian MNEs) will need to be educated and made aware of implications of BEPS and relevant impact on their business models and profitability going forward. Also tax impact and compliance in foreign jurisdictions will need to be reviewed in detail and risks to be identified.

Following services will be required by Indian MNEs.

– Initial awareness and training of relevant personnel in client organization

– Broad financial impact analysis under BEPS (considering current operations and structure)

– Review of Global and regional holding company structures as the case may be – particularly focusing on low or no tax jurisdictions.

– Advice on building of substance in overseas jurisdictions in line with BEPS and respective domestic tax laws (including GAAR regulations)

– Review of Global transfer pricing study and documentation – Also where the global turnover is more than Euro 750 million (approx. ` 5, 000 crores), there will be requirement for maintaining C-b-C reporting. As per Action point 13, C-b-C is to be maintained in the ultimate country of residence which in case of Indian companies will be in India. This is a completely new area and the rules may prescribe documentation requirements. This will also significantly increase one-time compliance costs for Indian MNEs and provide opportunities to advice as well assist in preparing this documentation in addition to local TP documentation. As far as Indian tax law is concerned, it will depend on what comes out in Finance Bill, 2016.

– Also in connection with C-b-C reports, there will need to be developed processes and tools for smooth reporting. The added issue will be re-aligning existing IT systems and training relevant personnel in client organization. This is management consulting service.

- Advice on 'Place of effective management' in connection with residential status of foreign subsidiaries (both operating as well as holding companies for holding foreign investments). The draft guidelines have been announced by CBDT and this presents an immediate opportunity even before BEPS comes into effect.

– Advising and analyzing risks on creating Permanent Establishment in foreign jurisdictions under BEPS – if there is a potential risk on PE, then what is the solution or fire walls to be constructed

– Supply chain related advice and assistance – re-align functions (e.g. manufacturing and distribution) and pricing to ensure that profits/income are allocated in accordance with value creation in each jurisdiction.

– Number of large Indian manufacturing, auto, pharma and other companies are focusing on IPRs and R&D in India. BEPS will throw unique tax challenges on IPR valuation and taxation issues. Also there is existing large transfer pricing litigation on account of Advertising & Marketing promotion expenses e.g. Maruti-Suzuki, Sony cases, etc. These will need advice and strategizing the same.

– Review of other intra-group transactions e.g. financing, royalty and technical service fees, management cross charges, Indian HO cross charges, Corporate guarantee, etc – this should be aligned with value creation and suitably need to be remunerated to Indian parent.

– Effect on Global ETR for Indian MNEs in manufacturing as well as those focused on exports, including units in SEZs

– Action point 3 deals with introduction of Controlled Foreign Companies (CFCs). The draft CFC regulations were introduced in draft Direct Taxes Code Bill but never got legislated. It is now possible that CFC regulations will be introduced in future. This may need to be evaluated.

Mid size Indian companies with outbound focus in few countries

Similar issues will arise like in case of large Indian MNEs but the scale and complexities may be lower depending on size of business operations outside India.

Following services will be required.

– Initial awareness and training

– Broad financial impact under BEPS

– Review of holding company and operating overseas subsidiary to evaluate applicability of POEM, if any

– Tax and Treaty related advice and assistance

– Transfer pricing arrangements and documentation/certification assistance, as required

– Review of existing international transactions e.g. exports to group companies which act as distributor, royalty and technical fees, management cross charges, impact of parent corporate guarantees, if any, etc

– Advice on tax in foreign jurisdictions in alignment with tax advisors in those jurisdictions

– Effect on ETR and financial impact, as the case may be

– Any other relevant issue (as applicable to large Indian companies above).

Foreign outsourcing companies operating in India

Foreign companies have set up captive outsourcing centres to cater to parent needs in India. Over years, the operations have moved in many cases from low end to high end activities. Considering that focus of BEPS will be allocation of profits based on economic activities and value creation, this will assume larger importance.

Following issues will arise and services needed to address the same.

– Action point 7 deals with preventing artificial avoidance of PE status. The question is whether high end activities creating value will now create PE in India for such units?

– Will POEM get attracted due to high end activities (and possibly due to key commercial and managerial personnel being in India)?

– Transfer pricing methodology (Functions, assets, risks) may undergo change due to high end activities e.g. Transactional Net Margin Method may be questioned. Also the basis of calculating costs may be scrutinized more rigorously.

– Will high end activities create intangible in India? How would these be valued?

In summary, BEPS will change the way international tax planning has been done over last 2 decades or so. Substance over form, transparency, certainty and exchange of information will be relevant. In light of these, corporate and business houses will need to re-work their business structures and models which will create opportunities to professionals.

CA Rashmin Sanghvi

"Has BEPS project been successful?"

1. Has BEPS project been successful? Answer to this question can be considered in many alternative manners. *

1.1 "Will tax evasion and tax avoidance stop after BEPS reports?"

Clear answer is "No".

1.2 "Under the circumstances, have the BEPS groups made good enough recommendations to help Governments in reducing tax avoidance and tax evasion?"

Yes. They have achieved a brilliant success.

Between these two extremes let us understand what BEPS groups have done and what may be expected in the near future.

1.3 If by the term "success" we mean, that **"The tax payers will start honestly paying up all their taxes";** the question itself is laughable. प्रश्नस्य अनौचित्यम्. This society (Sansar) continuously plays the game of greed and fear. People will continue to be driven by greed and fear. No amount of law making is going to change the people's desires to avoid taxes. And when they want to avoid taxes, they will find new ways of tax avoidance.

The question can be compared with following questions:

"Did Mahavir Bhagwan/ Buddha Bhagwan/ Ram Bhagwan/ Jesus Christ or Mohammed Payagamber - succeed in making all their followers honest and divine?" Gods will come and go, society will evade and avoid tax as long as a tax law remains on the statute books. Expecting all the tax payers to be honest is like expecting the fish not to drink water.

Only thing that a law can do is: make tax avoidance difficult. However, in all countries, there always are a few smart people who avoid & evade taxes. Governments continue to make harsher & broader laws to frighten tax evaders. In the process the law becomes tyrannical & tax avoidance becomes a way of life. This is an involved issue to be discussed later in this article.

***Note**: There are independent papers in this issue for different BEPS Action Reports. I am dealing with the issue at Macro level only.

1.4 "Have the BEPS Groups made recommendations, which if passed into law will make tax avoidance/ evasion impossible?"

Again, my answer is: "NO". Law can make it difficult. But no law will ever make it impossible to avoid or evade tax. The attempts to make tax avoidance difficult can succeed to an extent. Beyond a limit, the law will become tyrannical and will throttle even the honest tax payer.

1.5 Let us come down to harsh ground realities. G20 and at its instructions, OECD have made several different groups of Government officers. They were expected to come out with appropriate recommendations for changing the OECD model of Double Tax Avoidance Agreement (DTA) as well as domestic law for making tax avoidance difficult. For tax evasion, BEPS reports are not applicable. There are different recommendations for tax evasion.

This is a **collective effort** of several countries. The moment there is a collective effort there will be people with **conflicting interests.** In these efforts, countries which admittedly are tax havens (including some countries that act as tax havens but do not admit that they are tax havens) have also participated. Then there are countries like USA that openly declare that they will support only such provisions which are beneficial to USA. World interest is subordinate to US interest. Hence they try to bring provisions which should not harm American interest. If the rest of the world wants provisions which would be fair to all the countries but which would affect US interest, such laws or such recommendations will not see the light of the day.

The query may be restated as: "In such a situation (of conflicting interests with some lobbies being more powerful than others) have the BEPS groups succeeded in making useful recommendations?" Answer is "Yes".

1.6 Role of BEPS Group

The only role that BEPS group had was to make recommendations. Once the recommendations are made, it is for the individual Governments to act and make necessary modifications in their domestic laws. It is for the OECD & UN to amend the treaty models and commentaries appropriately.

1.7 BEPS groups have already **instilled fear in the minds of MNCs** and their tax consultants. They have realised that their massive tax avoidance games will not be tolerated. People have already started taking corrective steps.

Tax Havens & MNCs were shouting from the roof tops that "tax avoidance is our birth right". They were ridiculing Governments and academicians who protested against tax avoidance. With a concerted action by so many nations, their bravado is falling aside. This itself is a big achievement for the BEPS groups.

1.8 We can't expect from the BEPS group – what was not their brief. For example, present treaty models are clearly in favour of COR at the cost of COS. There is a serious need to resolve this injustice. But this issue was not part of the brief given to BEPS groups. So we can't expect it from them. It is for countries like India, China, Africa, Latin America, etc. to seriously take up the issue of fair share of taxes for COS countries.

2. **Circumstances** in which BEPS action has been taken up are only too well known. Let me summarise.

In the year 2008 American financial crisis erupted and the world came to know that American Government and several banks, financial institutions and other corporations were in serious financial crisis. The American crisis soon spread to Europe and Japan. Now even china is feeling the pressures. In an interconnected world fall of the biggest economy has affected all other economies at varying degrees. During this crisis, Iceland, Greece & Cyprus went insolvent.

An offshoot of the American Crisis was that several Governments realised that Multi-National Corporations (MNCs) were avoiding taxes in a big way. Governments needed more revenue. Main Group expected to provide revenue was not coming forward. Some specific MNCs blatantly avoided taxes and made proud statements as if it was their birth right to avoid taxes.

The Economic Crisis brought G 20 nations together to consider remedial actions. Blatant tax avoidance by MNCs made the G 20 consider corrective action. These nations together asked OECD to make proper recommendations to curb tax avoidance and evasion.

The fact that twenty nations could come together, rise above their differences and take collective action; is **it itself a big achievement**. Rarely have so many nations* agreed upon something so quickly.

Normally, for any specific action OECD takes several years. Vested interest lobbies dominating in such institutions do not allow smooth conclusions of issues. Despite these traditions, the fact that BEPS groups have been able to publish fifteen reports in a period of two years (2013 to 2015) **is creditable**.

3. **Action Taken:**
The BEPS groups have formed Monitoring system. All G 20 & OECD member countries are expected to implement a minimum level of recommendations by introducing anti-avoidance provisions into domestic tax laws. OECD & UN will modify their model treaties and commentaries to specifically provide that treaties are not meant for abuse; nor for double non-taxation.

Limitations of Benefits (LOB) clause will be substantially amended – under Action 6. Treaty Shopping will not be permissible. With these provisions, most companies that have resorted to treaty shopping by incorporating SPVs in Singapore will find it difficult to get treaty benefits. (Note: Most of the SPVs in Mauritius & UAE will lose treaty benefits because of POEM.)

Britain has already passed: "Diverted Profits Tax Act" or Google Tax Act. Similar law has been passed by Australia. Commentators have commented that both these laws are not well drafted. They may improve the laws, or there will be litigation.

CFC rules will be made strict. US Government has made budget 2016 proposals. They have proposed to amend CFC provisions with retrospective effect. Government expects to recover back taxes of $ 500 billion.

Transfer pricing provisions will be still stricter.

A Multilateral Treaty to be signed by ninety countries will bring into force all amendments in OECD model at one stroke.

Tax Havens & their banks are already forced to be transparent. They have to share information. It is said that Switzerland and Mauritius have already started sharing information.

Report on Artificial Splitting of Permanent Establishment is inadequate. It may not serve purpose. Thin capitalisation will not work.

Country by Country Reporting is being introduced by all important countries. This will force many large MNCs to report country wise profits. Disproportionately large profits in tax havens may not be accepted.

Soon many nations may be expected to pass several laws in line with BEPS reports.

Thus, overall, many avenues of Tax Avoidance will be severely curbed.

4. Other Issues to be noted

4.1 Tax Justice Network have done tremendous service in exposing tax evasion and tax avoidance. They have even exposed the politicians/ rulers of some countries. Being exposed & embarrassed, these nations also had to agree to BEPS actions. TJN contribution in this process is significant.

4.2 There are some tax consultants who constantly innovated "Tax Avoidance Products". Then openly canvassed for such products and made far more money than the regular tax consultants. Same consultants are now shouting from the roof top: "Come to me. I will advise you on BEPS".

I don't know: "Is it Comedy or Tragedy?"

4.3 It is the responsibility of the Governments to ensure that the laws are simple and easy to understand; and easy to comply with. The honest tax payer should not suffer a harsh law because of the unscrupulous tax payers and tax consultants.

4.4 All the BEPS Action Reports are concerning international taxation. They will have no impact on purely domestic income taxation.

4.5 BEPS is new name for the old and established games. Base Erosion & Profit Shifting is a game of avoiding taxes – as old as tax laws.

Base Erosion would mean, reducing taxable income of a country. Same illustrations are: Resorting to transfer pricing. Reducing revenues and increasing expenses in a normal country and transferring resulting profits in a tax haven. There are almost fifty tax havens in the world helping this process.

Profit Shifting – Hutchison – Vodafone share transfer case is an ideal illustration of trying to shift taxable capital gains from India to Cayman Islands.

BEPS is only a new name given to old Tax Avoidance games. Governments try to curb tax avoidance. Within the Government, vested interest – politicians – create safe harbours for themselves. Participatory Notes in India are classic illustration of this process. What is new is: So many Governments have come together to curb tax avoidance.

What remains to be seen is: How the vested interests will still retain avenues for – earning black money, doing round tripping, investing their funds back in

India and securing tax exemption for own investments. It will be climax of the drama being played out in tax field.

5. 1st Action Report on Digital Commerce:

OECD is discussing E-Commerce since **1997**. It provided a definition of E-Commerce as: "Commercial transactions in which the order is placed electronically (using computer and internet) and the goods and services are delivered in tangible or electronic (digitized) form." Use of internet and computer network was an intrinsic part of the definition.

In the year **2001**, Indian High Powered Committee emphasised in its report that: "Existing rules of international taxation are inadequate to tax E-commerce transactions. Existing definition of Permanent Establishment cannot be applied to E-Commerce. We need new rules".

This proposal was rejected by OECD through its report in the year **2005**. It clearly said that "E-Commerce business is too small. Existing rules are fine. And the rules cannot be changed".

Microsoft internet explorer started in the year 1995. Google was set up in the year 1998. Yet, till 2005 OECD did not consider them as important. Through Google Ireland, Google executed its now famous tax avoidance scheme – of "Double Irish". Google operated in Germany, France, Britain etc. but paid hardly any taxes in those countries.

When the American financial crisis forced these countries to review the tax leakages, a public outcry started. People who were losing jobs in Europe were not happy that someone made billions of dollars and paid no taxes.

All this culminated into formation of BEPS Group and the first task given to the group was – find out how to tax E-Commerce. The group came out with its statements and in the year 2013 clearly admitted that "Existing rules of international taxation are outdated". (There were further drafts published in 2014.) Final reports have been published in November, 2015. Moral of the history: It required a huge economic crisis affecting its dominating members – for OECD to accept the writing on the wall: Existing Rules are outdated.

And yet,

While Action 2 to 15 reports have been delivered and concrete action has been recommended in most of the reports; no specific action has been recommended in the first report itself.

Why?

Consider the facts that:

COR can always tax the global profits of a resident MNC. The issue being debated at BEPS groups was, these MNCs were escaping COS tax. And major E-Commerce companies are resident of USA. USA would not allow any modification in OECD model that will reduce its rights to tax in favour of COS countries.

Within India, the Tug of War is between (i) Revenue department and (ii) Tax Payer & Tax Consultants. Internationally, the Tug of War is amongst COS & COR. These different wars keep going on for ever.

If one considers all publications by OECD on this subject, one realises that there must have been good debates between the COR & COS countries. Finally what the COS country members in BEPS group have been able to get in the report is – three options given to the members including an option for Equalisation Levy. Though no specific recommendation is made.

BEPS group has **failed in** giving specific solution for E-Commerce taxation. Members within the group representing COS countries have succeeded in extracting the option for Equalisation Levy.

6. Consequences in Future

Any discussion on BEPS is not complete until we can say clearly what can be the consequences once BEPS reports are implemented. This is an attempt at looking into the future. We cannot predict the future but can try to project the future. Based on the projections, tax payers and tax consultants can prepare themselves. When the laws are passed and actually put into practice, the projections have to be modified and appropriate actions may be taken.

We may appreciate that the G 20, OECD, UN and EU all are together in this exercise of curbing tax avoidance as well as tax evasion. This is a multi-pronged attack on tax avoidance as well as tax evasion. I am highlighting both the aspects separately below.

6.1 Tax Evasion

Financial Intelligence Units (FIUs) have been set up worldwide under the Prevention of Money Laundering Act (PMLA). All banks and financial institutions are duty bound to report suspicious transactions. Certain banks which have been party to money laundering have come to grief. They have paid huge fines. In this process, money transfer from or through tax havens is automatically covered. There have been several cases of tax evasion caught under PMLA. It is true that PMLA covers criminal money laundering. It is not the target to find out and control black money. However, when suspicious transactions are reported to the Finance Ministry, and when they find out that some tax payers have evaded Indian taxes, naturally they follow up with Income-tax search and seizures.

More than 80 countries have signed agreement for **Automatic, Simultaneous Exchange of Information.** When one country finds out that the resident of another country has resorted to some tax evasion, the officers of the country are expected to immediately inform the officers of the relevant country. In future, exchange of information amongst tax departments of several countries will be very common and quick. India's agreement with USA has become effective from 1st January, 2016. Agreements with other countries will be effective from 1st January, 2017.

Government of India has passed **Black Money Law** where the tax payers can be imposed tax and penalty together amounting to 120% of the black money. Simultaneously, **FEMA** has been amended with powers to seize Indian assets equivalent to black money held outside India.

With all these actions, the chances that Government of India will find out black money held abroad by Indian residents have become much brighter. With specific deeming provisions under the law, it will be difficult for the tax payer to have lengthy litigation and delay Indian taxes. Thus there is a whole package to attack tax evasion.

6.2 Tax Avoidance

We have many Specific Anti-Avoidance Rules **(SAAR)**. Section 64 is one of the simplest SAAR. Transfer Pricing provisions are a broad assault on tax avoidance. Place of Effective Management (POEM) provisions are also a serious threat to tax avoidance. Unfortunately all these provisions simultaneously pose huge risks of arbitrary action by Income-tax department against even honest tax payers. These are existing harsh provisions against tax avoidance. These provisions will now be further strengthened by (i) **GAAR** & (ii) **BEPS**.

Altogether, tax compliance in India will be extremely difficult. If the Government does not come forward with specific actions for **Tax Payer Protection**, Indian economy will be seriously harmed. Recently, the Government has issued internal circular (Instruction No. 17/2015 dated 9th November, 2015) whereby a tax payer can complain against arbitrary high pitched orders issued by Income-tax commissioners. When a tax payer complains to one tax authority about the action by another tax authority, one can easily anticipate that he will get no justice. The failure of Dispute Redressal Panel (DRP) in giving relief to tax payers is an ongoing experience.

In India, tax commissioners are not accountable for their actions. UPA Government of course never took any action. Current Government also, after making big statements against tax terrorism, has only increased arbitrary powers of revenue officers and provided no effective protection to the tax payer.

6.3 Tax Litigation

With the massive package of existing and new anti-avoidance provisions, tax litigation is bound to multiply.

7. Tax Payer Protection

7.1 It is an important aspect of tax administration and compliance to provide tax payer protection. In India, tax payers have had bad experience. Even the Government of India has used the term: "Tax Terrorism". Income-tax Officers have terrorised certain tax payers. It is no secret that Income-tax Commissioners (or for that matter any revenue officers) are not held accountable by the Government.

We in India already have a number of SAARs. Then transfer pricing provisions were added. These provisions give vast powers to presume incomes were none existed. Tax demands for absurd amounts have been raised in India. The judicial system works. But it is very slow. "Justice delayed is justice denied". Continuous fear of revenue officers harassing the businessmen has actually frustrated the enterprising spirit. For a businessman, Income-tax commissioner is not the only tax commissioner. He has to deal with several revenue departments, scores of Government inspectors and several investigating agencies. At present, it is a great miracle that any one even thinks of putting up a new business/ industry.

In this existing harsh environment, BEPS reports have added the fear. When these recommendations will be implemented by passing domestic laws, the presumptive powers of the Tax Commissioners will increase. With this, the power to cause injustice and terror will increase. The natural result will be more harassment.

We can't criticise the BEPS group for not providing tax payer protection. Probably it was not their brief. However it is for the G20 and OECD to build into the law, the tax payer protection.

7.2 Following is the brief narration of a very commonly repeated vicious cycle:

Greedy tax payers don't want to pay the tax. Best professional brains and tax havens create products to help the greedy. They work out elaborate schemes to avoid tax. Then Governments pass harsh laws giving presumptive powers to the tax commissioners. The greedy commissioners use these powers to extract bribes. Those who have saved vast amounts of tax can afford to give bribes and even to lobby before Governments and get out of the problems. The honest tax payer who has already paid full taxes has no money left to pay for the bribes or to pay for the lobbying before the Governments. When these people start suffering, industrial growth dies. With that, whole economy suffers.

Whatever I have said in this paragraph is not theory. This has been proved by experience in India. India justified harsh provisions under Foreign Exchange Regulation Act (FERA) by citing shortage of foreign exchange. The law was absurd and harsh. It prohibited genuine business activities and made almost every person who had to do anything with foreign exchange a guilty in the eyes of the law. RBI and Government went on continuously increasing the restrictions, Enforcement Directorate abused all the restrictions. Indian economy suffered vastly. India was stuck with a GDP growth rate of around 3%. It was only after the liberalisation process started in the year 1991; that Indian economy started looking up.

With BEPS and the combined package of laws, there is a certainty that an experience similar to FERA will be repeated unless tax payer protection is built into the law.

7.3 This Government simultaneously talks of contradictory issues:

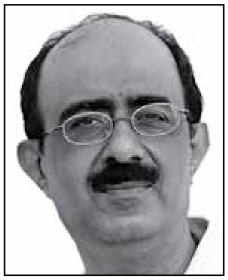
(i) Tax Payer Friendly regime; and

(ii) Harsh anti-avoidance & penal provisions.

Excellent balance between the two can be achieved if harshness is restricted to tax evaders & avoiders; and friendly approach is adopted for honest tax payers. This requires discretion and accountability on the part of tax commissioners. Let us hope, Government is able to achieve the fine balance between two opposing issues.

8. Conclusion

BEPS groups have largely succeeded in the brief given to them. Tax Avoidance & Evasion – both will be difficult. Governments need to be equally serious about Tax Payer protection. Otherwise India will go back to pre-1991 rates of GDP growth.

CA Mitesh Katira & CA Dinesh Kumar Tejwani

DIGITAL INDIA SERIES
Start-up India Action Plan

In a landmark event on 16th January 2016, PM Modi announced Start-up India Action Plan. This is seen as the starting point of dialogue between the start-up ecosystem and policy makers. This kind of high profile event has not even been witnessed even in the most start-up friendly nations like Israel or USA.

Perhaps this is the most exciting time for the Indian start-ups with Government announcing compliance simplification + mentoring + fund allocation of ` 10,000 crores dedicated for the start-up ecosystem. PM Modi said "I see start-ups, technology and innovation as exciting and effective instruments for India's transformation."

As tax consultants and practitioners, we need to be sensitized and updated about this wave called start-ups which is fast changing the scenario around the country. It is uprooting not even the established concepts but bringing the traditional businesses out of their comfort zone. For example, OYO Rooms whose name PM Modi referred to in his speech, Ritesh, a 21 year old boy could make an inventory of 14,000 rooms in 80 cities of India. While his closest competitor, which is surprisingly Taj Hotels set up by iconic conglomerate, is having inventory of 9,000 rooms!!

Let us look at the broad guidelines of "Start-up India Action Plan".

Objective

Start-ups are seen as great means towards sustainable economic growth and large scale employment generation. The objective of Action Plan is to

– Spread start-up system from technology sector to other wide array of sectors

– From big cities to semi-urban and rural areas

The Plan seeks to remove the difficulties faced by start-ups such as:

- Time consuming and difficult regulatory compliances
- Long drawn closure in case of failure
- Lack of credit and funding

The Plan also seeks to provide impetus to startups by:

- Promoting awareness and adoption of IPR
- Tax exemptions
- Encouraging innovation through incubation and mentoring

The Action Plan

The Action Plan is divided across the following areas:

- Simplification and handholding
- Funding support and incentives
- Industry-Academia partnership and incubation

Simplification

- A non-intrusive model shall be brought in place which will be "self-certification" driven for 9 labour and environment laws. There will be no inspection for three years under labour laws. The compliance will be via start-up mobile app. Pollution control shall also be driven by self-certification in case of "white category" businesses.
- A mobile app will be made available from 1st April 2016:
  - o To register a start-up
  - o For compliances via self-certification
  - o For collaborating with start-up ecosystem partners
  - o For applying under various eligible schemes
- The Insolvency and Bankruptcy Code 2015 will make it faster and easier for start-ups to wind up. The bill is currently under the scrutiny of the joint committee of the Parliament. The bill provides for permission for start-ups to wind up within 90 days of application. On receiving such permission, an insolvency professional will be appointed to liquidate assets and pay off creditors within 6 months.

Hand Holding

- Start-up India hub will be set up to create a single point of contact for startups. The hub will collaborate with Central and State Governments, VCs, angel networks, banks, incubators etc. The hub will assist start-ups through advisory and mentorship programs.
- To promote awareness and adoption of IPRs, the Government will facilitate legal support and fast-track patent examination. For effective implementation of the scheme, the Controller General of Patents, Designs and Trademarks (CGPDTM) shall create a panel of "facilitators". Entire fee of facilitators will be borne by the Government.
- From 1st of April 2015, PSUs are mandated to procure at least 20% of their requirements from the MSMEs (Micro Small and Medium Enterprises). To ensure level-playing field for the start-ups in manufacturing space, Government shall exempt them from "prior experience / turnover" criterion. However, there will be no compromise on the quality and other allied conditions.

Funding

- Government will set-up a fund with an initial corpus of INR 2,500 crore and will make it INR 10,000 crore over a period 4 years. The fund will be in the nature of fund of funds. It will not invest directly into start-ups, but shall participate in the capital of SEBI registered venture funds. The maximum investment in a fund by this FOF is capped at 50% of its size. This fund shall be professionally managed and LIC will be a co-investor. This will help be catalyst to develop domestic venture fund industry.
- Credit guarantee mechanism through National Credit Guarantee Trust Company (NCGTC)/ SIDBI is being envisaged with a budgetary corpus of INR 500 crore per year for the next four years. This will help start-ups get debt funding.

Incentives

- Income tax exemption on capital gains shall be given to persons who invest such capital gains in the fund of funds recognized by the Government. At present capital gain exemption is available for investment in manufacturing MSMEs. This exemption will be extended to start-ups.

- With a view to stimulate the development of start-ups in India and provide them a competitive platform, profits of start-up will be exempted from income-tax for a period of 3 years. This fiscal exemption shall facilitate growth of business and meet the working capital requirements during the initial years of operations. The exemption shall be available subject to non-distribution of dividend by the start-up.

- Currently, investment by venture capital funds in start-ups is exempted from operations of the provisions of Sec. 56(2)(viib). This section taxes excess of share issue amount in excess of its fair market value. The exemption shall be extended to investment made by incubators in the start-ups. This shall encourage seed level investments in the start-ups.

- Rebate up to 80% on patent filing fees.

Mentoring

- To bolster the start-up ecosystem in India, the Government is proposing to introduce start-up fests at national and international levels. These fests would provide a platform to start-ups in India to showcase their ideas and work with a larger audience comprising of potential investors, mentors and fellow start-ups.

- Launch of Atal Innovation Mission (AIM) with Self-Employment and Talent Utilization (SETU) Programme. The idea behind this programme is innovation promotion and entrepreneurship promotion. This envisages starting of specialized incubators, tinkering labs, strengthening the existing incubation facilities, organizing the State and National awards etc.

- To encourage innovation by young students in science and technology, interesting schemes are proposed. These are: "Innovation Core" for schools, "NIDHI" for running competitions in innovation and Ucchatar Avishkar Yojana for R&D, especially for students of IITs.

- To help set up incubation facilities with public private partnership. The plan is to set-up 35 new incubators in existing institutions and 35 new private sector incubators. Government will provide funding support to these incubators.

- To set up 7 new Research Parks for joint R&D efforts with academia and industry partnership.

- To promote bio-entrepreneurship. This will be achieved by setting up bio-incubators and bio-tech equity fund.

- To launch Incubator Grand Challenge to create world class incubators.

Reaction to the Action Plan

While in general, startups have welcomed the action plan as a good beginning, some criticism has followed.

The excitement of several start-ups was contained once they knew of the definition of start-ups in order to claim tax exemption. A startup must satisfy the following 6 conditions

1. It must be a private limited company, LLP or Partnership firm

2. It should not be more than 5 years old

3. Turnover shoud be below INR 25 Crore

4. Should develop an innovative commercial product

5. Should obtain certification from inter-ministerial Board set up by DIPP to validate innovative nature of business

6. Should fulfil one of the six conditions of recommendation or funding

The tax exemption for 3 years during first 5 years of operations is also seen generally meaningless as most of the start-ups do not make any profit during initial years.

According to iSPIRIT 34 items were listed as key irritants. Out of these only eight have been resolved, action has been promised on remaining 15 and 11 have been left high and dry.

The plan to invest INR 10,000 crore in fund of funds has received criticism mainly on these two counts :

- Tax payers money will be invested in very high risk enterprises
- The size of fund is too small to be of any significance in promoting local venture capital industry

It must be noted that at present, venture funds in India are either foreign firms (Sequoia Capital, Accel Partners and Matrix Partners) or local firms (Kalaari Capital, Nexus Venture Partners and Helion Venture Partners) who raise over 90% of their capital from foreign institutional investors.

Opportunities for tax professionals

The effort to launch a Start-up Action Plan is a laudable piece of work by the Government. There may be several lacunae or lack of clarity at this stage, but with time more clarity is sure to follow.

With this Action Plan, there will be several new opportunities for the tax professionals in the time of looming start-up ecosystem. Some of these are:

1. Registration and approval of the start-ups and Funds under various laws
2. Transaction advisory to handle various tax laws, under new innovative models.
3. Structuring and modelling of entities for the incubators and funds
4. Claiming of tax exemptions for start-ups
5. Claiming of tax exemptions from capital gains for the funds
6. Advisory on the funding and Investor Relationship Management

Finally some interesting tweets

Rajan Anandan
Best Start-up event I have ever attended. Thank you #StartupIndia. Congrats @amitabhk87 for a truly amazing launch!

Mahesh Murthy
#StartupIndia Zero tax on start-up profits in 1st 3 years. Could see @Flipkart in audience wasn't unduly excited with that.

Dr. Subhash Chandra
To transform India to a nation of job creators we must make our start-up system strong. Great #StartupIndia initiative by @narendramodi.

ERRATA

In the Chamber's Journal of January 2016 - The name and photo of the co-author Shri Harsh Kothari for the Special Story “Important Supreme Court Decisions” on the topic “Mangalore Ganesh Beedi Works vs. CIT (Civil Appeal Nos. 10547-10548 of 2011)” on Page 35 has been missed out. The article has been jointly authored by Shri Madhur Agarwal, Advocate & Shri Harsh Kothari. The error is regretted.

R. P. Garg, *Advocate*

HOT SPOT
POEM – A test of corporate residence

"Place to places the Corporates wonder,
Off take key MC declarations at Bunder.
Evoke the whole, in substance they ponder,
Mandate their fiscal presence thereunder."

Introduction

POEM (Place of effective management) is one of the modern model determinative tests of residence of a corporate body. It is 'a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made'. India adopts it as one of an alternate twin tests by the Finance Act, 2015 replacing the test, where lies the 'control and management wholly'. The other test of residence of a company is 'if it is an Indian Company' i.e., its incorporation is in India.

The residence concept of a company is as artificial as the company itself and its location can be determined by analogy. Alike living person, a company's residence is where it resides and/or abides, that is, where its head and brain is; and for purposes of income tax where its real business is carried on. The real business is where the central management and control actually abides. This is a pure question of fact, to be determined, not according to the construction of this or that regulation or by-law, but upon a scrutiny of the course of business and trading. In a way the seat of central management and control became rule of law, which in effect is akin to key management and commercial decision.

Corporate Working

The company is a juristic person and being artificial legal person, by itself it cannot act at all. It has to act only through some living persons who exercise its chartered formal powers, duties and functions, namely; (a) Shareholders through general or extraordinary meetings; and (b) Directors through their meetings of the Board.

(a) Shareholders governance of the company: Initially Salomon's case (1897) AC 22 viewed that General Meeting was the voice and the soul of the company and that the directors were there to act, to some extent at least, at its behest.

(b) Directors Governance of the Company: Then after a decade *Automatic Self-Cleansing Filter Syndicate Co. vs. Cuninghame (1906) 2 Ch. 34,* viewed conversely stating that the power of management and control lies in the hands of directors and not with the General Meeting. The General Meeting can replace the directors or it may alter the Articles, but it is very rare indeed to find the shareholders reserving for themselves the right to manage and control the Company.

This doctrine was revisited in the case of *Shaw & Sons (Salford) Ltd. vs. Shaw (1935) 2KB113* by detailing as: `A company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its Articles be exercised by directors; certain other powers may be reserved for the shareholders in General Meeting. If powers of management are vested in the directors, they and they alone can exercise those powers. The only way in which the General body of the shareholders can control the exercise of the powers vested by the Articles in the directors is by altering the Articles, or, if opportunity arises under the Articles, by refusing to re-elect the directors of whose actions they disapprove. They cannot themselves usurp the powers which by the Articles are vested in the directors any more than the directors can usurp the powers vested by the Articles in the general body of shareholders.'

Powers and duties of the shareholders in General Meeting, apart from those of appointing and dismissing the directors; are approval of the accounts, passing the dividend, having a voice in matters such as issuing new capital, reduction of capital and changes in the objects clause of the Memorandum or changes in the Articles. These powers and rights do not constitute the management and control of the business.

The Companies Act defines the framework for the governance of a company through its Memorandum and Articles containing the rules for the internal management of the company. Articles provide the power of management of the company ultimately to the Board of directors who is the real source of management and control and important feeder for determining POEM

COUNTRY-WISE POSITION

Countries attach importance to different levels of management while interpreting the concept of POEM. This POEM is differently coined with varying contents from State-to-State. The variations are many but substantively conveying same or similar understanding. To wit:

1	Where lies, place of management	Bulgaria Croatia, Czech Republic, Germany, Portugal, Switzerland,
2	ii) Where is, place of day-to-day management	Denmark
3	Where is its Head Office	Japan, Slovenia
4	Where is central management and control	
	Australia, Canada, Cyprus, UK	
5	Where is place of effective management is of non-executive Board	Austria, Belgium, France, Italy, Netherland, Norway (Armenia , Botswana, Uganda
6	Where effective management is of top management	Portugal, Spain, Switzerland, Turkey, (Belarus, Taipei, Tajikistan, Trinidad,
7	Where is company's centre of Management	New Zeland
8	Where is company's main activity	Israel
9	Where lies the control and management wholly	India (Pre 2015)
10	Where company's main business purpose is carried out	Italy
11	Where shareholders voting rights are exercised	Germany
12	Where company incorporated and managed and controlled	UAE, Ukraine, USA, Vietnam

One has to weigh country wise significance of each factor to find out and determine the residence of a company. It is a question of degree and as aforesaid primarily a question of fact.

Model Conventions

OECD/UN/US MCs – guide to determine residence of a person including a company as per respective domestic law, by reasons of a company's Place of incorporation or place of management. The first is seen as an 'objective bright line test that determines it as the place of registration or incorporation. The second is a subjective broad line test as effective management place i.e., POEM.

In a case of multiple residence situations a tie breaker rule is adopted. OECD and UN Models adopt POEM as a tie breaker but US Model goes by 'where it is created or organised'

Poem Composition Histry in Model Conventions

OECD MC: In 1957 the OEEC Fiscal Committee on Fiscal Domicile formed a Working Party on Fiscal Domicile ('the Working Party') issued reports on the concept of fiscal domicile. In this first report, the Working Party considered to attribute residency to the country, like India, where the corporation is 'managed and controlled' (CM). The Party acknowledged that the test of managed and controlled was not a clear concept as doubts could arise whether the reference is to the management and control by the managers, by the Board, or by the shareholders.

In 1958: The Working Party's fourth report changed over from CM to the concept of effective management by referring to the use of the term in the context of Shipping and Air Transport Enterprises, noting that while the concept of MC (or CMC) is adopted for determining residency of the Corporation by the UK Courts, the concept is stated to be the same as effective management of the enterprise. With this clarification, the OEEC substituted the test of CM by POEM as the rule of a tie breaker.

In 1963: By 1963, almost all the member countries of OECD had endorsed the view that the concept of management and control and POEM had the same meaning. Thereafter and therefore test of effective management formed the basis of Article 4(3) of the 1963 OECD draft and 1977 OECD MC thereof. The similarity between the concept "management and control" and "effective management" was expressed thus[1]:

> "Concerning conventions concluded by the United Kingdom which provide that a company shall be regarded as resident in the State in which "its business is managed and controlled", it has been made clear, on the United Kingdom side, that this expression means the "effective management" of the enterprise."

In 2000: By stating that it is not possible for a company to have its POEM at more than one place at any time and it acts as a means of resolution in situations of conflicting tax residency claims by two countries, the 2000 Update to the OECD MC clarified the concept "place of effective management" as:

> "As a result of these considerations, the "place of effective management" has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place

1. *Paragraph 23 of Commentary*

where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given, and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time."

In 2008: There arose some interpretative differences with regard to the exact meaning of the term POEM considering the frequent updates, and also that OECD has so far been unable to reach a consensus on the interpretation of POEM, the 2008 Update of the OECD MC amended the Article 4(3) by deleting the reference to POEM ordinarily being where the most senior person or group of persons, say Board of Directors, makes its decisions. The MC also recognized that, as a result of the different interpretations of POEM, some countries may like to deal with dual residents in a different manner. To meet these countries' concerns, the commentary refers to the MAP in the case of a dual resident entity and provides for residency to be decided by mutual agreement. The Commentary further goes on to provide guidance on the salient factors to be taken account of by the competent authorities in determining corporate residence by observing: *"where the meetings of its board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc."*

In 2014: The MC[2] on Article 4(3) of OECD Model Tax Convention on Income and Capital defines POEM to mean "place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made."

BEPS: The report on BEPS Action Plan 6 titled 'Prevent Treaty Abuse' (the Report) identifies treaty abuse as one of the most important sources of BEPS concerns. The Report proposes to replace Article 4(3) of OECD "Competent Authority Rule". The Report also provides for "POEM" Rule as an alternative, but however, Condensed Version (2014) prefers "Competent Authority Rule" over "POEM" Rule. The Report concludes that the "Competent Authority Rule" is a better solution to the issue of dual residence of entities other than individuals

UN Commentary

The UN commentary on Article 3(3)[3] narrates the circumstances which may, *inter alia*, be taken into account for determining POEM, namely, i) the place where a company is actually managed and controlled; ii) the place where the decision-making at the highest level on the important policies essential for the management of the company takes place; iii) the place that plays a leading part in the management of a company from an economic and functional point of view; and iv) the place where the most important accounting books are kept.

Thus, the UN commentary regards the place where decision making for entire company takes place as POEM. It does not give importance to factors like place of shareholders' meeting or Board meeting to decide POEM. It visualises that the place where most important accounting books are kept is a factor which can be easily misused by the companies to artificially

2. Para 24, Page 90 of OECD Model Tax Convention

3. (Para 10, Page 94, UN Model Tax Convention (version 2011) characterise a particular place to be POEM by merely keeping books of accounts at such place.

The UN commentary[4] on Article 1 of UN Model Tax Convention states that "the mere fact that meetings of a board of directors of a company take place in a country is not sufficient to conclude that this is where the company is effectively managed."

US-MTC Technical Explanation 2006

US MC on this as "Thus, if a company is a resident of the United States because it is incorporated under the laws of one of the states and is a resident of the other Contracting State because its place of effective management is in that State, then it will be a resident only of the United States. However, if the incorporation test does not resolve the question because, for example, the company was incorporated in one Contracting State and continued into the other Contracting State, but the first-mentioned Contracting State does not recognize the migration and continues to treat the company as a resident, then the competent authorities will try to determine a single State of residence for the company.

If the competent authorities do not reach an agreement on a single State of residence, that company may not claim any benefit accorded to residents of a Contracting State by the Convention. The company may, however, claim any benefits that are not limited to residents, such as those provided by paragraph 1 of Article 24 (Non-Discrimination). Thus, for example, a State cannot discriminate against a dual resident company..."

Indian Determination

In India the Income-tax Act, 1961 provides by section 6(3) an Indian company as resident, if it is formed and registered under Companies Act, 1956 and its registered (or principal) office is in India. Alternately, it is resident if the control and management of the affairs during the previous (fiscal) year up to 2015 was situated wholly in India; and presently post 2015, if its place of effective management (POEM) in that year (previous year) is in India. An "Indian company" means a company formed and registered under the Companies Act, 1956 (1 of 1956) and by section 2(26) certain companies are included in the definition of an Indian company, namely- a company formed and registered under any law relating to companies formerly in force in any part of India; a corporation established by or under a Central, State or Provincial Act; any institution, association or body which is declared by the CBDT to be a company under clause (17); a company formed and registered under any law for the time being in force in that State ; a company formed and registered under any law for the time being in force in that Union Territory. In all cases the registered or, as the case may be, principal office of the company, corporation, institution, association or body is in India. Like the levy of Income Tax, residence of a company is an annual determination.

Alternate and second determination of company's residence is POEM. It is defined by the Explanation to section 6(3) as 'a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made'.

By virtue of section 2(30), a company who is not a resident under section 6(3) is non-resident. A company who is 'not ordinary resident' within the meaning section 6(6) is also non-resident for purposes of sections 92, 93 and 168.

Implications of Twin but Alternative Tests

Section 6(3) provides twin but alternate tests to determine the residence of a company. It is generally understood and said that criteria (i) is to determine residence of an India incorporated company and criteria (ii) is for company

4. *(Para 45, Page 52 of UN Model Tax Convention 2011)*

other than an Indian company i.e., a company incorporated outside India, though the section provides it as an alternate test of determining residence of a company. The two tests theory for establishing the residential status is apt to confusion, as if (i), the place of incorporation, is for the Indian companies, and (ii), the place of control / effective control, is for the foreign companies. The twin tests principle applies to all companies; they are residents where central control is situated or by POEM. If this test is uniformly applied, a company registered in India is resident by criteria (i), could yet be non-resident by not satisfying criteria (ii). It may be that by virtue of criteria (i) no inquiry is to be made, if a company is registered in India as it would be a resident in any case and on its determination, the status of non-resident would also be excluded by virtue of criteria (i). The question would still be debatable, if a dual status is determinable by the two criteria, as how to determine its non-residency, by excluding criteria (i) or criteria (ii)? From 2015 the second criteria though is changed to POEM, the 'place of effective management', the question of dual status of residence and non-resident may still arise. Would it be treated and assessed as resident or a non-resident? Whose choice is to opt?

Further there could be a situation that an Indian company could be resident abroad because of the existence of the control and management there as well resident of India because of its incorporation here. Such a company enjoys dual residence. The concept of dual residence as applicable to companies is analogous to the concept as applicable to individual. Like an individual, the company could reside in two places at the same time.[5]

A company resides for purposes of income-tax where its real business is carried on and that is where the central management and control actually abides[6] which sometimes has been stated in the form of 'head, seat and directing power'. The question depends on the fact of the management and not on the physical situation of the thing that is managed. A company is managed by the board of directors and if the meetings of the board of directors are held within India, it may be said that the central control and management is situated here. The direction, management and control 'the head and seat and directing power' of a company's affairs does, therefore, situate at the place where the directors' meetings are held and, consequently, a non-Indian company would be resident in that country if the meetings of the directors who manage and control the business are held there. The word 'affairs', as it appear pre-2015 definition, means affairs which are relevant for the purpose of the Income-tax Act and which have some relation to the income sought to be assessed. It is not the bare possession of powers by the directors, but their taking part in or controlling the affairs relating to the trading, that is of importance in determining the question of the place where the control is exercised. They must exercise their power of control in relation to business or activity wherefrom the profit is derived.[7]

The erstwhile sentence "where the control and management of its affairs is situated" referred to a place from where factually and effectively the day-to-day affairs of the company were managed and controlled and not to the place in which might reside the ultimate control of the company. It referred to a place where actions were put into service. It meant (i) the place where the Board of directors of the company or its executive directors make their decisions; or (ii) in a case where the board of directors routinely approve the commercial and strategic decisions made by the executive directors or

5. (1925) AC 495 : Swadeshi Central Railways Co. Ltd. vs. Thompson (Inspector of Taxes)

6. (1906) AC 455 (HL), De Beers Consolidated Mines Ltd. vs. Howe (Surveyor of Taxes); (1876) 1 Ex. D 428 Calcutta Jute Mills Co. Ltd. vs. Henry Nicholson; (1876) 1 Ex. D 428 : Cesena Sulphur Co. Ltd. vs. Henry Nicholson

7. (1915) 6 TC 542 (HL) : Egyptian Hotels Ltd. vs. Mitchell; [1985] 23 Taxman 46 (Cal.) : CIT v. Bank of China officers of the company, the place where such executive directors or officers of the company performed their functions.[8]

In India, the pre-2015 rule required CM wholly in India in the previous year and a typical case popularly known as Radha Rani[9] was noticed by the ITAT wherein a Singapore Tax residency certificate holder was held a non-resident in India, even though the majority shareholding was with an Indian resident, all employees were in India, the address from where the company operated was in Delhi, all the investments were made in group companies in India, source of investment was from India and one of the Indian directors attended the meeting from India and even if one of board meetings could be considered to have been held in India would not negate the position. Be it noted that merely by diverting fraction of control and management outside India, tax residency in India was potentially avoided.

POEM – as a test of residence replaces management and control

To thwart the potential tax avoidance and also to be within the ken of OECD guidelines and to align the provisions of the Act with DTAA entered with several countries, Finance Act 2015 replaced the condition of CM with POEM.

which is explained to be 'a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made'.

Two Poems in India

India has POEM at two places in the Act, one for tonnage tax benefit under section 115VC of the Act where It defines POEM as a place where the BOD or the executive directors make their decisions or in case where they routinely approve commercial and strategic decisions made by the executive directors or officers, the place where such executive directors or officers perform their functions; and the other for corporate residency test u/s. 6(3) of the Act where the definition of POEM. Whereas definition under section 6(3) is applicable to the entire Act, the POEM defined under section 115VC of the Act is limited for the purpose of the said section. Thus there may result a conflict as to whether the definition under section 6(3) would override the meaning provided Section 115VC of the Act which is part of tonnage tax provision also requires POEM of an Indian company to be in India.

2015 Bill *vis-à-vis* Final provisions

The Explanatory Memorandum to the Finance Bill 2015 elaborates it as:

"Amendment to the conditions for determining residency status in respect of Companies

The existing provisions of section 6 of the Act provides for the conditions under which a person can be said to be resident in India for a previous year. In respect of a person being a company, the conditions are contained in clause (3) of section 6 of the Act.

Under the said clause, a company is said to be resident in India in any previous year, if-

(i) it is an Indian company; or

(ii) during that year, the control and management of its affairs is situated wholly in India.

Due to the requirement that whole of control and management should be situated in India and that too for the whole of the year, the condition has been rendered to be practically inapplicable. A company can easily avoid becoming a resident by simply holding a BOD meeting outside India. This facilitates the creation of shell companies which are incorporated outside but controlled from India.

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8. [2008] 307 ITR (A.T.) 142 (Delhi) KLM Royal Dutch Airlines vs. Dy. CIT

9. Radha Rani Holding (P) Ltd. vs. ADIT 110 TTJ 920

'Place of effective management' (POEM) is an internationally recognized concept for determination of residence of a company incorporated in a foreign jurisdiction. Most of the tax treaties entered into by India recognise 'the concept of 'place of effective management' for determination of residence of a company as a tie-breaker rule for the avoidance of double taxation. Many countries prefer the POEM test to be an appropriate test for determination of residence of a company. The principle of POEM is recognized and accepted by Organisation of Economic Co-operation and Development (OECD) also.

The OECD commentary on model convention provides definition of place of effective management to mean the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole, are, in substance, made.

The modification in the condition of residence in respect of company by including the concept of effective management would align the provisions of the Act with the Double Taxation Avoidance Agreements (DTAAs) entered into by India with other countries and would also be in line with international standards. It would also be a measure to deal with cases of the creation of shell companies outside India but being controlled and managed from India.

In view of the above, it is proposed to amend the provisions of S.6 to provide that a person being a company shall be said to be resident in India in any previous year, if,-

(i) it is an Indian company; or

ii) its place of effective management, at any time in that year, is in India.

Further, it is proposed to define the place of effective management to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made.

Since POEM is an internationally well-accepted concept, there are well recognised guiding principles for determination of POEM although it is a fact dependent exercise. However, it is proposed that in due course, a set of guiding principles to be followed in determination of POEM would be issued for the benefit of the taxpayers as well as, tax administration.

These amendments will take effect from 1st April 2016 and will, accordingly, apply in relation to the assessment year 2016-17 and subsequent assessment years."

Section 6(3) of the Act relating to tax residence as originally proposed was to provide that a company will be considered as resident of India if its POEM is in India at *"any time during the year"*.

It was a much wider rule than the pre-amended provision of the Act, which required control and management to be in India for the whole of the year. Usage of the phrase 'at any time' had the effect of a non-resident company qualifying to be a tax resident in India even if it were to have a POEM in India for a very short period, a complete reverse of Radha Rani. Such a provision would have onerous implications for foreign companies having Indian operations and could potentially have resulted in bringing all the foreign subsidiaries of the Indian holding company within the ambit of Indian taxation.

Wisely, the revised amendment passed in the Parliament (Lok Sabha) omitted the words 'at any time'. Hence, the test for POEM would now be applied for the year as a whole as against at any time in the year.

Composition of Poem

The POEM is composed of six stanzas: i) A place where, ii) key; iii) management and commercial decisions; iv) that are necessary for the conduct of the business v) of an entity as a whole vi) are, in substance made.

1. A Place where: It denotes geographical area within a country of making corporate decisions. There is no clarity on what would constitute the place where key management and commercial decisions are made. If read with, in the context of the primary term "its place of effective management" it is a place where the central management and control actually abides[10] irrespective of the fact where business operations are carried on.

In 1876 the two companies were held residents of UK in a complete dichotomy and conflicting concepts, in one because the directors meetings were in UK one, in Calcutta Jute Mills Co[11] where the company did not own any office in the UK; its majority shareholders were also non-UK persons; and in other, in Cesena Sulphur Company[12] where the working of the company and business was wholly under the order, direction and management of board meetings held in London.

POEM may be different from the place where the assets physically lie or where the transactions are actually carried out or where business is actually carried on. It is a place where the controlling and directive power and / or the head and brain of the trading venture is situated i.e. where central control is exercised and not at the place where managed day-to-day affairs.[13] A business is not necessarily controlled and managed at the place where accounts are maintained or where division of profits is decided on.[14]

The effective place of management is the place where the company etc., is actually managed, i.e., where key management and commercial decisions necessary for the conduct of the business of the enterprise are taken.

The applicant companies were subsidiaries of the American company and their shareholders are other companies (also the other subsidiaries of the same company) with registered office in different countries and though they have some Mauritians as directors but the real and effective management comes from the American company or other shareholding companies, say USA or Hong Kong or the like. The Authority found and noted[15] that the applicant investor company had its registered office in Mauritius; its only transaction is the investment in India; application for residency certificate showed certain features of the investor company that its effective place of management was in Mauritius took following steps to ensure Mauritian place of management in particular:

– The company has two resident directors of appropriate caliber to exercise independence of mind and judgment;

– The company's secretary is resident in Mauritius;

– The registered office is in Mauritius;

– Banking transactions would be channelled through Hong Kong and Shanghai -Banking Corporation;

– Accounting records would be maintained in Mauritius in accordance with the Companies Act, 1984;

– Board meetings would be held in or chaired from Mauritius;

– All statutory records such as maintained and members' register, would be kept at the registered office;

– The company would have an ordinary status.

10. *(1906) AC 455 (HL) : De Beers Consolidated Mines Ltd. vs. Howe (Surveyor of Taxes)*

11. *Calcutta Jute Mills Co. vs. Nicholsan (1 TC 83)*

12. *Cesena Sulphur Company vs. Nicholsan (1 TC 88)*

13. *[1958] 34 ITR 1 (SC) Erin Estate Galah, Ceylon vs. CIT; [1951] 19 ITR 168 (SC) V. VR. N. M. Subbayya Chettiar vs. CIT; [1953] 23 ITR 454 (Bom.) Narottam & Pereira Ltd. vs. CIT*

14. *(1911-15) 6 TC 542 (HL) The Egyptian Hotels*

15. *[1996] 89 Taxman 125 (AAR) Companies Incorporated in Mauritius, In re.*

AAR held the effective management was in Mauritius, firstly because there were no facts to at least prima facie indicate that such control emanates elsewhere than from Mauritius; secondly, because Article 4(3) is intended to break the tie on the issue of residence as between the two Contracting States. The company was found on Article 4(1), resident both in India and Mauritius but under article 4(3), the seat of effective managements as between the two Contracting States, was taken to be in Mauritius. Article 4(3) does not authorise the exploration of a possibility that the effective management, despite the company's location and residence in Mauritius, could lie elsewhere in a third country.

2. Key: (vital element; or of central importance or effective; strategic)

Key management and commercial decisions do have different meaning in different states. They relate to policy matters or management or administrative matters. What would be key strategic decision would vary depending upon the nature of the company's business? What is the strategic key decision for a trading or manufacturing company may not be for a holding or Investment Company. For Investment Company strategic decision would include decisions on investments, divesture of investments, the return on earnings, etc. It would, therefore, be essential to determine, on a case by case basis, what comprise crucial decisions for running of the business. Thus, one needs to analyse factual, contractual and organisational activities which have a certain degree of importance for the management of the company as a whole after taking into consideration the nature of the business of the company.

The place where all decisions are taken is the place of effective management, that is, the place of central management. In case management or administrative decisions for day-to-day running of the business is taken at different place, that place is the effective place of management. Effective place of decisions may also be a place where management and control is exercised independently of, or without regard to, the board of directors or from where is exercised the dictating or directing influence on the decisions of the board of directors as observed by Lord Patton[16].

> "In seeking to determine where 'central management and control' of a company incorporated outside the United Kingdom lies, it is essential to recognize the distinction between cases where management and control of the company is exercised through its own constitutional organs (the board of directors or the general meeting) and cases where the functions of those constitutional organs are 'usurped' – in the sense that management and control is exercised independently or, or without regard to, those constitutional organs. And in cases which fall within the former class, it is essential to recognize the distinction (in concept, at least) between the role of an 'outsider' in proposing, advising, influencing the decisions which the constitutional organs take in fulfilling their functions and the role of an outsider who dictates the decisions which are to be taken in that context an 'outsider' is a person who is not, himself, a participant in the formal process (a board meeting or a general meeting) through which the relevant constitutional organs fulfils its functions".

In Calcutta Jute Mills case (supra) the holding of board meetings and annual general meetings, *transacting business and exercising powers conferred upon them by the law and their Articles of Association were considered as vital,* the day-to-day exercising control over the business of the company by Indian director was not considered important because UK directors could recall him at their pleasure.

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16. HMRC vs. Smallwood [(2010)EWCA Civ.778]

There are three tiers of decision making control of a company: policy, management and administration. Each one is a key decision in its own segment. If each one is taken at different place(s), the effective management decision breaks the tie; effective in the sense of operational or in reality. An entity may have more than one place of decision making place or persons but it can have only one place of effective management.[17]

Place of effective management is the place key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made.

The decisions, the most senior person or group of persons (for example board of directors) makes are its key decisions and the place where the actions to be taken by the entity as a whole are determined is ordinarily the place of effective management.

All relevant facts and circumstances must be examined to determine the key decisions and in the result the place of effective management. An entity may have more than one place of management, but it can be only one place of effective management at any one time.[18] It refers to the place where, factually and effectively, the day-to-day affairs of the company are carried out and not to the place in which may reside the ultimate control. Since a company is a legal person, it can act only through its agents being directors, the "directing mind and will" who in fact control and determine the management and are the centre of its personality. An employee even if authorised by the Board of directors by a resolution to be a person in the control of the affairs of the factory cannot be so as such an employee only carries orders from the above. It makes no difference that he has been given some measure of discretion also and has supervisory control. It can at best be treated to be in the immediate control of the factory or having day-to-day control over the affairs of the factory, the ultimate control being retained by the company itself.[19]

Ultimate control, and the effective management (day-to-day control), are two different concepts and clause 3 refers to the place where the company is actually managed, and not where it is controlled. For Tie Breaking the choice is between them where the location of the effective/key management abides. Clause (3) of Article 4 contemplates not the location of a place of management generally but the location of the place of effective management as between the two Contracting States entering into the double taxation avoidance agreement.[20]

3. Management and Commercial decisions

Whereas management is an act of managing by direction or regulation; or an Apex body of organizations, who regulates, supervises, directs and controls the affairs; the commercial decisions are those related to or dealing in commerce; or having profit as its primary aim.

'Management and commercial' needs to be read as one term as both of them are joined by the conjunction 'and'. Key managerial and commercial decisions convey the making of decisions which are both managerial 'and' commercial. Otherwise, each and every small business decision taken may be said to be 'commercial' decision. Management and commercial decisions may include-a) Appointment/Termination of Key Managerial Personnel; b) Sourcing of raw materials, selection of distributors and its quality control; c) Reporting structure and key organisation/ management policy decisions; d) Negotiations/ execution of contracts Code of conduct, group ethos and ethics Product portfolio, methods

17. *Wednsleydale's Settlement Trustees vs. IRC (1996) STC 241*
18. *OECD Commentary on Article 4 Paragraph 24*
19. *[1997] 88 Comp. Cas. 285 (SC) : J.K. Industries Ltd. vs. Chief Inspector of Factories & Boilers*
20. *[1996] 86 Taxman 252 (AAR): X Ltd., In re*

of manufacture Global IT systems policy and MIS reporting Expansion and modernisation; e) Mergers and Acquisitions and restricting including divestment; f) Accounting policies, R&D, brand / patent registration; g) Common procurement or sourcing for the group, including master agreements; h) Borrowings / Debt financing, Capital sourcing; i) Pricing of products and services.

Management and commercial decisions involves the high-level decision-making processes, including activities involving high-level company matters such as general policies and strategic directions, major agreements and significant financial matters. It also includes activities such as the monitoring of the company's overall corporate performance and the review of strategic recommendations made in the light of the company's performance.

In Tax case of Cesena Sulphur Company[21] the Court gave importance to the administrative part of the business would be carried on at the place in London from which all the orders came, all the directions flowed and where the appointments of the various officers were made and revoked, where agents were nominated and recalled, where the money was received and dividends were declared and were payable. It was though the manufacturing part may be and was done in Italy; and so, supposing they found sulphur in some other part of the world, and carried on their business there, the manufacturing part of it would be carried on in that other place was taken to be not significant.

In the case of Erin Estate Galah Ceylon[22] the Supreme Court emphasised that control and management means actual control and management and not merely right to control and manage. The expression signifies controlling and directive power, "the head and brain" as it is sometimes called. Furthermore, it is settled, that "control and management" is de facto control and management and not merely the right or power to control and manage.

As to who takes the decisions, the general conception is that it is the top level managerial organs like Board of Directors, but we find a case of House of Lords in *Wood vs. Holder*[23] wherein it was envisaged if the decision is taken by an person who is not its constitutional organ, like Board of Directors, the place of effective management may be interpreted where the key decision are made by the outsider.

Another interesting case on POEM in the context of UK Mauritius came up before House of Lord in *HMRC vs. Smallwood*[24] with a pendulum like views throughout from Revenue officer, to Special Commissioners, the Judge on appeal and the House of Lords with 2: 1 majority. it was with regard to taxability of capital gains in UK *vis-a-vis* Article 13(4) of UK / Mauritius DTAA. In this case S, a UK resident throughout, created a Settlement Trust for himself and his family which held shares in Listed companies. With the approval of S a Mauritius Company PMIL was appointed as trustees who sold the shares on two dates on 10-01-2001 and 26-1-2001. PMIL resigned as trustees in favour of Mr. and Mrs. S on 2-3-2001 after being trustees for a brief period from 19-12-2000. S claimed no tax in UK on the ground that trustee PMIL was a Mauritius resident but Revenue maintained trust was resident both in UK and Mauritius and on tie breaking rule it was resident of UK. Special Commissioners sided with Revenue, the judge on first appeal favoured the assessee by holding that at the time of sale there was only one residence of PMIL, Mauritius, therefore no question of tie breaker. House of Lords held there was double residence in UK and Mauritius

21. *In Cesena Sulphur Company vs. Nicholsan (1 TC 88)*
22. *[1960] 40 ITR 1 (SC) : CIT vs. Nandlal Gandalal*
23. *(2006) EWAC 26(CA)*
24. *(2010) EWCA Civ 778 (CA)*

in the year (not to be considered on the date of sale) and applied POEM to resolve in favour of Revenue by 2:1 majority maintaining that - i) the scheme was devised in UK by S on the advice of KPMG, Bristol, ii) steps were orchestrated throughout from UK, both by KPMG and the Quilter, iii) appointment of PMIL, Mauritius for a brief period was an integral part of the scheme and iv) S was throughout in OK and therefore, the scheme of management of the trust and control of it was located in UK. the minority view was that PMIL was not acting on the advice of KPMG but took decision on their on right, albeit the advice and therefore POEM was in Mauritius.

4. "(Decisions) that are necessary for the conduct of the business

It is not that all management and commercial decisions that are material for determination of the issue but these are what should be necessary for the conduct of the business of the company.

Business includes any trade, commerce, or manufacture or any adventure or concern in the nature of trade, commerce of manufacture. Conduct of business is carrying on business. The term business here should be understood in a general sense, as an activity or occupation in which the company is engaged and since it is for income tax point of view, it should be for profit. It is a question of fact rather than of law. The Courts have identified the criteria as significant factors to be weighed in determining whether an activity to constitute business: i) the repetition of transaction or activity; ii) the commercial nature of the activities; iii) the size and scale of the activities; iv) the existence of profit motive; v) organisation and system underlying the activities; vi) the inherent characteristics or quality of the property dealt in; and vii) inherent characteristics of the company as an entity. Even a single transaction can constitute a business. If the business is not being conducted, or is no longer being conducted the test is not satisfied.

It is akin to conducting "affairs" referred to in criteria (ii) of pre 2015 provision. It refers to operations or activities in relation to the income which is sought to be assessed. A mere activity of an entity at a place which does not give rise to any income does not make that entity resident of that place.[25] It must mean affairs which are relevant for the purpose of the Income-tax Act and which have some relation to income[26]. It must mean affairs of a person which are capable of being controlled and managed by the said person as such.

Where a coparcener enters into partnership with strangers, the Hindu undivided family exercises no controlling power of management over the partnership firm. The partnership cannot be an "affair" of the Hindu undivided family capable of being controlled and managed by it as such. Control and management of affairs of firm refers to actual exercise of; and not illusory or merely notional. Once it is shown that control and management in the affairs of the firm was exercised by the partners residing in India, it would not be relevant to enquire whether the control and management thus exercised amounted to a substantial part of the control and management of the affairs of the firm.[27]

In case of a company: (1) the control and management of a business remains in the hand of a person or a group of persons, and the question to be asked is wherefrom the person or group of persons controls or directs the business. (2) Mere activity by the company in a place does not create residence, with the result that a company may be "residing" in one place and doing a great deal of business in another. (3) The central management and control of a company may be divided, and it may keep house and do business in more than one place, and, if so, it

25. *[1951] 19 ITR 168 (SC) V. VR. N. M. Subbayya Chettiar vs. CIT*

26. *ibid*

27. *[1954] 25 ITR 27 (SC) : Anglo-French Textile Co. Ltd. vs. CIT.*

may have more than one residence. (4) In case of dual residence, it is necessary to show that the company performs some of the vital organic functions incidental to its existence as such in both the places, so that in fact there are two centres of management.

5. (decisions...of the business) of the entity as a whole and

Again the necessary decisions should be looked at from the angle of the business of the company as a whole , 'an entity as a whole' Complete, entire, or overall as a whole taking everything into account.

The entity here is to be a company as the POEM determines the residence thereof. POEM refers to the place where the business decisions of the company as a whole are in substance made. The emphasis is on making decisions significantly affecting the entire entity rather than decisions that affect only a specific part, division, branch, office, unit, outlet, etc. of the company.

6. (Decisions...of the business) are in substance made

Whereas the substance require the material or essential part of the decisions or the decisions that are substantial, the word made refers to as 'caused to exist or happen; or as are put into existence.

The condition that decisions are in substance made means that only persons having actual power to make decisions will have to be considered for determining presence of POEM in India. The emphasis on a factual aspect or *de facto* is contemplated specifically having regard to the reference to 'in substance' decision making in POEM. Thus, substance over form will prevail and will require the identification of those persons in a company who actually "call the shots" and who exercise "realistic positive management".

This may be prone to litigation and make the task of tax authorities challenging, because the companies may by taking a position that their key decision-makers are not Indian residents but residents in the country in which the company claims to be resident and may avoid tax residency in India. Decisions made refer to as cause to exist or happen; or as are put into existence.

POEM VERSUS MANAGEMENT AND CONTROL

Except perhaps the definitional phraseology there is no much difference in the two concepts. Poem as such is used as a tie-breaker rule in Article 4(3) of Model conventions. UK has recognised that the POEM and CMC may be distinguishable under certain circumstances. Pointing out that when the two can be distinguished, the POEM will be found at a lower level than that of CMC.

CMC test was first adopted in UK over 150 years ago in the landmark case of DeBeers wherein Lord Loreburn having regard to the principal introduced in Calcutta Jute Mills and Cessna Sulphur case. It was adopted in India by the Supreme Court in Subayya Chettiar[28]. In the words of the Lord : "I regard that as the true rule; and the real business is carried on where the central management and control abides." In a number of cases thereafter[29] this rule was followed in UK.

The word 'central' qualifies the words 'management and control' in order to indicate that the test is focussed on people who occupy the principal power, the directors and not the minor managers. The place of CMC normally involves looking at the location of a company's

28. V. VR. N. M. Subayya Chettiar vs. CIT (19 ITR 168 (SC)

29. Wood and Another vs. Holden (Inspector of Taxes) (2006); The Trevor Smallwood Trust vs. HM Revenue and Customs (2008) head office, corporate seat or the place where the Board meets.

The two tests are, for practical purposes, the same. However, UK's opinion that CMC equates to POEM expressed in the OECD Commentary of the 1963 Draft and 1977 OECD MC has been revised. Though UK no longer supports the view that the two concepts are identical, however still it considers them to be similar, finding difficulty in distinguishing the two. The factors which one would consider for deciding the existence of POEM are largely consistent with the indicators to determine the place of CMC.

The concept of CM has been, over the years, understood and adopted in India in almost the same sense by the Supreme Court in V. VR. N. M. Subayya Chettiar's case (supra) as a reference to the overall policy or top management control. Such is also a thought process of the Model Commentaries in the past.

The genesis of the evolution of POEM in OECD MC drives home the point that the concept of effective management has its root in the concept of CMC. The historical evolution supports that the concept is considered the equivalent of the concept of "controlled and managed" (MC). In the earlier drafts of OECD, the tie-breaker rule was based on the concept of "controlled and managed". However, since the concept was not popularly incorporated in major treaties but was primarily used by the UK, one of the working party meet of OECD suggested switch over to the concept of POEM after noting the UK delegate view that the concept of POEM is at par with the expression CM hitherto used in the Model Convention draft. Thus the two concepts CM and POEM are at par in so far as the tie-breaker rule of the treaty.

Klaus Vogel in his Double Taxation Convention[30] suggests that POEM is similar to the place of management concept used under German domestic law. "As per the German case law, a place of management is regarded as the place where the management's important policies are actually made....What is decisive is not the place where the management directives take effect, but rather a place where they are given...... The centre of management activities of a company generally is the place at which the person authorized to represent the company carries on his business managing activities. A place from which a business is merely supervised would not qualify. If the commercial and the non-commercial side of a business are managed at different places, the location of commercial management will be controlling. If the place of effective management cannot be determined by the application of these criteria, the top manager's place of residence will regularly determine the residence of the company".

The UN MC, since 1979, has also primarily understood POEM to be the place where the body corporate is controlled and managed on a permanent/ regular basis when it says: *"It may therefore be inferred that in the OECD Model Convention the term "place of effective management" is to be interpreted as meaning the place where the business of a body corporate is managed and controlled, that is, for example, where the business has offices in which the regular managerial activities are carried out on a permanent basis."*

Indian cases on "Management and Control"

The Management and Control (MC) concept finds discussion in cases of determining residence of a company as well as of Hindu Undivided Family a unique Indian concept of a person with an opposite contrast – in former case MC wholly in India and in the later, not wholly outside India. MC as the concept is common in either case. These are:

1) V. VR. N. M. Subayya Chettiar[31] relies upon De Beers the UK case and observed: 'A company cannot eat or sleep, but it can keep

30. (Reprint 2010, Page 262).

31. V. VR. N. M. Subayya Chettiar vs. CIT (19 ITR 168 (SC) house and do business. We ought, therefore, to see where it really keeps house and does business……. The decision of *Chief Baron Kelly and Baron Huddleston in The Calcutta Jute Mills vs. Nicholson [1876] I Tax Cases 83* and The *Cesena Sulphur Company vs. Nicholson [1876] 1 Tax Cases 88*, now thirty years ago involved the principle that a company resides for purposes of income- tax where its real business is carried on. Those decisions have been acted upon ever since. I regard that as the true rule and the business is carried on where the central management and control actually abides. It also noted the observations enunciated in the decision of Swedish Central Railway: '…… that the conception of residence in the case of a fictitious "person" such as a company is as artificial as the company itself, and the locality of the residence can only be determined by analogy, by asking where is the head and seat and directing power of the affairs of the company'. …..'Control and management signifies in the present context, the controlling and directive power, 'the head and brain' as it is sometimes called, and 'situated' implies the functioning of such power at a particular place with some degree of permanence'.

2) *CIT vs. Nadal Mandalay*[32] says that 'Control and management signifies the controlling and directive power, the head and brain and is normally situated at a place from where such power is exercised with some degree of permanence. As a general rule, the control and management of a business remains in the hands of a person or a group of persons, and the question to be asked is wherefrom the person or group of persons controls or directs the business.'

3) In Narottam & Pereira Ltd.[33] the Bombay High court, following San Paulo Rly's case[34] of the House of Lords, the Bombay High Court held 'What is required to be considered is not the power or the capacity to manage and control, but the actual CM, or, in other words, not the *de jure* control and management but the *de facto* control and management. As a rule, the direction, management and control, 'the head and seat and directing power' of a company's affairs is situated at the place where the directors' meetings are held and consequently, a company would be resident in this country if the meetings of directors who manage and control the business are held here'. The facts in this case are that the assessee company, a subsidiary of Indian company, Scindia Steam Navigation Company Ltd., was engaged in the business of stevedoring in Ceylon. It was registered in Bombay, having registered office at Bombay; it was holding meetings of directors and shareholders also at Bombay. The income was earned in Ceylon. The business was managed in Ceylon by servants and agents holding power of attorney conferred with vast discretion and wide powers. As against the claim of the company that it is not resident in India or that the company should be taken to be a resident of Ceylon, i.e., the place where it carried on its business, the Court held that in construing the expression CM it is necessary to bear in mind the distinction between doing business and CM of the business. Business and the whole of it may be done outside India, and yet CM of that business may be wholly within India. It is entirely irrelevant where the business is done and where the income has been earned.

4. In Erin Estate, Galah, Ceylon[35] the Supreme Court elucidated CM as the controlling and directing power. True CM which must be shown to be situated and not merely theoretical control and power, it is not *de jure* control and power but the *de facto* power actually exercised in the course of the conduct and management of the affairs. The assessee, a registered firm in this case, owned a tea estate in Ceylon. All partners of the firm were resident in India. The

32. *CIT vs. Nadal Mandalay (40 ITR 1(SC)*
33. *Narottam & Pereira Ltd. vs. CIT, 23 ITR 454, 459*
34. *San Paulo Rly vs. Carter, 3 TC 407, 413 (HL)*
35. *Erin Estate, Galah, Ceylon vs. CIT (1958) 34 ITR 1 (SC)*

tea estate was managed by a superintendent in Ceylon. The partners gave detailed instructions to the superintendent for the operations to be undertaken for managing the business of tea gardens. The tax payer contended that since the superintendent was in charge of the management of the estate, the CM was entirely entrusted to him and thus it is wholly situated in Ceylon. The Court noted that in regard to significant and big matters a budget was required to be submitted by the superintendent to the partners, and it was after the budget was approved by them that the superintendent was at liberty to act upon. In regard to the manuring of tea gardens, the salary to be paid to the clerk, the purchase to be made, the expenditure to be incurred in constructing a building, the manner in which the goods should be packed and sent, all these were subject of discussion by the partners in their correspondences with the superintendent and in respect of all these, presumably the superintendent had asked for directions and the partners gave him the directions. If the partners resided in India, they would naturally have the legal right to control the affairs of the firm. The presence of this theoretical right to control and manage the affairs of the firm which inevitably vested in all the partners would not by itself show that the requisite CM was situated in India. The presence of partners in India gave rise to a rebuttable presumption of control being in India.

5. In Bank of China[36] Calcutta High Court the assessee, being the foreign banking company went into liquidation and a liquidator was appointed It was held that the assessee was to be deemed to be resident, as the company in liquidation had income from interest and rent in India and affairs relating to earning of such income were being controlled and managed in India by the official liquidator.

6. In Shaan Marine Services Pvt. Ltd.[37] the ITAT placing reliance on the OECD MC noted that the concept of POEM requires that decisions for the conduct of entity's business as a whole are in substance made. Also, the decisions of relevance are the key management and commercial decisions. It ruled in favour of the Cyprus company because India-Cyrus DTAA defines POEM to mean that, if the enterprise is registered and is having its headquarters, the place is the residence. In this case, Glendive, a company registered in and a tax resident of Cyprus, was engaged in the shipping business. It was a one-member company having no employees or a big office establishment as most its work was outsourced to other entities. It was contracted by a client in the United Arab Emirates (UAE) to transport cargo from India to UAE. It engaged the assessee, as its agent for handling, loading and other operations, obtaining necessary clearances from the Court, customs, income tax, immigration, etc., in India. It chartered a ship from another company for this purpose. Its agent filed the return of income (ROI) of Ship Co declaring "NIL" income by claiming that Glendive was registered and headquartered in Cyprus and, accordingly, such income was taxable only in Cyprus.

7. In DLJMB Mauritius Investment Co.[38] The Authority for Advance Ruling (AAR) ruled that as the situs of parental control as POEM of the company whose affairs and board meetings were in Mauritius, the POEM of the applicant was in Mauritius. In this case, the Applicant, a limited liability company in Mauritius proposed to make an investment in Indian shares, debentures and other debt instruments. He question was whether the company would be regarded as a person in terms of India-Mauritius treaty and whether it was also entitled to the benefit of the treaty. Since the company was to source income from India and thus incur tax liability in India, it was admitted that the company would trigger residency in terms of Article 4(1) of the treaty in both the countries' leading to application

36. *CIT vs. Bank of China (1985) 154 ITR 617 (CAL)*
37. *Shaan Marine Services Pvt. Ltd. vs. DDIT (165 TTJ 952)*
38. *DLJMB Mauritius Investment Co., In re. (1997) 228 ITR 268 (AAR)*

of tie-breaker test. The Applicant contended that its POEM was situated in Mauritius under Article 4(3) of India-Mauritius Tax Treaty on account of the – i) at least two directors of the company were resident in Mauritius and such directors had the appropriate calibre to exercise independence of mind and judgment; ii) the company secretary of the company was resident in Mauritius; iii) the registered office of the company was in Mauritius; iv) banking transactions were channelled through an offshore bank account in Mauritius; v) accounting records were maintained in Mauritius in accordance with the Mauritian Companies Act; vi) directors' meetings were held in Mauritius; vii) all statutory records, such as minutes and members' register were kept at the registered office; viii) the auditors were Mauritian residents; ix) the company had a Mauritian custodian for its assets; x) the company was regulated by the Mauritius Offshore Business Activities Authority of Mauritius (MOBAA); xi) the company was required to report on a quarterly basis its investments operations to MOBAA; xii) the company was subject to such enactments and conditions as may from time-to-time be adopted Mauritian authorities in relation to investment funds, collective investment schemes and conduct of investment business; and xii) the company was incorporated for investment in Indian companies, and investors from different jurisdictions were investing in the Mauritian company and directors in the company were appointed from different jurisdictions.

8. In another ruling[39] the AAR ruled that although the Board had the benefit of advice and recommendations from professionals and consultants in India it was not sufficient to dilute the decision-making power or control of Board. "The second body to assist the investment manager is the advisory board. This is a body comprised of professional business and financial executives. But the recommendations of the advisory board will not be binding on the investment manager unless otherwise agreed to by the trustee. Thirdly, the investment manager also enters into separate contracts with the Indian financial services company and the American company as investment advisors. The terms and conditions of the draft investment advisory agreement with the Indian financial service company have already been set out. The Indian financial service company and the American company team of advisors provide the investment manager with the advisory services, consulting services and assistance in the identification, analysis and review of the investments of the Contributory Trust.

From the terms of the advisory agreement, it is also seen that the investment advisors may function with the help of service units. But these only appear to be advisory bodies in no way controlling the decision of the board."

LEARNED AUTHORS VIEWS

Kanga, Palkhivala[40] says that as a rule, the direction, management and control, "the head and seat and directing power" of a company's affairs is situated at the place where the directors meetings are held, and consequently a company would be resident in this country if the meetings of directors who manage and control the business are held here…It is not what the directors have the power to do, but what they actually do, that is of importance in determining the question of the place where the control is exercised for as Lord Sumner said in *Egyptian Hotels Ltd. vs. Mitchell*, "Where the directors forebore to exercise their powers, the bare possession of those powers was not equivalent to taking part in or controlling the trading". In this clause……control means *de facto* control and not merely *de jure* control…."

39. *P No. 10 of 1996, In re (1996) 224 ITR 473 (AAR)*

40. *The Law and Practice of Income Tax' (Tenth Edition, Page 319)*

Sampath Iyengar[41] notes that this phrase has acquired a technical meaning. It refers to the 'head and brain' which directs the affairs of policy, finance, disposal of profits and such other vital things concerning the general and corporate affairs of the company. Control and management is situated where the central management and control actually abides, that is to say, where the supreme command over the company's affairs rests.'

Conclusion

On appraisal of the term POEM, its comparatives with CM and CMC, it may be conclude that in order to determine POEM, the countries world over follow three-step approach to identify and determine company's POEM as their centre of top level management-i) Substantive Test approach, ii) Personal Test approach; and iii) Territorial Test approach.

i) **Substantive Test** is to know the crucial decisions of the company. To identify what are the crucial relevant decisions for the management of the company is a question of fact. The type of management of a company also depends upon the nature of the business of the company.

ii) **Personal Test** is to find out who actually makes these decisions. On identification of crucial decisions relevant for the management of the company, the next step is to determine the persons who are involved in the decision-making process. Countries adopt either a single tier structure or two-tier structure for managing the affairs of the company. In order to evaluate whether decisions are actually taken by the Board, it would be necessary to evaluate agenda of the meeting, minutes of the meeting, the deliberation board members had before coming to a conclusion, etc. It is also necessary to evaluate whether decisions are actually taken by the Board or by the executive committee or by the shareholders of the company or even by outsiders.

iii) **Territorial Test** is to ascertain the location of making the key decisions by the managing persons. Any extraordinary, unique, occasional or temporary decision making at a location generally would not render that as the POEM. A company's centre of top-level management will generally be located where the Board of Directors perform their duties i.e., where the actual, organisational and legal activities in the normal course of business are performed. As already mentioned, the setting of mere business policies and exceptional decisions are not considered. Merely because one meeting is held in India would not make that jurisdiction as POEM. Further the place where decisions are actually implemented is not relevant. It is the place, where a collective body performs, takes business decisions that generally determine the location of such meetings as the POEM. Where the meetings merely serve to formally approve the decisions taken elsewhere, that location would not be decisive of the territorial test. On satisfaction of step 2 that no other persons are effectively allotted the power to represent the company and to replace the Board of Directors to perform management functions, the place where decision are actually taken by the Board could be deemed to be the POEM.

CBDT GUIDING NOTE

On the scope of POEM the CBDT has vide Letter [F. No. 142/11/2015-TPL], dated 23-12-2015 issued some guidelines. It has divided the guidelines in two parts i) POEM for company engaged in active business outside India (Para 7); and other companies (Para 8) with some precautions and explanations.

41. *Law of Income Tax (Eleventh Edition, Pages 1384 & 1386)*

i) POEM for company engaged in active business outside India

– is presumed to be outside India if the majority meetings of the board of directors of the company are held outside India.

– is considered to be in India if the Board of directors of the company are standing aside and not exercising their powers of management and such powers are being exercised by either the holding company or any other person (s) resident in India.

A company shall be said to be engaged in "active business outside India" if the passive income is not more than 50% of its total income and, i) less than 50% of its total assets are situated in India; and ii) less than 50% of total number of employees are situated in India or are resident in India; and iii) the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure. In other words if either its 50% of total income is not passive, or its total assets, or employees, or payroll expenditure is, half or more of total, in India (less than half outside India), it will not be engaged in "active business outside India" but will be the other company. It has to comply with the requirement of Paragraph 8 of the Guidance Note.

Passive income of a company shall be aggregate of, i) income from the transactions where both the purchase and sale of goods is from / to its associated enterprises; and ii) income by way of royalty, dividend, capital gains, interest or rental income.

Though the POEM is annual determination but for the purpose of determining whether the company is engaged in active business outside India the average of the data of the previous year and two years prior to that shall be taken into account. In case the company has been in existence for a shorter period, then data of such period shall be considered.

ii) POEM for other companies

Other companies' POEM is again in two stages: First stage would be identification or ascertaining the person or persons who actually make the key management and commercial decision for conduct of the company's business as a whole. Second stage would be determination of place where these decisions are in fact being made.

More importance would be given to the place where these management decisions are taken than the place where such decisions are implemented. Further the substance would be conclusive rather than the form.

For these other companies the location of company's board regularly meets and makes decisions, board delegated committee of key senior management members, companies Head Office, residence of directors or the decision taking persons if they use modern technology is adopted as the criterion. The guiding principles which may be taken into account for determining the POEM are given in the guiding note as follows:

(a) The location where a company's board regularly meets and makes decisions may be the company's place of effective management provided, the Board—

 (i) retains and exercises its authority to govern the company; and

 (ii) does, in substance, make the key management and commercial decisions necessary for the conduct of the company's business as a whole.

 It may be mentioned that mere formal holding of board meetings at a place would by itself not be conclusive for determination of POEM being located at that place. If the key decisions by the directors are in fact being taken in a place other than the place where the formal meetings are held then such other place would be relevant for POEM. As an example this may be the case where the board meetings are held in a location distinct from the place where head office of the company is located or such location is unconnected with the place where the predominant activity of the company is being carried out.

If a board has de facto delegated the authority to make the key management and commercial decisions for the company to the senior management or any other person including a shareholder and does nothing more than routinely ratifying the decisions that have been made, the company's place of effective management will ordinarily be the place where these senior managers or the other person make those decisions.

(b) A company's board may delegate some or all of its authority to one or more committees such as an executive committee consisting of key members of senior management. In these situations, the location where the members of the executive committee are based and where that committee develops and formulates the key strategies and policies for mere formal approval by the full board will often be considered to be the company's place of effective management.

The delegation of authority may be either de jure (by means of a formal resolution or Shareholder Agreement) or de facto (based upon the actual conduct of the board and the executive committee).

(c) The location of a company's head office will be a very important factor in the determination of the company's place of effective management because it often represents the place where key company decisions are made. The following points need to be considered for determining the location of the head office of the company:—

If the company's senior management and their support staff are based in a single location and that location is held out to the public as the company's principal place of business or headquarters then that location is the place where head office is located.

If the company is more decentralized (for example where various members of senior management may operate, from time to time, at offices located in the various countries) then the company's head office would be the location where these senior managers,—

(i) are primarily or predominantly based; or

(ii) normally return to following travel to other locations; or

(iii) meet when formulating or deciding key strategies and policies for the company as a whole.

Members of the senior management may operate from different locations on a more or less permanent basis and the members may participate in various meetings via telephone or video conferencing rather than by being physically present at meetings in a particular location. In such situation the head office would normally be the location, if any, where the highest level of management (for example, the Managing Director and Financial Director) and their direct support staff are located.

In situations where the senior management is so decentralised that it is not possible to determine the company's head office with a reasonable degree of certainty, the location of a company's head office would not be of much relevance in determining that company's place of effective management.

(d) It may be clarified that day to day routine operational decisions undertaken by junior and middle management shall not be relevant for the purpose of determination of POEM.

(e) The use of modern technology impacts the place of effective management in many ways. It is no longer necessary for the persons taking decision to be physically present at a particular location. Therefore physical location of board meeting or executive committee meeting or meeting of senior management may not be where the key decisions are in substance being made. In such cases the place where the directors or the persons taking the decisions or majority of them usually reside may also be a relevant factor.

(f) If the above factors do not lead to clear identification of POEM then the following secondary factors can be considered :—

  (i) Place where main and substantial activity of the company is carried out; or

  (ii) Place where the accounting records of the company are kept.

In order to ally the impact of some stray observations in some decisions it was emphasized that the determination of POEM is to be based on all relevant facts related to the management and control of the company, and is not to be determined on the basis of isolated facts that by itself do not establish effective management, as illustrated by the following examples:

i) The fact that a foreign company is completely owned by an Indian company will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied;

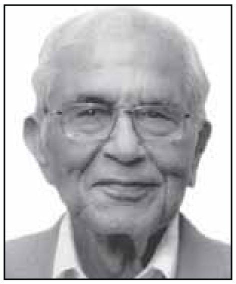
ii) The fact that one or some of the Directors of a foreign company reside in India will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied;

iii) The fact of, local management being situated in India in respect of activities carried out by a foreign company in India will not, by itself, be conclusive evidence that the conditions for establishing POEM have been satisfied;

The existence in India of support functions that are preparatory and auxiliary in character will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

The above principles are not to be seen with reference to any particular moment in time rather activities performed over a period of time, during the previous year, need to be considered. In other words a "snapshot" approach is not to be adopted. Further, based on the facts and circumstances if it is determined that during the previous year the POEM is in India and also outside India then POEM shall be presumed to be in India if it has been mainly / predominantly in India.

A procedural mandate is suggested, in case the company incorporated outside India is proposes as being resident in India, it has to be after seeking prior approval of the Principal Commissioner / the Commissioner who in turn shall provide an opportunity of being heard to the company before deciding the matter.



CA Narayan Varma

Right to Information

Editor's Note: *This article on RTI was written by Late Shri Narayan Varma for the booklet to be printed on the occasion of TAXCON 2015. However, due to certain unavoidable circumstances TAXCON 2015 could not be held. The Organisers have shared this with us. We all know RTI was very close to his heart. So as a tribute to him we are publishing this article. CA Narayan Varma expired on 24-12-2015. May his soul rest in peace.*

The Right to Information Act, 2005 is a potent piece of legislation under the Constitution. One can say that the Constitution is made effective through the legislation such as the RTI. The maxim POWER to EVERY CITIZEN is actualized through this one law more than any other or for that matter even all other laws put together.

Mahatma Gandhi once said:

"The true source of right is duty"

How true, our law is named "The Right to Information" but really it is duty to information.

RTI Act became effective on 12-10-2005. In this year, it completes 10 glorious years.

When one treats RTI as something basic to the democracy, one way of looking is that decade is not a long period and it has further to become more effective but other way of looking is that to survey and find out how much it has achieved and progressed and how much it has failed.

Nani Palkhivala in one of his talks said:

"One of the main reasons for India's backwardness and stunted development is that we as a nation have no sense of time at all. We are individually intelligent and collectively foolish. It is characteristic of us that in our national language the word 'KAL' is used to denote yesterday and tomorrow. I attribute this absence of time sense to two factors. We were the first country in the world to evolve the concepts of eternity and infinity: against the backdrop of eternity what does the waste of even several decades matter? Secondly, we were the first to evolve the doctrine of reincarnation: if you waste this life you will have several more in which to make good."

The word 'KAL' is unique. To me it seems the word was coined to understand philosophically life as a whole – beginning (yesterday) and ending (tomorrow) – from birth to death. It could go even beyond birth and death – i.e. of previous life before birth and future life beyond death.

You can't change the past but the future will always be there for you to make what you want out of it. Let us all join in making RTI movement universal in this country especially because we have just crossed ten years of its operation. It is said: A car's WINDSHIELD is so large & the Rear view Mirror so small because our PAST is not as important as our FUTURE. Let us march making RTI all pervasive.

As said above, India celebrates 10 years of the practice of the right to information. In this decade, this law, one critical to Indian democracy, has established the citizen's right to make informed choices, not just once every five years, but every single day. Governments at the Central and State levels have been forced to concede to the democratic principle of sharing power. An estimated five to eight million applications are filed every year, making it clear how popular the law is. The more than 50 RTI users who have been killed bear testimony to just how much the Act threatens vested interests. In posterity, those studying governance in independent India will be able to mark the patterns of a pre- and post-RTI era. It is, therefore, important to understand the immense contribution of the ordinary Indians who battled for years to get the entitlement and, since 2005, to implement the law.

Powerful and relevant local struggles can organically grow into national movements that enrich democratic practice. The demand for information was brilliant in its simplicity. People honed it locally on the nerve centres of unaccountable power. These demands for details of expenditures on roads, of life-saving medicines in hospitals, of disappearing rations, sent shockwaves through the establishment and shook the foundation of bureaucratic governance. The RTI has proved its efficacy from the panchayat to Parliament. Cutting through red tape and bureaucratic prevarication, it has exposed entrenched vested interests in policymaking and implementation, and undermined officials′ impunity in perpetuating both grand and mass corruption.

The RTI has been India's most powerful "weapon of the weak", enabling citizens everywhere to question and hold to account the legislature, executive and judiciary.

They have exposed misdeeds by governments across the board, in the delivery of basic services, in land and mining, as well as grand corruption in arbitrary contracts, like in the allocations of 2G spectrum and coal blocks.

In October 2015, PM Narendra Modi addressed the 10th annual convention of the Central Information Commission. He said:

"It is the common man's right to question Government and this is the foundation of democracy," Modi said, asserting that the Right to Information (RTI) could only be effective if it brought policy change. Adding that there is no place for secrecy in this day and age, Modi said, "The process of accessing information should be transparent, timely and trouble-free. Delayed information does not help solve the problem but increases it. Timely information can halt a wrong decision. We will emphasise this," he said. Modi's remark comes at a time when activists have criticized the Government's implementation of the RTI Act. The transparency watchdog CIC has over 35,000 pending complaints and a waiting period of over a year.

Former PM Manmohan Singh had used the convention to highlight the drain on public exchequer due to "vexatious and frivolous" complaints. However, PM Modi chose to strike a positive note exhorting Government officials to analyse the RTIs being filed in their departments and effect policy changes to ensure good governance.

"If a question is asked by a citizen, there must be some issue in Government that the need for question arose. A small RTI question can force you to change policy," Modi said.

We are the professionals – minimal less than 1% of total population of India. We are intellectual, we are prosperous individuals. I believe on us lies the responsibility of strengthening the democracy. While we devote our time to the profession & earn money, it is our duty to give some time and some money to the needy & deprived citizens. You may provide money to them but more important is to guide them to get their rights to achieve through RTI. They must become empowered citizens which RTI leads to.

Bill Gates Said:

With affluence comes responsibility – why I give

He further writes:

"At the headquarters of our foundation in Seattle, each floor has a quotation etched in glass. On one of the floors is a saying attributed to Mohandas Karamchand Gandhi: "the best way to find yourself is to lose yourself in the service of others."

These words of the Mahatma have a featured place in our building because they get at something very basic about philanthropy. They remind us that any search for real purpose in life must take us outside of ourselves.

Perhaps this statement resonates with me because I grew up hearing versions of it at home. My mother and father spoke often about the importance of giving back to the community, whether through volunteer work or financial contributions. They never let us forget that our relative affluence came with a deep responsibility to assist those who had not been born so lucky.

What's more, I could tell from a very early age that even as my parents gave, they received. It was clear that they derived real satisfaction and a sense of belonging from their advocacy work and their donations to various causes".

Before I end, I quote Justice V. R. Krishna Iyer "Ignorance is not bliss but bondage and knowledge is not folly but duty, if government by the people is to possess the semblance of reality, the battle for information swaraj needs awareness missiles".

I end with sincere request, become RTI friendly; provide some percentage of your time & money in service of the nation through spread of RTI.

B.V. Jhaveri, *Advocate*

DIRECT TAXES
Supreme Court

S. 256: While findings of fact found by the Tribunal are final and the High Court cannot reappraise the same, the High Court can take note of facts on record which are lost sight of by the Tribunal and also construe certain facts to be of significance as against the different view of the Tribunal

M/s. Ganapathy & Co. vs. CIT, Bangalore [2016] 65 Taxmann.com 194 (SC)

(i) It is well-settled that issues of fact determined by the Tribunal are final and the High Court in exercise of its reference jurisdiction should not act as an appellate Court to review such findings of fact arrived at by the Tribunal by a process of reappreciation and reappraisal of the evidence on record. The aforesaid position in law has been consistently laid down by the Supreme Court in several of its pronouncements out of which, illustratively, reference may be made to *Karnani Properties Ltd. vs. Commissioner of Income-Tax, West Bengal [82 ITR 547], Rameshwar Prasad Bagla vs. Commissioner of Income-Tax, U.P. [87 ITR 421]; Commissioner of Income-Tax, Bombay City vs. Greaves Cotton and Co. Ltd. [68 ITR 200] and K. Ravindranathan Nair vs. Commissioner of Income-Tax [247 ITR 178].*

(ii) The legal position in this regard may be summed up by reiterating that it is the Tribunal which is the final fact finding authority and it is beyond the power of the High Court in the exercise of its reference jurisdiction to reconsider such findings on a reappraisal of the evidence and materials on record unless a specific question with regard to an issue of fact being opposed to the weight of the materials on record is raised in the reference before the High Court.

(iii) Having reiterated the above position in law we do not see how the same can be said to have been transgressed by the impugned order of the High Court. Each relevant fact considered by the High Court to answer the questions referred to it on the claim(s) of deduction raised by the appellant-assesee are acknowledged, admitted and undisputed facts. No fresh determination of facts found by the Tribunal have been made by the High Court. What, however, the High Court did was to take into account certain additional facts, already on record, which were however not taken note of by the Tribunal to arrive at its findings, e.g., that the appellant-assessee had failed to furnish any proof of service rendered by UTC in the course of the relevant Assessment

Year i.e., 1984-1985. Alternatively, the High Court construed certain facts as, for example, compliance of the conditions subject to which registration was granted to the Aparna Ashram under Section 35(2A) of the Act to be of significance as against the contrary / different view of the learned Tribunal on this score. There was no departure from the basic facts found by the learned Tribunal in the two illustrative situations cited above, namely, that (i) the assessee had not adduced any proof of service rendered by UTC in the Assessment Year 1984-1985; (ii) that Aparna Ashram had not complied with the conditions subject to which registration had been granted to it under Section 35(2A) of the Act.

(iv) The difference in the approach between the Tribunal and the High Court, therefore, is not one relating to determination of new or additional facts but was merely one of emphasis on facts on which there is no dispute. This is surely an exercise that was within the jurisdiction of the High Court in the exercise of its reference power under the provisions of the Act as it then existed.

S. 271C: Penalty for failure to deduct TDS cannot be levied if Dept. is unable to show contumacious conduct on the part of the assessee

CIT, Delhi, vs. M/s. Bank of Nova Scotia [Civil Appeal No. 1704 of 2008, dated 7th January, 2016]

The Tribunal deleted the levy of penalty u / s. 271-C for failure to deduct tax at source on the basis that the department has to show that there was "contumacious conduct on the part of the assessee". It held:

"We have carefully considered the rival submissions. In the instant case we are not dealing with collection of tax u / s. 201(1) or compensatory interest u / s. 201(1A). The case of the assessee is that these amounts have already been paid so as to end dispute with Revenue. In the present appeals we are concerned with levy of penalty u / s. 271-C for which it is necessary to establish that there was contumacious conduct on the part of the assessee. We find that on similar facts Hon'ble Delhi High Court has deleted levy of penalty u / s. 271-C in the case of *M/s. Itochu Corporation, reported in 268 ITR 172 (Del.)* and in the case of *CIT vs. Mitsui & Company Ltd. Reported in 272 ITR 545*. Respectfully following the aforesaid judgments of Hon'ble Delhi High Court and the decision of the ITAT, Delhi in the case of Television Eighteen India Ltd., we allow the assessee's appeal and cancel the penalty as levied u / s. 271-C."

The department's appeal was dismissed by the High Court. On appeal to the Supreme Court, HELD dismissing the appeal:

"On facts, we are convinced that there is no substantial question of law, the facts and law having properly and correctly been assessed and approached by the Commissioner of Income Tax (Appeals) as well as by the Income Tax Appellate Tribunal. Thus, we see no merits in the appeal and it is accordingly dismissed. No costs."

> "Existence without knowledge and love cannot be; knowledge without love and love without knowledge cannot be. What we want is the harmony of Existence, Knowledge, and Bliss Infinite. For that is our goal. We want harmony, not one-sided development."
>
> — *Swami Vivekananda*



Ashok Patil, Mandar Vaidya & Priti Shukla
Advocates

DIRECT TAXES
High Court

1. Section 142(1) – Capital Receipt *vis-à-vis* Revenue Receipt – Termination of authorship/professional services – Asst. Year 1994-95.

CIT vs. SHARDA SINHA (2015) 94 CCH 0168 DelHC

Assessee was journalist by profession and was appointed as Foreign Correspondent in India of German news magazine *Der Spiegel* by agreement at monthly flat rate honorarium of $250 in addition to further payment for any published contributions whose copyright would be with German publisher. Either party could terminate contract at end of calendar quarter by giving notice of six weeks. Subsequently, *Der Speigel* terminated contract and paid compensation for association of past 23 years and loss of work space.In original return, assessee claimed impugned amount as Revenue receipt but on revising return, it was claimed to be capital receipt. AO negatived plea that impugned amount was capital receipt. It was held that termination of contract with Der Spiegel did not mean that assessee lost his right of authorship in future "for all publications in universe”. It was observed that as assessee was free to contribute his article/stories etc. to any other magazine, publication. That assessee "neither had any right/claim over sum so received from Der Spiegel, nor it was anticipated by him. CIT(A) held that contract with *Der Spiegel* appointing assessee as its foreign correspondent in India was capital asset and compensation received for loss of asset constituted receipt of capital nature. Compensation was therefore directed to be excluded from assessee's total income. On appeal In Tribunal, it was held that, Assessee was journalist by profession and was appointed as foreign correspondent in India of German news magazine Der Spiegel. German publisher paid a lump sum amount upon termination as sign off compensation for performance of authorship/ professional services for continuous period of 23 years. Letter written by publisher acknowledged that compensation was being paid "Due to loss of his work place and in consideration of his long time association” – Receipt in hands of assessee, was compensation for loss of income-generating asset – Termination of contract had fatally injured assessee's only source of income for last 20 years. On appeal in HC by the revenue, the court dismissed revenue’s appeal and held that mere fact that assessee was free to earn through other sources would not make difference to position in assessee’s case. Also, Supreme Court in *Kettlewell Bullen* and *Co. Ltd. and Oberoi Hotel Pvt. Ltd. vs. CIT [1999] 236 ITR 903 (SC),* had held that if receipt represented compensation for loss of source of income, it would be capital and it mattered little that assessee continued to be in receipt of income from its other similar operations.

2. Penalty u/s. 271(1)(c) – Furnishing of inaccurate particulars – Making a claim not sustainable in law – Asst. Year 2003-04.

CIT & ANR. vs. Euro Footwear Ltd. & Anr. (2015) 94 CCH 0128 All HC

Assessee claimed deduction u/s. 80HHC and 80-IB.Assessee claimed 30 per cent of gross total income u/s. 80-IB on income derived from Duty Entitlement Pass Book Scheme (DEPB) as well as on Duty Draw Back Scheme etc. AO held that income derived from DEPB and other export incentives were not income derived from industrial undertaking.AO allowed deductions u/s. 80-IB after deleting duty draw back and export incentives.AO was also of opinion that for claiming deductions on duty draw back etc., Assessee had furnished inaccurate particulars and therefore, initiated penalty proceedings u/s. 271(1)(c). Assessee, being aggrieved, filed appeal before CIT Appeals, that was allowed and order of penalty was set aside. Revenue filed an appeal in Tribunal. Tribunal dismissed appeal of revenue and held that assessee disclosed all income and claimed certain deductions that were disallowed. Mere fact that certain deductions were disallowed, would not mean that Assessee had furnished inaccurate particulars or had concealed particulars of his income. Words "inaccurate particulars" would mean details supplied in return, that was not accurate or that was not exact or correct or that was not according to truth or that was erroneous. On further appeal in HC by the Revenue, HC dismissed appeal of the Revenue and held that there was no finding of AO that details supplied by assessee in its return was inaccurate, incorrect, erroneous or false. Question of imposing penalty u/s. 271(1)(c) on mere making of claim could not arise nor such imposition of penalty would be sustainable in law. Mere making of claim for certain deductions by itself would not amount to furnishing inaccurate particulars regarding income of Assessee. In *Commissioner of Income Tax vs. Reliance Petro Products Pvt. Ltd. (2010) 322 ITR 158,* Supreme Court held that mere making of claim that is not sustainable in law, by itself, would not amount to furnishing inaccurate particulars regarding income of assessee. Such claim made by assessee in return, would not amount to inaccurate particulars.

3. Section 32 – Depreciation – Depreciation on intangible asset – Goodwill representing business – Denial of depreciation

Chowgule & Company Private Limited vs. ACIT (2016) 95 CCH 0021 Bom HC

Issue was whether ITAT was right in disallowing appellant-assessee's claim for depreciation on intangible asset by way of 'Goodwill' representing business and/or commercial rights acquired in course of amalgamation of company duly approved by High Court. High Court held that, Apex Court in case of *CIT, Kolkata vs. Smifs Securities Ltd.* had held that Explanation 3 of S. 32(1) states that expression 'asset' shall mean intangible asset, being know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature – Words 'any other business or commercial rights of similar nature' in clause (b) of Explanation 3 thereby indicates that goodwill would fall under expression 'any other business or commercial right of a similar nature'. Apex Court clearly came to conclusion that depreciation on Goodwill paid upon amalgamation was permissible deduction in terms of S. 32 – Substantial question of law thus answered in favour of assessee. Assessee's appeal partly allowed.

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DIRECT TAXES
Tribunal

Reported

1. Capital Gains – Section 54F of the Income Tax Act, 1961 – assessee had purchased new asset within two years from date of transfer of original asset – provisions of section 54F(4) would not be attracted – assessee is entitled to benefit of deduction under section 54F of the Act. A.Y.: 2008-09

Ashok Kapasiawala vs. ITO [2015] 63 taxmann.com 284 (Ahmedabad - Trib.)

The assessee before the Hon'ble Appellate Tribunal is an individual. The Assessee sold his office premises on 8-1-2008 and invested entire amount of sale consideration in residential property on 5-10-2009. The A.O. while finalizing the assessment order disallowed the claim of exemption under section 54F of the Act by observing that the assessee had not deposited the sales proceeds in the manner prescribed under section 54F(4). On appeal the First Appellate Authority upheld the action of the A. O.

The assessee being aggrieved by the order passed Ld. CIT(A) preferred an appeal before the Hon'ble Ahmedabad Appellate Tribunal. The Appellate Tribunal was pleased to allow the claim of the assessee by observing that the assessee had purchased new asset within two years from date of transfer of original asset. Hence, section 54F(4) requiring assessee to deposit amount within prescribed time would not be attracted. The assessee, therefore, would be entitled to benefit under section 54F of the Act.

2. Set off losses under the head capital gains – Section 74 of the Income tax Act, 1961 – brought forward loss from short-term capital asset – can be set-off against long-term capital gain and short-term capital gain. A.Y.: 2010 -11

GSB Capital Markets Ltd. vs. Dy. CIT - [2016] 65 taxmann.com 178 (Mumbai - Trib.)

The assessee in its return of income claimed set-off of brought forward loss arisen from transfer of short-term capital asset relevant to the assessment year 2009-10 against the capital gains arising from transfer of long-term capital asset during the relevant assessment year 2010-11. The A.O. while finalising the assessment disallowed the claim of the assessee by observing that the loss arising from transfer of short-term capital assets was assessed at 15 per cent tax while the gain arising from transfer of long-term capital assets was assessed at 20 per cent. Hence, the loss arising from short term capital asset could not be set-off against capital gains earned from long term capital asset in view of section 70(3) of the Act. On appeal the First Appellate Authority upheld the action of the A.O.

The assessee being aggrieved by the above order passed by Ld. CIT(A) preferred an appeal before the Hon'ble Mumbai Appellate Tribunal. The Appellate Tribunal allowed the claim of the Appellant by observing that the contention of the revenue that short-term capital loss cannot be set-off against long-term capital gains due to difference in tax rate can not be accepted because of the provisions of section

74(1)(a) which clearly stipulates that carried forward losses arising from transfer of short-term capital asset can be set-off against income from capital gains assessable for the assessment year in respect of any other capital asset.

Unreported

3. Deduction – Section 80-IC of the Income-tax Act, 1961 – Special provisions in respect of certain undertakings or enterprises in certain special category States – substantial expansion through investment in machinery – deduction under section 80-IC cannot be disallowed. A.Y.: 2008-09

Abhitech Energycon Ltd. vs. ACIT – [I.T.A. No.: 8721 / Mum / 2011; Order dated: 3-2-2016; Mumbai Tribunal]

The assessee engaged in the business of fuel additives. In the year 2004, the assessee shifted its manufacturing activities from Wada in Maharashtra to Baddi located in the State of Himachal Pradesh. During the relevant assessment year the assessee has carried out substantial expansion by making investment in machinery. The assessee in its return of income claimed deduction under section 80-IC of the Act. The A.O. disallowed the claim of the assessee on the basis that the undertaking located in Baddi is established by reconstruction of existing business, which is in violation of provisions of section 80-IC(4)(i) of the Act. On appeal, the First Appellate Authority upheld the action of the A.O.

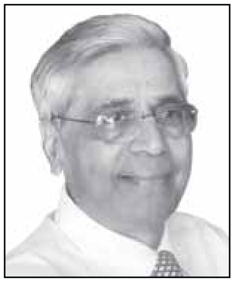
The assessee being aggrieved by the order passed by Ld. CIT(A) preferred an appeal before Hon'ble Mumbai Appellate Tribunal. Hon'ble Appellate Tribunal allowed the claim of the assessee by observing that the value of plant and machinery purchased by the assessee during the relevant assessment year show that the assessee has carried out "substantial expansion" of its undertaking, since the value of new machinery exceeds by more than 50% of the book value of Plant & Machinery. The Appellate Tribunal further observed that the details of employees, electricity bills and water bills issued by the Himachal Pradesh State Industrial Development Corporation Ltd and the letter issued by the Deputy Director of Industries, Baddi, Dist Solan (H.P) allocating the undertaking of the assessee as Micro / Small / Medium scale Enterprises for manufacturing activities shows that the new undertaking at Baddi cannot be considered as reconstruction of the unit.

4. Unexplained expenditure – Section 69C of the Income-tax Act, 1961 – Treating the purchases as bogus on the basis of information received from Sales Tax Department – unjustified. A.Y.: 2009-10

Shri Hiralal Chunnilal Jain vs. ITO – [I.T.A. No.: 4547 / Mum / 2014; Order dated: 1-1-2016; Mumbai Tribunal]

The Assessee is an individual engaged in business of resellers of ferrous and non-ferrous metals. During the assessment proceedings, the A.O. found that the assessee had purchased goods worth ` 7.21 lakhs from M/s. Shiv Sagar Steel (India). The A.O., further observed that the name of M/s. Shiv Sagar was appearing in the list of bogus parties forwarded by the sales tax authorities and the name of the assessee was appearing as a beneficiaries in the list. The A.O. directed the assessee to produce the purchase party. However, the supplier was not produced by the assessee. Summons issued to M/s. Shiv Sagar could not be served on the given address. The treated the purchase transaction bogus and added the entire purchase as unexplained expenditure under section69C of the Act.

On appeal the Ld. CIT(A) granted partial relief and reduced the addition to 20% of the purchases. The assessee being aggrieved preferred further appeal before the Hon'ble Mumbai Appellate Tribunal. The Appellate Tribunal allowed the appeal of the assessee by observing that the A.O. made the addition on the basis of information received from the Sales Tax Department, but, he did not make any independent inquiry. He did not follow the principles of natural justice before making the addition. The First Appellate Authority had reduced the addition to 20%, but he has not given any justification except stating that same was done to plug the probable leakage revenue. Considering the peculiar facts and circumstances of the case, we are reversing the order of the First Appellate Authority.



CA Sunil K. Jain

DIRECT TAXES
Statutes, Circulars & Notifications

NOTIFICATIONS

Income-tax (Twenty Second Amendment) Rules, 2015 – Permanent Account Number – Substitution of Rules 114B, 114C, 114D, 114E, Form Nos. 60, 61 and 61A

In regard to section 139A, section 271FAA and section 285BA, read with section 295 of the Income-tax Act, the Central Board of Direct Taxes made the Income–tax (22nd Amendment) Rules, 2015. Rules 114B, 114C and 114D shall come into force from the 1st day of April, 2016.

"114B. Transactions in relation to which permanent account number is to be quoted in all documents for the purpose of clause (c) of sub-section (5) of section 139A.– Every person shall quote his permanent account number in all documents pertaining to the transactions specified in the table given in the mentioned notification. If the person is a minor with no income chargeable to Income Tax, then he shall quote the permanent account number of his father or mother or guardian, as the case may be, in the document pertaining to the said transaction. If a person does not have a PAN he shall make a declaration in Form No. 60 giving therein the particulars of such transaction:"

"114C. Any person as mentioned in the rule, in relation to a transaction specified in rule 114B, has received any document shall ensure after verification that permanent account number has been duly and correctly mentioned therein or as the case may be, a declaration in Form 60 has been duly furnished with complete particulars."

"114D. Determines the time and manner in which persons referred to in rule 114C shall furnish a statement containing particulars of Form No. 60 in Form No. 61 to the Director of Income-tax (Intelligence and Criminal Investigation) or the Joint Director of Income-tax (Intelligence and Criminal Investigation)"

"114E deals with furnishing of statement of financial transaction in respect of a financial year in Form No. 61A"

(Notification No.SO 3545(E) [95/2015 (F.No.142/28/2012-(SO)TPL)], Dated 30-12-2015)

Income-tax (First Amendment) Rules, 2016 – Substitution of Rule 17 – Exercise of option – Form Nos. 9A, 10:

In regard Section 11 read with section 295 of the Income-tax Act, CBDT made the Income-tax (1st Amendment) Rules, 2016 to come into force from the 1st day of April, 2016. Rule 17 shall include that option to be exercised in accordance with the provisions of the Explanation to section 11(1) in respect of income of any previous year relevant to the assessment year beginning on or after the 1st day of April, 2016 shall be in Form

No. 9A. The statement to be furnished to the Assessing Officer or the prescribed authority under section 11(2) or under the said provision as applicable under clause (21) of section 10 shall be in Form No. 10. Both the forms should be furnished electronically before the expiry of the time to file the return of income.

(Notification No.SO 110(E) [95/2015 (No.CW-II-11/4/2015)-C.W.I], dated 12-1-2016)

Section 90 of the Income-tax Act, 1961 – Double Taxation Agreement – Agreement for Avoidance of Double Taxation and Prevention of Fiscal Evasion with Foreign Countries – Belarus

A Protocol amending the agreement between the Government of the Republic of India and the Government of the Republic of Belarus for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on property (Capital) of the 27th September, 1997 was signed at Minsk, in June, 2015. The Central Government notified that all the provisions of the Protocol given in the mentioned notification, shall be given effect to in the Union of India with effect from the 19th November, 2015.

(Notification No. SO 111(E) [No. 2/2016 (F.No.501/07/1999-FTD-I)], dated 13-1-2016)

Sovereign Gold Bond Scheme, 2016

In regard of section 3(iii) of the Government Securities Act, 2006, the Central Government made the Sovereign Gold Bond Scheme, 2016. The Subscription of the Gold Bond under this Scheme shall open on and from the 18th day of January 2016 and shall close on the 22nd day of January 2016, provided that the Central Government may, with prior notice, close the Scheme before the period specified above. The interest on the Gold Bonds shall commence from the date of its issue and shall have a fixed rate of interest at 2.75 per cent per annum on the amount of initial investment which shall be payable half-yearly and the last interest will be payable along with the principal on maturity. The Gold Bond shall be repayable on the expiration of eight years from the 8th February, 2016, the date of the issue of Gold Bonds, whereas premature redemption of Gold Bond may be permitted after fifth year from the date of issue of such Gold Bond. The interest on the Gold Bond shall be taxable as per the provisions of the Income-tax Act, 1961 and the capital gains tax shall also remain the same as in the case of physical gold. All other terms and conditions specified in the notification of Government of India in the Ministry of Finance (Department of Economic Affairs), dated the 8th October, 2008 shall apply to the Gold Bond issued under this scheme. The necessary forms for Application, ack. receipt, Gold bonds and nomination facilities; names of designated banks and post office, List of Post Offices Identified for Sale of Sovereign Gold Bonds are mentioned in the said notification.

(Notification [F.No.4 (19)-W&M/2014] dated 14-1-2016)

Authority for Advance Rulings – Procedures for appointment as Chairman and Vice-Chairman

In regard section 245-O(3) read with section 295(2)(p)(1) of the Income-tax Act, the Board made the Authority for Advance Rulings (Procedure for Appointment as Chairman and Vice-Chairman) Rules, 2016. Vacancy as and when shall be circulated through open advertisement and applicants shall be asked to forward complete application through Registrar of Supreme Court or High Court, as the case may be. For this purpose, there shall be a Selection Committee consisting of the following members (a) the Chief Justice of India or a Judge of the Supreme Court as nominated by the Chief Justice of India as Chairman; (b) the Secretary to the Government of India in the Ministry of Finance, Department of Revenue;

(c) the Secretary to the Government of India in the Ministry of Law and Justice, Department of Legal Affairs; (d) the Secretary to the Government of India in Ministry of Personnel, Public Grievances and Pensions, Department of Personnel and Training. The required quorum is three and the Committee may devise its own procedure for selection and appointment of the Chairman and the Vice-Chairman.

(Notification No. GSR 100(E) [F.No. Q.23016/6-2015-A dated 21-1-2016)

CIRCULARS

Section 194A of the Income-tax Act, 1961 – Deduction of Tax at Source – Interest other than interest on securities – Notified Institution – TDS under section 194A on interest on fixed deposit made on direction of courts

The CBDT clarified that, as per the judgment in the case of CO Bank in Writ Petition No. 3563 of 2012 [2014] 51 taxmann.com (Delhi), interest on FDRs made in the name of Registrar General of the Court or the depositor of the fund on the directions of the Court, will not be subject to TDS till the matter is decided by the Court. However, once the Court decides the ownership of the money lying in the fixed deposit, the provisions of section 194A will apply to the recipient of the income.

(Circular No. 23/2015 [F.No.279/MISC/140/2015-ITJ], dated 28-12-2015)

Section 153C, read with Section 158BD, of the Income-tax Act, 1961 – Search and Seizure – Assessment of income in case of other person – Recording of satisfaction note under section 158BD/153C of said Act

The Central Board of Direct Taxes accepted the view of the Hon'ble Supreme Court in the case of M/s. Calcutta Knitwears in its detailed judgment in Civil Appeal No. 3958 of 2014 dated 12-3-2014 [2014] 43 taxmann.com 446 (SC) in which it laid down that for the purpose of section 158BD of the Act, recording of a satisfaction note is a prerequisite and the satisfaction note must be prepared by the AO before he transmits the record to the other AO who has jurisdiction over such other person u/s. 158BD. Several High Courts have held that the provisions of section 153C of the Act are substantially similar/ *pari materia* to the provisions of section 158BD of the Act and therefore, the above guidelines of the Hon'ble SC, apply to proceedings u/s. 153C of the IT Act, for the purposes of assessment of income of other than the searched person.

(Circular No. 24/2015 [F.No. 279/Misc./140/2015/ ITJ], dated 31-12-2015)

Section 115JB, read with sections 115JA and 271(1)(C), of the Income-tax Act, 1961 – Minimum Alternate Tax – Penalty under section 271(1)(C) Wherein additions/disallowances made under normal provisions of the said Act but tax levied under MAT provisions under sections 115JB/115JC, for cases prior to Assessment Year 2016-17

In view of the Delhi High Court judgment dated 26-8-2010 in ITA No. 1420 of 2009 [2010] 194 Taxman 387 (Delhi) in the case of Nalwa Sons Investment Ltd., and substitution of Explanation 4 of section 271 of the Act with prospective effect, CBDT stated that prior to 1-4-2016, where the income tax payable on the total income as computed under the normal provisions of the Act is less than the tax payable on the book profits u/s. 115JB of the Act, then penalty under section 271(1)(c) of the Act, shall not be attracted with reference to additions/disallowances made under normal provisions. It was further clarified that in cases prior to 1-4-2016, if any adjustment is made in the income computed for the purpose of MAT, then the levy of penalty u/s. 271(1)(c) of the Act, will depend on the nature of adjustment. The above settled position is to be followed in respect of section 115JC of the Act also.

(Circular No. 25/2015 [F. No. 279/Misc./140/2015/ ITJ], dated 31-12-2015)

Section 237 of the Income-tax Act, 1961 – Refunds – Issue of refunds up to ` 5,000/- and refunds in cases where outstanding arrear is up to ` 5,000/- in non-CASS cases for assessment years 2013-14 and 2014-15

The CBDT directed that in order to provide relief to small taxpayers, refunds up to ` 6,000/- and refunds in cases where arrear demand is up to ` 5,000/- may be issued without any adjustment of outstanding arrears under section 243 of the Act during FY 2015-16. This must be completed before 31st January 2016 and the report must be sent to the Member (Revenue).

(Office Memorandum F. No. 312/109/2015-OT, dated 14-1-2016)

Jurisdiction of competent authorities in foreign tax & tax research division – Usage of form – Updated contact details of officers dealing with exchange of information under various treaties

Frequently Exchange of Information addressed to Foreign Tax Authorities, received from field formations are not addressed to the appropriate/jurisdictional Competent Authority/Joint Secretary in Foreign Tax & Tax Research Division. Further, many Pr. CsIT/ Pr. DsIT(Inv.) do not using the Form A issued by the C.B.D.T. in the revised Manual on Exchange of Information in May 2015 for sending the requests for information to Foreign Tax Authorities. In view of the above, the distribution of jurisdictions between the Competent Authorities (Joint Secretary, FT&TR-I and Joint Secretary, FT&TR-II) along with the updated contact details of officers in Exchange of Information Cell was provided. All request for exchange of information must be sent in 'Form A', since requests made using old proforma may not be processed in the FT&TR Division.

(Letter F. No.500/20/2013/FT&TR-III (2)] dated 21-1-2016)

PRESS RELEASES

Section 90 of the Income-tax Act, 1961 – Double Taxation Agreement – Agreement for avoidance of double taxation and Prevention of Fiscal Evasion with Foreign Countries – Slovenia & Maldives

The Union Cabinet has approved the signing of a Protocol amending the Convention between India and Slovenia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income.

The Union Cabinet also approved the signing and ratification of an Agreement for the exchange of information between India and Maldives with respect to taxes. This will broaden the scope of the existing framework of exchange of tax related information which will help curb tax evasion and tax avoidance between the two countries and will also enable mutual assistance in collection of taxes.

(Press Release, dated 30-12-2015)

Section 249 of the Income-tax Act, 1961 – Commissioner (Appeals) – Form of Appeal and Limitation – Electronic filing of First Appeal before CIT (Appeals)

In order to digitize various functions of the Income Tax Department, electronic filing of appeal before CIT(Appeals) has been made mandatory for persons who are required to file the return of income electronically. The existing Form 35 for filing of First Appeal has been substituted by a new Form. The new format for filing of appeals is more structured, objective, systematic, and aligned with the current provisions of the Income-tax Act. With these changes, the burden of compliance on the taxpayers in appellate proceedings will be significantly reduced.

(Press Release, dated 30-12-2015)

Guidance Note on implementation of reporting requirements under rules 114F to 114H of the Income-tax Rules, 1962

The Guidance Note is for providing guidance to the Financial Institutions, Regulators and officers of the Income Tax Department for ensuring compliance with the reporting requirements provided in Rules 114F to 114H and Form 61B of the Income-tax Rules, 1962. The Guidance Note is intended to explain the reporting requirements of FATCA and CRS in a simple manner. Since a large part of the Rules is based on IGA between India-USA and the CRS on AEOI, the Financial Institutions may refer to the IGA and CRS along with its Commentary to get further understanding of the terms used. All the stakeholders are requested to provide feedback and suggestions so that Guidance Note can be further updated as per evolving issues in the implementation of FATCA and CRS.

(Press Release, dated 31-12-2015)

Section 197, read with sections 195, 206C, of the Income-tax Act, 1961 – deduction of tax at source – Certificate for deduction at lower rate – Advisory for deductors

Deductors deduct tax at lower rate on payment/credit to deductee on production of lower deduction certificate manually issued by Assessing Officers under section 197 and quote the same in quarterly TDS statement. Instances of huge default of 'Short Deduction' are observed due to wrong quoting of 197 certificate number. CPC (TDS) has provided the facility of validating the 197 certificate to the deductors on TRACES. This enables a deductor to first validate the 197 certificates given to him by their deductees and then furnish the same in the TDS/TCS statement. If the 197 certificate is not valid as per TRACES validation, the deductor should always insist upon an ITD system generated certificate having a unique 10 digit alpha numeric number. This would minimize the generation of default of "Short Deduction due to 197 certificates".

(Press Release, Dated 1-1-2016)

Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 – Declarations and Payments made under said Act

The Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 provided for a one time compliance window to declare assets held abroad and pay due taxes and penalty on the value of assets declared. A total of 644 declarations were made under the compliance window provided in the Act which closed on 30th September, 2015. The amount involved in these 644 declarations was ` 4,164 crore. The amount received by way tax and penalty up to last date 31st December, 2015 was ` 2,428.4 crore. The shortfall was primarily on account of certain declarations, in respect of which there was prior information under the provisions of Double Taxation Avoidance Agreements/Tax Information Exchange Agreements or receipt of payment after 31st December, 2015.

(Press Release, dated 6-1-2016)

Sections 260A & 237 of the Income-tax Act, 1961 – Refunds of smaller amount – High Courts, Appeals to – Initiatives taken for reducing litigation

Several initiatives have been taken by the Central Board of Direct Taxes in the last three months up to December 2015 to significantly reduce disputes and provide relief to taxpayers facing long standing litigation. The significant steps taken by CBDT include issue of a Circular revising the monetary limits for filing of appeals by the Department with the objective of reducing litigation as a part of its initiatives to reduce grievances of the taxpayers. Besides this, the CBDT has issued a number of Circulars for withdrawing or not pressing of appeals on settled issues relating to the subjects like

Interest from non-statutory liquidity ratio (non-SLR) securities, allowability of employer's contribution to funds for welfare of employees in terms of section 43(b) of the Income-tax Act, TDS under section 194A of the Act on interest on fixed deposit made on the directions of the courts, Recording of satisfaction note under sections 158BD/153C of the Income-tax Act, Non levy of penalty u/s. 271(1) (c) wherein additions/disallowances were made under normal provisions of Income-tax Act, 1961 but tax was levied under MAT provisions under sections 115JB/115JC, for cases prior to A.Y. 2016-17 etc.

The Central Board of Direct Taxes had issued instructions to Central Processing Centre (CPC), Bengaluru and the field officers in December, 2015 to issue refunds of amounts less than ` 50,000/- expeditiously. As a result, 18,28,627 refunds below ` 50,000/- involving a sum of ` 1,793 crore have been issued between 1st December, 2015 and 10th January, 2016. These refunds relate to Assessment Years 2013-14 to 2015-16.

(Press Release, dated 15-1-2016)

INSTRUCTIONS

Section 143 of the Income-tax Act, 1961 – Assessment – Scrutiny Assessment – Issuing Questionnaire in cases selected for scrutiny

The CBDT instructed all the Assessing Officers that in cases selected for scrutiny, the initial notice issued under section 143(2) of the Income-tax Act, 1961 should accompany a notice under section 142(1) along with the questionnaire containing details of specific documents/information/evidences etc. that are required to be furnished by the taxpayer in connection with scrutiny assessment proceeding in their respective case. This will prevent undue hardship to the taxpayers and unnecessary wastage of their time.

(Instruction No.19/2015 [F.No. 225/328/2015-ITA-II], dated 29-12-2015)

Section 143 of the Income-tax Act, 1961 – Assessment – Scrutiny assessment – Some important issues and scope of scrutiny in cases selected through computer aided scrutiny selection (CASS)

CBDT clarified the scope and applicability of the Instruction No. 7/2014 dated 26-9-2014 for the cases selected for scrutiny through CASS. The said Instruction is applicable where the case is selected for scrutiny under CASS only on the parameter(s) of AIR/CIB/26AS data. If a case has been selected under CASS for any other parameter besides the AIR/CIB/26AS data, then the said Instruction would not apply. In such cases, the Assessing Officer, shall confine the Questionnaire only to the specific issues pertaining to AIR/CIB/26AS data. Wider scrutiny in these cases can only be conducted as per the guidelines and procedures stated in Instruction No. 7/2014.

(Instruction No. 20/2015 [F. No. 225/269/2015-ITA-II], dated 29-12-2015)

CA Tarunkumar Singhal & Sunil Moti Lala, *Advocate*

INTERNATIONAL TAXATION

Case Law Update

A. AUTHORITY FOR ADVANCE RULINGS ('AAR')

1) Settlement amount received by FIIs in lieu of right to sue was a capital receipt and in the absence of the cost of acquisition of the said right the computation mechanism failed and accordingly, the applicant was not subject to tax in India

Aberdeen Claims Administration Inc In re – [2016] 65 taxmann.com 246 (AAR – New Delhi)

Facts

1. The applicants, 19 mutual funds under the Aberdeen Group held American Depository shares and equity shares of Satyam Computer Services. During 2009, the CEO of Satyam confessed that the financial results had been manipulated and inflated as a result of which the value of the shares dropped drastically forcing the applicant to sell their entire shareholding. The applicants initiated legal claims against Satyam and its auditors. The applicants established two trusts and assigned the aforesaid Legal claims to the trusts, retaining all beneficial interest. After prolonged proceedings, Satyam and its auditors entered into a settlement agreement with the applicants in lieu of the waiver of legal claims. Accordingly, the applicants filed an application for advance ruling with the following questions:

- Whether the settlement amount to be received by the applicants was chargeable to tax under the provisions of the Act.
- If the answer to the first question was in the affirmative, what would be the basis and method of determination of taxable income, applicable tax rate, applicable rate of deduction of tax at source and at what stage was such tax required to be deducted and whether the settlement amount would attract Indian taxes at the time of deposit of the same in the escrow account.

Ruling

1. The AAR held that the settlement amount was received as per a Court order and was not a periodical monetary return. It observed that the claim was against the right to sue and was not linked with income generating apparatus and that it could not be said to relate to any sort of business activity carried on by the applicants. It held that the said sum was capital in nature and could be taxed only if specifically provided for in the Act. Though the right to sue constituted a capital asset, it was neither transferable nor could its cost of acquisition be determined as a result of which the computation mechanism in

section 45 of the Act failed and therefore there was no income chargeable under the Act.

2. It also observed that the applicants were not doing any activity constituting business to earn such income as it was not in the business of suing and seeking settlement amounts. It held that the theory of loss of future income could not apply to the applicants.

3. In regard to the contention of the Revenue that the settlement received was part of business receipts as per the surrogatum principle i.e. that the character of receipt of an award of damages/ claim as capital or revenue depends on what such amount was intended to replace, the AAR held that the said principle was not applicable to amounts received pursuant to a fraud and that the applicants were FIIs and as per the SEBI regulations FIIs do not carry out trading in securities but hold the securities as investments.

4. Accordingly it held that the settlement claim received did not constitute income chargeable under the Act.

2) Supply management services, being in the nature of procurement services could not be taxed as technical or consultancy services under the India – UK DTAA. Since managerial services were excluded from the ambit of Fees for technical services – payment not subject to tax. Further, in the absence of PE in India, amount receivable were not taxable in India

Cummins Ltd. In re – [2016] 65 taxmann.com 247 (AAR – New Delhi)

Facts

1. The applicant, a company incorporated in the UK, provided supply management services *vide* a Material Supplies Management Service Agreement to Cummins Technologies India Ltd. ('Cummins India') in relation to purchases made by Cummins India from third parties in the UK and US. The applicant raised the following questions before the AAR:

- Whether the supply management service fee received by it from Cummins India was in the nature of Fees for technical services or Royalty under Article 13 of the India-UK Double Tax Avoidance Agreement.
- In view of the fact that the applicant does not have a Permanent Establishment in India in terms of Article 5 of the DTAA, whether the payments received by it were chargeable to tax in India.
- Whether transfer pricing provisions would be applicable in respect of supply of management service fees
- Based on the answers to the Questions 1 and 2, whether Cummins India was required to withhold tax in India under Section 195 of the Act.

Ruling

1. The AAR dismissed the contention of the Revenue that the intention of the contract entered into between the applicant and Cummins India was to obtain tax benefit under the DTAA as the DTAA did not tax managerial services under Fees for technical services and required technical knowledge to be made available to the recipient of services for it to be classified as technical services.

2. It held that as per Article 13 of the DTAA, payment for technical services would be taxable only if it made available the technical knowledge to the payer and since the applicant merely ensured market competitive pricing and did not impart technical knowledge to Cummins India based on which Cummins India could acquire such skills and use it in the future, the said payments could not be taxable as technical services. It also held that procurement services could never be classified as technical or consulting in nature. Further, it noted that

the services were in the nature of managerial services and that managerial services were excluded from the ambit of Fees for technical services under the DTAA. Accordingly, it held that the payment did not constitute Fees for technical services under Article 13.

3. As regards Royalty, it held that services related to identification of products and competitive pricing could not qualify as royalty under the DTAA as it was not related with the use of or the right to use any copyright, patent, trademark, design or modal, plan, secret formula or process.

4. Further it held that since the applicant had no PE in India, the fees receivable were not taxable in India.

5. The AAR held that the transfer pricing provisions were not applicable to the current case and that Cummins India was not required to withhold tax under section 195 of the Act.

3) Where a Mauritius company proposed to transfer shares held by it in an Indian company in favour of a company proposed to be incorporated in Singapore pursuant to a group reorganization initiated 20 years back, it could not be said to be a tax avoidance scheme because treaty benefits were available. Applicant was not liable to capital gains tax as per Article 13 of the DTAA. Further, in the absence of PE in India, no MAT was applicable. Transfer Pricing provisions were not applicable absent income chargeable under the Act

Dow Agro Sciences Agricultural Products Ltd. In re – [2015] 65 taxmann.com 245 (AAR- New Delhi)

Facts

1. The applicant, a company incorporated in Mauritius, was a part of the Dow Group of companies and held 99 per cent of the share capital of Dow Agrosciences India Pvt. Ltd. ('DAS India'). Pursuant to restructuring of the Group's overall holding structure, the applicant proposed to transfer the shares held by it in DAS India to a holding company in Singapore, thereby shifting the holding company to the Asia Pacific region for better control and increased focus on operations. Based on the aforesaid proposed transaction, the applicant raised the following questions before the AAR:

- Whether the investment held by the Applicant in DAS India would be considered as a capital asset under section 2(14) of the Act.
- Whether capital gains arising from the transfer of shares would be subject to tax in India
- If the shares were not classified as capital assets, whether the gains from the transfer of shares would be taxable in India in the absence of a Permanent Establishment in India.
- Whether the applicant would be liable to pay Minimum Alternate Tax under the provisions of section 115JB of the Act.
- Whether the proposed transfer of shares attracted the Transfer Pricing provisions.
- Whether the sale consideration receivable would be subject to deduction of tax at source if the proposed transaction was not taxable in India
- Whether the applicant was required to file any return of income under section 139 of the Act if the proposed transfer was not taxable in India.

Ruling

1. The AAR held that the equity shares held by the Applicant in DAS India was to be considered as capital assets and not stock-in-trade considering Instruction No 1827 and

Supplementary Circular No 4 / 2007 issued by the Central Board of Direct Taxes as well as the accounting, intention and quantum test relied on by the applicant. Considering Article 13 of the DTAA, it held that there was no capital gains tax arising from the proposed transfer of shares of DAS India by the applicant.

2. The AAR dismissed the allegations made by the Revenue that the transaction was a scheme for avoidance of payment of tax in India and that the applicant was a shell company not entitled to the benefits of the DTAA. It noted that the transaction began almost 20 years back and that DAS India was incorporated in 1994 pursuant to which the applicant had invested in various tranches during the period ranging from 1995 to 2005 after prior approval of the DIPP and RBI. It held that a transaction beginning almost 20 years ago could not have been a scheme to avoid payment of taxes. Further, it appreciated the business considerations underlying the proposed restructuring.

3. Additionally, the revenue contended that the applicant had a Permanent Establishment in India as huge royalty and service charges were paid by DAS India to the US parent, DAS India was a trading company, exports by DAS India were on behalf of the US Parent company and that DAS India's employees were offered ESOPs by the US Parent. Considering that the applicant did not carry on any business activity in India nor had any office, employees or agents in India it held that there was no PE. It held that the contentions of the tax department were irrelevant. Since there was no PE, the AAR held that there was no tax liability under Article 13(2) of the DTAA.

4. The AAR dismissed the contention of the Revenue that the capital gains should be assessed in the hands of the US company since it was the beneficial shareholder of DAS India.

5. Further, it rejected the contention of the Revenue that sale proceeds should be treated as dividends in India to the extent of accumulated profits since DAS India had not declared dividends since 2004.

6. As regards the applicability of MAT to the applicant on the gains arising pursuant to the transaction, the AAR held that since the applicant did not have a permanent establishment in India, MAT was not applicable in light of the decision of the Apex Court in Castleton Investment Ltd. and the circular issued by the Government stating that no MAT would be levied on foreign companies not having a place of business / PE in India.

7. As regards the applicability of transfer pricing provisions, it held that since there was no income chargeable to tax in India, the transfer pricing provisions would not apply.

8. Further, it was held that since the gains were not taxable in India, the provisions of section 195 of the Act would not apply.

9. The AAR held that the Applicant did not have to file a return of income under section 139 of the Act as the transfer of shares was not subject to tax in India.

B. HIGH COURT JUDGMENTS

4) Advertisement, Marketing & Sales Promotion expenses could not be considered as an international transaction in the absence of any agreement, arrangement etc., merely on the basis of the Bright Line Test

Maruti Suzuki India Ltd. vs. CIT – [2015] 64 taxmann.com 150 (Del.)

Facts

1. The assessee, a subsidiary of Suzuki Motor Corporation ('SMC'), was engaged in the manufacture of passenger cars in India. As per a licence agreement between the assessee and SMC, the assessee was permitted to use the co-branded trademark of Maruti Suzuki on its vehicles. During the relevant year, the

assessee had entered into various international transactions with its AE which were referred to the TPO for determination of ALP. It had also incurred Advertisement, Marketing and Promotion expenses towards the promotion of its brand.

2. The TPO made a TP adjustment of ` 252.26 crore – ` 98.14 crore as regards royalty paid by the assessee to SMC on the ground that the foreign trademark for which royalty was being paid had no brand value and ` 154.12 crore towards the AMP expenses incurred by the assessee. The addition on account of AMP expenses was arrived at by applying the Bright Line Test. Since the ratio of selling and distribution expenses as a percentage of sales of the assessee was higher than that incurred by comparable companies, the TPO concluded that the excess was on account of promotion the Suzuki Brand.

3. The DRP and ITAT upheld the order of the AO / TPO.

4. Aggrieved, the assessee filed an appeal before the Hon'ble High Court and contended that the application of the Bright Line Test was rejected by the Court in the case of *Sony Ericsson Mobile Communications India Pvt. Ltd. vs. CIT [2015] 374 ITR 118* and that in the absence of an agreement, arrangement or understanding between the assessee and SMC, mere incurring of AMP expenditure could not be considered as an international transaction.

Judgment

1. As regards the issue of whether the AMP transaction constituted an international transaction, the Revenue contended that in light of Sony Ericsson (supra), the AMP expenditure constituted an international transaction. The Hon'ble High Court noted that in the aforesaid decision, none of the assessees questioned the existence of an international transaction and therefore it could not be squarely applied to the instant case.

2. The Court noted that the Revenue authorities failed to show the existence of any agreement, understanding or arrangement between the assessee and SMC regarding the AMP expenditure and that the Bright Line Test was applied to the AMP expenditure of the assessee to deduce the existence of an international transaction and to make a quantitative adjustment to the ALP to the extent the expenditure incurred by the assessee exceeded that of the comparable companies.

3. It held that the Court in Sony Ericsson (supra), had negated the use of the Bright Line Test for the purpose of determining the existence of an international transaction as well as for benchmarking international transactions. It also noted that the Revenue was not able to counter the submissions of the assessee that it had substantially benefited from the AMP expenses as it held the highest market share of automobiles manufactured in India and that the AMP expense of SMC worldwide was 7.5 per cent of its sales whereas that of the assessee was 1.87 per cent.

4. Examining the definition of international transaction under section 92B of the Act, the Court held that the existence of an agreement, arrangement or understanding was a *sine qua non* and that the onus to prove the same was on the Revenue, which was not fulfilled in the case of the assessee. It held that Chapter X envisaged the adjustment in the price of the international transaction and that the very existence of an international transaction could not be presumed by assigning a price to it and then deducing that since it is not at ALP, an adjustment was to be made. It noted that the revenue sought to resort to a quantitative adjustment by first determining whether the AMP expenditure of the assessee on application of the Bright Line Test was excessive, thereby alleging the existence of an international transaction involving the AE. This approach was held to be contrary to the provisions of the Act.

5. It also held that as per the decision of Sony Ericsson, AMP adjustments could not be made in respect of a full risk manufacturer.

6. Accordingly, the Court set aside the orders of the AO, TPO and DRP.

Note: The Court has come to the same finding as above in the cases of *CIT vs. Whirpool of India Ltd – [2015] 64 taxmann.com 324 (Del), Honda Siel Power Products Ltd. vs. DCIT – [2015] 64 taxmann.com 328 (Del) and Bausch & Lomb Eyecare (India) Pvt. Ltd. vs. ACIT – TS-626-HC-2015 (Del.) - TP.*

5) Where the value of international transactions exceeded ` 5 crore reference to TPO was mandatory. Final assessment order without the passing of a draft assessment order was in violation of section 144C of the Act and therefore invalid

Carrier Race Technologies Pvt. Ltd. vs. ITO (WP No 13442 of 2015)

Facts

1. The assessee had entered into international transactions during the relevant year. During assessment proceedings, the AO did not make a reference to the TPO and proceeded to make a TP adjustment himself. The AO did not pass a draft assessment order under section 144C of the Act against which the assessee could file its objections with the DRP. Instead a final assessment order was passed and the AO subsequently issued a corrigendum stating that the final assessment order should be treated as the draft assessment order.

2. Aggrieved, the assessee filed a writ petition before the Hon'ble High Court against the assessment order and corrigendum. The assessee contended that the assessment order should be quashed as neither did the AO follow the procedure laid down under section 144C of the Act nor did he follow CBDT Instructions providing mandatory reference to a TPO for determination of ALP of transactions exceeding ` 5 crore.

Judgment

1. The Hon'ble High Court held that where the final assessment order was passed without issuing a draft assessment order it was not in accordance with section 144C and therefore invalid. Further, since the corrigendum issued by the AO was passed in the subsequent month the Court held that it was invalid since it was beyond the time limit provided under law.

2. It further held that the provisions of the Act clearly provided that reference was to be mandatorily made to the TPO where the value of international transactions exceeded ` 5 crore.

3. Accordingly, the order of the AO was set aside.

6) Comparable Uncontrolled Price Method was the most appropriate method where the assessee profit sharing ratio with its AE was the standard practice adopted by third parties as well

Pr CIT vs. Toll Global Forwarding India Pvt. Ltd. (ITA No 374 / 2015 & ITA 396 / 2015)

Facts

1. The assessee was a logistics service provider, offering international and domestic freight handling services including defined air and ocean transport and freight forwarding services. The residual profits earned by the assessee were split between the assessee and its AEs in the ratio of 50:50. It used the Comparable Uncontrolled Price Method for benchmarking its international transactions.

2. The international transactions undertaken by the assessee were referred to the TPO for determination of ALP. The TPO rejected the application of the CUP method since the assessee had not furnished third party documents / vouchers etc. to benchmark the international transactions. Accordingly, the TPO adopted TNMM and made an upward addition to the

income of the assessee. The DRP upheld the order of the TPO.

3. Aggrieved, the assessee filed an appeal before the ITAT. The ITAT observed that the business model of sharing residual profits in the ratio of 50:50 was a standard practice in the assessee's business. It acknowledged that where a standard formula was adopted, the data regarding the precise amount charged / received may not be available. In spite of the assessee not providing adequate comparable data, the ITAT held that the transactions were at arm's length price since the profit sharing ratio between the assessee and the AE was no different from that adopted by unrelated parties.

4. Accordingly, the Revenue filed an appeal before the Hon'ble High Court.

Judgment

1. The Hon'ble High Court held that the order of the ITAT was well-reasoned as it expounded the legal principles governing the determination of ALP. Accordingly it upheld the order of the ITAT and ruled in favour of the assessee.

7) Journey of vessels from Singapore to Dubai consisting of a journey between two ports in India would fall within the definition of term 'international traffic' in terms of Article 3(h) of the DTAA and consequently the assessee was eligible for the benefits under Article 8 of the DTAA

CIT vs. Taurus Shipping Services – [2015] 64 taxmann.com 64 (Guj.)

Facts

1. The assessee acted as an agent of three vessels on behalf of a company incorporated in Singapore viz. Jaldhi Overseas Pte. Ltd. ('the freight beneficiary') and had transported goods from Kandla Port to Visag as a part of a larger journey of the vessels from Singapore to Dubai. The freight beneficiary claimed benefit of Article 8 of the Double Tax Avoidance Agreement ('DTAA') between India and Singapore.

2. The Assessing Officer held that the transportation between Kandla and Visag could not be considered as international traffic as defined in the DTAA and therefore denied the assessee benefit under Article 8 of the DTAA.

3. The assessee preferred an appeal before the Income Tax Appellate Tribunal ('ITAT'), wherein the ITAT ruled in favour of the assessee.

4. Aggrieved, the Revenue filed an appeal before the Hon'ble High Court

Judgment

1. The Honourable High Court held that the term 'international traffic' was defined in Clause 3(h) of the DTAA to mean any transport by a ship or aircraft operated by an enterprise of a contracting state, except when the ship or aircraft is operated solely between places in the other Contracting State. Placing emphasis on the word 'solely', the Court held that since the transportation between Kandla and Visag was undertaken during a larger journey of vessels from Singapore to Dubai it did not satisfy the requirement of being solely between two ports in India and therefore the exclusion prescribed in the definition of international traffic did not apply to the assessee and that the transport undertaken by the assessee would be treated as international traffic and consequently the assessee was eligible for the benefits under Article 8 of the DTAA, which provides that profits derived by an enterprise of a contracting state from the ships or aircrafts in international traffic would be taxable only in that State.

8) Commission earned by a non-resident agent who carried on business of selling Indian goods outside India could not be said to have deemed to accrue or arise in India. Further,

withdrawal of a Circular cannot have retrospective operation

CIT vs. Gujarat Reclaim & Rubber Products Ltd. (ITA No. 2116 of 2013 and 169 of 2014) – TS-732-HC-2015 (Bom.)

Facts

1. During AYs 2007-08 and 2008-09, the assessee had made payments on account of commission to its non-resident agent in respect of sales made outside India. The AO disallowed the payment of commission under section 40(a)(i) for failure to deduct tax at source in view of the fact that Circulars No. 23 of 1969 and 786 of 2000 issued by the Central Board of Direct Taxes stating that commission paid to non-resident agents for sales outside India did not give it rise to income, had been withdrawn by Circular No. 7 dated 22nd October, 2009.

2. On appeal, for AY 2007-08, the CIT(A) upheld the order of the AO whereas for AY 2008-09, the CIT(A), relying on the ruling in Ardeshi B Cursetjee & Sons (115 TTJ 916) allowed the assessee's appeal by holding that the commission agent did not have any business connection or permanent establishment in India and that no income arose or accrued to the non-resident agent in India. Additionally, the CIT(A) held that Circular No. 7 of 2009, withdrawing the earlier circulars would not have retrospective effect so as to render the earlier Circulars as inoperative for the relevant assessment years.

3. Aggrieved, the assessee and the Revenue preferred an appeal to the ITAT, wherein the ITAT ruled in favour of the assessee for both assessment years.

4. Accordingly, the Revenue filed an appeal before the Hon'ble High Court.

Judgment

1. The Hon'ble High Court relying on the decision of the Apex Court in *CIT vs. Toshuku Ltd. (125 ITR 525)* having almost identical facts, held that the commission earned by the non-resident agent carrying on business of selling Indian goods outside India could not have deemed to be income accruing or arising in India. Accordingly it upheld the decision of the Tribunal.

2. Further it also noted that Circular No. 23 of 1969 was admittedly in force during the two Assessment Years and that it was only subsequently i.e. on 22nd October, 2009 that the earlier Circular of 1969 and its reiteration as found in Circular No. 786 of 2000 were withdrawn. Relying on *UTI vs. P. K. Unny 249 ITR 612*, it held that such subsequent withdrawal of an earlier Circular could not have retrospective operation.

C) TRIBUNAL DECISIONS

9) India – Netherlands DTAA – Article 13(5) – Whether Capital gains arising to a foreign company on transfer of shares held in an Indian company under the court approved buy-back scheme is taxable in India under India-Netherlands tax treaty – Held : Yes

Accordis Beheer B. V. vs. DIT 2016-TII-12-ITAT-MUM-INTL – Assessment Year : 2006-07

Facts of the case

1. The assessee is a resident of Netherlands. It held 38.24 per cent of shares comprising of 1,09,52,280 shares in the paid-up capital of Century Enka Ltd, an Indian public listed company.

2. During the year under consideration, the assessee tendered 85,93,109 equity shares having a face value of INR 10 each to Century Enka Ltd. at INR 122 per shares under a scheme of arrangement, by way of buy-back of own shares, as per the approval given by the Calcutta High Court under Section 391 of the Companies Act, 1956. The said tendering of shares resulted in a capital gain of INR 58.64 crore.

3. The assessee, relying on Article 13(5) of the tax treaty, claimed that the capital gain referred above is not taxable in India. The Article 13(5) of the tax treaty provides that gains shall be taxable in Netherlands if such gains are realised in the course of corporate organisation, reorganisation, amalgamation, division or similar transaction.

4. The Assessing Officer (AO) observed that the assessee did not pay tax on the impugned capital gains in Netherlands since the same was exempt under the tax provisions of that country. The basic purpose of the tax treaty, as well as Section 90 of the Income-tax Act, 1961 (the Act), is that the assessee should not be liable for double taxation, whereas, in the present case, the assessee is trying to claim double benefit by taking recourse to the tax treaty. Accordingly, the AO held that the aforesaid capital gains are taxable in India under Article 13(5) of the tax treaty.

5. With regard to the rate at which the capital gain is taxable, the AO held that the concessional rate of taxation at 10%, provided in the second proviso to Section 112 of the Act, is not applicable to the assessee. Accordingly, the AO levied tax at 20%.

6. The Commissioner of Income Tax (Appeals) CIT(A) upheld the action of the AO in taxing the capital gain arising on account of buy-back of shares of CE Group. However, the CIT(A) held that the assessee is eligible for concessional rate of tax at 10% on capital gains.

Decision

The Tribunal held as under :

i) In view of decisions – *DIT vs. ICICI Bank Ltd. [2015] 370 ITR 17 (Bom.), DIT vs. Green Emirate Shipping & Travels [2006] 100 ITD 203 (Mum.)* relied on by the assessee, it has been observed that payment of tax on capital gains in Netherlands may not be a condition for availing tax treaty benefits in India.

ii) The CIT(A) relying on the decision of *McDowell & Co. vs. CTO [1985] 154 ITR 148 (SC)* observed that colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid payment of tax by resorting to dubious methods. In the present case, the assessee is pleading for relief on the basis of its own interpretation of Article 13(5) of the tax treaty. The fact that it has tendered the shares to Century Enka Ltd. under a scheme of arrangement approved by the Calcutta High Court is not disputed. Therefore, there is no colourable device in the claim made by the assessee.

iii) The assessee contended that it has transferred the shares under a scheme of arrangement approved by the High Court, and the same falls in the category of 'reorganisation' specified in Article 13(5) of the tax treaty. The Tribunal observed, upon perusal of the Given in the Dictionary titled as 'Dictionary for Accountants' by Eric L Kohler meaning of reorganisation, it indicates that there should be a major change in the financial structure and the same should result in alteration in the rights and interest of security holders. However, in the present case, there is a reduction in the share capital and the same cannot be considered as a major change in financial structure.

iv) Further, the security holders continue to enjoy the same type of rights and interests even after the reduction of share capital and, hence, there is no alteration in the rights and interests of security holders. Accordingly, the arrangement entered by the assessee in selling part of its share holding to the company in the scheme of buy-back does not fall under the definition of 'reorganisation'.

v) The assessee relied on a study material titled as 'Strategic Financial Management' issued by the Institute of Chartered Accountants of India (ICAI). However, these discussions made by the ICAI only explain various forms of financial management.

vi) There is no change in the rights and interests of the shareholders. Only change that occurred on reduction of share capital through writing-off of the shares purchased from the assessee is in the shareholding pattern of the promoter groups. The same cannot be considered as change in the rights and interests of shareholders. Before and even after the reduction of share capital, the promoter groups continue to remain as promoter groups with the same rights and interests.

vii) On reference to the definition of the term 'arrangement' given under Section 390 of the Companies Act, 1956, it is observed that it consists of either consolidation of shares of different classes or division of the shares into different classes or both.

viii) The decision in the case of relied on by the assessee, is distinguishable on the facts of the present case and may not help the assessee.

ix) The CIT(A) observed that the scheme of arrangement framed by Century Enka Ltd. was only with the purpose of providing an exit route to the non-resident shareholders. Thus, the objective of the scheme was to enable the assessee to transfer its shareholding. It was observed that the subsequent cancellation or writing off the shares has nothing to do with the transfer made by the assessee, even though the same has resulted in reduction of paid-up share capital of the company. The Tribunal agreed with the observations made by the CIT(A).

x) The view taken by the CIT(A) is agreed upon that they are two different actions and both should not be clubbed together, even though Century Enka Ltd. has combined the same, for the sake of its convenience, in the scheme of arrangement. The assessee should in no way concerned by the action of cancellation of share resulting in reduction of share capital.

xi) Accordingly, the attempt of the assessee to bring the transferring of shares within the ambit of the term 'reorganisation' may not be correct, since the object of the arrangement was not financial restructuring, but to provide an exit route to the non-resident shareholders. In view of the above, the CIT(A) was justified in upholding the view taken by the AO on this issue.

xii) Regarding the rate for the purpose of payment of tax, the assessee contended that this issue is covered in favour of the assessee by the decision of the Delhi High Court in the case of *Cairn U.K. Holdings Ltd. 6 [2013] 359 ITR 268 (Del.)*, which was followed by the Tribunal in the case of *ADIT vs. Abbott Capital India Ltd [2014] 65 SOT 121 (Mum.)*. Accordingly, it has been held that the assessee is entitled to concessional rate of tax at 10 per cent on the impugned capital gains.

10) Sections 44BB & 44DA – Whether revenue received for providing services of geophysical and geological interpretation of 3D and 2D seismic data, cannot be considered as FTS and the same is chargeable to tax under the provisions of Section 44BB – Held : Yes

Addl DIT vs. Landmark Graphics Malasia SDN BHD 2016-TII-09-ITAT-DEL-INTL – Assessment Year: 2004-05

Facts of the case

The assessee is in the business of providing services for geophysical and geological interpretation of 3D and 20 seismic data. The assessee had filed return and thereafter a refund was issued. Consequently, a notice u/s. 148 was issued. During assessment, the AO held that the revenue received for providing services for geophysical and geological interpretation of 3D and 20 seismic data are Fees for Technical Services and also that the income of the assessee was not taxable under the presumptive provisions of section 44BB as the nature of services rendered by the assessee were technical in nature and not for a project undertaken by the recipient which was taxable u/s. 44BB.

Decision

On appeal, the CIT(A) partly allowed the claim.

The Tribunal held that,

i) In the light of settled principle of law in the case cited as ONGC, the issue in controversy has become apparently clear that "mining project" or "like projects" occurring in Explanation 2 to Section 9(1) would cover rendering of service like imparting of training and carrying out drilling operations for exploration of and extraction of oil and natural gas and hence, payments made under such agreement to a non-resident/ foreign company would be chargeable to tax under the provisions of Section 44BB and CIT(A) has rightly decided the issue in favour of assessee.

ii) The ratio of judgment in cases cited as B J Services Company Middle East Limited and *Baker Hughes Asia Pacific Limited vs. ADIT* is, 'Section 44DA inserted in Finance Act 2010 w.e.f. 1-4-2011 in Section 44BB are prospective in nature', would only apply to the Assessment Year 2011-12 and onwards and not in the case of the assessee *qua* the Assessment Year 2004-05.

iii) The aforesaid issue i.e. 'as to whether FTS is not eligible for 44BB came up for adjudication before Supreme Court in the case of ONGC 2015-TII-03-SC-INTL and the same has been decided in favour of the assessee as per findings returned by Supreme Court. So, by following the judgment in case of ONGC delivered by the Supreme Court, we hereby affirm the findings of CIT(A) that FTS is not eligible for section 44BB.

Cases followed

i) *ONGC - 2015-TII-03-SC-INTL,*

ii) *B. J. Services Company Middle East Limited vs. DCIT - 2011-TII-31-HC-UKHAND-INTL,*

iii) *Baker Hughes Asia Pacific Limited vs. ADIT - 2014-TII-104-ITAT-DEL-INTL.*

11) Transfer Pricing – Foreign Exchange Fluctuation – Whether the profit or loss arising out foreign exchange fluctuation has to be taken into consideration while arriving at the operating cost in transfer pricing matters – Held : Yes; – Whether the assessee needs to submit categorical workings on record and substantiated with material evidence to establish that 30% portion of the foreign exchange fluctuation was abnormal – Held : Yes.

Dong A India Automotive Pvt. Ltd. vs. ACIT 2016-TII-51-ITAT-MAD-TP – Assessment Year: 2009-10

Facts

The assesee is a private limited. It had filed the present petition for rectification order passed by the Tribunal. The assessee had claimed for exclusion of foreign exchange loss from computation of operating margin, as such loss was abnormal loss on account of huge fluctuations in exchange rates and had claimed that 30% portion of the foreign exchange fluctuation was abnormal, whereas the Tribunal had held that the profit or loss arising due to forex fluctuations cannot be ignored while arriving at the operating cost for deriving the PU in Transfer pricing matters.

Decision

The Tribunal held as under :

i) On the issue whether loss arising out of foreign exchange fluctuation should be excluded from the computation of the operating cost of the assessee the Bench has discussed the issue in detail and held following the decision rendered in the case *M/s. Infac India (P) Ltd - 2015-TII-314-ITAT-MAD-TP* and the decision rendered in the case *M/s. SAP Labs India Pvt. Ltd. vs. ACIT - 2010-TII-44-ITAT-BANG-TP*, that the profit or loss arising out foreign exchange fluctuation has to be taken into consideration while arriving at the operating cost in transfer pricing matters;

ii) Futher the definition of operating expenses mentioned in Rule 10TA(j)(iv), has come into effect from 4-2-2015 and that too in regard to the Safe Harbour Rules for international taxation and therefore not applicable to the relevant case before us. Moreover no categorical workings were brought on record before us substantiated with material evidence to establish that 30% portion of the foreign exchange fluctuation was abnormal. For the above stated reasons we are of the considered view that there is no mistake apparent on record in the order of the Tribunal which is required to be rectified. Therefore, the Miscellaneous Petition filed by the assessee is devoid of merits.

12) Transfer Pricing – Whether if there is no bifurcation available in respect of the revenues of a company from Transaction processing and Technical services, is it possible to separately consider its profitability from rendering of 'Transaction processing services' – Held : No; Whether when a certain company is following different year ending from that of the assessee company, can it still be considered as a valid comparable for the purpose of determination of ALP – Held : Yes; Whether while selecting comparables for ALP determination, the quantum of turnover can be a reason for the exclusion of a company which is otherwise a valid comparable – Held : No; Whether the amount of foreign exchange gain or loss arising out of revenue transactions is required to be considered as an item of operating revenue or cost, both of the assessee as well as comparables – Held : Yes; Whether when normal business practice requires payment of dues beyond a reasonable period, the TPO can charge interest only if the payment was made beyond the arm's length period – Held : Yes

Ameriprise India Pvt Ltd. vs. DCIT 2016-TII-52-ITAT-DEL-TP – Assessment Year: 2010-11

Facts

1. The assessee is a wholly owned subsidiary of Ameriprise, US, which parent company was engaged in the business of insurance, annuities, asset management and brokerage. Assessee was incorporated in August, 2005 and started operations in October, 2005.

2. It was engaged in providing Information Technology (IT) enabled services to Ameriprise US. The assessee reported two international transactions, including remuneration from the 'Provision of IT-enabled back office services' with transacted value of ` 60,57,56,819/-. The assessee

applied TNMM as the most appropriate method for benchmarking the international transaction of provision of IT enabled back office support services.

3. Profit level indicator (PLI) of Operating Profit/Operating Cost (OP/OC) was computed by the assessee at 15.66%. Eleven companies were considered as comparable. It was shown that their arithmetic mean of operating profits compared favourably with assessee's profit rate and, hence, the international transaction of 'Provision of IT enabled back office services' was at ALP.

4. On a reference made by the AO for determining the ALP of the international transactions, the TPO treated only five companies as comparable from the assessee's list. He added eight new companies, thereby making a total of thirteen companies, considered as comparable.

5. Next issue taken up before us is against treating foreign exchange difference as non-operating as against the assessee's treatment of operating cost.

6. Assessee had shown certain receivables from its AE. On examination of the assessee's balance sheet, it was noticed by the TPO that payments against the invoices raised by the assessee were not received within the stipulated time as provided in the Agreement. On being called upon to furnish the time period for payment as per Service agreement and why the delayed payments be not treated as unsecured loans advanced to the AEs, the assessee submitted 'receivables was not an international transaction which warranted benchmarking.' The TPO rejected this contention and held that interest at the rate of 14.74% was chargeable at arm's length level in respect of delayed receipt of invoice values. The DRP held that since, normal business practice requires payment of dues beyond a reasonable period, the TPO was justified to charge interest beyond the arm's length period. Any delay beyond a period of 30 days, in an arm's length situation would have warranted a return base on opportunity cost of the money. Accordingly, DRP upheld that any delay beyond the arm's length period should be subject matter of adjustment.

Decision

The Tribunal held in favour of the assessee as under :

A) Consideration of comparables

i) Re: TCS E-Serve International Ltd.

This company is engaged in rendering BPO services to the banking and financial services industry (BFSI) and Travel, Tourism and Hospitality (TTH). It is providing services to BFSI and TTH and such services include 'Transaction processing' and 'Technical services'. In other words, the remuneration of this company from the above referred two segments includes compensation for rendering 'Technical services' and 'Transaction processing'. Insofar as the 'Transaction processing' services are concerned, these are ITES, which are broadly similar to those rendered by the assessee, though not specifically similar. However, the 'Technical services' involve software testing, verification and validation of software item, implementation and data centre management activities. The 'Technical services' rendered by this company are in the nature of servicing and maintenance of software. We find that the assessee is a company providing non-development software services, in the nature of conversion of data from hard copy or files into electronic format. The assessee is not providing any software development services to its AE. On the other hand, this company is also providing 'Technical services' to its AE involving software testing, verification and validation of software, which are akin to software maintenance services falling, within the overall category of software development services. The TPO has taken entity level figures of TCS E-Serve International Ltd. for comparison. We note that, there is no bifurcation available in respect of the revenues of this company from Transaction processing (which are in the nature of ITES, the same as provided by the assessee) and Technical services (which are in the nature of software development, absent in the assessee's case). In the absence of the availability of any such segregation of the total revenue of this company, it is not possible to separately consider its profitability from rendering of 'Transaction processing services'. As such, the entity level figures render this company as unfit for comparison. Therefore, we order for the removal of this company from the final set of comparables;

ii) Re: R. Systems (Seg)

It is noticed that the assessee company is having financial year ending covering the period 1-4-2009 to 31-3-2010. In that view of the matter, a valid comparison can be made only if the comparable companies too have the same financial year. If the tested party has March year ending, then, the comparables must also have the data relating to the financial year ending 31st March itself. If such a data is not available, then, a company albeit comparable, also disqualifies. Espousing the facts of the instant case, we find that insofar as the functional comparability of this company is concerned, the TPO has not disputed the same. The only reason given for its exclusion is the non-availability of data for the relevant financial year. The AR contended that though the year ending of the above referred company is different, yet, the data for the relevant period is available from Annual report itself. It was so stated on the basis of the availability of the quarterly data from the Annual reports of the company, which could be adjusted for the FY ending 31-3-2010. We note that in the immediately preceding year, this company was considered by Coordinate Bench of Tribunal. It was directed that if the contention of the assessee is correct, that the relevant data for the concerned financial year can be deduced from the information available from their annual reports, then, there can be no objection to the inclusion of these companies in the list of comparables with the adjusted data for the relevant financial year itself. Respectfully following the reasoning of Co-ordinate Bench in immediately preceding year, we set aside the impugned order and remit the matter to the file of TPO/AO for examining this aspect of the matter;

iii) CG-VAK Software and Exports Ltd. (Seg.)

The assessee included the segmental figures of this company in the list of comparables. The TPO eliminated this company on the ground that it was providing software services and ITES and its turnover from ITES was only 0.83 crore, which was less than the requisite turnover. We find that the TPO has accepted the functional comparability of this company on segmental level. The DR was also fair enough to candidly accept the functional similarity of the relevant segment of this company. In such circumstances, the question arises as to whether the relevant segment of this company can be excluded from the list of comparables merely on the ground that the revenue from this segment is only Rs.83 lakhs. In our considered opinion, the quantum of turnover can be no reason for the exclusion of a company which is otherwise comparable. We find that jurisdictional HC in the case of Chrys *Capital Investment Advisors (India) P. Ltd. vs. DCIT 2015-TII-13-HC-DEL-TP* has held, that high turnover or high profit can be no reason to eliminate an otherwise comparable company. The same applies with full force in the converse manner as well to a low turnover/low profit company. We, therefore, hold that a company cannot be excluded from the list of comparables on the ground of its low turnover. In principle, we direct the inclusion of the relevant segment of this company in the list of comparables. The TPO is directed to include the operating profit/operating costs of the ITES segment of this company in the list of comparables, after due verification of the necessary figures for determination of the operating profit margin etc.

B) Treatment of Foreign Exchange Fluctuation

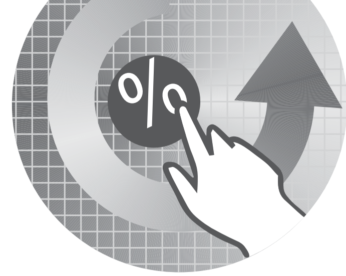
The Special Bench of the Tribunal in *ACIT vs. Prakash L. Shah 2008-TIOL-429-ITAT-MUM-SB* has held that the gain due to fluctuations in the foreign exchange rate emanating from export is its integral part and cannot be differentiated from the export proceeds simply on the ground that the foreign currency rate has increased subsequent to sale but prior to realization. It went on to add that when goods are exported and invoice is raised in currency of the country where such goods are sold and subsequently when the amount is realized in that foreign currency and then converted into Indian rupees, the entire amount is relatable to the exports. In fact, it is only the translation of invoice value from the foreign currency to the Indian rupees. The Special Bench held that the exchange rate gain or loss cannot have a different character from the transaction to which it pertains. The Bench found fallacy in the submission made on behalf of the Revenue that the exchange rate difference should be detached from the exports and be considered as an independent transaction. Eventually, the Special Bench held that such exchange rate fluctuation gain/loss arising from exports cannot be viewed differently from sale proceeds. In view of the foregoing discussion and respectfully following the view taken by Co-ordinate Bench in immediately preceding year, we are of the considered opinion that the amount of foreign exchange gain/loss arising out of revenue transactions is required to be considered as an item of operating revenue/cost, both of the assessee as well as comparables. We, therefore, hold that the AO was not justified in considering forex loss as non-operating cost as against the assessee's claim of operating cost. With the above remarks, we set aside the impugned order and send the matter back to the file of TPO/AO for determining the ALP of the international transaction afresh in conformity with our above observations.

C) Inter-company Receivables

We note that there is no change in the terms and conditions of the Agreement between Ameriprise USA and assessee. Clause 6.5 of the agreement provides that the payment shall be cleared within thirty days from the date of invoice, however, under no circumstance shall the payment be delayed for more than 60 days. In the instant case, the payment was realized in days, which is well within the outer time limit of 60 days. In the instant facts, we don't feel necessary to get into the issue of whether the instant transaction is an international transaction or not. Respectfully following the decision of Co-ordinate Bench in preceding year, we direct that there can be no question of charging any interest as a separate TP adjustment.

"Education is the manifestation of the perfection already in man. Religion is the manifestation of the Divinity already in man. Therefore the only duty of the teacher in both cases is to remove all obstructions from the way. Hands off! as I always say, and everything will be right. That is, our duty is to clear the way. The Lord does the rest."

— *Swami Vivekananda*



CA. Hasmukh Kamdar

INDIRECT TAXES

Central Excise and Customs – Case Law Update

Demand – Clandestine Clearance

M/s Salts & Chemicals Pvt. Ltd. vs. Commissioner of C.Ex. Kolkata-IV [2016(331) ELT 449 (Tri. Kolkata)]

Facts in this case were as follows –

It was observed from the records of the assessee that during the period from June, 2010 to September, 2010, there was mismatch between the Opening Balance (OB) and Closing Balance (CB) of the figures shown in the ER-1 returns and Daily Stock Account maintained. On the basis of this difference in the figures, a show cause notice was issued demanding the duty on differential quantity as reflected in ER-1 returns alleging clandestine clearance of the same without payment of duty. The adjudication authority confirmed the demand.

The learned Commissioner (Appeals), in turn, upheld the order of the adjudicating authority and dismissed the appeal. The Appellant therefore filed this appeal before the Hon'ble Tribunal.

On behalf of the Appellants it was submitted that, on switching over from the manual system of maintenance of records/accounts to computerisation, in the month of May 2010, there was mistake in entering the data relating to opening and closing balance of stock. Opening and closing balances were shown correctly in the Daily Stock Account; however, inadvertently there was error in showing the same in ER-1 returns filed with the Department for the respective months. It was further submitted that mere clerical mistake in recording OB and CB of stock in the ER-1 returns cannot be construed as clearance of goods without payment of duty. Reliance was placed on the following decisions of the Hon. Tribunal.

Commissioner of Central Excise Ludhiana vs. Renny Steel Castings – [2011(274) ELT.94 (Tri. Del.)]

R K Patel & Co. vs. Commissioner of Central Excise- [2008 (227) ELT 558 (Tri. Mumbai)]

Hilton Tobacco vs. Commissioner Central Excise, Hyderabad - 2005 (183) ELT 378 (Tri. Bang.)]

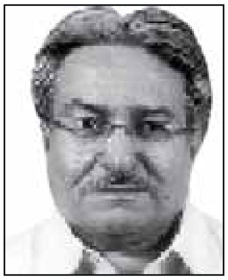
On behalf of Revenue findings of the learned Commissioner (Appeals) were reiterated.

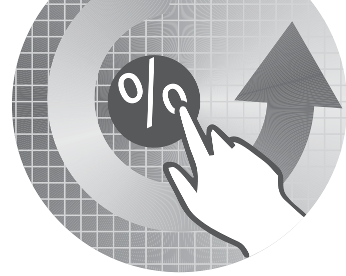
The Hon'ble Tribunal observed as follows —

The learned Commissioner (Appeals) has simply upheld the order of the lower authority without recording any reasons.

The allegation of clandestine removal rests on the discrepancy in the figures of OB and CB of stock mentioned in the monthly ER-1 returns. There is no difference between the OB and CB in Daily Stock Account. On careful analysis of the aforesaid discrepancy, there is force in the Appellants contention that due to inadvertence, while filing ER-1 returns, OB and CB have not matched for the said period. There is no discrepancy noticed by the Department in the Daily Stock Account in recording OB and CB of stock. While recording the figures in ER1 returns, there could be possibility of writing error in entering the data relating to OB and CB due to switching over from a manual system of maintenance of records to computerised system. The appellant's further contention that if there was any intention to clear the goods clandestinely, then the Appellants would not have maintained different figures of stock in DSA and ER-1 returns, is acceptable. Besides, except for the said errors in recording the OB and CB in ER-1 returns, the Department has not adduced any other evidence in support of clandestine removal.

In the result the impugned Order was set aside and Appeal was allowed with consequential relief.





CA Janak Vaghani

INDIRECT TAXES
VAT Update

1. Trade Circular

i) Trade Circular No. 1T of 2016, dated 1-1-2016
E-returns under the Maharashtra Tax on Luxuries Act, 1987

The Commissioner of Sales tax has issued above circular informing trade process relating to E filing of returns under the Maharashtra Tax on Luxuries Act, 1987 from 1-1-2016 which is allowed now on voluntary basis and soon will be made mandatory. The said circular also provides process for enrolment of e-services which is a onetime event by dealers who are not filing e-returns under the MVAT or CST Act.

ii) Trade Circular No. 2T of 2016, dated 21-1-2016
Registration under The Maharashtra Tax on Luxuries Act, 1987 and The Maharashtra Tax on Entry of Goods into Local Are as Act, 2002.

The Commissioner of Sales Tax has issued above circular to clarify that application for registration of dealer under The Maharashtra Tax on Luxuries Act, 1987 and The Maharashtra Tax on Entry of Goods into Local Are as Act, 2002 have to be submitted manually before the registration authority with a list of documents specified in annexure A attached to the said circular.

iii) Trade Circular No. 3T of 2016, dated 28-1-2016
Extension of Time for furnishing VAT Audit Report in Form 704 for the year 2014-15

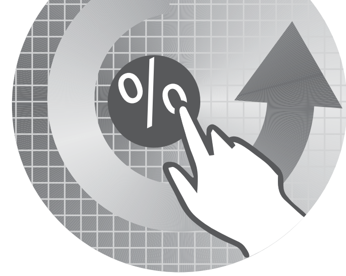
The Commissioner of Sales Tax *vide* above circular has extended the due date for furnishing the VAT audit report in form 704 from 15-1-2016 to 21-1-2016 and likewise extended the due date for physical Submissions of Statement of Submission and Acknowledgement of VAT Audit Report in Form 704 for the year 2014-15 from 25-1-2016 to 1-2-2016.

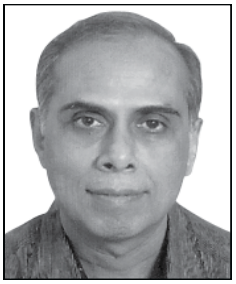
2. Website Updates

i) List of orders/Judgments delivered by Hon'ble Maharashtra Sales Tax Tribunal from 1-4-2015 to 31-12-2015
List of orders/Judgments delivered by Hon'ble Maharashtra Sales Tax Tribunal and received by the department from 1-4-2015 to 31-12-2015 is made available on web site of the department under 'What's New ' .

ii) List of Officers Working in Vikrikar Bhavan Mazgaon Office
The list of Officers working in Vikrikar Bhavan Mazgaon Office along with their contact details is made available on the website of the department under 'What's New'.

iii) Cases Allocation Chart
The cases allocation chart as per reorganisation is made available on the website of the department under 'What's New'.





CA Rajkamal Shah & CA Naresh Sheth

INDIRECT TAXES

Service Tax – Statute Update

1. Valuation of construction services in respect of flats given to Land Owner by Builder/Developer against the transfer of land and development rights

- High Level Committee (HLC) has deliberated on issue of divergence of view between Para 6.2.1 of the Education Guide 2012 and the CBEC Circular No. 151/2/2012 – ST dated 10-2-2012 on how flats handed over to land owners are to be valued for the purpose of Service tax levy.
- Education guide clarified that value of construction service provided to land owner will be the value of the land when same is transferred and point of taxation will be determined accordingly.

  Circular No. 151/2/2012 – ST dated 10.02.2012 states the value of land/ development rights in the land may not be ascertainable ordinarily and therefore, value, in the case of flats given to the land owner, is determinable in terms of section 67(1)(iii) read with Rule 3(a) of Service Tax (Determination of Value) Rules, 2006. Accordingly the value of these flats would be equal to the value of similar flats charged by the builder/ developer to normal buyers (other than land owners).

  If the price of the flats/houses undergoes a change over the period of sale, the value to be considered will be similar flats which are sold nearer to the date on which land is being made available for construction.

  The builder/developer would be liable to pay service tax on flats given to the land owner at the time of possession or right in the property in the said flat are transferred to the land owner by entering into conveyance deed or similar instrument (Allotment letter).
- HLC states that Education Guide itself says that it is a mere education aid based on a broad understanding of a team of officers on the issues. It is neither a "Departmental circular" nor it is a manual instruction issued by CBEC. To that extent it does not command the required legal backing to be binding on the either side in any manner. The Education Guide was released purely as a measure of facilitation so that all the stakeholders could obtain some preliminary understanding of new issues for smooth transition to new tax regime.
- HLC has opined that clarification given in circular is more appropriate and circular prevails over the Education Guide, 2012.
- This clarification therefore directs assessing authorities to follow the Circular No. 151/2/2012 – ST dated 10-2-2012 for valuing the construction services provided by builder/developer to land owner against transfer of land / development rights and levy service tax accordingly.

Assessing Officers are clearly instructed not to follow the Education Guide for valuing flats allotted to land owner against the transfer of land / development rights.

[F.No.354/311/2015-TRU dated 20-1-2016]

2. Guidelines for e-payment of Refund/ Rebate

- In order to promote ease of doing business and to speed up transfer of funds directly to beneficiary's bank account after sanction of refund / rebate claim, the procedure for E-payment of refund / rebate is prescribed.
- Presently facility of E-payment of refunds / rebate is already operational in certain Central Excise Zones such as Mumbai-II, Hyderabad, Chandigarh and Chennai. All other field formations are instructed to follow the procedure for E-payment for refund / rebate by 10-2-2016.
- Readers are requested to refer the circular on CBEC website for detailed procedure.

[Circular No. 1013/1/2016-CX dated 12-1-2016]

3. Amendment in CENVAT Credit Rules, 2004 ('CCR'):

- An explanation has been inserted in Rule 2(l) of CCR wherein it is clarified that sales promotion would include services by way of sale of dutiable goods on commission basis.

  In other words, service tax paid on the commission for sale of dutiable goods will be input services and manufacturer will be entitled to cenvat thereof. This amendment would nullify the ratio laid down by Honorable Gujarat High Court in the case of *Commissioner of Central Excise, Ahmedabad – II vs. Cadila Healthcare Limited [2013 (1) ECS (1) (Guj-HC].*
- A proviso to Rule 3(4) of CCR has been inserted wherein it is clarified that Cenvat credit balance cannot be utilized for payment Swatch Bharat Cess.

[Circular No. 02/2016-CX (N.T), dated 3-2-2016]

CA Bharat Shemlani

INDIRECT TAXES
Service Tax – Case Law Update

1. Services

Insurance Auxiliary Service

1.1 Suprasesh General Insurance Service & Brokers P. Ltd vs. CST Chennai 2016 (41) STR 34 (Mad.)

The appellant in this case a re-insurance broker or insurance intermediary, engaged in negotiating and broking deal between Indian Insurance Companies and overseas re-insurer on brokerage due from overseas re-insurer and claimed the said service as export of service. The department contended that, service does not amount to export of service as same is provided to insurance company in India and brokerage is not received in convertible foreign exchange. The High Court after relying on decisions rendered under Income Tax Law held that, there is export of service by appellant.

Business Auxiliary Service

1.2 CST, Delhi vs. Ishida India Pvt. Ltd. 2016 (41) STR 87 (Tri.-Del.)

The assessee in this case engaged in procurement of order from Indian customer for holding company in Japan and claimed the same as export of service. The department alleged that service provided from India and used in India, therefore not fulfilling conditions stipulated in rule 3(2)(a) of ESR, 2005. The Tribunal held that, services were exported out of India and refund claim has been rightly allowed by Commissioner (A).

1.3 Tasty Bite Eatables Ltd. vs. CCE, Pune-III 2016 (41) STR 117 (Tri.-Mumbai)

The Tribunal in this case held that, processing of vegetables on behalf of client is in relation to agriculture hence not liable to service tax in view of CBEC Circular No. 143/12/2011-ST dated 26-5-2011. It is further held that, it is settled law that Revenue officers cannot argue against Board's Circular.

1.4 Charanjit Singh Khanuja vs. CST 2016 (41) STR 213 (Tri.-Del.)

The Tribunal in this case held that, distributors of Amway India Enterprises Pvt. Ltd. receiving commission either on own volume of purchases or on purchase made by sales group is liable to service tax under BAS.

1.5 CMA CGM Global (India) Pvt. Ltd. vs. CCE, Thane-II 2016 (41) STR 292 (Tri.-Mumbai)

The Tribunal in this case held that, preparation or reissue of documents such as bill of entry etc. is liable to service tax under BAS w.e.f. 16-6-2005 when explanation inserted to define Commission Agent.

Construction of Residential Complex Service

1.6 CCE, Aurangabad vs. Mall Enterprises 2016 (41) STR 119 (Tri.-Mumbai)

The Tribunal in this case held that, construction of residential quarter for staff is covered by exclusion clause given in the definition in Section 65(30) of FA, 1994 and therefore not liable to service tax.

Renting of Immovable Property Service

1.7 CCE& ST, Goa vs. Mormugao Port Trust 2016 (41) STR 127 (Tri-Mumbai)

The assessee a Port, leased vacant land to private parties who built dry dock, jetty etc. thereon for commercial purposes. The department sought tax on such activity. The Tribunal held that, lease agreement clearly indicating that lease was for vacant land and exclusion clause in definition did not envisage any restriction of non-commercial use.

Business Support Service

1.8 CCE&ST Kolhapur vs. Karan Agencies 2016 (41) STR 161 (Bom.)

The assessee in this case engaged in manufacture and sale of distillery products. They have paid lump sum amount to sugar mills after use of its infrastructure and brand name and retained balance profit. The department sought to tax them under BSS. The Tribunal held that, no support services provided to sugar mills in its business. Further, Sugar Mills are already discharging service tax under franchise service for consideration received by them.

Tour Operator Service

1.9 Jet Airways (India) Ltd. vs. CST, Mumbai-I 2016 (41) STR 225 (Tri.-Mumbai)

The appellant in this case offering Jet Escapes Packages to various passengers visiting website for booking air travel service and passenger opting for such package organizing their own travel dates. The Tribunal held that, appellant is not planning, scheduling or organizing tours for passengers and therefore not liable to service tax under Tour Operators Service.

1.10 Travel Inn India Pvt. Ltd. vs. CST, Delhi 2016 (41) STR 236 (Tri.-Del.)

The Tribunal in this case held that, benefit of Notification No. 1/2006-ST is available even if the CENVAT credit taken wrongly is reversed subsequently along with interest. It is further held that, date of deposit of cheque into treasury to be date of payment of service tax as per rule 6(2A) of STR, 1994.

Commercial Training or Coaching Centre Service:

1.11 Sri Chaitanya Educational Committee (SCEC) vs. CCCE&ST, Guntur 2016 (41) STR 241 (Tri.-Bang.)

The appellant in this case offered separate integrated programmes to students to prepare for specific entrance exam called ICON, NEON, LEO with different fee structure and about 94% of students opted for these special courses were students who also studied in appellant's college or were managed by them. The Tribunal held that, all students studied in college of / managed by assessee were not required to undergo coaching for entrance examination and it is only optional and hence separate course. In view thereof the schools/institutions/Jr. colleges run by the appellant were neither excluded by definition nor eligible for Exemption Notification No. 10/2003-ST.

Club or Association Service

1.12 In Re : Emerald Leisures Ltd. 2016 (41) STR 321 (AAR)

The Advance Authority in this case held that the term "activity" is very wide connotation and activity may be active or passive and includes provision of facility by club. It is further held that, assessee is involved in business of establishing and running indoor sports complex & club and shareholders may not be members of club and vice versa, hence the principle of mutuality not applicable in the present case and therefore, membership fees, annual fees and other charges received from members from time to time are liable for service tax.

2. Interest/Penalties/Others

2.1 Jyoti Enterprises vs. CCE&ST 2016 (41) STR 19 (All)

The High Court in this case held that, if an order serviced on family member and there is no assertion by appellant that person who received order at residence was not a family member or not connected with business then it amounts to proper service of order.

2.2 Amit Pandey Physics Classes vs. CCE&ST, Kanpur 2016 (41) STR 63 (Tri.-All.)

In this case the question before Tribunal was whether amount of service tax to be considered for calculation of service tax should exclude service tax paid before issuance of SCN. The Tribunal held that, there is no provision found to hold that service tax determined did not include amount already paid before issuance of SCN and payment of part of service tax amount before issuance of SCN does not mean that it is not to be assessed or determined under an order.

2.3 Exfo Electro-Optical Engineering (I) P. Ltd. vs. CCE, Pune-III 2016 (41) STR 65 (Tri-Mumbai)

The department in this case denied refund of accumulated CENVAT credit pertaining to input services received at unregistered premises. The Tribunal held that, appellant undisputedly taking credit on IT enabled services for providing IT services which were exported. The appellant is having centralized accounting system and other offices where input services received were also subsequently added in registration certificate, hence appellant is entitled to avail credit and consequent refund of unutilized credit.

2.4 SBI Capital Markets Ltd. vs. CCE&ST (LTU) Mumbai 2016 (41) STR 76 (Tri.-Mumbai)

The Tribunal in this case held that, whole proceedings of demand of CENVAT credit on certain input services vitiated for want of proper SCN as break up of amount under each head of input services proposed to be disallowed has not been given. Further, neither audit objection nor assessee's reply thereto discussed and reasons for disallowing credit also not flowing, therefore, a vague SCN vitiating adjudication order and hence said order to be set aside.

2.5 Larsen & Toubro Ltd. vs. CCE, Bhopal 2016 (41) STR 95 (Tri.-Del.)

The department in this case sought to levy service on supervision of erection and commissioning of limestone crushing plant on full value of purchase order. The Tribunal held that the purchase order is essentially for supply of plant and service component in form of supervision of erection and commissioning of plant supplied manifestly rendered free of cost and therefore no service tax liability to arise. Value of goods supplied not to be included in assessable value even as per Notification No. 12/2003-ST as no CENVAT credit taken in respect of such goods.

2.6 SRF Ltd. vs. CCE, Trichy 2016 (41) STR 123 (Tri.-Chennai)

The Tribunal in this held that, imposition of penalty under section 77 of FA, 1994 merely for not getting endorsement of subsequently carried out service on registration certificate is unjustified.

2.7 Hindustan Petroleum Corporation Ltd. vs. CST, Mumbai-I 2016 (41) STR 223 (Tri.-Mumbai)

The Tribunal in this case held that, loading of ATF in aircraft on foreign trips eligible for refund as per Notification No. 17/2009-ST.

3. CENVAT Credit

3.1 CCE&ST, Tiruchirapalli vs. Grasim Industries Ltd. 2016 (41) STR 73 (Tri-Chennai)

The Tribunal in this case allowed CENVAT credit of service tax paid on maintenance of windmill and plantation maintenance as appellant being a cement plant required to plant trees by dictate of Pollution Control Board to prevent pollution.

3.2 Toll (I) Logistics Pvt. Ltd. vs. CCE, Pune-I 2016 (41) STR 80 (Tri.-Mumbai)

The department in this case denied input service credit on the ground that invoices containing address of unregistered premises. The Tribunal observed that, there is no lapse in payment of tax and filing service tax returns and other premises/units also belongs to assessee from where output services are provided. The appellant maintained proper records and credit taken utilized for providing output service and disclosed in returns hence credit is admissible.

3.3 Allspheres Entertainment Pvt. Ltd. vs. CCE, Meerut 2016 (41) STR 104 (Tri.-Del.)

The appellant in this case availed Cenvat credit on the basis of invoices/bills issued on unregistered premises. The Tribunal held that, rule 9(2) of CCR, 2004 does not state that premises of recipient ought to be registered premises in order to avail CENVAT credit. The said rule gives discretion to DC/AC to allow credit on being satisfied that goods or services covered by document are received and accounted for in books of account of receiver. In absence of any dispute regarding availment of services and utilization for payment of service tax or proper accounting of same, denial of credit of service tax paid by branch office on sole ground that invoices issued are in name of assessee's unregistered office is unjustified.

3.4 Kilburn Chemicals Ltd. vs. CCE, Tirunelveli 2016 (41) STR 131 (Tri.-Chennai)

The Tribunal in this case held as under:

- Disallowed credit of security services received at Guest House at Kolkata whereas manufacturing unit situated at Tuticorin;
- Allowed credit of erection and commissioning services availed for installing Wind Turbine Generators for electricity generation away from factory.
- When authorities below fail to bifurcate quantum of credit attributable to each service, scrutiny at appeal becomes difficult and hence demand has to be set aside.

3.5 CCE, Chennai-III vs. Visteon Powertrain Control Systems (P) Ltd. 2016 (41) STR 168 (Mad.)

The High Court in this case held that, the amendment to CCR, 2004 denying CENVAT credit on outdoor catering services is effective from 1-4-2011 and not applicable prior to that period.

3.6 Gujarat State Fertilizers & Chemicals Ltd. vs. CCE&ST, Surat-II 2016 (41) STR 191 (Tri.-Ahmd.)

The Tribunal in this case after observing the display of photographs brochures and samples without being paid any consideration is not sales promotion hence disallowed CENVAT credit of commission paid to distributors after relying on Gujarat High Court decision in *Cadila Healthcare Ltd. 2013 (30) STR (Guj.).*

Janak C. Pandya, Company Secretary

CORPORATE LAWS
Company Law Update

[2016] 194 Comp Cas 16 (CLB)
[Before the Company Law Board – New Delhi Bench.
Sajal Dutta vs. Ruby General Hospital Ltd. (CLB)

The jurisdiction under Sections 397 and 398 of the Companies Act, 1956 is a unique jurisdiction carved out in the annals of Indian jurisprudence to go by equality and that the facts of the case are to be tested on the anvil of oppression and mis-management, irrespective of the fact whether such acts are in compliance or non-compliance of law

Brief Facts

The First Petitioner, along with his two group companies as petitioners, filed a petition against Ruby General Hospital Limited ("Co."), his brother, Dr. Kamal Kumar Dutta ("R2") and another shareholder. The petition was filed under Sections 235, 307, 398, 399, 402, 403 and 406 of the Companies Act, 1956 ("Act"). The Petitioners challenged the following corporate actions taken by the Co. and other shareholders:

1. Alteration of shareholding of the Co. in violation of *status quo* order passed by this Hon'ble Bench.
2. Issue and allotment of 30,55,329 equity shares to R2.
3. Amount paid by the petitioners shown as "disputed liability".
4. Non-cancellation of 25,000 shares allotted to R2.
5. Appointment of two new directors on the Board of Co.

Other submissions made by the petitioners are as under:

a. It was alleged that prior to the above changes, the petitioners were holding 47.3% and R2 was holding 46.37% of the shares of the Co.

b. After the above events, R2 was claiming to hold around 86.95% shares of the Co.

c. IDBI had sanctioned loan to the Co. purely based on petitioner's creditworthiness.

d. R2 had supplied obsolete, dysfunctional and second hand medical equipments and used machinery to the Co. and also over invoiced the cost of the same to the Co.

e. R2 wanted to issue shares in lieu of the aforesaid medical equipments.

f. On the direction of the Hon'ble High Court of Calcutta, the RBI allowed the issuance of shares to R2 on a nonrepatriable basis against the valuation of the said second hand medical equipments.

g. The petitioners challenged the RBI's above order which is still pending before the Hon'ble High Court.

h. The decisions of CLB in *Dr. Kamal K. Dutta vs. Ruby General Hospital Ltd. [2002] 108 Comp Cas 312 (CLB)* and the High Court in *Ruby General Hospital Ltd. vs. Dr. Kamal Kumar Dutta [2006] 129 Comp Cas 1 (Cal)* were also referred.

i. The Hon'ble Supreme Court in its judgment *Kamal Kumar Dutta vs. Ruby General Hospital Ltd. [2006] 134 Comp Cas 678 (SC)* has set aside the Calcutta High Court Order in its judgment and confirming the CLB judgment for maintaining the status quo as to shareholding of both the groups.

j. The allotment made post Supreme Court's judgment is in violation of Section 81(1) of the Act and as per Article 6 of the Articles of Association of the Co.

k. Misuse of hospital premises and media report has resulted in suspension of pathology department accreditation with NABL.

The submissions made by the respondents are as under:

1. R2 with his other NRI doctor friends decided to establish a hospital and agreed to take the petitioner as a partner.

2. As agreed, R2 will bring cash and substantial equipment and in lieu of which they will be allotted shares up to 88.88% of the Co.

3. SIA has granted the permission to the NRI friends to hold 88.88% shares and balance 11.12% to be held by resident Indians.

4. Various accounts signed by the petitioners indicate that the cost of medical equipments were duly capitalized and for a part amount of ` 74 lakhs, shares were allotted.

5. However, due to technical issue of non-obtaining RBI permission, the petitioners had reversed the above position and transferred the amount to share application money.

6. The petitioner had allotted the shares to himself and his group companies and also removed the NRI directors.

7. The CLB, on the petition of R2 had directed the petitioners to bring the un-amended accounts and get the same approved in the annual general meeting of the Co. In the said AGM, a resolution was passed to allot shares to R2.

8. The Supreme Court's judgment which had reversed the order of the Calcutta High court was referred and that subsequent actions were taken as per the said order.

9. On various miscellaneous allegations of mismanagement and siphoning of funds etc., arguments and counter arguments were made.

After the submissions were made by both sides, the issue before the bench was whether the following corporate actions are considered to be acts of oppression and mismanagement against the petitioner:

a. Issue and allotment of shares to R2.

b. Cancellation of allotment of shares to the petitioner and showing the amount as "disputed liability".

c. Non–cancellation of allotment of shares to R2.

d. Efforts made to remove the petitioner as a director of the Co.

e. Appointment of three new directors.

Judgment and Reasoning

The Hon'ble Bench provided the following judgment:

a. The resolution passed for issue and allotment of shares is valid. The board had passed the allotment resolution for discharging its obligation towards value of second hand medical equipments after a great lapse of time. Thus, this resolution does not relate to any independent arrangement, which requires disclosure as the same is related to past arrangement. Further, the interest of R2 was already known to the petitioner right from the beginning, thus, this contract was not falling under Sections 299 and 300 of the Act. Thus, the resolution for allotment of shares was valid. The reference of various judgments cited by R2 were accepted. The judgment in the cases of *Hely-Hutchinson vs. Brayhead Ltd. [1968] 1 QBD 549 CA; Movitex Ltd. vs. Bulfield [1988] BCLC 104; Narayandas Shreeram Somani vs. Sangli Bank Ltd. [1965] 35 Comp Cas 596 (SC); and Rolta India Ltd. vs. Venire Industries Ltd. [2000] 100 Comp Cas 19 (Bom)* were referred.

   Reliance was also placed by R2 as to decision in *Sree Ayyanar Spinning and Weaving Mills Ltd. vs. V.V.V. Rajendran [1973] 43 Comp Cas 225 (Mad.), 231* and Palmer Company Law, which stated that Section 81 comes into operation where it is proposed to issue shares by following the normal procedure but not when the allotment of shares is being made for consideration other than cash.

b. The amount shown as "disputed liability" should be returned to the petitioner as after the cancellation of the shares allotted to the petitioner, the said amount remains with the company without falling into the "share application" accounting head or loan or debentures. As the said amount was not returned, it must now be refunded with interest.

c. On cancellation of allotment of shares to R2, the CLB observed that upon review of the Supreme Court judgment, it had not given any direction to cancel those shares. Further, such allotment has not affected the 11.12% shareholding earmarked to resident shareholders and hence the said allotment has not been declared as invalid.

d. The petitioner ceased to be a director of the Co. within 60 days from the date of order as available on the CLB website. The reasoning is that it is a directorial complaint and not a shareholder complaint. The Bench further observed that as the petitioner is already holding 11.12% shares and it is in the interest of the Company and to free the Company from litigation he should cease to be a Director.

e. Co. shall release all guarantees given by the petitioner.

f. Appointment of three directors is valid as these people have been appointed upon the wish of the majority. So majority rule prevails unless the same is tearing into shareholders rights and is harmful to the company.

g. If the petitioner seeks exit, then on a fair valuation basis, the Co. shall provide such exit.

"Knowledge is power, and getting one you get the other. By knowledge you can even banish the material world"

— *Swami Vivekananda*

CA Mayur Nayak, CA Natwar Thakrar &
CA Pankaj Bhuta

OTHER LAWS
FEMA Update

In this article, we have discussed recent amendments to FEMA through Circulars & Press Releases issued by RBI.

A. Circulars issued by RBI

1. Export of Goods and Services – Project Exports

The Government of India (GOI) has renamed 'OCCI' as 'Project Export Promotion Council' (PEPC) and the definition of civil construction contracts has been amended to include turnkey engineering contracts, process and engineering consultancy services and project construction items (excluding steel & cement) along with civil construction contracts. The necessary changes have been accordingly made in Memorandum of Instructions on Project and Service Exports (PEM) and annexed to this circular.

(A.P. (DIR Series) Circular No. 39 dated January 14, 2016)

(Comment: This circular widens the scope of civil construction contracts as advised by GOI and also brings in the necessary changes in the Memorandum of Instructions on Project and Service Exports (PEM))

2. Foreign Direct Investment – Reporting under FDI Scheme, Mandatory filing of forms ARF, FCGPR and FCTRS on e-Biz platform and discontinuation of physical filing from February 8, 2016 export of goods and services – Project Exports

With a view to promoting the ease of reporting of transactions related to Foreign Direct Investment (FDI), under the aegis of the e-Biz project of the GOI, RBI has enabled online filing of the following returns with the Reserve Bank of India viz.:

Advance Remittance Form (ARF) which is used by the companies to report the FDI inflows to RBI;

– FCGPR Form which a company submits to RBI for reporting the issue of eligible instruments to the overseas investor against the above-mentioned FDI inflow; and

– FCTRS Form which is submitted to RBI for transfer of securities between resident and person outside India.

At present both the options, i.e. online filing and physical filing of abovementioned forms, were available to the users.

Based on the experience, RBI has decided that from February 8, 2016 the physical filing of forms ARF, FCGPR and FC-TRS will be discontinued and forms submitted in online mode only through e-Biz portal will be accepted.

(A.P. (DIR Series) Circular No. 40 dated February 1, 2016)

(Comment: By a number of circulars in 2015, RBI had notified availability of the above mentioned forms on e-Biz portal and allowed online as well as manual filing. Based on public response, RBI has now made online filing of Forms ARF, FC-GPR and FCTRS mandatory. Online filing will streamline the processing of forms and it would easy to pinpoint responsibility/cause for delays in submission of the forms.)

B. Press Releases issued by RBI

1. RBI simplifies Communication Process: Issues Comprehensive Master Directions, to begin with on Forex

On 4th January 2016, RBI issued 17 Master Directions (Master Direction 1 & Master Direction 11 are yet to be issued) covering foreign exchange transactions. Master Directions on foreign exchange issued consolidate all relevant A.P (DIR Series) Circulars issued so far within the ambit of the relevant regulations, amended up to date. The Master Directions issued will consolidate instructions on rules and regulations framed by the Reserve Bank under various Acts including banking issues and foreign exchange transactions. Any change in the rules, regulation or policy will be communicated during the year by way of circulars. The Master Directions will be updated suitably and simultaneously whenever there is a change in the rules/regulations or there is a change in the policy. All the changes will get reflected in the Master Directions available on the RBI website along with the dates on which changes are made. The existing set of Master Circulars issued on various subjects will stand withdrawn with the issue of the Master Direction on the subject.

Till date the following Master Directions have been issued:

- Master Direction - Money Changing Activities
- Master Direction – Opening and Maintenance of Rupee/Foreign Currency Vostro Accounts of Non-Resident Exchange House
- Master Direction - External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorised Dealers and Persons other than Authorised Dealers
- Master Direction - Miscellaneous
- Master Direction – Reporting under Foreign Exchange Management Act, 1999
- Master Direction – Import of Goods and Services
- Master Direction – Export of Goods and Services
- Master Direction – Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad
- Master Direction - Deposits and Accounts
- Master Direction - Remittance of Assets
- Master Direction – Acquisition and Transfer of Immovable Property under Foreign Exchange Management Act, 1999
- Master Direction - Establishment of Liaison/ Branch/ Project Offices in India by Foreign Entities
- Master Direction - Insurance
- Master Direction - Other Remittance Facilities
- Master Direction - Liberalized Remittance Scheme (LRS)
- Master Direction – Borrowing and Lending transactions in Indian Rupee between Persons Resident in India and Non-Resident Indians/ Persons of Indian Origin
- Master Direction- Compounding of Contraventions under FEMA, 1999

Detailed directions can be read at the following link: https://rbi.org.in/Scripts/BS_ViewMasterDirections.aspx.

(Press Release 2015-2016/1566 dated 4th January, 2016)

***(Comment: The RBI, while doing away with the practice of annually issuing Master Circulars has promised that while communicating changes through circulars, it will also simultaneously update Master Directions on the website along** with the dates on which changes are made. This **would significantly assist both users as well** as FEMA practitioners to have a consolidated view of the rules and regulations at one place. **Explanations to rules and regulations by way** of Frequently Asked Questions (FAQs) on the Master Directions are awaited.)*

2. RBI announces Regulatory Relaxations for Start-ups

In the Sixth Bi-monthly Monetary Policy Statement for 2015-16 released on February 2, 2016, in keeping with the GOI's initiatives to promote ease of doing business and contribute to conducive growth of entrepreneurship, particularly in respect of the start-up enterprises, the following regulatory changes for easing the cross-border transactions are proposed to be made, in consultation with the Government of India:

(i) Enabling start-up enterprises, irrespective of the sector in which they are engaged, to receive foreign venture capital investment and also explicitly enabling transfer of shares from Foreign Venture Capital Investors to other residents or non-residents;

(ii) Permitting, in case of transfer of ownership of a start-up enterprises, receipt of the consideration amount on a deferred basis as also enabling escrow arrangement or indemnity arrangement up to a period of 18 months;

(iii) Enabling online submission of A2 forms for outward remittances on the basis of the form alone or with document(s) upload / submission, depending on the nature of remittance; and

(iv) Simplifying the process for dealing with delayed reporting of Foreign Direct Investment (FDI) related transaction by building a penalty structure into the regulations itself.

The notifications / circulars under FEMA), wherever necessary, are expected shortly.

In addition, RBI has informed that following proposals are under consideration, in consultation with the Government of India

(i) Permitting start-up enterprises to access rupee loans under External Commercial Borrowing (ECB) framework with relaxations in respect of eligible lenders, etc.;

(ii) Issuance of innovative FDI instruments like convertible notes by start-up enterprises; and

(iii) Streamlining of overseas investment operations for the start-up enterprises.

Certain other issues under the existing regime shall be clarified viz:

(i) Issue of shares without cash payment through sweat equity or against any legitimate payment owed by the company remittance of which does not require any permission under FEMA; and

(ii) Collection of payments by start-up enterprises on behalf of their subsidiaries abroad.

The RBI has already created a dedicated mailbox to provide assistance and guidance to the start-up sector.

(Press Release 2015-2016/1809 dated 2nd February, 2016)

*(Comment: In keeping with the GOI's initiatives **to promote entrepreneurship, particularly in respect of the start-up enterprises, RBI has provided first hand information about certain** changes proposed in the policy frame work to **promote ease of doing business and contribute** to conducive growth.)*

Ajay Singh, *Advocate* & CA Namrata Bhandarkar

BEST OF THE REST

1. Right to livelihood – Freezing of Bank Account – Petitioner guarantor of loan – Writ Petition – Issue involving contractual matter, open for petitioner to approach forum for redressal of his contractual rights – No interference warranted under writ jurisdiction – Constitution of India, Articles 21 & 226

Petitioner had opened a Savings Bank Account at State Bank of India. Petitioner stood as a Guarantor of Fishery loan of ` 1,80,000/- given to Shri Akhom Nirmai Singh. On party's failure to pay the loan, the Bank restrained the petitioner from operating his account.

Petitioner filed a writ petition with the grievance that on repeated request being made the respondent has failed to allow him to operate his account and that the action has amounted to deprivation of the petitioner of his and his dependants' livelihood. Petitioner claimed that restraining him to use the account was arbitrary and unreasonable being violative of Article 21 of the Constitution of India.

Respondent's contention was that the Petitioner stood as guarantor in respect of the loan granted by executing a Deed of Guarantee and in the certificate from the Employer issued by the State Government and produced by the State Government, he had agreed to allow the respondent to deduct money from his account towards loan amount. Despite its repeated demand notices and reminders, since the petitioner failed to persuade the borrower to pay and hence the petitioner was not permitted to withdraw money from his account. Therefore the writ petition was not maintainable at all because the issue involved is purely contractual one and that the court may not exercise discretionary jurisdiction under Article 226 of the Constitution. Respondent relied on decision of the Apex Court in the case of *State of HP vs. Raja Mahendra Pal 4 SCC 43* wherein the Apex Court had observed that right to livelihood as contemplated under Article 21 of the Constitution cannot be so widely construed which may result in defeating the purpose sought to be achieved by the aforesaid Article.

In view of the facts, the Hon'ble Manipur High Court observed that it was not in dispute that petitioner stood as Guarantor in respect of the Fishery Loan granted to. It cannot be held that the petitioner's right guaranteed under the Article 21 of the Constitution has been infringed and it is the petitioner who has relinquished his right voluntarily and consciously by giving specific instruction to the bank and the respondent has simply carried out the said instruction. Further, it is the petitioner who has connected its savings bank account to the loan transaction. On the other hand, there is substance that the issue involved therein is a contractual matter. In case the petitioner is aggrieved by the action of the respondent it is open to him to approach the appropriate forum for redressal of his contractual rights. The Court therefore held that this was not fit case to exercise its discretionary jurisdiction under Article 226 of the Constitution to interfere with the action of recovering the loan amount and the petition was dismissed accordingly.

Longjam Narahari Singh vs. The State of Manipur & Another AIR 2015 Manipur 22

2. Admissibility of insufficiently stamped document – Has to be decided by court at stage when it is raised – Court cannot keep it pending till final hearing of case-Rajasthan Stamp Act Ss. 39(1), 42

The petitioner had filed a writ petition against order of the Rent Tribunal wherein the application of the petitioner had been rejected. During the proceedings before the Tribunal, the petitioner had raised an objection questioning admissibility of the document and had requested for impounding thereof which was deferred by the Rent Tribunal observing that it is a legal question which may be determined at the time of final hearing in the matter.

The contention of the petitioner was that question regarding admissibility of the document in evidence has to be decided by the court as and when it is raised and therefore the decision could not have been deferred by the Rent Tribunal. Further if the document is not sufficiently stamped, it was the duty of the court to impound the document and refer the same to Collector for determination of stamp duty and that the order passed by the Rent Tribunal is not sustainable in the eyes of law.

The Hon'ble Rajasthan High Court observed that it is well settled that when a document is tendered in evidence by the party to the proceedings and as objection is raised by the other party that the document is inadmissible in evidence being not sufficiently stamped or unregistered, it is obligatory upon the court to decide the objection raised and should not be deferred till the final hearing. In relation to the admissibility of the document in evidence being not duly stamped, it is to be noticed that as per section 37 of the Act every person having by law or consent of the parties authority to receive evidence and every person in charge of the public office except an officer of Police before whom any instrument chargeable to duty is produced and if it appears to him that such instrument is not duly stamped shall impound and refer the same to Collector for the determination of the stamp duty together with the penalty payable. Thus it is the duty of the court to impound the document not duly stamped and make a reference to the Collector for determination of stamp duty and penalty payable, notwithstanding the fact that the party concerned has expressed his readiness and willingness to pay the deficient stamp duty and penalty.

Further, in view of the provisions of section 39(1) of the Act, a document not duly stamped cannot be admitted in evidence unless the duty with which the same is chargeable or the deficient duty and penalty as determined by the Collector (Stamp) under the provisions of section 37 or in terms as provided by proviso to section 39 are duly paid.

Thus, the objection raised by the petitioner regarding admissibility of the document and necessity to impound the same on account of it being not sufficiently stamp was set aside to the Rent Tribunal.

Gurpreet Singh alias Dimple vs. Rent Tribunal, Ganganagar and others. AIR 2015 Rajasthan 217

3. Right to life – Available to all living beings – Flying of kites by using Chinese Manjha – Serious dangers to human being, animals and birds caused – Authorities directed to ensure complete prohibition on manufacture,

use and sale of Chinese Manjha at statewide level – Prevention of Cruelty to Animals Act 1960, S. 11

The petition was instituted as public interest litigation to highlight the serious dangers to public safety that is being caused by the use of "Chinese Manjha" as an appendage to kites. The String or Manjha, was stated, made of metallic/ nylon yarn with an abrasive coat of crushed glass gummed on it which makes it razor sharp. As a result, serious injuries are liable to be caused. The petitioner relied upon a report published in the daily newspaper 'Hindustan' dated 25-9-2015 which indicated that a death had been caused as result of an accident due to kite string. The kite string is also known to cause grievous injuries to birds. The petitioner sought there reliefs (i) Prohibition on the manufacture or sale of the string (ii) Designation of areas for the flying of kites which would obviate dangers to public safety (iii) Treatment of persons who are injured.

The Allahabad High Court observed that the issue must be tackled by making sporadic raids, as has been done by the District administration but first and foremost, steps must be taken by the authorities to ensure that there is a complete prohibition on the manufacture of "Chinese Manjha" at a statewide level. Where any such activities are found to be carried out illegally necessary enforcement action should be taken in respect of such establishments and for ceasing all material. Secondly, a sustained awareness and publicity campaign should be carried out so as to ensure that members of the public particularly the younger generation which indulges in the sport of kites particularly in and around the 'Makar Sankranti' festival is made conscious of the dangers involved. This should be ensured by carrying out a sustained publicity campaign in the print and electronic media and by utilising the social media to propagate public service messages

The Court further clarified that they are not imposing any ban on flying of kites but are issuing necessary directions so that such materials which causes grave danger to humans beings, animals and birds as the petitioner has highlighted is not used. The danger and problem is not confined to Allahabad. Apart from the district of Allahabad if the Principle Secretary (Home) shall issue a communication to Collectors of each district containing directions in implementation of this order. The directions contained in the order were not intended to be exhaustive catalogue and the State Government shall adopt all appropriate steps for enforcement in accordance with law including necessary steps to prohibit manufacture, use and sale of "Chinese Manjha" in any form whatsoever. The petition was accordingly disposed of.

Anurag Mishra Mishra vs. State of U.P. and other AIR 2016 Allahabad 1

4. Disclosure of information – Free of cost information – Can be given only in case where application is not considered within 30 days of filing application – Or if First Appellate authority itself directs PIO to provide information free of cost – Right to Information Act, S. 7

A social worker moved an application under section 6 of the Act seeking information in respect of one Fisheries Extension Worker. The petitioner refused to provide the required information on the ground that the information sought for pertains to individual fisheries extension worker and no public interest is involved in providing the information therefore the same cannot be provided. The petitioner preferred First Appeal under section 19, which was disposed of directing the petitioner to provide the information. The petitioner thereafter informed respondent to deposit ` 6/- as required fee for the information. Respondent in turn preferred a Second Appeal before the Commission, which further directed the petitioner to provide the information and at the same time impose penalty of ` 5,000/- and cost of ` 500/- payable to the respondent. Against this order writ petition was filed by the petitioner before the High Court.

The Hon'ble Chhattisgarh High Court observed that a careful reading of the provisions contained in section 7 makes it clear that the stage of providing information free of cost would occasion only when the PIO fails to pass any order disposing any application by rejecting the same within 30 days or in other words, when the PIO fails to take up the application for taking decision in the matter within 30 days, he has to provide information free of cost, but in case where the PIO has passed the order within 30 days rejecting the application and the First Appellate Authority has set aside the order and directs providing of information, occasion for providing information free of cost would not arise. It would be different if the First Appellate Authority itself directs the PIO to provide the information free of cost. But in the case in hand, the First Appellate Authority has not directed the petitioner to provide information free of cost. Since, the application is considered and disposed off under section 7, applicability of outer limit of 30 days would have no application and any further action in the matter has to be decided in terms of the order passed by the First or Second Appellate Authority.

The Court further went on to observe that the respondent having not deposited the requisite fee when the same was demanded from him after the order passed by the First Appellate Authority, it could not be said that it was the petitioner alone who was responsible for causing delay. Instead of depositing ` 6/-, respondent incurred more expenses by preferring Second Appeal. Therefore, the court was of the opinion that the respondent himself was not in dire need of the information but was trying to settle score with the petitioner who had rejected his application in the first case.

S. K. Shrivastava vs. State and others AIR 2016 Chhattisgarh 1

5. Unstamped arbitration agreement – Admissible in evidence after impounding it and getting it properly stamped – Stamp Act 1899, Sections 35, 33, 38

A part of the building which was held by the trustees on behalf of the Trusts was leased out by the plaintiffs to the defendants. The tenancy agreement between the plaintiffs and the defendant was on ` 10/- stamp paper and also contained an arbitration clause. The plaintiffs advocate issued a 15 days notice to the defendants asking them to quit, vacate and deliver up vacant possessions of the property to the trustees. After the expiry of 15 days the defendants did not hand over the possession to the plaintiffs. Suit was filed by the plaintiffs against the defendants.

One of the fundamental questions that arose in the suit was since the tenancy agreement was deficiently stamped, if the arbitration clause was valid at all?

The Calcutta High Court observed that there is no dispute that the agreement containing the arbitration clause is unstamped. Section 35 of the Indian Stamp Act, 1899 stipulates that in most clear terms that if an instrument required to be stamped or is deficiently stamped it cannot be looked into for any purpose. However, section 33 of the Act has given power to the court to impound the document and send it to Collector for stamping. After stamping of the document S. 35 and S. 38 it is admissible in evidence. Further, even at the interim stage of a proceeding, a court cannot look into an unstamped document. However, considering at that stage the court has the power to impound or get it properly stamped from the Collector and thereby cure the defect, protective order can be passed assuming that documents would be valid at later stage. Therefore, the court held that arbitration cannot be overlooked as invalid.

Suresh Tulshan, Trustee of K P Foundation vs. Marco Polo Restaurant Pvt. Ltd. AIR 2016 Kolkata 27

ML-380

CA Rajaram Ajgaonkar

ECONOMY AND FINANCE

TESTING TIMES

As expected, the month of January 2016 remained extremely eventful, not only for India but for the whole world. The world economy suddenly started exhibiting signs of weakness. The commodities were already experiencing a fall in prices. Crude oil further buckled to supply pressure. To worsen the situation, oil suddenly lost its stability and drifted lower in a semi panic situation. Sanctions on Iran were lifted and that resulted in more pressure on oil prices. Now Iran is able to pump in more oil in the world markets, already facing a glut like situation. This could result in a further increase in supply of oil and can exert downward pressure on prices. Slowing economies across the world were reducing the consumption of oil and its derivatives further and that triggered the fall of oil prices to a 12 year low during the month. Oil breached USD 30 a barrel mark for a few days and bounced back but how long this bounce back can sustain is a million dollar question. Many experts are of the view that the glut in the oil prices may not be corrected easily due to structural imbalances caused by economic slump in many economies. Many of the oil exporting countries may not be able to reduce their oil supply to stabilise the prices and that may exert a pressure on oil prices to move to 20 USD a barrel. The upward movement in the oil prices seen in the last week of January may only be a relief rally. It may take quite some time for oil prices to stabilise and regain even a part of the lost ground.

Adding to the woes of the world, the Chinese economy has displayed further signs of weakness. As per the latest estimate, the economy may grow at less than 7 per cent rate for the current year, which may be less than the growth rate expected to be achieved by India. A crash in commodity prices has further created a dent into the Chinese economy, which has created lots of over capacity for various metals and other commodities. The Chinese stock market has shown further weakness during the month and the market collapsed by more than 20 per cent. The total fall in the Chinese stock market since June 2015 is more than 45 per cent, which is extremely significant by any standard. Chinese investors have lost wealth worth trillions of Dollars. Foreign investors, who had invested in China, especially out of the liquidity emerging as a result of Quantitative Easing, have also been bruised badly and many of them have lost confidence in the immediate future of the economy. Many foreign investors are trying to withdraw their money from the Chinese market, which has not only caused pressure on the prices of the stocks but also on the Chinese currency and the economy of the country. Though the Chinese Government is taking all the efforts to contain the rout, they have only achieved limited success so far. If this situation continues, the economy will lose further momentum and may end up growing at a low rate of sub 5 per cent within the next couple of years. This can be a bad news not only for the country but also for the rest of the world as the economy has become the second largest economy of the world. Slow down in China can also have contagious effect on whole of Asia Pacific region, wherein growth can slow down. The countries in the region are already suffering from low commodity prices, and their suffering can increase with their exports to China slowing down, negatively affecting their GDP and growth.

The woes of Europe remain unabated and they are worsening to an extent due to migration of refugees from neighbouring region suffering from political instability and a war like situation. The migrants are causing pressure on the resources of many nations especially in Eastern Europe and that can slow down the European growth prospects in the immediate future. Though there is a view that the new migrants may increase the labour force as well as consumption in the countries in the region, it will certainly take some time while this happens and the region will have to bear the brunt on an immediate basis. On political as well as on humanitarian grounds, it is becoming impossible for many European countries to stop the influx of these refugees and that will certainly affect their growth. It does not seem easy for Europe to start growing at a respectable rate in the immediate future.

Japan continuously faces its own challenges. The Central Bank of the country has reduced the interest rates to sub zero level but still it is not able to control the appreciation of its currency as it is considered as a safe haven currency. The appreciating Japanese Yen is further likely to reduce the ability of Japanese exports to compete in the global marketplace and that can be bad news for the economy already suffering from low growth for decades. Countries like Australia and Indonesia, who are major exporters of commodities, are also facing problems due to low commodity prices. Their exports are down and that is marring the growth prospects of their respective economies. Economies of Hong Kong and Singapore are trade based and as the region to which they cater is facing a slow down, their economies are likely to suffer.

The economies of Africa as well as Middle East are very much dependent on commodity exports. Many countries, which had been doing comparatively better than others, were oil exporting countries; and they are now suffering due to a sharp fall in oil prices. Other countries like South Africa, Zimbabwe etc., have been traditional exporters of coal and minerals. They have built large capacities for export of these commodities on the back of Chinese demand. In fact China had helped many countries in the African continent for developing infrastructure for export of mineral products. The slowing Chinese economy has not only reduced the demand of the commodities, which these countries export but it has also reduced the aid from that country. The overall impact of the same on the economies in the region is quiet substantial and it may put some of the economies in recession. The region is currently suffering from economic pessimism, which can also result in unrest and civil wars in the region.

The story of South America is not different than that of Africa. The region is exporting crude oil and commodities like wheat, rice, sugar etc. Though the currencies of many of the countries in the region have weakened, they are not able to take advantage of the same for their exports due to global over supply of the commodities. Some of the countries in the region are facing political unrest and the situation may worsen due to unhappy citizens. The revival may take some time and the region may hardly be able to contribute to the global growth in the near future.

The only continent, which is doing better, is North America. The biggest economy in the region is the US, which is growing much better than earlier, helped by Quantitative Easing adopted by the Central Bank of the country. Though the Easing has been stopped, the positive momentum in the economy persists even today. The US, being a major consumer of the commodities, has gained advantage of availability of cheaper materials. The economy is growing reasonably well but the consumption in the economy is not growing adequately as many citizens are using savings from low commodity prices to reduce their mortgages. The future may not remain buoyant for the country. The global pressures may slow down this biggest economy of the world, which is a sweet spot in the majorly gloomy environment.

The other bright spot in the world economy, amongst specially emerging markets, is India. The country is expected to grow at the rate of 7.3% for the current fiscal, which is one of the best growth rates in the world. The expectation is that the growth will improve further in the next fiscal year. India is a major importer of oil and it used to spend huge part of foreign exchange earnings on import of oil and its derivatives. The falling oil prices have given a major advantage to the country and its foreign exchange outflow has substantially reduced on account of low price of this commodity. The Indian Government has mopped up its resources by increasing the excise on the crude oil derivatives, which has gathered substantial kitty for the Government to fight its budgetary deficit. As of now, the fall in oil prices is going to help the country to reduce its trade deficit, budgetary deficit and to improve foreign exchange reserves. These developments will help the country to have more strength to fight the slowdown in the world and to clock higher GDP growth over the next few years.

The Indian Government is conscious about the current challenges of the country. The Government is spending more money on developmental projects and infra development, which will help the country to attract more investments. It is also working on ease of doing business which was one of the major tripping points for foreign investment. India is encouraging its subjects for manufacturing in India so that the advantage of domestic cheap labour can be taken by the country especially while the labour cost is increasing in China. Success of all these efforts also depends on the political will of the opposition to allow the reforms to take speed as the ruling party is not in majority in the Upper House. That house is dominated by the opposition, which can stall all the legislative efforts of the publically elected members of Parliament. The times can be great provided all of us work in tandem for the benefit of our country and countrymen. Missed opportunities can have serious repercussions.

The global equity markets have been in turmoil during the last month. The case was not different for the Indian markets. The volatility was high and the markets lost substantial ground on account of increase in risk. The uncertainty of the economic outlook in the world due to a slowdown in China and on account of drop in oil prices to an unprecedented level has created substantial risk to various economies. The world being economically inter-connected, many other economies are likely to be affected. The worst part is, nobody is certain that when the pain is going to be over. Though the stock markets have dropped substantially and many stock markets are quoting near their 52 weeks low index levels, the possibility of a further drop in stock prices very much exists. Therefore, though investors may stick to their SIP plans, aggressive investment in equity at this juncture is not recommended. Indian markets can slip to a lower level, though they are not looking expensive now.

The recession like condition is threatening the world. Though India appears to be one of the sweet spots in the gloomy environment, it cannot escape the wrath of the global winds and its growth rate can get affected therefrom. Therefore, most of the asset classes may not perform well in the immediate future, except for fixed deposits, Government securities, debentures of top rated companies and mutual fund schemes investing in above referred asset classes. Investors need to exercise extreme caution before doing any adventurous investments. They should not try to earn high income risking their capital. The asset quality should be considered as a key parameter in such testing times. Investors are advised to stick to their pre-determined investment plans and be more conservative than before for at least some more time by when the current economic storm passes away.

CA. Ninad Karpe

The Lighter Side

SIN TAX!

When I was in school, I was repeatedly told that if I sin, I would go to Hell. The thought of an after-life in Hell frightened me so much that I never thought of sinning.

And now it seems I have an option – sin and pay sin tax!

Recently, I read a news item suggesting that the Government wants to levy sin tax of 40% on goods like cigarettes, alcohol and carbonated drinks. These items are obviously considered "bad" and "harmful" and hence "sinful". It almost seems to say that consuming these will mean that I have to pay a tax (as a penalty) and perhaps avert the possibility of going straight to hell.

My fertile mind is thinking – this will open up one more opportunity for tax professionals. Other than sales tax consultants, service tax consultants, excise duty consultants and income tax consultants, you will now see a new breed of consultants – "Sin tax consultants". So, if I specialise in this field, my business card would read "Ninad Karpe, Sin Tax Consultant". In a social gathering, I wonder how many guests would then want to shake hands with me.

There are various ways of atoning a sin – confession, fasting, visiting a holy shrine, taking a dip in a holy river or sending messages to friends for forgiveness. Now there is an easier solution available – sin and just pay the tax!

So, let us get ready to welcome yet another tax in our tax lexicon – SIN TAX!


Ajay Singh, *Advocate*, CA. Ashok M. Manghnani
Hon. Jt. Secretaries

The Chamber News

Important events and happenings that took place between 8th January, 2016 to 8th February, 2016 are being reported as under.

I. ADMISSION OF NEW MEMBERS

1) The following new members were admitted in the Managing Council Meeting held on 19th January, 2016.

Life Membership

1.	Mr. Gahlot Amar Rajendra Pal Singh	ITP	Mumbai

Ordinary Membership

1.	Mr. Varma Jitendra Ramvilas	CA	Wardha
2.	Mr. Jain Sushil Tolchand (Oct. 15. to Mar. 16)	CA	Mumbai
3.	Mr. Navarathan M. M. (Oct. 15 to Mar. 16)	CA	Chennai
4.	Mr. Agrawal Rajesh Mangal Chand (Oct. 15 to Mar. 16)	CA	Bilaspur
5.	Mr. Poojary Narayan Raju (Oct. 15 to Mar. 16)	STP	Mumbai
6.	Mr. Moolya Yogeshkumar V. (Oct. 15 to Mar. 16)	ITP	Mumbai
7.	Mr. Thakore Hetal Naren	Advocate	Mumbai
8.	Mr. Trivedi Deepak Suresh	CA	Nagpur
9.	Mr. Kariya Nilesh Visanji	CA	Thane
10.	Mr. Deora Ashok Jodhraj	CA	Chennai
11.	Mr. Shah Nirav Dhirajlal	CA	Mumbai
12.	Mr. Kataruka Shambhunath Devi Prasad (Oct. 15 to Mar. 16)	CA	Mumbai

Student Membership

1	Mr. Agarwal Piyush Pradeep	ICAI-Appeared	Mumbai
2	Ms. Agarwal Paridhi Pradeep	ICAI-Appeared	Mumbai

II. PAST PROGRAMMES

1. INDIRECT TAXES COMMITTEE

4th Residential Refresher Course on Service Tax was held on 29th to 31st January, 2016 at Aamby Valley City. The conference was inaugurated by President CA Avinash Lalwani by lighting the lamp. The conference was addressed by eminent speakers and Brains' Trust Session was held where eminent trustees replied to the queries raised by the delegates. The total enrolment for the RRC was 148.

2. INTERNATIONAL TAXATION COMMITTEE

The **Workshop on Taxation of Foreign Remittances** was held on 22nd & 23rd January, 2016 at West End Hotel, Churchgate, Mumbai. The conference was addressed by eminent speakers.

III. FUTURE PROGRAMMES

(For full details of the future programmes, kindly visit www.ctconline.org or refer The CTC News of January, 2016)

1. ALLIED LAWS COMMITTEE

The **Half Day Seminar on Labour Laws** jointly with Bombay Chartered Accountant’s Society will be held on 2nd April, 2016 at BCAS Office, 7, Jolly Bhavan, New Marine Lines.

2. CORPORATE MEMBERS COMMITTEE

A. The **Full Day Seminar on Limited Liability Partnership** jointly with Direct Taxes Committee will be held on 27th February, 2016 at West End Hotel, New Marine Lines.

B. The **Lecture Meeting on Impact of Budget Proposals on Capital Markets and Industry** will be held on 9th March, 2016 at Walchand Hirachand Hall, IMC.

3. DIRECT TAXES COMMITTEE

A. The **Public Meeting on Union Budget – 2016** will be held jointly with Indirect Taxes Committee along with Ghatkopar CA Study Circle of WIRC, Forum of Free Enterprises and 14 other organisations on 3rd March, 2016 at New SNDT Bhuriben, Cama Lane, Ghatkopar (West), Mumbai.

B. **Half Day Workshop on Direct Tax Provisions of Finance Bill 2016** jointly with WIRC of ICAI will be held on 12th March, 2016 at M. C. Ghia Hall, Kala Ghoda, Fort.

4. INDIRECT TAXES COMMITTEE

A. The **Live Screening of the Finance Minister's Speech & Presentation of Budget 2016** jointly with Direct Taxes Committee will be held on 29th February, 2016 at CTC Conference Room.

B. The **Public Meeting on Direct & Indirect Tax Provisions of Finance Bill – 2016 j**ointly with Direct Taxes Committee & Maharashtra Chamber of Commerce will be held on 5th March, 2016 at Maharashtra Chamber of Commerce, Kala Ghoda, Mumbai.

C. The remaining session of **Workshop on MVAT Act, Service Tax & Allied Laws** jointly with AIFTP (WZ), BCAS, MCTC, STPAM and WIRC of ICAI will be held from 5th March, 2016 to 30th April, 2016 at STPAM Library Hill, Mazgaon.

D. The **Workshop on Finance Bill, 2016 (Indirect Taxes Provisions)** Jointly with WIRC of ICAI will be held on 12th March, 2016 at M. C. Ghia Hall, Fort.

5. INTERNATIONAL TAXATION COMMITTEE

A. The **Advanced FEMA Conference** jointly with Bombay Chartered Accountant's Society will be held on 18th March, 2016 at 4th Floor, Walchand Hirachand Hall, IMC.

B. The **Advanced Workshop on Principles of Transfer Pricing** (4 days) will be held on 22nd, 23rd, 29th & 30th April, 2016 at West End Hotel, New Marine Lines, Mumbai.

6. MEMBERSHIP & PUBLIC RELATIONS COMMITTEE

A. The **Full Day Seminar on "Various Laws Assessment & Appeal under Sales Tax & Income Tax"** jointly with The Income Tax Bar Association & Tax Practitioners Association, Kolhapur will be held on 13th February, 2016 at Hotel Woodland, Tarabai Park, Kolhapur.

B. The **Free Health Check Up Camp for Members, Staff & Family** will be held on 24th February, 2016 at CTC Conference Room.

7. RESEARCH AND PUBLICATIONS COMMITTEE

The **e-book on the Amendments introduced in the Budget 2016** will be released within 72 hours of the date of budget. The e-book will not only cover all the amendments in details but also in-depth analysis by tax luminaries.

Register your e-mail ID with us on office@ctconline.org, President@ctconline.org to receive a copy of e-book. Kindly visit – http://ctconline.org/index.php/publications

8. STUDENT & IT CONNECT COMMITTEE:

A. The **Office Productivity : Technology Tools and Tips** will be held on 10th February, 2016 at Conference Room, Consultair Investments Pvt. Ltd., Eros Theatre Building, Churchgate.

B. The Lecture Meeting on **"Protect Yourself from Cyber Frauds**" will be held on 17th March, 2016 at 4th Floor, Walchand Hirachand Hall, IMC.

C. The **Dastur Essay Competition - 2016 for Student of Law & Accountancy**

Topics : (1) Reshaping India through Priceless Heritage, (2) Religion & Terrorism, (3) My favourite Sports Person

Registration Deadline – 24th February, 2016 & Submission Deadline – 15th March, 2016

For Rules & Regulations of the Essay Competition kindly visit Chamber's website www.ctconline.org.

D. The **Lecture Meeting on Statutory Audit of Bank Branches and Practical Issues** on the subject "Overview of Bank Branch Audit including LFAR and IRAC Norms" by CA Vipul Choksi will be held on 21st March, 2016 at Maheshwari Bhavan, 1st Floor, Marine Lines. All are cordially invited to attend the meeting.

E. The **Youth Residential Refresher Course** jointly with Bombay Chartered Accountant's Society will be held on month of April 2016. Kindly block the month in your calendar. More details would be available in next announcement.

9. DELHI CHAPTER

A. The Seminar on **"E-Commerce – Business models, Regulatory aspects, Direct & Indirect Taxes etc."** will be held on 13th February, 2016 at India International Centre, New Delhi.

B. The **Half day Seminar on Finance Bill 2016** – jointly with Northern Region Chapter of International Fiscal Association – India Branch / other professional bodies will be held on 3rd March, 2016 at Multipurpose Hall, Lodhi Estate, New Delhi.

10. OTHER

The **Amita Memorial Lecture Meeting** jointly with Bombay Chartered Accountants Society will be held on 11th February, 2016 at 4th Floor, Walchand Hirachand Hall, IMC.

The Chamber of Tax Consultants

Vision Statement

The Chamber of Tax Consultants (The Chamber) shall be a powerhouse of knowledge in the field of fiscal laws in the global economy.

The Chamber shall contribute to the development of law and the profession through research, analysis and dissemination of knowledge.

The Chamber shall be a voice which is heard and recognised by all Government and Regulatory agencies through effective representations.

The Chamber shall be pre–eminent in laying down and upholding, among the professionals, the tradition of excellence in service, principled conduct and social responsibility.

STUDENT & IT CONNECT COMMITTEE

Half Day Visit at National Stock Exchange held on 9th January, 2016 at NSE, BKC, Mumbai.

CA Ashok Manghnani, Hon. Jt. Secretary delivering opening remarks. Seen from L to R : S/Shri CA Parimal Parikh, Chairman, Ms. Jyoti Bhudia, Faculty and CA Aalok Mehta, Vice Chairman.

CA Parimal Parikh, Chairman welcoming the faculties and students. Seen from L to R : S/Shri Ashok Manghnani, Hon. Jt. Secretary, Ms. Jyoti Bhudia, Faculty and CA Aalok Mehta, Vice Chairman

Ms. Jyoti Bhudia addressing the students

Section of Students.

DIRECT TAXES COMMITTEE

Intensive Study Group (Direct Taxes) Meeting on the subject "Recent Important Decisions under Direct Taxes" held on 12th January, 2016 at CTC office.

Mr. Rahul Hakani, Advocate addressing the members

STUDY CIRCLE & STUDY GROUP COMMITTEE

Study Group Meeting on the subject "Recent Judgments under Direct Taxes" held on 11th January, 2016 at IMC.

CA Yogesh Thar addressing the members.

Study Circle Meeting on the subject "Issues in Reassessment" held on 15th January, 2016 at IMC.

CA Mahendra Sanghvi addressing the members. Seen from L to R : S/Shri CA Dilip Sanghvi, Vice Chairman, CA Ashok Sharma, Chairman, CA Avinash Lalwani, President, CA Dinesh R. Shah & CA Sanjay Chokshi, Convenors.

INTERNATIONAL TAXES COMMITTEE

Intensive Study Group on International Taxation Meeting on the subject "BEPS Action Plan 1 – Digital Economy (Study of the Action Plan with specific reference to its practical applicability in Indian Scenario) held on 13th January, 2016 at CTC Office.

CA Rashmin Sanghvi, chairing the session.

CA Rutvik Sanghvi addressing the members.

FEMA Study Circle Meeting on the subject "FEMA – Export of Goods & Service" held on 25th January, 2016 at CTC Office.

CA Viral Satra addressing the members.

Intensive Study Group on International Taxation Meeting on the subject "BEPS Action Plan 6 – Prevent Treaty Abuse" held on 2nd February, 2016 at CTC Office.

CA Shreyas Shah addressing the members.

MEMBERSHIP & PUBLIC RELATIONS COMMITTEE

Half Day Seminar on Allied Laws at Vapi Jointly with VAPI Branch of WIRC of ICAI and Vapi Industrial Associates held on 27th January, 2016.

Dignitaries on dais. Seen from L to R : S/Shri CA G. B. Laddha, Past Chairman of Vapi Branch WIRC of ICAI, Mr. Ramesh Soni, Faculty on Labour Law, Mr. Parthiv Mehta, Secretary of VIA and CA Hemant Parab, Chairman of Membership & Public Relations Committee of CTC

Mr. Ramesh Soni addressing the members on the subject "Labour Laws".

CA Mitesh V. Katira addressing the members on the subject "Digital smart use of Technology CAs".

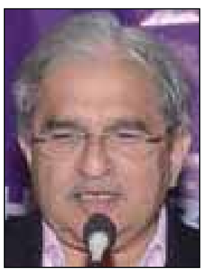
DIRECT TAXES COMMITTEE

Full Day Seminar on Capital Gains held on 16th January, 2016 at West End Hotel

CA Hitesh R. Shah, Vice President delivering the opening remarks. Seen from L to R : S/Shri CA Ketan Vajani, Chairman, CA Anil Sathe, Faculty and CA Dinesh Poddar, Convenor.

CA Ketan Vajani, Chairman welcoming the Faculties and Delegates. Seen from L to R : S/Shri CA Anil Sathe, Faculty, CA Hitesh R. Shah, Vice President and CA Dinesh Poddar, Convenor.

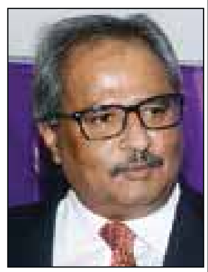
Faculties



CA Anil Sathe

CA Gautam Nayak

CA N. C. Hegde



Mr. K. Gopal, Advocate

Section of Delegates

Lecture Meeting on "Section 14A – The Unending and Unpredictable Journey" held on 22nd January, 2016 at Walchand Hirachand Hall, IMC

CA Yogesh Thar addressing the members. Seen from L to R: S/Shri CA Ketan Vajani, Chairman, CA Avinash Lalwani, President and Rahul Sarda, Advocate.

Section of members.

CTC - DELHI CHAPTER

FELICITATION FUNCTION

Life Time Achievement Award conferred to Shri V. P. Verma, Advocate & Past President

and

Full Day Seminar on Prevailing Industries Issues / Concerns and Case Studies on Companies Act, 2013

On 16th January, 2016 at India International Centre, New Delhi

CA Avinash Lalwani, President delivering opening remarks. Seen from L to R : S/Shri CA C. S. Mathur, Past Chairman, Delhi Chapter, R. P. Garg, Chairman, Delhi Chapter, V. P. Verma, Advocate & Past President and CA Ashok Manghnani, Hon. Jt. Secretary.

CA Vijay Gupta, Hon. Jt. Secretary, Delhi Chapter welcoming the Guests and Delegates. Seen from L to R : S/Shri CA C. S. Mathur, Past Chairman, Delhi Chapter, R. P. Garg, Chairman, Delhi Chapter, CA Avinash Lalwani, President, V. P. Verma, Advocate & Past President and CA Ashok Manghnani, Hon. Jt. Secretary.

Shri R. P. Garg, Chairman, Delhi Chapter offering shawl to Shri V. P. Verma, Advocate & Past President. Seen from L to R : S/Shri CA C. S. Mathur, Past Chairman, Delhi Chapter, CA Avinash Lalwani, President & CA Ashok Manghnani, Hon. Jt. Secretary.

CA Ashok Manghnani, Hon. Jt. Secretary offering Shrifal to Shri V. P. Verma, Advocate & Past President. Seen from L to R : S/Shri CA CA Avinash Lalwani, President.

CA C. S. Mathur, Past Chairman, Delhi Chapter offering Shrifal to Shri V. P. Verma, Advocate & Past President. Seen from L to R : S/Shri CA Avinash Lalwani, President and CA Ashok Manghnani, Hon. Jt. Secretary.

CA Avinash Lalwani, President felicitating Shri V. P. Verma, Advocate & Past President by offering Plaque. Seen from L to R : S/Shri CA Vijay Gupta, Jt. Hon. Secretary, Delhi Chapter, R. P. Garg, Chairman, Delhi Chapter, CA C. S. Mathur, Past Chairman, Delhi Chapter, CA Suhit Agarwal, Vice Chairman, Delhi Chapter, CA Sapna Gupta, Hon. Jt. Secretary, Delhi Chapter and CA Ashok Manghnani, Hon. Jt. Secretary

CTC - DELHI CHAPTER

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Life Time Achievement Award to Shri V. P. Verma, Advocate & Past President
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Full Day Seminar on Prevailing Industries Issues / Concerns and Case Studies on Companies Act, 2013
On 16th January, 2016 at India International Centre, New Delhi.

Shri V. P. Verma, Advocate & Past President addressing the Members on his Journey that immensely enriched the tax profession in general and the CTC in particular. Seen from L to R: S/Shri CA C. S. Mathur, Past Chairman, Delhi Chapter, R. P. Garg, Chairman, Delhi Chapter, CA Avinash Lalwani, President and CA Ashok Manghnani, Hon. Jt. Secretary.

Faculties of full day seminar

Mr. Lalit Kumar, Advocate

Mr. R. P. Garg, Former Senior Vice President of ICAI

Mr. Vinod Wahi, Advocate

Mr. Harish Kumar, Advocate

STUDENT & IT CONNECT COMMITTEE

Understanding Startup Investment held on 21st January, 2016 at Babubhai Chinai Committee Room, IMC.

CA Avinash Lalwani, President delivering the opening remarks. Seen from L to R : S/Shri CA Dinesh Tejwani, Vice Chairman, Suhas Baliga, Faculty, Deepak Gupta, Faculty and CA Parimal Parikh, Chairman.

Faculties

Mr. Deepak Gupta

Mr. Suhas Baliga

Section of Delegates.

Shri Hitesh R Shah,Vice President with Hon'ble Union Minister Sushma Swaraj, while making representation on Income Tax Act for benefit of common people at Samvad Programme held on 30-1-2016 at Mulund.

Shri Hitesh R Shah,Vice President, making representation on Income Tax Act to Hon'ble Union Minister Sushma Swaraj at Samvad Programme held on 30-1-2016 at Mulund. Seen from L to R: Ms. Nishtha Pandya, Convenor, L & R Committee, S/Shri Krish Desai, Vice Chairman, L & R Committee, Ajay Singh, Hon. Jt Secretary and Hinesh Doshi, Hon.Treasurer.

CTC Team with CBDT Member Shri R. C. Mishra at Delhi on 25-1-2016.

S/Shri Hitesh R. Shah, Vice President, K. Gopal, Past President and Rahul Hakani, Chairman, R & P Committee, presenting the Chamber's Publication on Black Money to Hon'ble Finance Minister Shri Arun Jaitley and Law Minister Shri Sadanand Devegowda on 25-1-2016 at Delhi.

CTC Team with Justice R. V. Easwar (Retd.) of Delhi High Court at Delhi on 24-1-2016

INTERNATIONAL TAXATION COMMITTEE

Workshop on Taxation of Foreign Remittances held on 22nd & 23rd January, 2016 at West End Hotel.

Dignitaries during the Inauguration. Seen from L to R : CA Jay Kalra, Co-ordinator, CA Avinash Lalwani, President, CA Naresh Ajwani, Chairman, CA Nilesh Kapadia, Faculty and CA Ganesh Rajgopalan, Convenor.

CA Avinash Lalwani, President delivering the opening remarks. Seen from L to R : S/Shri CA Naresh Ajwani, Chairman, CA Nilesh Kapadia, Faculty and CA Ganesh Rajgopalan, Convenor.

CA Naresh Ajwani, Chairman welcoming the Faculties and Delegates. Seen from L to R : S/Shri CA Avinash Lalwani, President, CA Nilesh Kapadia, Faculty and CA Ganesh Rajgopalan, Convenor.

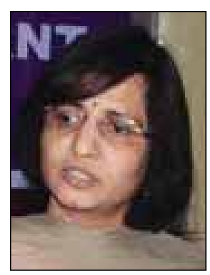
Faculties

CA Nilesh Kapadia

CA Rashmin Sanghvi

CA Sanjay Sanghvi, Advocate

CA Sudhir Nayak



CA Geeta Jani

CA Hitesh Gajaria

CA Paresh Shah

CA Anil Doshi

CA Shabbir Motorwala

Section of delegates

THE CHAMBER'S JOURNAL
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