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Emerging business models post BEPS

April 2016

Introduction

- MNCs operate globally with their value chains spread across multiple legal entities located in different jurisdictions. Use of favourable tax regimes has been part of tax strategy of many of them. The changing regulatory environment now makes it necessary to reassess the tax footprint of these value chains.

- The BEPS initiative can be best summarized by the following three key objectives:

  - **Coherence**: Loopholes resulting from different interpretation of facts for tax purposes in different jurisdictions will be closed.

  - **Substance**: The allocation of taxable profit to jurisdictions will increasingly depend on where people are located and perform demonstrably decisive functions.

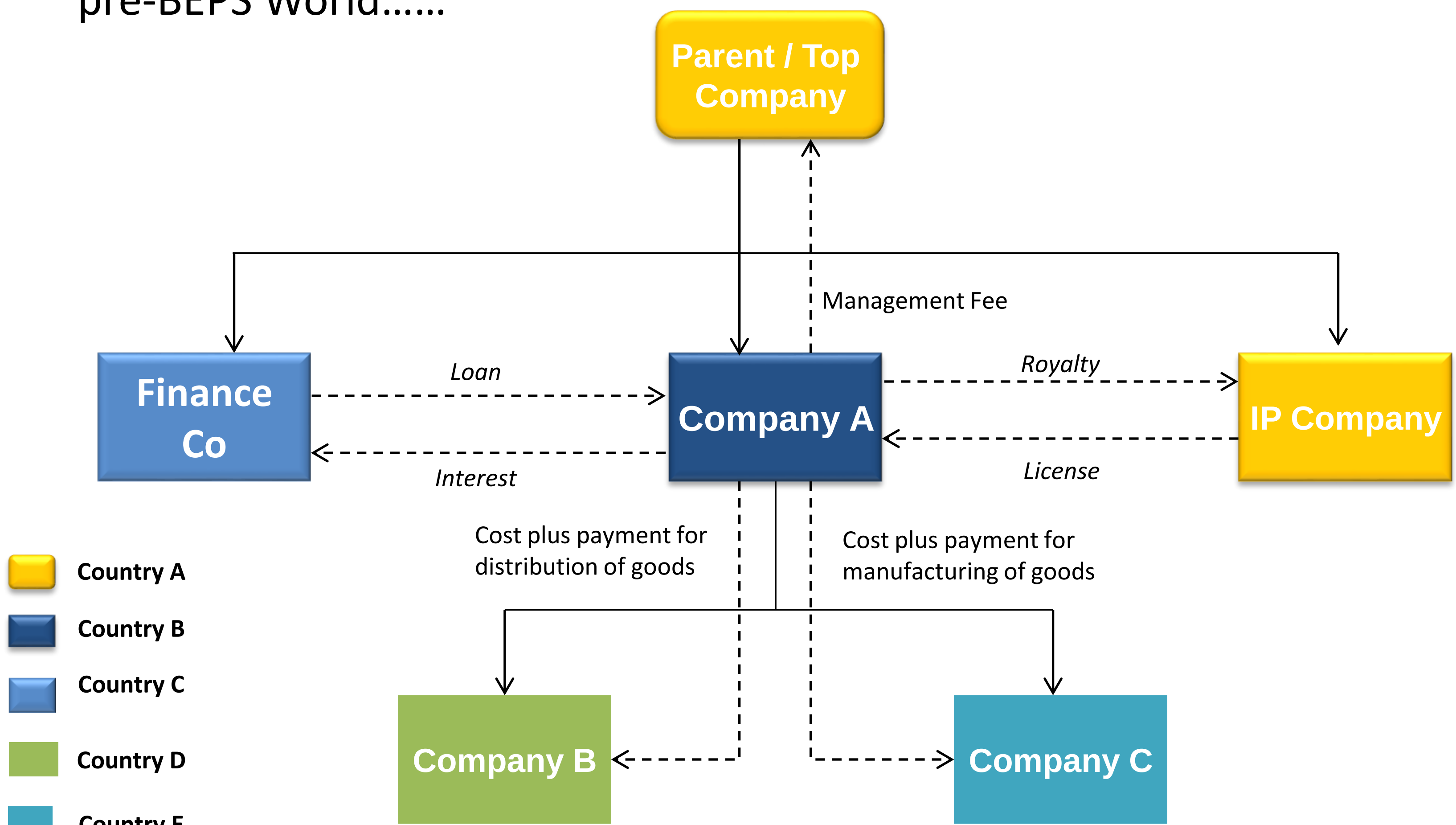
  - **Transparency**: Taxpayers will be obliged to disclose more tax-relevant data to tax authorities allowing them to track the allocation of taxable income and substance across the globe.

- Traditional models like principal company with limited substance earning complete residual profit in the value chain or IP companies that have completely outsourced the R&D activities to affiliates have already lost credibility.

- Artificial structures predominantly based on legal agreements will likely be challenged by revenue authorities around the globe and will not prevail.

Business Model of a Typical MNC Structure

A “brilliant” tax structure in a pre-BEPS World……



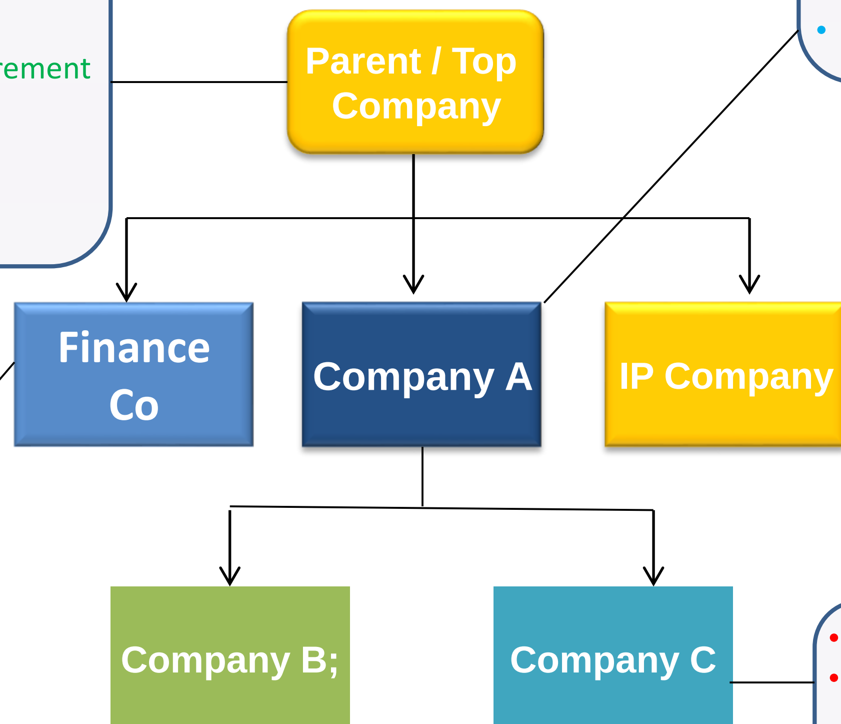
Reaction from the OECD

And reaction from the OECD……

Potential BEPS impact
- Immediate
- Medium term
- Longer term;

- Increased risk of place of management PE
- Increased reporting and disclosure requirement
- Increased TP documentation requirement
- Increased risk of intra-group management charge
- Increased use of CFC rule in more jurisdictions

- Alignment for substance and return
- Treaty abuse
- Level of substance
- TP arrangement
- Taxation of income from online sale
- Use of hybrid entities
- Treaty abuse



- Risk of Hybrid structure
- TP alignment with value creation and exploitation of intangibles
- R&D arrangement
- Level of substance, particularly where preferential ruling obtained

- Hybrid mismatch
- Base erosion limitations
- TP for treasury arrangements
- Preferential regimes – increased disclosure and substance requirement
- Treaty abuse

- Increased tax authority aggression
- Focus on PEs – commissionaire, place of management
- Disclosure requirements for TP
- Threat of re – characterisation increase

Country A | Country B | Country C | Country D | Country E

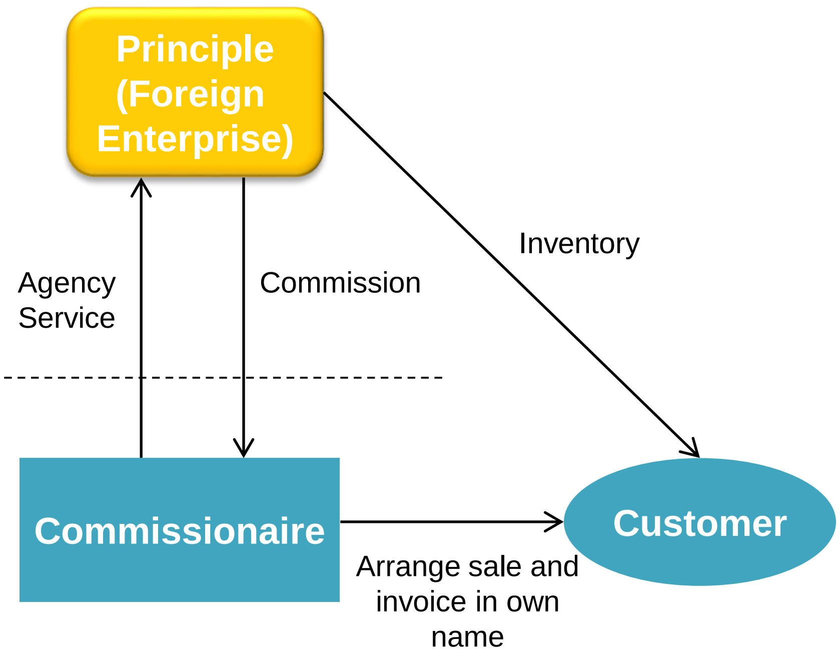
Impact of BEPS action plan on Permanent Establishment

Impact of BEPS on Permanent Establishment

- 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 in that State a Permanent Establishment ('PE') to which the profits are attributable.
- The definition of PE included in tax treaties is therefore crucial in determining whether a non-resident enterprise must pay income tax in another State or not.
- Action plan 7 will have an impact on the following aspects of centralised operating models:
  - Commissionaire and similar arrangements;
  - Facilities, such as warehouses, owned by the foreign principal used for storage, delivery or purchase of inventory;
  - Inventory owned by the foreign principal held at facilities used for storage, delivery, display or processing (for example, toll manufacturing and consignment stock);
  - Models where functions that could be seen as “complementary business activities forming part of a cohesive business operation” are carried out by group entities at the same or different places in the same country

Impact of BEPS on Permanent Establishment

Commissionaire arrangement



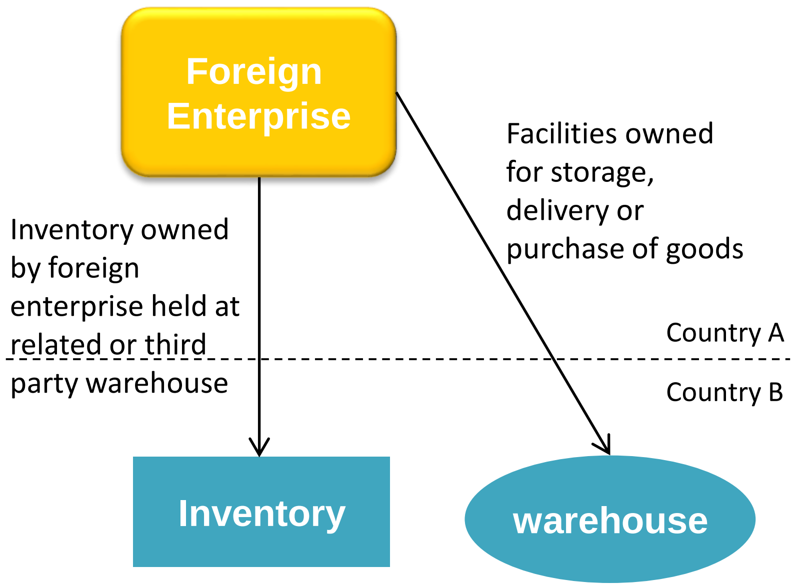
Impact of BEPS on Commissionaire arrangement

- A commissionaire arrangement is an arrangement through which a person sells products in a state in its own name but on behalf of a foreign enterprise, who is the owner of these products.
- Foreign enterprise using commissionaire arrangement dose not have PE because it is able to avoid the application of Article 5(5) of the OECD model tax convention
- In many cases, commissionaire arrangement and similar strategies were put in place in order to erode the taxable base of the state where sales took place.

Impact on MNCs - As a matter of policy, where the activities that intermediary exercises in a country are intended to result in the regular conclusion of the contracts to be performed by a foreign enterprise, such enterprise should be considered to have a taxable presence in that country.

Impact of BEPS on Permanent Establishment

Inventory arrangement



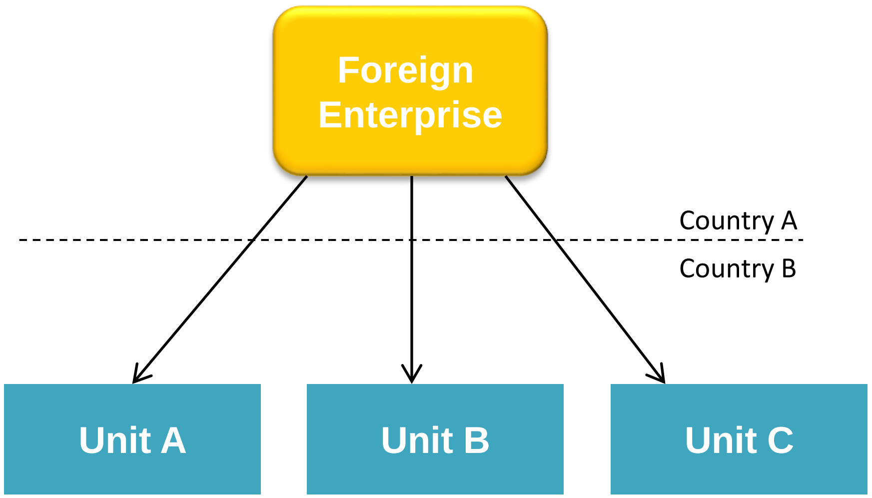
Impact of BEPS on Inventory arrangement

- Article 5(4) of the OECD model specifically exempts certain activities from creating a PE where a place of business is used solely for activities listed in that paragraph
- The activities covered by these exceptions were generally considered to be of a preparatory or auxiliary nature, which nowadays correspond to core business activities
- Action plan 7 will modify the Article 5(4) so that exemption from PE status for preparatory or auxiliary activities would be given, taking into account the nature of the principal's business.

Impact on MNCs – It is necessary for the business to check whether such activities constitute an essential and significant part of the principle's business. If so, it will not be considered preparatory or auxiliary, and will therefore not be exempt from PE status.

Impact of BEPS on Permanent Establishment

Fragmentation of activities



Fragmentation of cohesive operating business into several smaller operation in order to argue that each part is merely engaged in preparatory or auxiliary activities

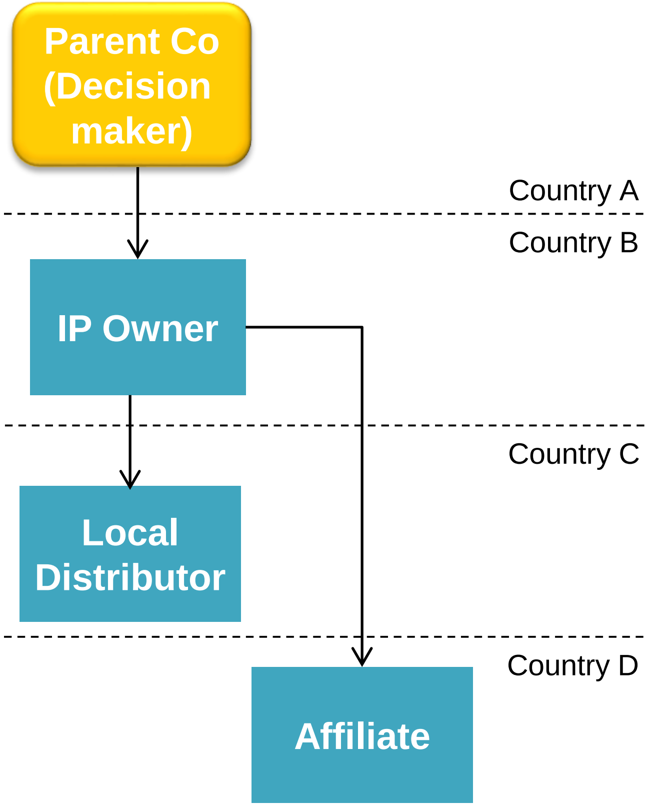
Impact of BEPS Fragmentation of activities

- The activities performed at each place of business were viewed separately when determining whether or not a PE exists
- The biggest impact of Action plan 7 is the introduction of an ‘anti-fragmentation rule
- Now it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of Article 5(4).

Impact on MNCs – Multinationals have to be able to substantiate the business reason for allocating various functions and risks along value chains over different group entities within the same jurisdiction

Impact of BEPS action plans on IP holding entity

Impact of BEPS on IP holding entity



IP owner and parent company relationship
- IP owner has an exclusive right over the IP rights outside of parent company's jurisdiction.
- The entrepreneurial profit associated with the IP rights accrues to the IP owner.
- While there is some substance in the IP owner, strategic decision making with regards to the worldwide rights remains in the parent company.

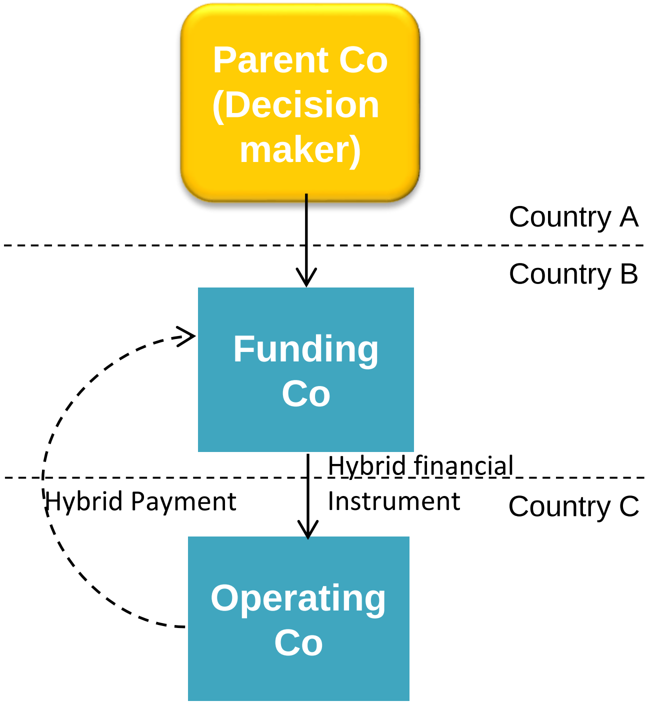
IP owner and local distributor relationship
- IP owner licenses IP to a local distributor who makes sales to third parties in the local jurisdiction.

IP owner and affiliates relationship
- IP owner enters into agreements with affiliates to provide R&D and other services applicable to the IP.

- **The combined effect of Actions 5, 8, 9 and 10 on IP structures is that -**
  - **MNCs will need to confirm that IP owner carries out not only the funding for development but also the decision-making ,control over development, enhancement, maintenance, protection and exploitation of the IP**
  - **IP owner will also need to execute substantial proportion of the R&D activity.**

Impact of BEPS action plans on funding entity

Impact of BEPS on funding entity



- Parent Co, the strategic decision maker, instructs Funding Co to infuse capital in operating companies within the Group
- Funding Co, relatively low-activity company typically set-up in a low-tax jurisdiction, infuses funds using Hybrid Financial Instrument in operating co.
- Operating Co, involved in actual economic activity, typically set-up in a high tax jurisdiction makes Hybrid payments i.e. Interest to Funding Co
- Internal financial arrangements have created opportunities for groups to shift profits from one jurisdiction to another through use of interest deductions and other financial payments
- Payments to Funding Co from Operating Co is not commensurate to the risk

- **The combined effect of Actions 2, 4 and 9 on funding structures is that -**
  - **Organisation will have to plug mismatch between substance of operations and profitability.**
  - **Debt and equity funding needs to be more balanced.**
  - **Companies having foreign financing entity in A country and treasury team in country B may pose a challenge. One could ask why financing company is located where it is.**
  - **It will be essential to demonstrate that the funding entity not only has financial capacity to invest but also has the functional capacity to manage related risk.**

Impact of BEPS action plan on digital economy

Impact of BEPS on digital economy

- In today's digital global economy many companies have embraced technology to enhance their operations and drive cost out of the value chain. Digital trade allows firms to do business in a country in which they have no PE or physical presence.

- Taxation of digital economy remains one of the most challenging area for the revenue authorities across the globe today.

- In its recommendation, BEPS, has given following three different options:
  - A new nexus in the form of a significant economic presence in a country on the basis of factors that evidence a purposeful and sustained interaction with economy of that country via technology and other automated tools;
  - A withholding tax on certain types of digital transaction; and
  - An equalisation levy to tax a non-resident enterprise's significant economic presence in a country.

- Increasingly countries are implementing diverse national digital economy tax policies that reinterpret, and may even digress from, the new BEPS guidelines.

- Finance Bill 2016 proposed an 'Equalisation levy' aka 'India's Google Tax' based on the basic framework of withholding tax mechanism to give effect the Action Plan 1 of BEPS project to tax cross border digital transaction.

Impact of BEPS action plan on Merger & Acquisition transactions

Impact of BEPS on M & A transactions

- In case the target company has a tax rate in the lowest quartile for its sector – do you consider this to be an optimised tax structure creating future value, or an indicator of aggressive structuring and therefore likely to leak future value?
- Gaining an accurate estimation of a target's future tax rate will become harder – this uncertainty may reduce the investor community's confidence.
- BEPS will impact on all aspects of the deal processes: due diligence; transaction structuring; and deal valuation.
- Tax due diligence may increasingly become future-focused as well as backward-looking.
- BEPS will impact integration; compliance and reporting; as well as the operation and maintenance of structures.
- Traditional acquisition structures will need to be revisited and possibly reshaped in light of BEPS to rely on substance, transparency (e.g. disclosure of tax ruling) and arm's length leverage.
- The exercise will also included a redefinition of roles and responsibilities across the entire value chain to align both business models to achieve operational and financial benefits while complying with new BEPS documentation requirements and transparency regulations.

Impact of BEPS action plans on tax compliance

Impact of BEPS on tax compliance

OECD recommendations will have an impact on the tax compliance process in the following ways:

Action Plan 13

- A re-examination of existing global TP documentation under Action plan 13 is needed
- The new three-tiered approach (master file; local file; country-by-country report) will not only provide tax administrations with more detailed information regarding the global value chain of a company, but will bring inconsistencies in TP policies.
- New mandatory disclosure requirement will empower tax administration across globe to scrutinise the allocation of profits that results from existing TP policies within MNEs.

Action Plan 8 to 10

- Emphasis on significant people functions and their relative functional contributions to key processes within MNEs.
- Shifting focus from the legal form to economic reality of a transaction
- Contractual allocation of risk without sufficient control will not be regarded as arm's- length behaviour
- Requires a through two sided analysis to determine which party to the transaction is entitled to the profits related to Intangibles

Action Plan 7

- Threshold for creating a taxable presence for corporate income tax purpose in a country is lowered
- Inventory holding, warehousing functions and sales activities are particular target

Step plan to perform compliance requirement by MNEs

The first step for MNEs to prepare for the increased compliance requirements is to perform a BEPS impact assessment

The assessment should identify the key attention points and specific jurisdiction in which they are operating and that may be affected by BEPS

A detailed analysis of potential country specific impact areas should be performed

Determine whether additional resources are required (internal or external) in order to gather and provide required information (for example, to meet Action 13 requirement)

Ultimately, impact assessment should result in a transition plan covering all relevant impact areas

Impact of BEPS action plans on tax controversy

Impact of BEPS on tax controversy

- BEPS Action Plans may result in more tax controversies and more potential double taxation as countries may fight over the same tax revenue
- Greater tax controversy resources will be required to respond to the changing environment.
- The following analysis provide an insight on what dispute resolution mechanisms may be available in case of tax controversy for taxpayers :
- **Domestic dispute resolution :**
  - MNCs generally focus on global business opportunities and global tax impact
  - This focus may easily be misunderstood or misinterpreted as a focus on eroding a local country's tax base
  - Most preferable options for domestic dispute resolution include : Audit and settlement process, Alternative dispute resolution (also known as mediation) and court based adjudication
- **International dispute resolution:**
  - Increasing international trade and investment is accompanied by growth in cross-boarder commercial disputes
  - Mutual agreement procedure, International and commercial arbitration, Advance pricing agreement have emerged as preferred options for resolving cross-boarder tax disputes

Conclusion

What can be done???

- Review operations and structures to identify areas of risk.
- Review existing documentation and critically assess whether it supports substance.
- Keep BEPS in mind when business changes.
- Seek APAs or bi/multi-lateral rulings to gain certainty.
- significant care must be given to substance requirements at the level of the principal and the IP company. The company need to be equipped to make relevant decisions, and capacities to independently prepare decisions and guidance for the other group entities.
- Traditional transfer pricing methods allocating routine profits to risk-limited distributors and manufacturers may no longer be advisable. The BRICs and many UN countries emphasize the importance of location benefits and market access, demanding that these are reflected in the transfer prices.
- BEPS make it necessary to redirect the thinking on tax efficient restructuring of value chains using transfer pricing as a key driver

Will there be tax planning opportunity in post BEPS world

- Post BEPS tax planning opportunities will still exist, but realizing the benefits of tax planning will require a greater emphasis on economic substance supporting the profit generated around the world.
- Potential tax benefits expected from such a structure might also be nullified by exit taxes when converting the operating model and moving functions, risks and assets between different jurisdictions.
- When setting up a new business or whenever there is an internal or external triggering event making a reorganization of the existing business necessary, there can be tax-planning opportunities.
- Moving away from rigid transfer pricing systems and introduction of flexible profit split models that are based on contribution by each entity across the value chain can be useful.
- Revenue authorities have proven to be open to such practical and administrable solutions in the course of mutual agreement procedures.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