Recent Trends in International Tax

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WHAT THE BEPS ARE WE TALKING ABOUT?
BEPS
15 ACTIONS
Reforming the international tax system to tackle tax avoidance
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Why BEPS?

- Aggressive tax planning
- Tax avoidance
- Tax evasion
- Anti-avoidance
- A "fair share" of tax
- Profit shifting;
- Base erosion;
- Diverted profits
- Beneficial ownership
- Treaty shopping
- Double Non-taxation
- Failing concept of PE in a digital economy
- Weak transfer pricing mechanism.

As per OECD estimates, the base erosion and profit shifting has resulted in a loss of $100-240 billion every year to countries which is around 4-10% of global corporate income tax revenue.

What is BEPS?

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

- Corporate tax is levied at a domestic level. However cross border interactions can also leave gaps, which result in income not being taxed anywhere. BEPS strategies take advantage of these gaps between tax systems in order to achieve double non-taxation.

- The OECD has been providing solutions to tackle aggressive tax planning for years. The debate over BEPS has now reached the highest political levels in many OECD and non-OECD countries. The OECD does not see BEPS as a problem created by one or more specific companies.

- The work on BEPS received strong and consistent support by the G20 and it is a key item on the Finance Ministers' and Leaders' agendas. Furthermore, all G20 countries have participated as equal partners in the development of the work.

- In October 2015, the OECD released final reports on the15 BEPS focus areas and recommended changes in key elements of the international tax architecture.

OECD's 15 Action Plans to counter BEPS

- **Action 1: Digital economy**
- **Action 2: Hybrids**
- **Action 3: CFCs**
- **Action 4: Interest deductions**
- **Action 5: Harmful tax practices**
- **Action 6: Prevent treaty abuse**
- **Action 7: Permanent establishment status**
- **Action 8: Transfer pricing – intangibles**
- **Action 9: Transfer pricing - risk & capital**
- **Action 10: Transfer pricing – high-risk transactions**
- **Action 11: BEPS data collection**
- **Action 12: Disclosure of aggressive tax planning**
- **Action 13: Transfer pricing documentation**
- **Action 14: Dispute resolution**
- **Action 15: Multilateral instrument**

Beyond Tax: how BEPS will alter businesses

- **Treaty benefits** -Is the use of holding and finance companies 'inappropriate'?
  -various aspects of BEPS Action 6

- **Financing and treasury** -The impact of BEPS on financing and treasury
  the way financing and treasury functions will be affected by Actions 2, 4, 5, 6, 8, 9, 10, 13 and 15 of the BEPS Project.

- **Digital economy** -The impact of BEPS on the digital economy andthe specific issues related to profit shifting in the fast changing digital economy.

- **Operating models -**The impact of BEPS Action 7 on operating models
  the impact that BEPS Action 7 will have on centralised operating models,and the changes which multinationals should be considering to guard against exposure to the new rules.

- **Intangible assets** -The impact of BEPS on intangible assets . The BEPS Action Plan is changing the tax landscape for intangible assets, and what this means for taxpayers.

- **M&A -** The impact of BEPS in M&A transactions

- **Compliance management -**The impact of BEPS on tax compliance

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- **Tax controversy -**The impact of BEPS on tax controversy

Beyond Tax: how BEPS will alter businesses

- **Uncertainty Creates Risks** -If the rules become more ambiguous and complex, and less aligned — all of which appears to apply to the BEPS project — this will undoubtedly lead to more conflict and double taxation.

- **The devil is in the detail** - Despite thematic clarity from the OECD on its goals, many of the actual recommendations lack an agreed-upon list of concrete changes.

- **Beyond the tax department-** the impact of BEPS will reach far beyond the tax department and have implications on most parts of a company.

- For ex. BEPS recommendations on Action plan 7 — could lead to companies triggering tax liabilities in additional countries. Now sales and supply-chain-related activities might now create a “permanent establishment”. Even where the resultant tax liability may be negligible, or covered by transfer pricing adjustments, this can bring substantial compliance and accounting costs.

- BEPS recommendations concerning **interest deduction caps** will also have far- reaching business implications. Those overseeing capital management will accordingly need to confirm that they not source funds in ways so that a lack of tax benefit will drive up costs.

- BEPS will cause a substantial increase in **tax controversy**. Certain jurisdictions are already asking for nontax information in an aggressive way, which may be a sign of a future approach.

- In response to BEPS, companies will need to be extra vigilant that their tax function is aligned with other parts of the business.

Multi Lateral Instruments

- On November 24, 2016, the OECD released a multilateral convention .The release of the MLI follows negotiations involving more than 100 jurisdictions, including India.

- The purpose of the MLI is to allow swift implementation of a series of tax treaty measures that were contained in the OECD BEPS Project - as an alternative to the burdensome task of renegotiating over 2,000 bilateral tax treaties to implement BEPS project.

- Once in effect, the MLI may have a significant impact on the world's existing bilateral tax treaties. Effects may include the denial of certain tax treaty benefits, the reallocation of certain taxing rights, and the modification of existing dispute resolution procedures.

- Once adopted, MLI will replace certain portions of existing bilateral treaties that each country has with several countries .

- A number of countries have a number of domestic anti – avoidance legislations. So a fundamental question for arises how will the MLI and the domestic legislations interplay. For example LOB in the treaty Vs GAAR in the Income Tax Act,1961. Thus a potential worry for FII and FPIs in tax efficient jurisdictions.

Trumping the US Tax Reforms

- US has enacted sweeping tax reforms which will now become a legislation
- Global tax policy to be impacted as the corporate tax rate has been slashed from 35% to 21%.
- The following are the other key reforms:
  - Move from the residential to territorial system
  - Limitations on interest deductibility
  - Introduction of Base Erosion Anti-Abuse Tax (BEAT)
  - Tax rates cut for individuals across levels with a top rate of 37%
  - Standard deduction increased for taxpayers who do not itemise deductions
  - Many deductions eliminated or limited including deductions for mortgage interest and state and local taxes (SALT)
  - Alternative Minimum Tax (AMT) for individuals retained – but with higher exemption and phase out amounts
  - Doubling of Estate Tax exemption to $10MM
  - Corporate Alternate Minimum Tax ('AMT') repealed
  - Immediate write-offs for new business investments in certain depreciable personal property.

India Impact

- Outbound investment into the US will become far more attractive. There would be increased cashflows in US due to reduction in tax cost
- Indian companies having branch in US, additional branch profit tax @ 15% would apply.
- Given interest deductibility limitations, intra-group debt financing of US may no longer be advantageous and there would be to need to re-evaluate the capital structure of US operations.
- Greater incentive for the pharmaceutical companies and the companies relying extensively on intangibles to shift their intangibles/intellectual property to US due to beneficial tax treatment which were earlier parked in the tax havens
- After reduction in tax rate to 21%, there could be higher tax cost if a US subsidiary is established to have POEM in India.
- Levy of one-time ‘deemed repatriation’ tax may encourage dividends / buybacks from India, which trigger additional tax costs
- Optimizing India taxes and repatriation strategies are critical in US outbound structures

Trends in International Tax - The Indian Scenario

Multi Lateral Instruments – India's Take

The MLI specifies certain minimum standards to be adhered to by the Treaty Partners, the MLI would apply to a bi – lateral treaty if both the parties agree to be covered by the Articles sought to be modified and notify such Treaty. Such notification is referred to as Covered Tax Agreements(CTA)

- <u>Article 3 – Fiscally Transparent Entities</u>

  - ❖ India's treaties with most countries do not contain a provision for giving Treaty relief to fiscally transparent entities.
  - ❖ India has considered this in India – US Treaty and the amended India – UK Treaty specifically to partnerships and trusts.
  - ❖ The controversy was decided in favour by the Income Tax Tribunal in case of Link Later's and Bombay High court in Clifford Chance Case, even though the Revenue has not accepted this position and challenged the same.
  - ❖ This is not a minimum standard but only an optional one.
  - ❖ India has reserved its right in entirety the application of this Article and had indicated that it will not apply this to any of its bi – lateral treaties.

Multi Lateral Instruments – India's Take

- Article – 4 – Dual Resident Entities

  ❖ Intention is to modify the tie- breaker rules of the Tax Treaty in respect of a persons other than individuals i.e., Companies, LLPs and other non – incorporates entities.

  ❖ The modification provides that Competent Authorities shall determine by way of mutual agreement the residency having regard to the place of effective management.

  ❖ India has recently introduced detailed POEM test in its domestic laws.

  ❖ No formal reservation against this Article, however there would be practical issues. The competent authorities would be unable to reach an agreement as the domestic POEM and the at guidelines are not totally in sync with the OECD commentaries on this subject.

  ❖ This can be a vexed issued for India's Treaty Partners unless India follows the International approach for its POEM.

- Article – 5 – Methods for elimination of double taxation

  ❖ Three alternative steps to avoid double taxation – Option A and Option B exemption methods with specific reference to deductibility in a Contracting State and Option C is credit method.

  ❖ India has reserved its right not to go with Article 5 as India in general has adapted credit methods as per Article 23B of the OECD Convention.

  ❖ This being not a mandating minimum standard does not affect India's bi – lateral tax treaties

Multi Lateral Instruments – India's Take

- Article 6 – Preamble to a Bi – lateral Treaty

  ❖ This is a minimum standard under the MLI and provides the Treaty partners to prevent Treaty abuse and modify the existing language to the Preamble to the Treaty by inserting prevention of Treaty abuse.

  ❖ India has been silent on its position on Article 6.

  ❖ If a Treaty already does not contain such language the preamble language needs to be changed as it is a prescribed minimum standard.

  ❖ The India – US Treaty does not have a similar language and given the fact that USA has not signed the MLI it would be interesting to see how this will be adapted.

- Article – 7 Treaty Abuse

  ❖ Three conditions are specified and expects at least one of the conditions to be adapted as minimum standard

    - a principal purpose test (PPT)
    - a PPT supplemented with a simplified limitation of benefits (SLOB)
    - Detailed limitation of benefits (LOB)

  ❖ The PPT test is a default test and Parties can choose a supplementary SLOB or a LOB.

  ❖ India has opted for PPT with SLOB.

  ❖ Given the introduction of GAAR inter-play with Treaty law is to be seen.

Multi Lateral Instruments – India's Take

- ❖ PPT test can get triggered even if tax benefit is one of the consideration to the transaction, whereas a GAAR requires tax benefit to be the main benefit.

- ❖ Further GAAR has an Approving panel, however PPT test would be decided by Competent Authorities would apply if one has a disagreement with the decision.

- ❖ As per all the Treaties India has entered into India being the source country has the right to levy a withholding tax where the recipient is the beneficial owner and here the PPT has little or no role to play.

- ❖ Possibility that when one is dealing with Article 10,11 and 12 of the relevant bi- lateral Treaties, the question of PPT may not arise as irrespective of whether the transaction is to claim a benefit, the source country ie: India is protected by way of withholding tax !

- ❖ PPT does not provides for procedural safe guards whereas GAAR has an Approving panel therefore can domestic law be invoked over Treaty ,taking recourse to section 90(2) of the Act?

- Article – 8 Dividend Transfers

  - ❖ Article 8 seeks to modify the provision of the Treaty to provide for minimum shareholding period for the beneficial owner to get reduced rate of tax withheld by the source country.

  - ❖ India has made a reservation against this Article since India levies a dividend distribution tax on the distributing company. This will have an impact on the Treaty partners

Multi Lateral Instruments – India's Take

- Article 9 – Capital gains on alienation of shares or interest in entities deriving value principally from Immovable property
  - ❖ This Article now provides for a source country to tax the gains in two parts;
  - ❖ Part A – where the existing Treaty provides a right to tax such gains if the value threshold is met anytime during the year preceding the alienation and the alienation interest are that of interest in unincorporated entities such as partnerships or trusts.
  - ❖ Part B – In a situation where the Treaty does not provide to a provision to apply to such a right to tax gains derived from alienation of shares in entities deriving value principally from immovable property then the Contracting State shall notify, termed as Choice Notification.
  - ❖ India has chosen both Parts, however the other Treaty partner also needs to adopt similar position, for this to apply.

- Article – 10 Anti-abuse rule for PE's in third jurisdictions
  - ❖ The MLI provides in Article 10 to avoid such misuse through Triangular cases, by providing that if the tax payable on the attributable income in the third State is less than 60% of the tax that would have been payable in the Country of Residence of the PE, then the Treaty relief would not apply, termed as the 60% test.
  - ❖ India has made no reservation to this Article. However if the other Treaty partner were to notify this position then same shall be applied by India.

Multi Lateral Instruments – India's Take

- <u>Article – 11 Tax Agreements to restrict a party 's right to tax its own Residents</u>
  - ❖ The MLI under this Article provides that CTA shall not affect the taxation of a Contracting State of its residents. This is intended to address the concern that the provisions in a CTA that are to tax non – residents, should not be a limiting factor to tax its residents.
  - ❖ India has made no reservations to this Article.

- <u>Article – 12 Artificial Avoidance of PE</u>
  - ❖ This is based on the BEPS report dealing with artificial avoidance of PE's through commissionaire arrangements.
  - ❖ The Article provides that similar arrangements shall be deemed to be a PE.
  - ❖ Also it clarifies that if a person acting a behalf does in the ordinary course of business in an independent capacity, then he shall be considered as independent, unless he acts exclusively, or almost exclusively on behalf of the other enterprise, then he would constitute a PE.
  - ❖ This is not a minimum standard and India has reserved its right for this reservation
  - ❖ However India's most Treaty partners have not notified this and hence applicability of this is questionable as both parties need to notify.

Multi Lateral Instruments – India's Take

- Article – 13 Artificial Avoidance of PE Status through activity exemptions
  - ❖ Provides for curbing specific activity based exemptions to avoid PE in the source country by curbing activities which were hitherto considered as preparatory and auxiliary in nature. Parties may have two options;
    - Option A – Replaces existing Treaty provisions so as not to change the negotiated list of activities but consider within this list/activities that is done from the fixed place of business which shall fall within its ambit as preparatory or auxiliary in nature.
    - Option B – Does not relate to activities from the fixed place of business but provides a carve out. In that sense option B gives more flexibility to Treaty partners.
  - ❖ India has chosen option A. This can have a conflicting effect from other Treaty partners if they choose for reservation under Option B.
- Article – 14 Splitting up of contracts.
  - ❖ Provides a mechanism in cases to avoid a PE in construction or installation projects through splitting up of contracts and are well within the threshold period of 6 months or 9 months depending on the respective bi- lateral Treaty.
  - ❖ This Article provides that in related enterprises, the activities connected with construction / installation shall be considered based on functions and aggregated to determine the threshold for the existence of a PE.

Multi Lateral Instruments – India's Take

- ❖ However this is not a minimum standard and parties can reserve their right to adopt it or not
- ❖ India in this situation has remained silent; However if the other party has accepted this Article then India would be compelled to adopt this in its Treaties.

- <u>Article 15- Definition of Closely related persons.</u>
  - ❖ For the purpose of Article 12,13, and 14 of the MLI, closely related persons shall be one if they directly or indirectly control more than 50% of the aggregate notify power or value of the company's share.
  - ❖ India has expressed no reservation in respect of this Article.

- <u>Article 16 – Mutual Agreement Procedure</u>
  - ❖ Provides for MAP as a minimum standard to be adopted by the parties.
  - ❖ Parties can express reservation if their existing Treaties have a MAP procedure and same has been notified in the CTA.
  - ❖ India has made a reservation against Article 16(1) on the basis that its present Tax treaties meet the minimum standard as required under the BEPS dispute resolution partners.
  - ❖ However India has not made any additional reservations.

Multi Lateral Instruments – India's Take

- Article 17 – Corresponding Adjustments

  - ❖ Provides for making corresponding adjustment in respect of transfer pricing disputes to relieve double taxation.
  - ❖ This is not a minimum standard and parties have the flexibility to adopt this or not.
  - ❖ India in some of its treaties have this provision of correlative adjustment and has notified the same.
  - ❖ India had taken a position that in the absence of correlative adjustment in Article 9(2) in the Treaty, it cannot enter into bi-lateral APA's in respect of Transfer pricing disputes.
  - ❖ However very recently the CBDT had changed its position and had held that its is open to correlative adjustment in a APA if the other Treaty partner is accepting such a position.

- Article – 18 to 26 Arbitration

  - ❖ Provides for best practices for dispute resolution and for a detailed mandatory binding arbitration in respect of disputes where the Competent Authorities are unable to reach an agreement. It is an optional Article.
  - ❖ India has out on basis that it could dilute its sovereign powers, being to levy and collect of tax
  - ❖ However this position seem to be misplaced as constitutional experts opine that as soon as we agree to enter into a Tax Convention as per delegated powers under section 90 of the Act, the sovereign powers to that extent has been diluted for larger economic good.

From the BEPS Package

Country by Country Reporting

Equalisation Levy

CBCR

- CbCR is a proposed annual reporting framework for multinational enterprise ('MNE') groups stipulating provision of financial data by country and by entity.

- CbCR, as proposed in the Union Budget 2016 is broadly in line with OECD BEPS Action Plan 13 report ('the BEPS report').

- The report has recommended a three-tier standardised approach i.e. preparation and maintenance of Master file; Local file and CbCR.

- Objective is to 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.

- CbCR in India should include - information in respect of the amount of revenue, profit or loss before income-tax, amount of income-tax paid, stated capital, accumulated earnings, number of employees and tangible assets with regard to each country or territory in which the group operates.

- The report should also incude details of each constituent entity of the group along with the nature and details of the main business activity or activities of each constituent entity

- CbCR is required to be filed by:
  - The parent entity, resident in India; or
  - The Indian constituent entity in India if the parent entity is a resident of:
    - a country with which there is no agreement for exchange of information; or
    - a country which is not exchanging information despite an agreement; and
  - If there are more than one constituent entities in India, the group may nominate one entity as the designated entity to furnish the CbCR in India.
  - If an international group, having parent entity which is not resident in India, had designated an alternate entity for filing its report with the tax jurisdiction in which the alternate entity is resident, then the entities of such operating group in India would not be obliged to furnish CbCR, if the CbCR can be obtained under the information exchange agreement between such jurisdictions
- Applicability - threshold limit - turnover of Euro 750 million. CbCR must be furnished annually on or before the due date of furnishing the Return of Income for the relevant year. Accordingly, the first set of CbCRs is expected to be filed by November 2017.
- For non-compliance with CbCR provisions penalty is prescribed at Rs 5,00,000 each.
- The MNEs will have to undertake risk assessment, evaluate preparedness from a reporting perspective and tie up loose ends at the earliest.

Equalisation Levy

- OECD BEPS Action Plan 1 dealt with the subject of ‘Digital Economy’. The said Action Plan 1 highlighted various challenges on taxation of the transactions carried in digital economy and suggested alternative approaches for taxing such transactions.

- Finance Act 2016, taking cue from the BEPS Action Plan 1, inserted a separate Chapter VIII titled “Equalisation Levy”. The said levy came into effect from 1st June 2016.

- The applicability & scope of Chapter VIII has been briefly tabulated below:

Sl No	Payer	Recipient	EQL Not applicable	EQL applicable
1	Resident	Resident	✓	
2	Non-Resident	Non-Resident	✓	
3	Non-Resident	Resident	✓	
4	Resident	Non-Resident (having PE with the specified service effectively connected to PE)	✓	
5	Resident (carrying on B&P)	Non-Resident (other than at Sr. No. 4 above)		✓

Few of the issues which were debated by the stakeholders are summarised below:

- *Is imposition of EQL constitutional?*

  Article 248 of the Constitution of India grants power to Parliament to make laws in respect of matters not enumerated in Concurrent & State list. Having regard to the same, question on constitutionality of EQL was raised.

- *Is EQL in the nature of income tax or indirect tax?*

  As the Equalization Levy is not imposed on income, it does not fall within the scope of "income-tax" or "tax on income" or "any identical or substantially similar taxes", which typically define the scope of taxes covered within the tax treaties.

  Therefore it is kept outside the purview of the limitations imposed by tax treaties, a feature, which makes it the only option that can be adopted without violating or in any other way affecting the treaty obligations of the Contracting States in a tax treaty.

- *Will imposing EQL be a breach of India's treaty obligations?*

  The BEPS Report on Action 1 recognizes that imposition of equalisation levy may not be compatible with the Source State's obligations under existing bilateral tax treaties. Accordingly, the Report points out that countries may introduce it in their domestic laws

  Thus as acknowledged in the BEPS Report on Action 1, imposition of equalisation levy as unilateral measure under the Source State's tax law may lead to protracted litigation in tax treaty situations.

Indirect Transfer Provisions

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- **'Indirect Transfer' of Assets -** The debate surrounds taxability of an offshore transaction (of a resident state), which has underlying assets in a foreign jurisdiction, and if that jurisdiction in its capacity as a source country, has the right to tax such transactions?

- In India, the subject has been debated post-apex court verdict in Vodafone which has led law makers to resort to retrospective law to overrule the judiciary's verdict..

- In the Vodafone case, a tax demand of Rs 11,200 crore (along with interest) on its 2007 acquisition of Honk Kong-based Hutchison Whampoas stake in Hutchison Essar, yet to be resolved revolves around indirect transfer provision.

- Recently the Income Tax Appellate Tribunal has ordered UK's Cairn Energy Plc to pay Rs 10,000 crore capital gains tax on transfer of ownership from Cairn UK Holdings to Cairn India

- The Union Budget 2017 provided relief to Category I and II FPIs will an exemption from offshore asset sales whose underlying securities are in India.

- The Indian tax scenario is aggressive as these retrospective amendments are leading to tax demands which is multifold times the original tax bill.

Indirect Transfer Provisions

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- China introduced a legislation to tax indirect transfer of a capital asset situated in China.

- It is believed the Chinese authorities borrowed a leaf from the Indian tax authorities' action in Vodafone's case.

- Circular no. 698 required non-resident transferors to report their share transfer transactions, together with the relevant supporting documentation, including share transfer agreements, after they indirectly transfer their equity interests in Chinese resident companies, via disposal of intermediate holding company.

- Though Indian tax law did not have a GAAR section, the Supreme Court agreed that the government could invoke a judicial GAAR principle to pierce the corporate veil and look through the intermediate holding companies when a business purpose is lacking on considering various factors.

- The Chinese legal and regulatory framework on the taxation of indirect transfers is more explicit.

- A holding company without personnel and operating assets would probably be disregarded in an indirect transfer, though the holding company was interposed with various legal and business considerations.

- In contrast, the Indian Supreme Court recognises that investing in the host country through an intermediate holding structure is a common international practice and usually serves legitimate commercial purposes such as the facilitation of a future exit or the limitation of legal liability.

Indirect Transfer Provisions

- To apply look-through treatment, the onus is on Indian tax authorities to prove that the holding structure is an artificial device for tax evasion.

- Apparently, the interpretation of business purpose by the Indian Supreme Court is more lenient than Chinese tax authorities as the business purpose of the holding structure does not equate to a physical substance in the intermediate holding company.

GAAR

- General Anti-Avoidance Rule (GAAR) is an anti-tax avoidance regulation . GAAR, which was originally to be implemented from April 1, 2014, will now come into effect from April 1, 2017 (Assessment Year 2018-19). It was first introduced by then Finance Minister, Pranab Mukherjee, on 16 March 2012 during the Budget session.

- The introduction of GAAR in India impacts decades of jurisprudence and could also impact existing investment and operating structures.

- The extant GAAR provisions have the impact of regarding 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 —
  - 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 domestic tax law expressly provides that GAAR provisions would override all Tax treaties.

- The GAAR provisions vest Tax authorities with wide powers to, inter-alia, disregard, look through or re-characterise arrangements, ignore arrangements, etc.

- What is further concerning is the apparently open-ended residual power in the statute, that the tax consequences will be determined in a manner, which is deemed appropriate. Therefore, invocation of GAAR could have very wide and far reaching ramifications.

- Where GAAR is applied in the case of a taxpayer, there is no corresponding or consequential relief available to the counter party irrespective of whether or not such a counterparty is a related party or part of the same group as the taxpayer. In fact there is no provision for grant of corresponding relief even to the taxpayer for say a different year.

- A significant shift in the approach to tax planning in various cross border transactions will be imperative once the GAAR provisions become effective.

- Through the use of GAAR, government may try to tax Participatory Notes as indirect investments.

- There is a paradigm shift about what would now be acceptable as tax planning and given the environment it seems clear that we are moving slowly but surely towards more ***substance-based legitimate tax planning.***

<u>GAAR v PPT</u>

- Action Plan 6 (Prevent Treaty Abuse) report includes a minimum standard on preventing abuse and countries need to implement at least any one of the anti-abuse measures specified.
- India has opted for the Principal Purpose Test (“PPT”) with a simplified LOB
- The scope of domestic GAAR is more restrictive in comparison to PPT.
- Issue arises whether principle of choice is available for Taxpayer to opt to be governed by GAAR visa-a-vis PPT to determine tax avoidance motive under section 90(2) of the IT Act.
- Question arises where taxpayer is able to establish that GAAR provisions are satisfied or it is covered by exclusions even though PPT test under treaty is not satisfied, can taxpayer avail treaty benefit.
- Even though this appears attractive, issue requires detailed deliberation and clarity to avoid uncertainty and protracted litigation.

MIND THE GAAR

GAAR v PPT

- With GAAR in place, Indian businesses need to have a re-look at all their business arrangements, not merely the ones made for tax avoidance.
- GAAR is being implemented in a period where MNE’s have serious concerns on protracted litigation on tax issues.
- Every arrangement, either with a related party or an unrelated party, if resulting in a tax benefit, whether intentionally or un-intentionally, has to be relooked into.
- The onus would lie on the taxpayer to establish that a transaction is not undertaken with the objective of tax avoidance and would be required to maintain documentation to prove the business purpose of a transaction or arrangement
- The co-existence of GAAR and SAAR, as well as GAAR overriding the Treaty will certainly lead to complexities in implementation and does not leave much option for tax planning.
- The powers provided to tax authorities are open ended and will potentially lead to significant uncertainty and litigation therefore, the taxpayer would have to be proactive and preemptively identify explanations for each and every business transaction.

POEM

- The guidelines are primarily designed to impact Indian companies that have created foreign company structures to shelter profits in overseas jurisdictions, while their control and management may still be in India.
- The Finance Act, 2015 has sought to amend the definition by regarding a company incorporated outside India as resident in India, if the territorial nexus of that company with India is established by virtue of its place of effective management (POEM) being in India.
- Prior to the amendment by the Finance Act, 2015, the Indian tax law defined a resident company as a company incorporated in India, or a company whose control and management is situated wholly in India.
- "Place of effective management means 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,
- One of the main consequences of creating tax residency in India is that the company will be taxed on worldwide income.
- As such a company with POEM in India will still qualify as a “foreign company,” and will be taxed at the rate of 40%.
- Furthermore, risk of double taxation on account of “residence-residence” conflict as well as on account of “residence-source” conflicts may be exacerbated

POEM

- The parties most impacted by the amended PoEM rule shall be Indian individuals and companies which have set up foreign JV's and or WOS and routinely take decisions for such entities from India, also affected will be groups where the executives of the Indian entity are also on the board of the foreign subsidiary.

- These companies shall soon see that their legitimate foreign companies are now deemed to be Indian residents and are subject to taxation in India, this imposes a huge cost in the form of taxes (incomes of foreign companies are taxable at 40% in India) on such companies and the group as a whole.

- The consequence of this provision, unless amended or clarified, is going to be a large uptick in tax disputes, where the department will invariably look at a foreign entity owned by Indians and tax it at the maximum marginal rates. That there is no established jurisprudence on this matter in India also means that litigation on this matter will only increase.

- Start-ups and established Indian players have few options by way of recourse, one option would be to decouple ownership and management/Control and ensure that such management is situated only outside of India and no overlaps exist. This is easier said than done and will certainly be a challenge for all businesses looking to go global.

POEM

- Understanding the concept of place of effective management - International perspective

Income Tax Act, 1961	OECD Commentary	UN Commentary
• 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 • Set of guiding principles for determination of PoEM have been issued for the benefit of the taxpayers as well as for tax administration	• 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 • 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	• Place where the company is actually managed and controlled • where the decision-making at the highest level on the important policies essential for the management of the company takes place • that plays a leading part in the management of a company from an economic and functional point of view • where the most important accounting books are kept

- Determination of POEM in India based on whether or not the company is engaged in active business outside India whereas OECD provides for including factors such as: where the person's headquarters is located; what country's law governs the legal status of the person; where its accounting records are kept.

POEM

- The definition used to establish POEM in India is not as specific or rational as the definition used by OCED.
- This has created uncertainty for foreign firms, as they could be taxed up to 40, in addition to 30 percent tax on income distributed to Indian shareholders.
- Thus focus of OECD Commentary is on –
  - Effective management and not simply management
  - Key management and commercial decisions in substance made/taken in a country
  - Ordinarily be a place where most senior person or group of persons make decisions
  - Actions to be taken as whole are determined.

  Thus OECD takes holistic approach and a stray decision or a board meeting may not determine POEM.

  Management and commercial decisions are the key determining factors and thus making simple operating decisions may not be that relevant/important
- Concern regarding the use of digital and conferencing services by top management, which would complicate the traditional application of POEM norms and expose liability to treaty contravention and double taxation.

POEM - MLI

- Article 4 of the MLI has been adopted which requires Contracting States to resolve dual-residence conflicts through mutual agreement procedure (MAP).

- Likely to have an adverse impact on Indian multinationals with global operations.

- Article 4(1) of the MLI seeks to replace the POEM test to resolve dual-residence conflicts with a more subjective mechanism that allows for a case-by-case solution of such cases.

- The reliance on MAP to settle dual-residence conflicts is problematic,

  - first, because of the ineffectiveness of MAP itself, and
  - secondly, because of India’s odd understanding of the nature and application of the POEM test.

- The CBDT issued, in December 2016, guidance on POEM in which it noted that “the process of determination of POEM would be primarily based on the fact as to whether or not a company is engaged in active business outside India.”

- Internationally, however, the concept of POEM does not rest on the place where a company actively carries on business activities, but on the place where the shots are called.

- There is no hierarchy between the different tests of corporate residence and it will be very difficult for the Indian tax authority to come to an agreement with its foreign counterpart on whether the POEM or the incorporation test is the most appropriate test to determine residence.

- The US-New Zealand tax treaty is a classic example: the two countries have almost never been able to mutually settle dual-residence conflicts through MAP.

- The underlying view today is that it takes Contracting States years of negotiations to resolve MAP disputes given that tax treaties only require them to “endeavor” and not in fact commit to resolve cases in a time-bound manner.

- An ineffective MAP leaves ample room for arbitrariness and companies do not have any other option but to wait and see what position, if at all, is eventually taken by the Contracting States on their residence status.

- The use of MAP to settle dual-residence conflicts will almost always be detrimental to the interests of companies.

- Importantly, Article 4(1) of the MLI provides that in the absence of a mutual agreement, a dual-resident company shall not be entitled to any relief or exemption from tax provided under the treaty except to the extent and manner as agreed by the contracting states.

- It is therefore important that Indian multinational corporations structure their business operations after careful planning to prevent such conflicts from taking place in the first place.

Credit for Foreign Tax

- From taxation point of view, direct investment from India completely distorts the dividend repatriation back into India. In many cases, only 40 to 45 percent of the earnings of the foreign company are available to the Indian parent.
- There is double taxation of the same income: once in the hands of the foreign company and then in the hands of Indian company.
- In order to address such situation, many countries and tax treaties allow tax credit for the corporate taxes paid on profits in the country of source against taxes payable on dividends in the country of residence of the recipient company.
- Under these provisions, the recipient of dividend could claim tax credit, for taxes paid in the other countries by the subsidiary companies on profits from which such dividends are distributed. Such tax credit is known as "underlying tax credit".
- Underlying tax credit is over and above tax credit for taxes withheld on dividend distributed by the subsidiary companies. Since underlying tax credit is not available in India, except under some tax treaties like India - Mauritius, the net result is higher incidence of tax.
- As per existing provisions of the ITA, income of an Indian company is subject to tax at the rate of 30% in addition to 3% cess, subject to 12% surcharge if income exceed 1 crore.
- Therefore dividends received by an Indian company from an overseas company will be subject to tax in India at the rate of 30% in addition to 3% cess, subject to 12% surcharge if income exceed 1 crore.

Credit for Foreign Tax

- An Indian company could claim such underlying tax credit if the double taxation avoidance agreement ("DTAA") that India has entered into with the country of residence of the company paying such dividends provides for the same.

- Indian company can claim tax credit in India for the taxes that have been withheld by the foreign company on such distribution.

- As such, there is no golden rule for a preferred structure for outbound investments as it depends on the country in which the investment is sought. However, countries like Mauritius, U.K., and Netherlands etc. are close contenders for location of Offshore Holding Company out of India for holding investments worldwide

MLI Position

- Article 5 – Methods for elimination of double taxation, contains provisions that provide three options, one of which countries may choose to address cases of double non-taxation that may where countries use the exemption method to prevent double taxation of income that is not taxed in the state of source.

- India has reserved its right not to go with Article 5 as India in general has adapted credit methods as per Article 23B of the OECD Convention.

- This being not a mandating minimum standard does not affect India's bi – lateral tax treaties

- Indian-resident taxpayers pay taxes on their global income in India, including on foreign source income which has already been subject to tax overseas. FTC eliminates double taxation on the same income
- DTAAs usually provide the mechanism to mitigate the impact of juridical double taxation, generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods
- To address this concern, many countries have provided a relief under their domestic tax laws through Foreign Tax Credit (FTC) rules, in addition to the relief under the DTAAs.
- The FTC mechanism in India is at present governed by sections 90, 90A and Sec 91 of the Act.Sec 90 provides relief from double taxation of income in India through a DTAA concluded between the Government of India and the Government of another country.
- The Central Board of Direct Taxes (CBDT) recently notified Foreign Tax Credit Rules (notified FTC rules) in India which will be applicable from 01 April 2017.

Recently Ammended Treaties to curb Round Tripping

India Mauritius DTAA

- Capital gains taxable in India prospectively.
- The revised treaty to take effect from 1st April 2017.
- LOB clause included to ensure substance.

India Cyprus DTAA

- Cyprus was earlier a NJA for not sharing tax information.
- Capital gains taxable in India prospectively.
- Provides for assistance in collection of taxes and provides for effective exchange of information on tax matters including bank information

India-Singapore DTAA

- Capital gains taxable in India prospectively.
- The revised treaty to take effect from 1st April 2017.
- The said treaty had a provision that any changes in the Mauritius treaty would automatically apply. Thus now in line with India-Mauritius Treaty.

PAN requirements for Non-residents

- The earlier provisions of section 206AA of the Act, inter alia, provide that any person who is entitled to receive any amount on which tax is deductible at source, shall furnish his PAN to the deductor, failing which a higher withholding tax rate will be applicable.

- In order to reduce compliance burden, the Finance Act, 2016 amended the provisions of section 206AA of the Act (w.e.f. June 1, 2016) to provide relaxation from higher withholding tax rate while making payment to non-residents in the absence of PAN.

- Rule 37BC of the Rules provides that the provisions of section 206AA of the Act shall not apply on following payments made to non-residents who do not have PAN in India:
  a. Interest;
  b. Royalty;
  c. Fee for Technical Services; and
  d. Payments on transfer of any capital asset

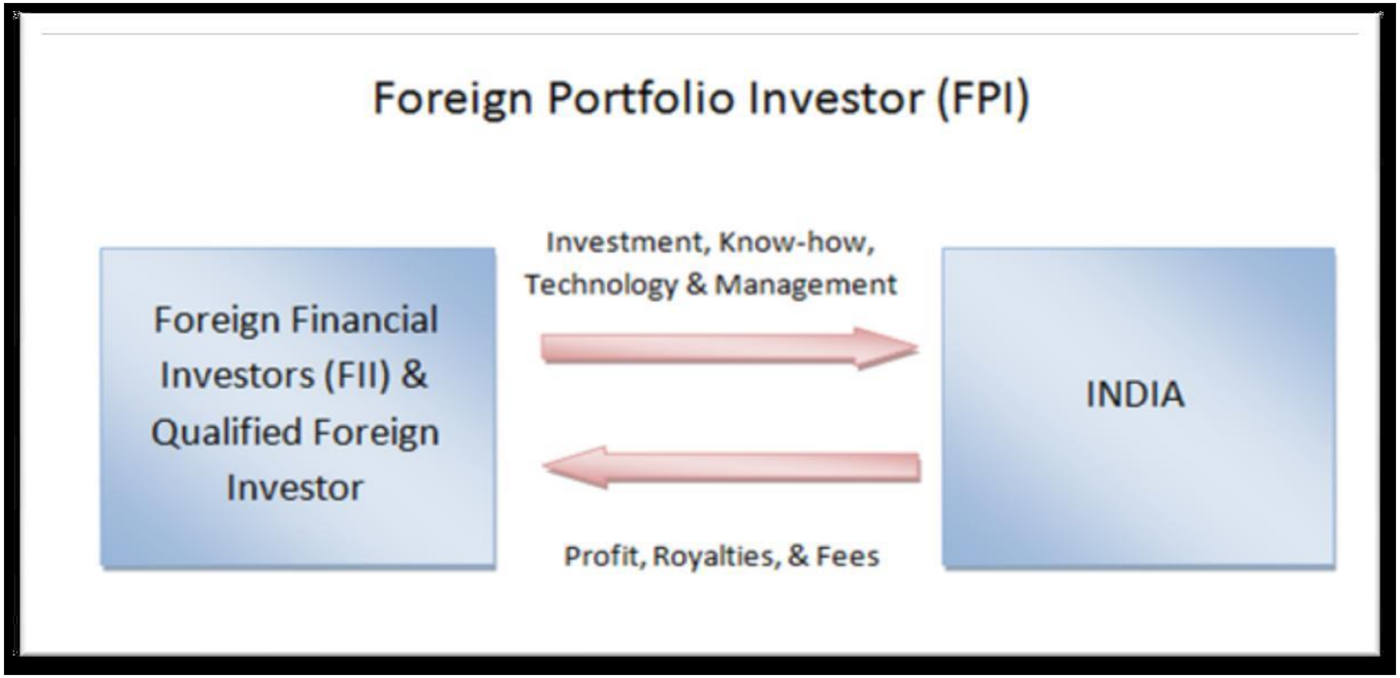
- In respect of the above specified payments, the non-residents shall be, however required to furnish following details and documents:
  a. Name, e-mail id, contact number;
  b. Address in the country of residence;
  c. Tax Residency Certificate (TRC), if the law of country of residence provides for such certificate; and
  d. Tax Identification Number (TIN) in the country of residence. Where TIN is not available, a unique identification number is required to be furnished through which the deductee is identified in the country of residence

Foreign Portfolio Investor

- In the year 2016, considerable developments have taken place on the Foreign Portfolio Investors ("FPI") front. There have been changes to the norms governing FPIs that have impacted the permitted investments by them in India.

- The changes/amendments made in DTAAs & Indirect Transfer rules, the Foreign Portfolio Investors are expected to face challenges, whereby making them liable to pay higher tax.

- Foreign Portfolio Investors (FPI) makes investments in India by acquiring shares/assets of the Indian company, Know-how, Technology & Management etc and earns by the way of Profit, Royalty & Fees.



Current/Likely Tax Issues

- **Clarification on Indirect Transfer of Shares:**

  A High Level Committee to be constituted which would be chaired by Revenue Secretary and will consist of CBDT chairman and an expert from outside to oversee fresh cases where assessing officer applies retrospective amendment in relation to indirect transfer of shares.

  However, the CBDT constituted a working group on 15 June 2016, after it received queries about indirect transfer provisions raised by offshore funds registered as FPIs. After considering the comments of the working group, CBDT issued clarification through a set of 19 questions and answers depicting various scenarios under which offshore funds may have invested in companies in India.

  For example, in case a fund is set up in an offshore jurisdiction pools money from retail/institutional investors and invests in shares of Indian listed companies, if the fund on request of its unit holders/shareholders, redeems their units/shares, then CBDT clarified that it will be liable to pay taxes in India.

Current/Likely Tax Issues

- **Treaty Amendments:**

  Recently India has also amended the DTAA with Mauritius and Singapore. While this allows India to tax capital gains on investments in the nature of shares, made by an FPI, this will not impact investments made by them in debentures & derivatives in India.

  Further rationalization can be done by the government with respect to the taxation of derivatives; FPIs should be given the option of categorizing their income from derivative transactions as business income. The short-term capital gain tax on derivatives should be made on a par with that on equities.

  Under the Indian income tax law, shares of listed Indian companies held by FPIs are deemed to be capital assets irrespective of the holding period. As such, income from sale of shares results in capital gains and at present, FPIs enjoy the benefits of capital gains provisions under the Singapore Treaty. Investments until March 31, 2017 have been exempted from capital gains tax and will impact prospective investments with effect from April 1, 2017.

  The amended India – Mauritius treaty, FPIs (including P-note holders) who invest in securities listed on the Indian stock exchange but exit before 12 months from the date of purchase will be impacted as they are to pay short term capital gains tax @ 15%. During the transition period (i.e. during 01.04.2017 to 31.03.2019), and subject to the satisfaction of the LOB clause, this rate may be reduced to 7.5%. However, gains accruing to the investors who invest in listed securities for more than 12 months will continue to remain exempt.

Conclusion

<u>The evolving International Tax framework is being framed to achieve :</u>

- Substance - to realign taxation with economic substance and value creation
- Ensure international tax transparency and information exchange
- Restore public confidence in the corporate taxation system
- Ensure a level playing field in the global economy i.e. reducing the gaps in the allocation rights between the source and residence country in tax teaties.
- Ring fencing source taxation rights
- Prevent Treaty Abuse
- Aiming at better accountability from MNE's
- A efficient tax system and rules embracing new technological advancements.
- Improving dispute resolution

Thank You

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