After studying this chapter, you would be able to -

- appreciate the concept of controlled foreign corporations (CFCs), the need for, and the components of, CFC regulations

- appreciate the concept of Base Erosion and Profit Shifting (BEPS), significance of the various Action Plans of BEPS and the provisions incorporated in Indian tax laws in line with the different Action Plans of BEPS

- identify and examine the various anti-avoidance measures incorporated in the Income-tax Act, 1961 and rules thereunder to prevent tax avoidance in respect of international transactions

- appreciate the concept of GAAR and examine the GAAR provisions incorporated in the Income-tax Act, 1961 and rules thereunder

- integrate, analyse and apply the above concepts, principles, measures and provisions in making computations and addressing relevant issues.
8.1 CONTROLLED FOREIGN CORPORATIONS

(1) INTRODUCTION

CFC Regulations: A significant anti-avoidance measure

Tax avoidance has been accepted as an area of concern in international tax arena, which is the reason why several countries have been legislating anti-avoidance measures in their domestic tax code. Controlled Foreign Company (CFC) Regulations are one such set of anti-avoidance measures. Taxation of foreign passive income is at the heart of CFC Regulations.

Income from a foreign source is usually taxed after it is accrued or received as income in the country of residence of the recipient. Therefore, it is possible to defer or avoid the tax on foreign dividend income until it is repatriated. Many residence states regard this tax deferral as unjustifiable loss of tax revenue. Moreover, it gives the residents who invest overseas a tax advantage over those who invest at home.

Controlled Foreign Corporations: Meaning

Controlled Foreign Corporations (CFCs) are corporate entities incorporated in an overseas low tax jurisdiction and controlled directly or indirectly by residents of a higher tax jurisdiction (Parent State). Since each corporate entity is treated as a separate legal entity, the profits earned by such CFCs are not taxed at the owner level until they are distributed. CFCs tend to earn passive income; such income is not distributed, thereby resulting in tax deferral in the Parent State. It is to curb such tax avoidance that CFC Regulations are legislated by various countries.

CFC Legislation: Protecting domestic tax base from erosion

In order to protect the domestic tax base from erosion through certain tax structuring in CFCs and at the same time not denying the foreign subsidiaries income from their genuine business in the same foreign country, many countries have introduced targeted CFC legislation.

The International Bureau of Fiscal Documentation has explained CFC legislations as under:

"The term is generally used in the context of tax avoidance rules designed to combat the diversion by resident taxpayers of income to companies they control and which are typically resident in countries imposing low-or-no taxation. Under these rules income of the controlled company is typically either deemed to be realized directly by the shareholders or deemed to be distributed to them by way of dividend. Often only part of the controlled company’s income is dealt with in this way, typically passive income such as dividends, interest and royalties (tainted income). Many but not all controlled foreign company regimes apply only to corporate shareholders."

CFC legislations target the income earned and accumulated in non-resident entities that are under the influence or control of its own tax residents, who are subject to worldwide taxation. It is generally presumed that, in such situations, they can influence the profit distribution or repatriation policies as shareholders. Different countries, depending upon their fiscal need and tax environment, develop
different types of rules and regulations to tax profit earned by their CFCs. The basic mechanism and
details may, therefore, vary among jurisdictions. Countries with CFC rules include, but are not limited
to, the United States, the United Kingdom, Germany, and Japan.

(2) NEED FOR CFC LEGISLATION

As explained above, under the tax laws of several countries, a shareholder of a corporation is
generally not taxed on the corporation's income until the income is distributed as a dividend.
Therefore, it was common for publicly traded companies to form foreign subsidiaries in low-tax
jurisdictions or tax havens and shift "portable" income to those subsidiaries. Generally, income
shifted were mainly investment income (interest and dividends) and passive income (rents and
royalties), as well as sales and services income involving related parties. Tax in parent country on
this income was avoided until the tax haven country paid a dividend to the shareholding company.
In some countries, this dividend could be avoided indefinitely by loaning the earnings to the
shareholder without actually declaring a dividend.

Many developed countries (where global multi-nationals are generally based) have high tax rates as
compared to developing countries, which used their low tax rates as a means of attracting inward
investment. As a result, when dividends were repatriated from these lower tax countries, the
recipient generally suffered additional tax on those profits. Therefore, many companies have a
tendency to leave the profits from these low-taxed subsidiaries offshore, with the objective of
deferring home country taxation.

In the USA, the volume of profits held offshore was so large that a special ‘amnesty’ was introduced
in 2004, whereby companies could repatriate dividends for a one year period, and pay tax on these
dividends at an effective rate of 5.25% as against the normal 35% tax rate then prevailing. This is
an indicator that ‘deferral trap’ is a major issue for companies around the globe.

In order to address this issue, governments in various countries have introduced legislation aimed
at eliminating the benefits of deferral, by currently taxing income in the parent country even when
the income has not been repatriated or remitted to that country. These laws are generally referred
to as Controlled Foreign Corporation (CFC) laws.

(3) OVERVIEW OF CFC REGIMES

The CFC legislation sets out rules for determining the type of entity which will be viewed as
‘controlled’ for the purposes of its CFC regime, with the starting point generally being the entities
which are not tax resident in the parent jurisdiction. One important point here is that, while we refer
to the rules as ‘controlled foreign corporation’ rules, they are not necessarily limited to dealing with
entities viewed as corporate entities.

Ownership/Control Test

The rules generally have an ownership/control test, so that an entity will be treated as a CFC, only
if a certain percentage of ownership/control is in the hands of residents of the parent country. CFC
rules may have a threshold for domestic ownership, below which a foreign entity is not considered a CFC. Alternatively, or in addition, domestic members of a foreign entity owning less than a certain portion or class of shares may be excluded from the deemed income regime.

Most CFC rules only apply to those CFCs (entity) over which the domestic shareholder or a number of domestic shareholders have a certain degree of control. Control may be defined as the voting power to influence the business of a CFC, and/or simply having a significant stake in the CFC’s assets, profits or liquidation proceeds (i.e., controlling ownership). Under most CFC regimes, control of more than 50% of resident shareholders is required. If there is more than one shareholder who is treated as an unrelated shareholder, a minimum stake of these unrelated shareholders may or may not be required. CFC rules apply to both direct and indirect subsidiaries of resident shareholder, so that taxpayers do not resort to creating multiple layers of holding companies.

**Consequence of being deemed as a CFC: Passive income subject to tax in the hands of the resident parent entity**

Once the CFC has been identified, the rules then set out the consequences of being treated as a CFC. The significant consequence is to tax certain income of the CFC ‘currently’ in the hands of the parent, as if it had been remitted to the parent or was the income of the parent, even though there is no actual remittance and the income clearly remains in the legal ownership of the CFC itself.

The methods of taxing CFC income and the type of CFC income taxed will vary, but in general, CFC rules attempt to tax ‘passive’ type income (dividend, certain types of interest and royalties), income received by foreign entities taxed at a lower tax rate than applicable in the parent country or income from related parties. CFC regimes which target income taxed at a lower rate typically do so by either listing countries with low tax rates or by setting a minimum tax rate threshold, or by a combination of both.

The most complicated part of CFC rules are the rules of defining what kind of income is “low taxed”. What is “low” taxation is determined by comparing the taxes levied abroad on such income at the relevant rates, which would have been payable at home country and what has actually been paid abroad.

**Components of CFC’s income includible in the hands of the domestic person**

The rules vary between countries, and therefore, this paragraph does not specifically describe the tax system of any particular country. However, the features listed are prevalent in many CFC systems. A domestic person who is a member of a foreign corporation (a CFC) that is controlled by domestic members must include in its income, its share of the CFC’s subject income. The includible income (usually determined net of expenses) generally comprises of income received by the CFC from -

(1) investment or passive sources, including interest, unrelated party dividends, rents from unrelated parties, and royalties from unrelated parties;
(2) purchasing goods from related parties or selling goods to related parties where the goods are both produced and for use outside the CFC's country;

(3) performing services outside the CFC's country for related parties;

(4) non-operating, insubstantial, or passive businesses.

In addition, many CFC rules treat as a deemed dividend, earnings of the CFC loaned by the CFC to domestic related parties. Further, CFC rules also permit exclusion from taxable income of dividends paid by a CFC from earnings previously taxed to members under the CFC rules.

**Participation exemptions & Tax credits : Mechanisms to mitigate the effect of CFC Provisions**

Irrespective of how the income is technically attributed/distributed to the domestic shareholder, this nature of mechanism has the inherent danger of taxing the foreign income abroad and the same income under CFC rules at home and potentially again on distribution back home again. Most countries with CFC rules have in place mechanisms such as participation exemptions or underlying tax credits to mitigate the effect of the CFC provisions. A participation exemption may typically provide that certain types of dividends are not taxed in the hands of shareholders. In addition, some participation exemption regimes may provide that capital gains on shares would not be taxed as long as a specified proportion of the company's share capital is held for a specified period.

Thus, in order to avoid double taxation, a credit is given with respect to the CFC income in the home country as regards foreign taxes paid and on distribution, again, a tax credit is given of the (entire
CFC) income distributed from a CFC. Other jurisdictions exempt dividend from a CFC.

Components of a CFC Regulation: In a nutshell

<table>
<thead>
<tr>
<th>Defining the types of owners and entities affected</th>
<th>Specifying the types of incomes or investments includible as CFC income</th>
</tr>
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<tbody>
<tr>
<td>Specifying the means of preventing double inclusion of the same income</td>
<td>Specifying the exceptions to inclusion in the computation of CFC income</td>
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</table>

(4) APPROACHES IN TAXING CFC INCOME

(i) Categorization of countries based on their tax system, KYC norms and extent of co-operation accorded in sharing of information etc.

All countries have a right to tax their subjects according to their own wisdom and having regard to the economic situation of the country. Some countries, in spite of levying low tax or no tax at all may have sophisticated taxation system, sufficient KYC norms, and co-operative approach at the time of sharing of details of information of assets/investments made by residents/citizens of the country making the requisition. Such countries must be considered as
White listed category jurisdictions. However, there also exist such jurisdictions which must be black listed and CFC rules must be applied by using techniques such as substance over form, look through approach, business purpose rule, etc. Accordingly, it is important to classify countries into various categories. White-listed category jurisdictions which do not assist tax evasion / unacceptable tax avoidance must not be doubted subject to satisfying the substance over form principle, business purpose test and other Anti-Avoidance rules including Transfer pricing regulations.

(ii) Income specific CFC legislation

Under this approach, tax is levied on the specified income of a resident shareholder. The target is to tax certain passive income such as income from investment, income from properties owned by the foreign corporation of which the residents of a jurisdiction are shareholders. Here, on fulfilling certain conditions, CFC legislation presumes that shareholders are acting in a *malafide* manner by allocating profits to a low taxed jurisdiction and such income is deliberately intended to be parked outside the home country to avoid taxes thereon.

Certain active income may also be subject to taxation on satisfying certain conditions. For example, in some countries, residential status of a corporate entity is dependent upon the place of incorporation or its place of effective management (example – India). Therefore, if the place of effective management of a wholly owned subsidiary, say ABC Ltd. (incorporated in a low tax jurisdiction) of A Ltd (an Indian resident company) is found to be in India, the entire profits of ABC Ltd will be taxable in India. Further, being a resident, ABC Ltd. would be required to file its return of income, deduct tax at source on specified payments, furnish TDS statements, get its books of account audited from an accountant under section 44AB and further, also comply with Indian transfer pricing regulations.

(5) THE INDIAN SCENARIO

Indian resident companies are required to pay taxes on their global income including foreign source income. India is a developing country and it follows United Nations double taxation avoidance treaty model, and accordingly, taxes all the income earned from a foreign source and grants credit for the taxes paid abroad for avoidance of double taxation. A non-resident company is taxable in India in respect of income accruing or deeming to accrue or arise in India.

Accordingly, income derived by a foreign subsidiary (the holding company being an Indian company) is only taxed abroad, unless it gets distributed back to India. This non-taxation of foreign source income of an Indian company’s foreign subsidiary provides a number of tax planning opportunities to Indian corporate groups enabling them:

- to reduce foreign taxes by choosing a jurisdiction with low / zero tax rates or beneficial regimes for certain types of income; and
- to defer or mitigate taxation in India on these (low) taxed overseas profits until distributed to India.
These strategies seek income being earned in a low tax regime (e.g. tax havens) and not repatriated to India. Such an activity is possible as there are no compulsions on India's foreign subsidiary under exchange control regime to repatriate such profits into India. Such strategies include but are not limited to setting up either foreign holding company or companies holding global intellectual property (rights) or a global operating company.

In past, the Income-tax Act, 1961 had sections 104 to 109 to levy additional tax on undistributed profits including that of residents. The Finance Act 1987 withdrew these provisions. Circular 495 dated 22 September 1987 explained this withdrawal as follows:

“10.1 Sections 104 to 109 relate to levy of additional tax on certain closely-held companies (other than those in which the public are substantially interested) if they fail to distribute a specified percentage of their distributable profits as dividends. These provisions had lost much of their relevance with the reduction of the maximum marginal rate of personal tax to 50 per cent which is lower than the rate for corporation tax on closely-held companies. Sections 104 to 109 have, therefore, been omitted by the Finance Act, 1987.”

As a substitute, deemed dividend provisions in section 2(22)(e) of the Act were suitably amended to take care of the abuse. Circular 495 dated 22 September 1987 read as follows:

“10.2 With the deletion of sections 104 to 109 there was a likehood of closely-held companies not distributing their profits to shareholders by way of dividends but by way of loans or advances so that these are not taxed in the hands of the shareholders. To forestall this manipulation, sub-clause (e) of clause (22) of section 2 has been suitably amended.”

India is essentially a capital importing country. Hence, earlier, there was not much of outbound investment from India. However, in the last couple of decades, India has witnessed a sharp rise in outbound investments, thereby necessitating regulations around taxation of foreign passive income in its tax legislation.

Taking a leaf out from the Vijay Mathur Committee reforms, the then Union Minister Shri Pranab Mukherjee introduced CFC Regulations in the Revised Direct Taxes Code Bill, 2010 (‘DTC’) for public suggestions. Along with the multiple objectives of eliminating distortions in the tax structure, rationalization of tax levies, enhanced tax compliance and reduction in tax litigations, the Government had set its sights high on broadcasting the sources from which it could generate revenue. This was evident in the proposals to bring in the regime of CFC regulations in final draft of DTC. The CFC Rules introduced in DTC provided that profits earned by a CFC, located in territory with a lower rate of taxation, would be included in the taxable profits of parent company located in India. As per the Budget Speech 2015-16 of Shri Arun Jaitley, Finance Minister, since most of the provisions of the DTC had already been included in the Income-tax Act, 1961, and the remaining were being addressed in that budget; and also considering that the jurisprudence under the Income-tax Act has been well evolved, there was no great merit in going ahead with the DTC. Therefore, the Income-tax Act, 1961 would continue with amendments being made every year through the Annual Finance Act. Certain significant proposals in the DTC have been incorporated in the Income-tax Act, 1961 in line with the expressed intent, the most important being General Anti Avoidance Rules (GAAR) which became
effective from A.Y. 2018-19, which is discussed at length later in this chapter. Further, the concept of Place of Effective Management ("POEM") has also been introduced in the Indian taxation regime to determine the residential status of a company, other than an Indian company. Simultaneously, adequate safeguard by way of transition provisions have been put in place to take care of the concerns of those companies becoming resident in India for the first time on account of their place of effective management being in India during the relevant previous year. The provisions relating to POEM have been discussed at length in Chapter 2 – Non-resident Taxation, contained in Module 1 of the Study Material. Further, in order to encourage repatriation of profits, section 115BBD has been inserted in the Income-tax Act, 1961 which provides a concessional tax rate of 15% (gross basis) on dividends received from a specified foreign company i.e., a foreign company in which the Indian company holds 26% or more in the nominal value of the equity share capital of the company.

Strengthening CFC Rules is also a BEPS Action Plan (Action Plan 3) which has been detailed in the ensuing part of this chapter containing a discussion on Base Erosion and Profit Shifting.

8.2 BASE EROSION AND PROFIT SHIFTING

(1) BACKGROUND

Impact of Globalisation

Globalisation has benefited our domestic economies, boosted trade and increased foreign direct investments in many countries. The unrestricted movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers, technological and telecommunication developments, and the ever-increasing importance of managing risks and of developing, protecting and exploiting intellectual property, have had an important impact on the way cross-border activities take place. In this way, it accelerated growth, created jobs and fostered innovation. Globalisation is not new, but the pace of integration of national economies and markets has increased substantially in recent years. It has a significant impact on a country’s corporate income tax regimes.

Growth of E-Commerce and consequent aggressive tax planning

Way back in 1920s, the League of Nations recognised that the interaction of domestic tax systems can lead to double taxation with adverse effects on growth and global prosperity. Globally, countries concur on the need to eliminate double taxation and the need to achieve this on the basis of accepted international laws that are clear and predictable, giving certainty to both governments and businesses. International tax law is, therefore, a pillar in facilitating the development of the global economy. With the economy, the enterprises also became more globally integrated. Multi-national enterprises (MNE) now represent a significant proportion of global GDP. Further, intra-firm trade comprises of a growing proportion of overall trade. Also, the increasing significance of the service component of the economy, and of digital products which are deliverable over the Internet, has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers. These developments have been accompanied...
by the increasing sophistication of tax planners in identifying and exploiting the legal arbitrage opportunities and the boundaries of acceptable tax planning, thus, encouraging MNEs to minimise their tax burden by resorting to aggressive tax planning.

**Adverse Effects of 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. This has become a critical issue since governments have to cope with less revenue and a higher cost to ensure compliance. Moreover, BEPS undermines the integrity of the tax system, as reporting of low corporate taxes is considered to be unfair. In developing countries, the lack of tax revenue leads to significant under-funding of public investment that could help foster economic growth. Further, when tax laws permit businesses to reduce their tax burden by shifting their income away from jurisdictions where income producing activities are conducted, other taxpayers, especially individual taxpayers in that jurisdiction bear a greater share of the burden. This gives rise to tax fairness issues on account of individuals having to bear a higher tax burden. Also, enterprises that operate only in domestic markets, including family-owned businesses or new innovative businesses, may have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax. Fair competition is harmed by the distortions induced by BEPS.

**Need for international collaboration to protect tax sovereignty of its countries**

Taxation is at the core of countries’ sovereignty, but the interaction of domestic tax laws in certain cases leads to gaps and frictions. While developing their domestic tax laws, sovereign states may not adequately take into consideration the effect of other countries’ laws. The interaction of separate sets of laws enforced by sovereign countries causes frictions, including potential double taxation for corporations operating in many countries. It also causes gaps, in cases where corporate income is untaxed, both in the country of source and in the country of residence, or is taxed only at nominal rates. In the domestic context, coherence is generally achieved through a principle of matching – a payment that is deductible by the payer is usually taxable in the hands of the recipient, unless explicitly exempted. There is no similar principle of coherence at the international level, which leaves considerable scope for arbitrage by taxpayers, though sovereign states have united to ensure coherence in a narrow field, namely to prevent double taxation. BEPS relates primarily to instances where the interaction of different tax rules leads to double non-taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. International standards have tried to reduce these frictions in a manner that respects tax sovereignty; however, gaps still remain. Therefore, there is a need for countries to collaborate on tax matters so that they are able to get their due share of taxes.

**(2) OVERVIEW OF BEPS**

In the background of the above repercussions, in February 2013, the OECD published a report on “Addressing Base Erosion and Profit Shifting” iterating the need for analyzing the issue of tax base
erosion and profit shifting by global corporations. The OECD followed it up with publishing draft Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan) in July 2013 which came to final fruition in October 2015. The BEPS action plan identifies fifteen actions to address BEPS in a comprehensive manner and sets a deadline to implement those actions.

The Action Plans were structured around three fundamental pillars viz.:

(i) Reinforcing of ‘substance’ requirements in existing international standards;
(ii) Alignment of taxation with location of value creation and economic activity; and
(iii) Improving transparency and tax certainty.

A brief classification of the various action plans based on the fundamental pillars is as under:

<table>
<thead>
<tr>
<th>Coherence</th>
<th>Substance</th>
<th>Transparency</th>
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<tbody>
<tr>
<td>Action 2: Neutralize the effects of hybrid mismatch arrangements</td>
<td><strong>Action 6</strong>: Prevent tax treaty abuse</td>
<td><strong>Action 11</strong>: Establish methodologies to collect and analyze data on BEPS</td>
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<td>Action 3: Strengthen controlled foreign company rules</td>
<td><strong>Action 7</strong>: Prevent the artificial avoidance of permanent establishment status</td>
<td><strong>Action 12</strong>: Require taxpayers to disclose their aggressive tax planning arrangements</td>
</tr>
<tr>
<td>Action 4: Limit base erosion via interest deductions and other financial payments</td>
<td><strong>Action 8</strong>: Consider transfer pricing for intangibles</td>
<td><strong>Action 13</strong>: Re-examine transfer pricing documentation</td>
</tr>
<tr>
<td>Action 5: Counter harmful tax practices more effectively</td>
<td><strong>Action 9</strong>: Consider transfer pricing for risks and capital</td>
<td><strong>Action 14</strong>: Make dispute resolution mechanisms more effective</td>
</tr>
<tr>
<td>Action 15: Develop a multilateral instrument</td>
<td><strong>Action 10</strong>: Consider transfer pricing for other high-risk transactions</td>
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</table>
An unprecedented amount of interest and participation has been witnessed by OECD with more than sixty countries, both OECD members and G-20 countries, being directly involved as a part of technical groups in the development of congruent international tax standards.

The summary explanatory statement indicates the level of political commitment by OECD, G20 and other States involved in the 2015 work to the various reports. The OECD has iterated the following terms to indicate the commitment by various participant countries:

**New minimum standard** - New minimum standard implies application of a new rule to be implemented by all states, since non-implementation may result in negative spill overs (including adverse impact of competitiveness) on other countries. Each of the four BEPS minimum standards [namely, Actions 5, 6, 13 and 14] is subject to peer review in order to ensure timely and accurate implementation and thus safeguard the level playing field. All members of the Inclusive Framework
on BEPS commit to implementing the minimum standards, and commit to participating in the peer review.

**Revision of a standard which already exists** – Existing standards have been updated and will be implemented but with the caveat that all BEPS participants have not endorsed the underlying standards on tax treaties or transfer pricing; and

**Best practice** – A best practice is not a standard but optional recommendation for states to follow. Guidance based on best practices will support those countries proposing to act in the areas of mandatory disclosure initiatives or controlled foreign company (CFC) legislation.

(3) **ACTION PLAN 1 – ADDRESSING THE CHALLENGES OF THE DIGITAL ECONOMY**

**Digital economy: Dissolving link between income-producing activity and physical location**

At present, in the digital domain, business may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. Hence, business in digital domain doesn’t actually occur in any physical location but instead takes place in "cyberspace." Persons carrying business in digital domain could be located anywhere in the world. Entrepreneurs across the world have been quick to evolve their business to take advantage of these changes. It has also made it possible for the businesses to conduct themselves in ways that did not exist earlier, and given rise to new business models that rely more on digital and telecommunication network, do not require physical presence, and derives substantial value from data collected and transmitted from such networks.

Given the rise of e-commerce, an entire digital economy has emerged in the last decade. Since there is a concept of 'intangibility' attached to the digital model of business, tax authorities often faced challenges rightly bringing to tax the profits earned from a digital business. To address the same, the first action plan of the BEPS project was developed by the OECD which outlines the methods and principles based on which physical and digital economies can be taxed at par. Before the same, physical locations of the servers of such digital businesses were considered to establish the tax jurisdiction in which the profits of digital businesses could be taxed. However, it was observed that servers were therefore placed in tax efficient jurisdictions, even though the main income generation and customers were from other jurisdictions.

**Taxation issues in E-Commerce**

These new business models have created new tax challenges. The typical taxation issues relating to e-commerce are:

(i) the difficulty in characterizing the nature of payment and establishing a nexus or link between a taxable transaction, activity and a taxing jurisdiction,
(ii) the difficulty of locating the transaction, activity and identifying the taxpayer for income tax purposes.

The digital business, thus, challenges physical presence-based permanent establishment rules. If permanent establishment (PE) principles are to remain effective in the new economy, the fundamental PE components developed for the old economy i.e., place of business, location, and permanency must be reconciled with the new digital reality.

**OECD Recommendations under Action Plan 1 of the BEPS project**

The OECD has recommended several options to tackle the direct tax challenges which include:

- **Modifying the existing Permanent Establishment (PE) rule** to provide whether an enterprise engaged in fully de-materialized digital activities would constitute a PE, if it maintained a significant digital presence in another country's economy.

- **A virtual fixed place of business PE in the concept of PE** i.e., creation of a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website.

- **Imposition of a final withholding tax** on certain payments for digital goods or services provided by a foreign e-commerce provider or **imposition of a equalisation levy** on consideration for certain digital transactions received by a non-resident from a resident or from a non-resident having PE in other contracting state.

Taking into consideration the potential of new digital economy and the rapidly evolving nature of business operations, it becomes necessary to address the challenges in terms of taxation of such digital transactions.

**Indian Taxation Regime**

**Insertion of Chapter VIII in the Finance Act, 2016 on Equalisation Levy to address this challenge**

In order to address the challenges of the digital economy, Chapter VIII of the Finance Act, 2016, titled "Equalisation Levy", provides for an equalisation levy of 6% of the amount of consideration for specified services received or receivable by a non-resident not having permanent establishment in
India, from a resident in India who carries out business or profession, or from a non-resident having permanent establishment in India.

**Meaning of “Specified Service”**

1. Online advertisement;
2. Any provision for digital advertising space or any other facility or service for the purpose of online advertisement;

Specified Service also includes any other service as may be notified by the Central Government.

Further, in order to reduce burden of small players in the digital domain, it is also provided that no such levy shall be made if the aggregate amount of consideration for specified services received or receivable by a non-resident from a person resident in India or from a non-resident having a permanent establishment in India does not exceed ₹ 1 lakh in any previous year.

**ACTION PLAN 2 - NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS**

Before understanding what Action Plan 2 recommends, we must understand what a hybrid mismatch is.

**Hybrid Mismatch Arrangement: Meaning**

A hybrid mismatch is an arrangement that:

- Exploits a difference in the tax treatment
- Of an entity or an instrument
- Under the laws of two or more tax jurisdictions
- To achieve double non-taxation

Hybrid mismatch arrangements are sometimes used to achieve unintended double non-taxation or long-term tax deferral in one or more of the following ways -
Specific country laws that allow taxpayers to opt for the tax treatment of certain domestic and foreign entities may aid hybrid mismatches. It may not be easy to find out which country has in fact lost tax revenue, since the laws of each country involved have been complied with; however, there is a reduction of the overall tax paid by all parties involved as a whole, which ultimately has an adverse effect on competition, economic efficiency, transparency and fairness.

The Final Report on Action Plan 2 is detailed providing examples on operational practicality of various proposals for amendments to domestic law. The Report provides recommendations for both general changes to domestic law followed by a set of dedicated anti-hybrid rules. Treaty changes are also recommended. A snap shot of the Action Plan 2 is as below:
Recommended general amendments are as follows:

- **A rule denying transparency to entities where the non-resident investors’ resident country treats the entity as opaque;**

**Example**
Let us say, X Co., a parent company in country X indirectly holds Y Co., an operating company in country Y. Between X Co. and Y Co. is a hybrid entity that is treated as transparent or disregarded for country X tax purposes and as non-transparent for country Y tax purposes. X Co. holds all or almost all equity interest in the hybrid entity which in turn holds all or almost all equity interests in Y Co. The hybrid entity borrows money from a third party and the loan is used to invest equity into Y Co (or to buy the shares in Y Co from either another company of the same group or from an unrelated third party). The hybrid entity pays interest on the loan. Except for the interest, the hybrid entity does not claim any other significant deduction and does not have any significant income.

With respect to Country Y, for tax purposes, Hybrid Entity is subject to corporate income tax. Its interest expenses can be used to offset other country Y group companies’ income under...
the country Y group tax relief regime. On the other hand, country X treats the hybrid entity as transparent or disregarded, with the result that its interest expenses are allocated to X Co, which deducts the interest expense to offset unrelated income. The net effect is that there are two deductions for the same contractual obligation in two different countries. Therefore, by virtue of rule denying transparency to an entity which is treated as opaque in the subsidiary company’s country, the double deduction can be avoided.

- A rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer;

**Example**

N Co, a company resident in country N is funded by M Co., a company resident in country M with an instrument that qualifies as equity in country M but as debt in country N. A payment made under the instrument would be deductible as interest expense for N Co under country N tax law. The corresponding receipts are treated as exempt dividends under the tax laws of country M. Consequently, deduction is available under the tax laws of country N without a corresponding income inclusion in country M.

Therefore, by virtue of rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer, exemption of such income in country M would not be possible.

- A rule denying a foreign tax credit for withholding tax where that tax is also credited to some other entity; and

- Amendments to CFC and similar regimes attributing local shareholders the income of foreign entities that are treated as transparent under their local law.

**Treaty changes** - Action Plan 2 recommends a new provision in the case of income earned by a transparent entity. As per the new provision, treaty benefits will only be afforded to so much of the income of the entity as the income of a resident of that State. A specific or general saving rule is proposed so that a State can tax a resident entity generally unrestricted by treaty.

**Anti-hybrid rules** - The report further issued a series of dedicated domestic anti-hybrid rules which would work in two stages. The primary rules would deny deductions to payers in situations where either

(i) Those payments will not be included in the recipient’s ordinary income, or

(ii) The same amount is being simultaneously deducted by another entity.

The examples in the 2015 Final Report demonstrate these outcomes (deduction and non-inclusion, or double deduction) arising from various hybrid financial instruments, financing transactions and under entity recognition and de-recognition rules.

The report also addresses banks and insurance companies wherein it recommends that there should be targeted rules addressing base erosion and profit shifting in such sectors. The basic rules might not work for them because they will typically have net interest income.
Treatment of Branch mismatches: 2017 Report

While the 2015 Report addresses mismatches that are a result of differences in the tax treatment or characterisation of hybrid entities, it did not directly consider similar issues that can arise through the use of branch structures. These branch mismatches occur where two jurisdictions take a different view as to the existence of, or the allocation of income or expenditure between, the branch in head office of the same taxpayer.

Branch mismatches arise where the ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping the charge to taxation in both the branch and residence jurisdiction. Unlike hybrid mismatches, which result from conflicts in the legal treatment of entities or instruments, branch mismatches are the result of differences in the way the branch and head office account for a payment made by or to the branch. The 2017 report identifies five basic types of branch mismatch arrangements that give rise to one of three types of mismatches:

- **Double Deduction / no inclusion outcomes**
- **Indirect deduction / no inclusion outcomes**
- **Deduction / no inclusion outcomes**

The 2017 report includes specific recommendations for improvements to domestic law intended to reduce the frequency of branch mismatches as well as targeted branch mismatch rules which adjust the tax consequences in either the residence or branch jurisdiction in order to neutralise the hybrid mismatch without disturbing any of the other tax, commercial or regulatory outcomes.

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(5) ACTION PLAN 3 - STRENGTHEN CONTROLLED FOREIGN COMPANY (CFC) RULES

Shifting investment income and passive income to subsidiaries in low tax or no tax jurisdictions: Deferral of home country taxation

Under the tax laws of several countries, a shareholder of a corporation is not taxed on the corporation’s income until the income is distributed as a dividend. Therefore, it was common for publicly traded companies to form foreign subsidiaries in tax havens and shift "portable" income to those subsidiaries. Generally, income shifted were mainly investment income (interest and dividends) and passive income (rents and royalties), as well as sales and services income involving related parties. Tax in parent country on this income was avoided until the tax haven country paid a dividend to the shareholding company. This dividend could be avoided indefinitely by loaning the earnings to the shareholder without actually declaring a dividend.

Many countries (where global multi-nationals are based) have high tax rates as compared to certain other countries, which used their low tax rates as a means of attracting inward investment. As a result, when dividends were repatriated from these lower tax countries, the recipient generally suffered additional tax on those profits. Therefore, many companies have a tendency to leave the profits from these low-taxed subsidiaries offshore, with the objective of deferring home country taxation.

Obviously, Governments were disturbed that multinationals based in their countries kept large amounts of profits offshore. In order to address this issue, governments in various countries have introduced legislation aimed at eliminating the benefits of deferral, by currently taxing income in the parent country even when the income has not been repatriated or remitted to that country. These rules are generally referred to as Controlled Foreign Corporation (CFC) rules.

CFC Rules : Addressing BEPS

Controlled foreign company (CFC) rules respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries by shifting income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation.

The OECD Final Report does not propose a minimum standard for controlled foreign company (CFC) regimes. However, OECD regards CFC rules as being important in tackling BEPS and has made a series of best practice recommendations in relation to the 'building blocks' of an effective CFC regime. The major reason why the OECD was unable to provide more than best practice was fundamental disagreement over the policy of CFC regimes, in particular whether states should use the regime to protect other states’ tax bases from earnings stripping.
Building Blocks

The OECD recommended ‘building blocks’ are as follows.

- **Computation and attribution of CFC income** - CFC income should be calculated under a notional application of the parent jurisdiction’s tax laws and attribution should be subject to a control threshold and based on proportionate ownership.

- **Prevention and elimination of double taxes** - CFC rules should not result in double taxation. The specific measures suggested are to provide a credit for foreign tax paid on CFC income, provide relief where a dividend is paid out of attributed income or where taxpayers dispose of their interest in a CFC where there has been attribution.

- **CFC definition** - CFC rules apply to foreign subsidiaries controlled by shareholders in the parent jurisdiction. OECD recommends application of CFC rules to non-corporate entities, if those entities earn income that raises BEPS concerns and such concerns are not addressed.

- **CFC exemptions and threshold requirements** - Companies should be exempted from CFC rules where they are subject to an effective tax rate that is not below the applicable tax rate in the parent jurisdiction.

- **Definition of CFC income** - CFC rules should have a definition of income that ensures that BEPS concerns are addressed, but countries are free to choose their own definition.
Indian Taxation Regime

- At present, there are no CFC rules in the Income-tax Act, 1961;
- CFC rules formed part of the proposed Direct Tax Code.
- CFC regime has been debated over last many years in India and is one of the last remaining concepts from the DTC to be incorporated in the Income-tax Act, 1961.
- In order to encourage repatriation of profits, section 115BBD provides a concessional tax rate of 15% (gross basis) on dividends received from a specified foreign company i.e., a foreign company in which the Indian company holds 26% or more in the nominal value of the equity share capital of the company.

(6) ACTION PLAN 4 – INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

The OECD is concerned that multinational groups are able to erode their tax base (i.e., reduce their taxable profits) with interest expense, for example by:

- Locating third party debt in high tax countries;
- Using intra-group loans to achieve interest deductions in excess of the group’s actual third party interest expense;
- Using related party or third party debt to finance the production of exempt or deferred income.

BEPS Action Plan 4 calls for the development of recommendations for the design of domestic rules to prevent tax base erosion through the use of interest expense and other financial payments that are economically equivalent to interest.

Common Approach: Linking an entity’s net interest deduction to its level of economic activity

The mobility and fungibility of money enables multinational groups to achieve favourable tax results by adjusting the amount of debt in a group entity. The 2015 Report established a common approach which directly links an entity’s net interest deductions to its level of economic activity, based on taxable earnings before interest income and expense, depreciation and amortisation (EBITDA). This approach includes three elements:
Updation of BEPS Action 4 Report: Guidance on the design and operation of the group ratio rule and approaches to deal with risks posed by the banking and insurance sectors

In December 2016, the OECD released an updated version of the BEPS Action 4 Report (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments), which includes further guidance on two areas: the design and operation of the group ratio rule, and approaches to deal with risks posed by the banking and insurance sectors.

- **The design and operation of the group ratio rule** - The 2015 Action 4 Report set out a common approach to address BEPS involving interest and payments economically equivalent to interest. This included a ‘fixed ratio rule’ which limits an entity’s net interest deductions to a set percentage of its tax-EBITDA and a ‘group ratio rule’ to allow an entity to claim higher net interest deductions, based on a relevant financial ratio of its worldwide group. The report included a detailed outline of a rule based on the net third party interest/EBITDA ratio of a consolidated financial reporting group, and provided that further work would be conducted in 2016 on elements of the design and operation of the rule. The updated report does not change any of the conclusions agreed in 2015, but provides a further layer of technical detail to assist countries in implementing the group ratio rule in line with the common approach. **This emphasises the importance of a consistent approach in providing protection for countries and reducing compliance costs for groups, while including some flexibility for a country to take into account particular features of its tax law and policy.**

- **Banking and insurance sectors** - The 2015 report also identified factors which suggest that the common approach may not be suitable to deal with risks posed by entities in the banking and insurance sectors. **The updated report examines regulatory and commercial requirements which constrain the ability of groups to use interest for BEPS purposes, and limits on these constraints.** Overall, a number of features reduce the risk of BEPS involving interest posed by banking and insurance groups, but differences exist between
countries and sectors and in some countries risks remain. Each country should identify the risks it faces, distinguishing between those posed by banking groups and those posed by insurance groups. Where no material risks are identified, a country may reasonably exempt banking and/or insurance groups from the fixed ratio rule and group ratio rule without the need for additional tax rules. Where BEPS risks are identified, a country should introduce rules appropriate to address these risks, taking into account the regulatory regime and tax system in that country. The updated report considers how these rules may be designed, and includes a summary of selected rules currently applied by countries.

### Indian Taxation Regime

**New section 94B of the Income-tax Act, 1961: Addressing Thin Capitalization**

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

**Applicability**

The provision is applicable to an Indian company, or a permanent establishment of a foreign company, being the borrower, who pays interest in respect of any form of debt issued by a non-resident who is an 'associated enterprise' of the borrower. Further, the debt is deemed to be treated as issued by an associated enterprise where it provides an implicit or explicit guarantee to the lender, being a non-associated enterprise, or deposits a corresponding and matching amount of funds with such lender.

**Carry forward of disallowed interest expenditure**

The provision allows for carry forward of disallowed interest expense for 8 assessment years immediately succeeding the assessment year for which the disallowance is first made and deduction against the income computed under the head "Profits and gains of business or profession" to the extent of maximum allowable interest expenditure.

**Threshold limit**

In order to target only large interest payments, it provides for a threshold of interest expenditure of ₹1 crore in respect of any debt issued by a non-resident exceeding which the provision would be applicable. Banks and Insurance business are excluded from the ambit of the said provisions keeping in view of special nature of these businesses.
(7) ACTION PLAN 5 – COUNTER HARMFUL TAX PRACTICES

Substantial activity in preferential regime: Basis for tax concession

The report identifies factors for determining a potential harmful tax practice that results in low or no effective tax rate, lack of transparency, negotiable tax rate or base etc. A minimum standard has been set up based on an agreed methodology to assess whether there is substantial activity in a preferential regime, such as IP regime. For instance, in case of R&D activities, a minimum standard has been advocated that establishes nexus test as the means of identifying the R&D activities which provide the substance justifying the tax concession including tracking of expense and income on a particular products/product line.

Consensus on Framework: Six categories of rulings

As a key outcome of the work on BEPS Action 5, a framework covering all rulings that could give rise to BEPS concerns in the absence of compulsory spontaneous exchange has been agreed, which covers six categories of rulings:

- Cross border unilateral APAs/unilateral TP rulings
- Rulings giving a downward adjustment to profits
- PE rulings
- Conduit rulings
- Any other type of ruling which the FHTP apprehends BEPS concerns
- Rulings related to preferential regimes

FHTP – Forum on Harmful Tax Practices

Indian Taxation Regime

In India, the Finance Act, 2016 has introduced a concessional taxation regime for royalty income from patents for the purpose of promoting indigenous research and development and making India a global hub for research and development. The purpose of the concessional taxation regime is to encourage entities to retain and commercialise existing patents and for developing new innovative
patented products. Further, this beneficial taxation regime will incentivise entities to locate the high-value jobs associated with the development, manufacture and exploitation of patents in India.

**New section 115BBF of the Income-tax Act, 1961 : In line with nexus approach of BEPS Action 5**

The nexus approach has been recommended by the OECD under BEPS Action Plan 5. This approach requires attribution and taxation of income arising from exploitation of Intellectual property (IP) in the jurisdiction where substantial research and development (R & D) activities are undertaken instead of the jurisdiction of legal ownership. Accordingly, new section 115BBF has been inserted in the Income-tax Act, 1961 to provide that where the total income of the eligible assessee includes any income by way of royalty in respect of a patent developed and registered in India, then such royalty shall be taxable at the rate of 10% (plus applicable surcharge and cess). For this purpose, developed means atleast 75% of the expenditure should be incurred in India by the eligible assessee for any invention in respect of which patent is granted under the Patents Act, 1970.

**Meaning of Eligible Assessee**

Eligible assessee includes
- every such person, being the true and the first inventor of the invention, where more than one person is registered as patentee under Patents Act, 1970 in respect of that patent.

**8) ACTION PLAN 6 – PREVENTING TREATY ABUSE**

**Protection against treaty shopping: Minimum Standard**

Given the risk to revenues posed by treaty shopping, countries have committed to ensure a minimum level of protection against treaty shopping (the minimum standard). That commitment will require countries to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.

Countries will implement this common intention by including in their treaties:

(i) the combined approach of Limitation of Benefits (LOB) and Principal Purpose Test (PPT) rule,
(ii) the PPT rule alone, or

(iii) the LOB rule supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties.

Section A: Treaty Anti-abuse Rules

Section A of this report includes new treaty anti-abuse rules that provide safeguards against the abuse of treaty provisions and offer a certain degree of flexibility regarding how to do so. These new treaty anti-abuse rules first address treaty shopping, which involves strategies through which a person who is not a resident of a State attempts to obtain benefits that a tax treaty concluded by that State grants to residents of that State, for example by establishing a letterbox company in that State.

Section A also includes new rules to be included in tax treaties in order to address other forms of treaty abuse. These rules address:

(i) certain dividend transfer transactions intended to lower artificially withholding taxes payable on dividends;

(ii) transactions that circumvent the application of the treaty rule that allows source taxation of shares of companies that derive their value primarily from immovable property;

(iii) situations where an entity is resident of two Contracting States, and

(iv) situations where the State of residence exempts the income of permanent establishments situated in third States and where shares, debt-claims, rights or property are transferred to permanent establishments set up in countries that do not tax such income or offer preferential treatment to that income.

The report recognises that the adoption of anti-abuse rules in tax treaties is not adequate to address tax avoidance strategies that seek to circumvent provisions of domestic tax laws; these must be addressed through domestic anti-abuse rules, including through rules that will result from the work on other parts of the Action Plan.

The report also addresses two specific issues related to the interaction between treaties and domestic anti-abuse rules. The first issue relates to the application of tax treaties to restrict a Contracting State’s right to tax its own residents. A new rule will codify the principle that treaties do not restrict a State’s right to tax its own residents (subject to certain exceptions). The second issue deals with so-called “departure” or “exit” taxes, under which liability to tax on some types of income that has accrued for the benefit of a resident (whether an individual or a legal person) is triggered in the event that the resident ceases to be a resident of that State.

Section B : Clarity of intent to eliminate double taxation without creating opportunities for tax evasion and avoidance

Section B of the report addresses the part of Action seeking clarification “that tax treaties are not intended to be used to generate double non-taxation”. This clarification is provided through a
reformulation of the title and preamble of the Model Tax Convention that will clearly state that the joint intention of the parties to a tax treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance, in particular, through treaty shopping arrangements.

**Section C: Identifying tax policy considerations before entering into a treaty**

Section C of the report addresses the third part of the work mandated by Action 6, which was “to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country”. The policy considerations described in that section should help countries explain their decisions not to enter into tax treaties with certain low or no-tax jurisdictions; these policy considerations will also be relevant for countries that need to consider whether they should modify (or, ultimately, terminate) a treaty previously concluded in the event that a change of circumstances (such as changes to the domestic law of a treaty partner) raises BEPS concerns related to that treaty.

The three-pronged approach to address anti-treaty abuse is illustrated as under:
LoB clause introduced in India-Mauritius Tax Treaty - On 10th May, 2016, India and Mauritius has signed a protocol amending the India-Mauritius tax treaty at Mauritius. In the said treaty, for the first time, it has been provided that gains from the alienation of shares acquired on or after 1.4.2017 in a company which is a resident of India may be taxed in India. The tax rate on such capital gains arising during the period from 1.4.2017-31.3.2019 should, however, not exceed 50% of the tax rate applicable on such capital gains in India. A Limitation of Benefit (LOB) Clause has been introduced which provides that a resident of a Contracting State shall not be entitled to the benefits of 50% of the tax rate applicable in transition period if its affairs are arranged with the primary purpose of taking advantage of concessional rate of tax. Further, a shell or a conduit company claiming to be a resident of a Contracting State shall not be entitled to this benefit. A shell or conduit company has been defined as any legal entity falling within the meaning of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State. A resident of a Contracting State is deemed to be a shell/conduit company if its expenditure on operations in that Contracting State is less than Mauritian ₹15,00,000 or Indian ₹7,00,000 in the respective Contracting State as the case may be, in the immediately preceding period of 12 months from the date the gains arise.

LoB clause in India-Singapore Tax Treaty - On similar lines, India and Singapore has signed a protocol amending the India-Singapore tax treaty. Capital gains on alienation of shares would be taxable in a similar manner as laid out in India-Mauritius tax treaty, subject to LoB clause. The transition period benefit is also similar to that contained in India-Mauritius Tax Treaty. In respect of shares acquired after 1.4.2017 and sold before 1.4.2019, the expenditure test needs to be met for the 12 month period immediately preceding the date of transfer.

(9) ACTION PLAN 7 – PREVENT THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT (PE) STATUS

This report includes changes to the definition of permanent establishment (PE) in the OECD Model Tax Convention that will address strategies used to avoid having a taxable presence in a country under tax treaties.

These changes will ensure that 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 will be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business. The changes will also restrict the application of a number of exceptions to the definition of permanent establishment to activities that are preparatory or auxiliary nature and will ensure that it is not possible to take advantage of these exceptions by the fragmentation of a cohesive operating business into several small operations; they will also address situations where the exception applicable to construction sites is circumvented through the splitting-up contracts between closely related enterprises.
Thus, the following steps have been advocated:

- **Reworking exceptions to PE definition** – An anti-fragmentation rule to be adopted to aggregate all activities carried by an enterprise in a state, along with activities undertaken by its closely related entities undertaking business operation that create tax mismatch and are cohesive in nature. The above test can also be applied to understand whether the activities undertaken by an enterprise in a state are ‘preparatory or auxiliary’.

- **Analyzing arrangements entered through contractual agreements** – OECD proposes to include Commissionaire business model under the definition of PE. The emphasis is not on the taxable presence for a commissionaire arrangement unless it is performed as an independent business activity.

A Commissionaire arrangement may be broadly defined as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). Since Article 5(5) of the OECD Model Tax Convention relies on the formal conclusion of contracts in the name of the foreign enterprise, it is possible to avoid the application of that rule by changing the terms of contracts without material changes in the functions performed in a State. Commissionaire arrangements have been a major cause of concern for tax administrations in many countries.

As per the revised agency PE rule, a person who “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”, leading to a contract in the name of the foreign enterprise or provision of goods or services by that enterprise (even if it is not a party to the contract), it is covered under the definition of agency PE.
Before
Warehouse facilities used for storage or delivery of goods: no PE risk

After
Warehouse facilities used for storage or delivery of goods would be exempted only if the activity of the fixed place of business is of a preparatory or auxiliary character, otherwise there is a PE risk

Before
A purchasing office solely performing purchasing functions: no PE risk

After
A purchasing office merely performing purchasing functions would constitute a PE where that purchasing function forms an essential and significant part of the enterprise’s overall activity

Before
Existing anti-fragmentation rule covers only activities undertaken by one enterprise in several locations

After
A PE may exist if the enterprise or a connected enterprise carries on business activities at the same location, or different locations in the same country, and such activities constitute complementary functions that are part of a cohesive business operation, and such activities when combined, exceed what is preparatory or auxiliary

(10) ACTION PLAN 8-10 - TRANSFER PRICING OUTCOMES IN LINE WITH VALUE CREATION/INTANGIBLES/RISK AND CAPITAL AND OTHER HIGH-RISK TRANSACTIONS

The aforesaid Action plans represent the OECD’s work on transfer pricing which has been a core focus of the BEPS Action Plans. The specific Actions focus on Intangibles, Risks and capital and other high-risk transactions. These are the hard areas of transfer pricing and are summarized together in the Final Report ‘Aligning Transfer Pricing Outcomes with Value Creation’.

Clarification and Strengthening of existing standards on transfer pricing

Transfer pricing rules, which are set out in Article 9 of tax treaties based on the OECD and UN Model Tax Conventions and the Transfer Pricing Guidelines, are used to determine on the basis of the ALP the conditions, including the price, for transactions within an MNE group. The existing standards in this area have been clarified and strengthened, including the guidance on the arm’s length principle and an approach to ensure the appropriate pricing of hard-to-value-intangibles has been agreed upon within the arm’s length principle. The work has focused on three key areas.
### INTERNATIONAL TAXATION

<table>
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<th>Action Plan</th>
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<td>8</td>
<td>Addresses transfer pricing issues relating to controlled transactions involving intangibles, since intangibles are by definition mobile and they are generally difficult-to-value. Misallocation of the profits generated by valuable intangibles is a significant cause of BEPS.</td>
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<td>9</td>
<td>Contractual allocations of risk are respected only when they are supported by actual decision-making and thus exercising control over these risks.</td>
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<td>10</td>
<td>This action focuses on other high-risk areas, which include:&lt;br&gt;- the scope for addressing profit allocations resulting from controlled transactions which are not commercially rational,&lt;br&gt;- the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and&lt;br&gt;- the use of certain type of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with the value-creation.</td>
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The combined 2015 report on these action plans contains revised guidance which responds to these issues and ensures that transfer pricing rules secure outcomes that better align operational profits with the economic activities which generate them. The report also contains guidance on transactions involving cross-border commodity transactions as well as on low value-adding intra-group services. As those two areas were identified as of critical importance by developing countries, the guidance will be supplemented with further work mandated by the G20 Development Working Group.

### OECD Transfer Pricing Guidelines

In addition, the OECD Transfer Pricing Guidelines released in 2017 provide guidance on the application of the “arm’s length principle”, which represents the international consensus on the valuation, for income tax purposes, of cross-border transactions between associated enterprises. In today’s economy where multinational enterprises play an increasingly prominent role, transfer pricing continues to be high on the agenda of tax administrations and taxpayers alike. Governments need to ensure that the taxable profits of MNEs are not artificially shifted out of their jurisdiction and that the tax base reported by MNEs in their country reflects the economic activity undertaken therein and taxpayers need clear guidance on the proper application of the arm’s length principle.


- Analysis of contractual relations between parties in combination with the conduct of the parties - The OECD’s view is that contractual allocation of functions, assets and risks between
associated enterprises leaves the arm's length principle vulnerable to manipulation leading to outcomes which do not correspond to the value created through underlying economic activity. In order to deal with this, the revised transfer pricing guideline requires careful delineation of the actual transaction between the associated enterprises by analysing the contractual relations between the parties in combination with the conduct of the parties. The conduct will supplement or replace the contractual arrangements if the contracts are incomplete or are not supported by the conduct.

- **Risks and returns to be allocated to the party exercising control and having financial capacity to assume the risks** - The Report determines that a party that cannot exercise meaningful and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will not be allocated those risks and consequential returns. Rather, those risks and returns will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks.

- **Allocation of returns to MNE group members controlling economically significant risks and contributing assets** - The Report does not allocate the returns to the party which merely owns the assets rather, those returns are allocated to the MNE group members which perform important functions, control economically significant risks and contribute assets, as determined through the accurate delineation of the actual transaction. Similar considerations should apply to MNE group members who provide funding but perform few activities. Accordingly, the passive funder may only be entitled to a risk-free return, or less.

- **Actual nature of transaction to be determined for pricing, in a case where economic substance differs from form** - The OECD advocates that effort should be made to determine the actual nature of a transaction and then to price it, where the economic substance differs from form, or arrangements viewed in totality differ from those that would be made by independent enterprises.

- **Pricing methods to ensure that the profits are allocated to the most important economic activities** - Transactional profit split method is being analysed in order to provide additional guidance on the ways in which this method can be applied to align transfer pricing outcomes with value creation, including in the circumstances of integrated global value chains. Similarly, further guidance is expected on transfer pricing for financial transactions including identifying the economically relevant characteristics for determining arm’s length conditions. On low value adding intra group services, the guidance provides for an elective approach covering a wide category of services which command a very limited mark up on costs and which provide a consistent allocation key for all recipients for such services.
OECD’s guidance on transfer pricing for low value-adding intra-group services under BEPS Actions 8-10

The guidance is intended to achieve a balance between appropriate charges for low value adding services and head office expenses and the need to protect the tax base of payer countries.

Key features:

A standard definition of low value-adding intra-group services as being supportive in nature, not being part of the Multinational Enterprise’s (MNE) core business, not requiring or creating valuable intangibles and not involving significant risks.

- A list of services that would typically meet the definition. The services listed generally are back-office services.
- An elective simplified approach to determine arm’s length charges for low value adding services, including:

  - Standard 5% mark up
  - Elective simplified approach
  - Ability to use general allocation keys
  - Simplified benefits test
- Prescriptive guidance on documentation and reporting that should be prepared for the MNE to be able to apply the simplified approach
- The ability for tax administrations to include a threshold above which the simplified approach may be denied.

The Action Plan, thus, advocates a simplified approach to determination of arm’s length price which would reduce the compliance effort of meeting the benefit test, provide greater certainty for MNEs that price charged would be accepted by tax authorities, provide tax authorities with targeted documentation enabling effective review of compliance risks.

**Indian Taxation Regime**

In order to reduce transfer pricing disputes, to provide certainty to taxpayers, to align safe harbour margins with industry standards and to enlarge the scope of safe harbour transactions, the CBDT has notified a new safe harbour regime based on the report of the Committee set up in this regard. It has come into effect from 1st April, 2017, i.e., A.Y. 2017-18 and shall continue to remain in force for two immediately succeeding years thereafter, i.e. up to A.Y.2019-20. In these Rules, a new category of transactions being “Receipt of Low Value-Adding Intra-Group Services” has been introduced and the mark up of upto 5% recommended by OECD has been adopted in safe harbour rules.

**Action Plan 11 – Measuring and Monitoring BEPS**

The adverse fiscal and economic impacts of BEPS have been the focus of the OECD/G20 BEPS Project since its inception. While anecdotal evidence has shown that tax planning activities of some multinational enterprises (MNEs) take advantage of the mismatches and gaps in the international tax rules, separating taxable profits from the underlying value-creating activity, The Addressing Base Erosion and Profit Shifting report (OECD, 2013) recognised that the scale of the negative global impacts on economic activity and government revenues have been uncertain.

Although measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, the fiscal effects of BEPS are significant. BEPS causes other 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.

**Indicators of BEPS activity**

Six indicators of BEPS activity highlight BEPS behaviour using different sources of data, employing different metrics, and examining different BEPS channels. When combined and presented as a dashboard of indicators, they confirm the existence of BEPS, and its continued increase in scale in recent years.

- The profit rates of MNE affiliates located in lower-tax countries are higher than their group’s average worldwide profit rate. For example, the profit rates reported by MNE affiliates located in lower-tax countries are twice as high as their group’s worldwide profit rate on average.
(ii) **The effective tax rates paid by large MNE entities are estimated to be lower than similar enterprises with only domestic operations** - This tilts the playing-field against local businesses and non-tax aggressive MNEs, although some of this may be due to MNEs’ greater utilisation of available country tax preferences.

(iii) **Foreign direct investment (FDI) is increasingly concentrated** - FDI in countries with net FDI to GDP ratios of more than 200% increased from 38 times higher than all other countries in 2005 to 99 times higher in 2012.

(iv) **The separation of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomenon has grown rapidly** - For example, the ratio of the value of royalties received to spending on research and development in a group of low-tax countries was six times higher than the average ratio for all other countries, and has increased three-fold between 2009 and 2012.

(v) **Royalties received by entities located in these low-tax countries accounted for 3% of total royalties** - This provides evidence of the existence of BEPS, though not a direct measurement of the scale of BEPS.

(vi) **Debt from both related and third-parties is more concentrated in MNE affiliates in higher statutory tax-rate countries**. The interest-to-income ratio for affiliates of the largest global MNEs in higher-tax rate countries is almost three times higher than their MNE’s worldwide third-party interest-to-income ratio.

**Empirical Analysis: Confirming existence of BEPS and its adverse effects**

The new empirical analysis of the fiscal and economic effects of BEPS alongwith the existing empirical studies that prove the existence of profit shifting through transfer mispricing, strategic location of intangibles and debt, as well as treaty abuse, these BEPS indicators confirm that profit shifting is occurring, is significant in scale and likely to be increasing, and creates adverse economic distortions. Also, empirical analysis indicates that BEPS adversely affects competition between businesses, levels and location of debt, the location of intangible investments, and causes fiscal spillovers between countries and wasteful and inefficient expenditure of resources on tax engineering. The empirical analysis in this report, along with several academic studies, confirms that strong anti-avoidance rules reduce profit shifting in countries that have implemented them.

**Limitations**

These indicators and all analyses of BEPS are severely constrained by the limitations of the currently available data. The available data is not comprehensive across countries or companies, and often does not include actual taxes paid. In addition to this, the analyses of profit shifting to date have found it difficult to separate the effects of BEPS from real economic factors and the effects of deliberate government tax policy choices. Improving the tools and data available to measure BEPS will be critical for measuring and monitoring BEPS in the future, as well as evaluating the impact of
the countermeasures developed under the BEPS Action Plan.

While recognising the need to maintain appropriate safeguards to protect the confidentiality of taxpayer information, this report makes a number of recommendations that will improve the analysis of available data. Some of the information needed to improve the measurement and monitoring of BEPS is already collected by tax administrations, but not analysed or made available for analysis. The focus of the report’s recommendations in this area is on improved access to and enhanced analysis of existing data, and new data proposed to be collected under Actions 5, 13 and, where implemented, Action 12 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. For example, statistical analyses based upon Country-by-Country Reporting data have the potential to significantly enhance the economic analysis of BEPS. These improvements in the availability of data will ensure that governments and researchers will, in the future, be better able to measure and monitor BEPS and the actions taken to address BEPS.

(12) ACTION PLAN 12 – DISCLOSURE OF AGGRESSIVE TAX PLANNING ARRANGEMENTS

A significant challenge faced by tax authorities worldwide is the lack of timely, comprehensive and relevant information on aggressive tax planning strategies. Timely access to such information would facilitate quick response to tax risks through informed risk assessment, audits, or changes to legislation or regulations. BEPS Action Plan 12 recognises the advantages of tools designed to facilitate the information flow on tax risks to tax administrations and tax policy makers. The Report provides a modular framework for guidance drawn from best practices for use by countries without mandatory disclosure rules to design a regime that suits their requirement to get early information on potentially aggressive or abusive tax planning schemes and their users. The recommendations in this Report do not represent a minimum standard and countries can decide whether or not to introduce mandatory disclosure regimes. Where a country opts for mandatory disclosure rules, the recommendations provide the necessary flexibility to balance a country’s need for better and more timely information with the compliance burdens for taxpayers. It also sets out specific best practice recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations.
Design principles and significant objectives of a mandatory disclosure regime:

- Clarity and comprehensibility
- Ability to balance additional compliance costs to taxpayers with the benefits obtained by the tax administration
- Flexibility and dynamism: to allow the tax administration to adjust the system to respond to new risks (or carve-out obsolete risks)
- Accurate identification of the schemes to be disclosed
- Effective achievement of objectives
- Ensuring effective use of information collected

The primary object of mandatory disclosure regimes is to increase transparency by providing the tax administration with early information regarding potentially aggressive or abusive tax planning schemes and to identify the promoters and users of those schemes. Another objective of mandatory disclosure regimes is deterrence: taxpayers may rethink about entering into a scheme if it has to be disclosed.

Key design features for an effective mandatory disclosure regime:
The final report suggests the use of different hallmarks to identify cross-border schemes, given that the tax benefit of a cross-border scheme may arise in a different country. Such hallmarks include use of hybrids arrangements that separate legal and tax ownership of depreciable assets and cross-border transfers of assets at other than market value.

(13) ACTION PLAN 13 – RE-EXAMINE TRANSFER PRICING DOCUMENTATION

This report contains revised standards for transfer pricing documentation incorporating a master file, local file, and a template for country-by-country reporting of revenues, profits, taxes paid and certain measures of economic activity. The revised standardised approach requires taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing and other BEPS 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. Country-by-country reports will be disseminated through an automatic government-to-government exchange mechanism. The implementation package included in this report sets out guidance to ensure that the reports are provided in a timely manner, that confidentiality is preserved and that the information is used appropriately, by incorporating model legislation and model Competent Authority Agreements forming the basis for government-to-government exchanges of the reports.

Requirements as per OECD report on Action 13 of BEPS Action Plan

The OECD report provides for:

(a) revised standards for transfer pricing documentation; and

(b) a template for country-by-country reporting of income, earnings, taxes paid and certain measure of economic activity.

Three-tier structure mandated by BEPS

The BEPS report recommends that countries adopt a standardised approach to transfer pricing documentation; it mandates the following three-tier structure:-

<table>
<thead>
<tr>
<th>Document</th>
<th>Information</th>
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<tr>
<td>(1) Master File</td>
<td>Standardised information relevant for all multinational enterprises (MNE) group members. Master file requires MNEs to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies. The master file is to be delivered by MNEs directly to local tax administrations.</td>
</tr>
<tr>
<td>(2) Local file</td>
<td>Local file requires maintaining of transactional information specific to each country in detail covering related-party transactions and the</td>
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amounts involved in those transactions. In addition, relevant financial information regarding specific transactions, a comparability analysis and analysis of the selection and application of the most appropriate transfer pricing method should also be captured. The local file is to be delivered by MNEs directly to local tax administrations.

| (3) Country-by-country report | Information relating to the global allocation of the MNE’s income and taxes paid; and Indicators of the location of economic activity within the MNE group. CBC report requires MNEs to provide an annual report of economic indicators viz. the amount of revenue, profit before income tax, income tax paid and accrued in relation to the tax jurisdiction in which they do business. CBC reports are required to be filed in the jurisdiction of tax residence of the ultimate parent entity, being subsequently shared between other jurisdictions through automatic exchange of information mechanism. |

**Advantages of the three-tier structure [as per BEPS Report]:**

(a) Taxpayers will be required to articulate consistent transfer pricing positions;
(b) Tax administrations would get useful information to assess transfer pricing risks;
(c) Tax administrations would be able to make determinations about where their resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.

**Country-by-country Report : Reporting Requirements of MNEs**

The Country-by-Country (CbC) report has to be submitted by parent entity of an international group to the prescribed authority in its country of residence. This report is to be based on consolidated financial statement of the group.

(a) MNEs have to report annually and for each tax jurisdiction in which they do business:
   (1) the amount of revenue;
   (2) profit before income tax; and
   (3) income tax paid and accrued.

(b) MNEs have to report their total employment, capital, accumulated earnings and tangible assets in each tax jurisdiction.

(c) MNEs have to identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities each entity engages in.
Master File: Objective & Features

(a) The master file would provide an overview of the MNE groups business, including:
   (1) the nature of its global business operations,
   (2) its overall transfer pricing policies, and
   (3) its global allocation of income and economic activity
   in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.

(b) The master file is intended to provide a high-level overview in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context.

(c) The master file shall contain information which may not be restricted to transaction undertaken by a particular entity situated in particular country.

(d) Thus, information in master file would be more comprehensive than the existing regular transfer pricing documentation.

(e) The master file shall be furnished by each entity to the tax authority of the country in which it operates.

Indian Taxation Regime

Transfer Pricing provisions under the Income-tax Act, 1961

Chapter X of the Income-tax Act, 1961 comprising sections 92 to 92F contain provisions relating to transfer pricing regime.

Section 92D requires maintenance of prescribed information and document relating to the international transaction and specified domestic transaction.

Implementation of international consensus in India

India is one of the active members of BEPS initiative and part of international consensus. For the purpose of implementing the international consensus, a specific reporting regime in respect of CbC reporting and also the master file has been incorporated in the Income-tax Act, 1961. The essential elements have been incorporated in the Income-tax Act, 1961 while remaining aspects would be dealt with in detail in the Income-tax Rules, 1962.

Elements relating to CbC reporting requirement and related matters which have been incorporated in the Income-tax Act, 1961 [New Section 286]

(a) the reporting provision shall apply in respect of an international group for an accounting year, if the total consolidated group revenue as reflected in the consolidated financial statement (CFS) for the accounting year preceding such accounting year is above a threshold to be prescribed.
(b) the parent entity of an international group or the alternate reporting entity, if it is resident in
India shall be required to furnish the report in respect of the group to the prescribed authority
for every reporting accounting year, on or before the due date of furnishing of return of income
under section 139(1) for the relevant accounting year for which the report is being furnished,
in the prescribed form and manner;

(c) the parent entity shall be an entity which is required to prepare consolidated financial statement
under the applicable laws or would have been required to prepare such a statement, had equity
share of any entity of the group been listed on a recognized stock exchange in India;

(d) every constituent entity resident in India, of an international group having parent entity that is
not resident in India, shall notify the prescribed income-tax authority on or before the prescribed
date –
   (1) whether it is the alternate reporting entity of the international group; or
   (2) the details of the parent entity or the alternate reporting entity, if any of the international
group, and the country of territory of which the said entities are resident.

(e) the report shall be furnished in prescribed manner and in the prescribed form.

(f) It should contain aggregate information in respect of:
   (1) the amount of revenue,
   (2) profit and loss before income-tax,
   (3) amount of income-tax paid and accrued,
   (4) details of stated capital, accumulated earnings, number of employees, tangible assets
      other than cash or cash equivalent in respect of each country or territory along with
details of each constituent’s residential status, nature and detail of main business
activity and any other information as may be prescribed.

This shall be based on the template provided in the OECD BEPS report on Action Plan 13;

(g) A constituent entity of an international group resident in India, shall be required to furnish CbC
report to the prescribed authority if the parent entity of the group is resident ;-) -
   (1) in a country with which India does not have an arrangement for exchange of the CbC
      report; or
   (2) there has been a systemic failure of the country or territory i.e., such country is not
      exchanging information with India even though there is an agreement; and
   (3) this fact has been intimated to the entity by the prescribed authority.

(h) If there are more than one such constituent entity of the same group in India, then the group
can nominate (under intimation in writing on behalf of the group to the prescribed authority),
then, one constituent entity that shall furnish the report on behalf of the group. This entity would
then furnish the report;
(i) 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 group operating in India would not be obliged to furnish report if the report can be obtained under the agreement of exchange of such reports by Indian tax authorities;

(j) The prescribed authority may call for such document and information from the entity furnishing the report as it may specify in notice for the purpose of verifying the accuracy. The entity shall be required to make submission within thirty days of receipt of notice or further period if extended by the prescribed authority, but extension shall not be beyond a further period of 30 days.

Maintenance and furnishing of Master file: Consequent amendments in the Income-tax Act, 1961

<table>
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<tr>
<th>Section</th>
<th>Provision</th>
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<tr>
<td>Proviso to section 92D(1)</td>
<td>A person being constituent of an international group shall, in addition to the information related to the international transaction required under section 92D(1), also keep and maintain such information and document in respect of the international group to be prescribed by way of rules. The rules shall, thereafter, prescribe the information and document as mandated for master file under OECD BEPS Action 13 report;</td>
</tr>
<tr>
<td>92D(4)</td>
<td>The information and document shall also be furnished to the prescribed authority u/s 286(1) within such period as may be prescribed and the manner of furnishing may also be provided for in the rules</td>
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Threshold limit of consolidated group revenue for applicability of CbC reporting requirement

As indicated above, the CbC reporting requirement for a reporting year does not apply unless the consolidated revenues of the preceding accounting year of the group, based on consolidated financial statement, exceeds a threshold to be prescribed. The current international consensus is for a threshold of € 750 million equivalent in local currency. This threshold in Indian currency would be equivalent to ₹ 5395 crores (at current rates). Therefore, CbC reporting for an international group having Indian parent, for the previous year 2016-17, shall apply only if the consolidated revenue of the international group in previous year 2015-16 exceeds ₹ 5395 crore (the equivalent would be determinable based on exchange rate as on the last day of previous year 2015-16).
Eliminating opportunities for cross-border tax avoidance and evasion and the effective and efficient prevention of double taxation are significant to developing an international tax system that facilitates economic growth and a buoyant global economy. Countries concur that the measures introduced to address BEPS pursuant to the BEPS Action Plans should not result in unnecessary uncertainty for compliant taxpayers and in unintended double taxation. Improving dispute resolution mechanisms is, therefore, a critical component of the work on BEPS issues.

**MAP: Key to proper application and interpretation of tax treaties**

Article 25 of the OECD Model Tax Convention provides a mechanism, distinct from the general legal remedies available under domestic law, through which the competent authorities of the Contracting States may resolve differences or difficulties relating to interpretation or application of the Convention on a mutually-agreed basis. This mechanism, the mutual agreement procedure (MAP), is the key to the proper application and interpretation of tax treaties, particularly to ensure that taxpayers entitled to the benefits of the treaty are not subject to taxation by either of the Contracting States which is not in accordance with the terms of the treaty. Through the adoption of the Final Report of BEPS, countries have agreed to important changes in their approach to dispute resolution, in particular, by having developed a minimum standard with respect to the resolution of treaty-related disputes, committed to its rapid implementation and agreed to ensure its effective implementation through the establishment of a robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20.
Minimum Standard: Ensure effective implementation of MAP

The 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
- the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes
- that taxpayers can access the MAP when eligible.

Setting up FTA: Enabling Effective Monitoring of MAP Performance

The final report advocates setting up a Forum on Tax Administration (FTA), a subset of MAP Forum to deal with practical issues, as a minimum standard. The minimum standard is complemented by a set of best practices. States have agreed to join the FTA MAP Forum, report MAP statistics and agree to have their MAP performance monitored. In this way, a peer review mechanism has been set in place to ensure transparency in the area of exchange of information. The monitoring of the implementation of the minimum standard will be carried out pursuant to detailed terms of reference and an assessment methodology.

(15) ACTION PLAN 15 – DEVELOPING A MULTILATERAL INSTRUMENT

Analysis of tax and public international law issues relating to development of multilateral instrument

Action 15 of the BEPS Action Plan provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable countries that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.

Pursuant to this analysis, interested countries have to develop a multilateral instrument designed to provide an innovative approach to international tax matters, which reflect the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution. The aim of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures. 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. Based on the
public international law and the expertise of tax professionals, the 2014 Report, analysed the
technical feasibility of a multilateral hard law approach and its consequences on the prevalent tax
treaty system. The issues arising from the development of such an instrument were identified. The
Report also provided an analysis of the international tax, public international law, and political issues
arising from such an approach. The 2014 Report also concluded that a multilateral instrument is
desirable and feasible, and that negotiations for such an instrument should be convened quickly.

**Formation of Adhoc Group to develop a multilateral instrument on tax treaty measures to
tackle BEPS**

Based on this analysis, a mandate for the formation of an ad hoc Group to develop a multilateral
instrument on tax treaty measures to tackle BEPS, was approved by the OECD Committee on Fiscal
Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015.

In line with Action 15 report, an ad-hoc group was formed with a pre-defined purpose of development
of such Multilateral Instrument (MLI) and that adopted the text of the Convention and accompanying

Once drafted, the said document was thereafter kept open for signatures from 31 December 2016.
On 7th June 2017, 68 countries and jurisdictions, signed the BEPS MLI at the first joint signing
ceremony held in Paris. At the time of signature, signatories submitted a list of their tax treaties in
force that they would like to designate as Covered Tax Agreements (CTAs), i.e. to be amended
through the MLI.

The Multilateral Convention is an outcome of the OECD / G20 Project to tackle Base Erosion and
Profit Shifting (the "BEPS Project") i.e., tax planning strategies that exploit gaps and mismatches in
tax rules to artificially shift profits to low or no-tax locations where there is little or no economic
activity, resulting in little or no overall corporate tax being paid.

India was part of the Ad Hoc Group of more than 100 countries and jurisdictions from G20, OECD,
BEPS associates and other interested countries, which worked on an equal footing on the finalization
of the text of the Multilateral Convention, starting May 2015. The text of the Convention and the
accompanying Explanatory Statement was adopted by the Ad hoc Group on 24th November 2016.

The Convention enables all signatories, *inter alia*, to meet treaty-related minimum standards that
were agreed as part of the Final BEPS package, including the minimum standard for the prevention
of treaty abuse under Action 6.

The Convention will operate to modify tax treaties between two or more Parties to the Convention.
It will not function in the same way as an amending protocol to a single existing treaty, which would
directly amend the text of the Covered Tax Agreement. Instead, it will be applied alongside existing
tax treaties, modifying their application in order to implement the BEPS measures.

The Convention will modify India’s treaties in order to curb revenue loss through treaty abuse and
base erosion and profit shifting strategies by ensuring that profits are taxed where substantive
economic activities generating the profits are carried out and where value is created.
(16) CHALLENGES AHEAD

The Final reports have generated good response with about 90 countries having joined the Group as members, and 5 regional tax organizations having joined as observers. However, there are certain challenges that lie ahead on the journey of BEPS viz. inclusiveness, consistent implementation and monitoring impact. After widespread agreement among countries on the measures for tackling BEPS, implementation becomes key. There is a need for increased inclusiveness, a new framework for monitoring BEPS will be conceived and put in place, with all interested participating on an equal footing. Monitoring the impact of the BEPS measures will include assessing the implementation of the minimum standards agreed in the areas of treaty abuse, dispute resolution, country-by-country reporting and harmful tax practices, as well as of the other BEPS measures, together with the monitoring of their overall impact and effectiveness. Some of the measures may be immediately applicable, such as the revised guidance on transfer pricing, while others require changes in domestic laws and in bilateral tax treaties, and hence may take time for implementation.


8.3 OTHER ANTI AVOIDANCE MEASURES

We have seen that there is a growing concern amongst the revenue in many countries that taxpayers structure transactions to reduce the tax costs. We have also understood that the Base Erosion and Profits Shifting (BEPS) project of the Organization for Economic Cooperation and Development ("OECD") along with G-20 countries sort to tackle this issue. The BEPS Action plans have come out with various recommendations on the issue, both to address it within the international treaty framework (for example, introducing the principle purpose test, limitation of benefits clause, amending the permanent establishment clause, etc.) and in the domestic tax law context (for example, controlled foreign corporation rules, equalization levy, etc.).

Tax avoidance is not defined in taxing statutes. Tax avoidance is, nevertheless, the outcome of actions taken by the assessee, none of which or no combination of which is illegal or forbidden by the law as such. International literature on the subject tends to describe it in the following ways:

- Tax avoidance involves the legal exploitation of tax laws to one’s own advantage.
- Every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred, by taking advantage of some provisions or lack of provisions in the law.
- An arrangement entered into solely or primarily for the purpose of obtaining a tax advantage.

Taxpayers consider it their legitimate right to arrange their affairs in a manner as to pay the least tax possible. However, tax authorities internationally consider aggressive tax planning schemes by taxpayers to erode the tax base unnaturally, particularly when effective rates of tax diminish.
significantly. Several countries have, therefore, legislated to prevent tax avoidance in various ways.

The significant anti-avoidance measures under the Indian tax laws in respect of international transactions are –

The Specific Anti-Avoidance Rules (SAARs) include transfer pricing, thin capitalisation, disincentives for transactions with persons in notified jurisdictional area (discussed in Chapter 1 – Transfer Pricing), Tax Information Exchange Agreements (discussed in Chapter 3 – Double Taxation Relief and Chapter 7 – Tax Treaties – Overview, Features, Application and Interpretation) and Place of Effective Management (discussed in Chapter 2 – Non-resident Taxation). The General Anti-Avoidance Rules (GAAR) are discussed in detail hereunder -

The General Anti-Avoidance Rules (GAAR) provisions aim at combating ‘impermissible tax avoidance’. Many countries, like United Kingdom, China, South Africa, Australia, Canada, Brazil, GAAR, have incorporated General Anti-Avoidance Rules in their domestic tax laws to deal with aggressive tax planning.

**The Indian GAAR**

In India, the GAAR concept was initially introduced in the Direct Taxes Code Bill, 2009 [DTC Bill, 2009]. Later, a Revised Discussion Paper was released. The Direct Taxes Code Bill, 2010 [DTC Bill, 2010] proposed to introduce GAAR from 1st April 2012 onwards. The GAAR provisions were introduced in the Income-tax Act, 1961 vide the Finance Act, 2012 by insertion of new Chapter X-A. Chapter X-A was substituted by the Finance Act, 2013.

The Government subsequently set up a panel under Parthasarathy Shome to review the proposals.
The Committee suggested that the rules be deferred by three years to 2016-17, arguing that more time is needed to create administrative machinery for its implementation and called for intensive training of officials.

The Shome Committee Report explains the need for and rationale of GAAR as under:

(i) GAAR has been enacted as a codification of the proposition that, while interpreting the tax legislation, substance should be selected over a legal form.

(ii) Transactions have to be real and are not to be looked at in isolation.

(iii) The fact that the transactions are legal, does not imply that they are acceptable with reference to the underlying meaning embedded in the fiscal statute.

(iv) Thus, where there is no business purpose except to obtain a tax benefit, the GAAR provisions would not allow such a tax benefit to be availed through the tax statute. These propositions have comprised part of jurisprudence in direct tax laws as reflected in various judicial decisions.

(v) The GAAR provisions codify this 'substance over form' basis of the tax law.

The CBDT, vide Press Release dated January 27, 2017, clarified that the GAAR provisions shall be effective from A.Y.2018-19 onwards, i.e., financial year 2017-18 onwards. The provisions of GAAR are contained in Chapter X-A of the Income-tax Act, 1961. The necessary procedures for application of GAAR and conditions under which it shall not apply, have been enumerated in Rules 10U to 10UC of the Income-tax Rules, 1962.

Hitherto, the Act contained only Specific Anti-Avoidance Rules (SAARs) to prevent tax avoidance. SAAR targets known tax planning schemes which are commonly used by taxpayers but are not acceptable owing to misuse or abuse of tax laws, or they result in a consequence unintended in the law. In the Act, the following may, inter alia, be considered specific examples of SAAR -

(i) Section 40A(2) on excessive or unreasonable payments to related parties not deductible

(ii) Section 80-IA(8) on transactions with tax exempt entities to be valued at market value.

(iii) Sections 92 to 92F on transfer pricing regulations applicable to international transactions. These provisions also made applicable to specified domestic transactions by the Finance Act, 2012.

(iv) Section 93 on avoidance of tax by transfer of income to nonresidents through transfer of assets, rights or interest.

(v) Section 94 on avoidance of tax by certain transactions in securities.

(vi) Section 94A on transactions with persons located in notified jurisdictions.

(vii) Section 2(22)(e) on deemed dividend.

(viii) Section 40(a)(i) and (ia) on disallowance of expenses for non-deduction of tax at source.
(ix) Section 9 on scope of 'income deemed to accrue or arise in India'. The Finance Act, 2012 had widened its scope to overcome the Supreme Court's ruling in Vodafone and some other cases.

(x) Explanations 1 to 13 to section 43(1) on determination of actual cost of assets ignoring agreements, etc., in certain cases.

Tax treaties also provide certain anti-avoidance rules for instance, Limitation of Benefit (LOB) Clause and concept of Beneficial Ownership.

(1) Applicability of General Anti-Avoidance Rule [Section 95]

(i) Section 95 of the Act with regard to the applicability of GAAR provides that an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and the consequence in relation to tax arising there from may be determined subject to the provisions of this Chapter.

(ii) The section further clarifies that the provisions of this Chapter may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement.

(iii) The section starts with a non-obstante clause which means, if there is a conflict with provisions in other sections, then this section shall prevail over other conflicting provisions.

(iv) The term arrangement referred to in section 95 of the Act, has been defined in section 102(1) and means any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not, and includes the alienation of any property in such transaction, operation, scheme, agreement or understanding;

Example 1

Facts:
M/s India Chem Ltd. is a company incorporated in India. It sets up a unit in a Special Economic Zone (SEZ) in F.Y. 2013-14 for manufacturing of chemicals. It claims 100% deduction of profits earned from that unit in F.Y. 2020-21 and subsequent years as per section 10AA of the Act. Is GAAR applicable in such a case?

Interpretation:
There is an arrangement of setting up of a unit in SEZ which results in a tax benefit. However, this is a case of tax mitigation where the tax payer is taking advantage of a fiscal incentive offered to him by complying with the conditions imposed and economic consequences of the provisions in the legislation e.g., setting up the business unit in SEZ area. Hence, the Revenue would not invoke GAAR as regards this arrangement.

Example 1A

Facts:
In the above example 1, let us presume M/s India Chem Ltd. has another unit for manufacturing
chemicals in a non-SEZ area. It then diverts its production from such manufacturing unit and shows the same as manufactured in the tax exempt SEZ unit, while doing only the process of packaging there. Is GAAR applicable in such a case?

**Interpretation:**

This is a case of misrepresentation of facts by showing production of non-SEZ unit as production of SEZ unit. Hence, this is an arrangement of tax evasion and not tax avoidance.

Tax evasion, being unlawful, can be dealt with directly by establishing correct facts. GAAR provisions will not be invoked in such a case.

**Example 1B**

**Facts:**

In the above example 1A, let us presume that M/s India Chem Ltd. does not show production of non-SEZ unit as a production of SEZ unit but transfers the product of non-SEZ unit at a price lower than the fair market value and does only some insignificant activity in SEZ unit. Thus, it is able to show higher profits in SEZ unit than in non-SEZ unit, and consequently claims higher deduction in computation of income. Can GAAR be invoked to deny the tax benefit?

**Interpretation:**

As there is no misrepresentation of facts or false submissions, it is not a case of tax evasion. The company has tried to take advantage of tax provisions by diverting profits from non-SEZ unit to SEZ unit. This is not the intention of the SEZ legislation. However, such tax avoidance is specifically dealt with through transfer pricing regulations that deny tax benefits. Hence, the Revenue would not invoke GAAR in such a case.

**Example 1C**

**Facts:**

In the above example 1B, let us presume, that both units in SEZ area (say A) and non-SEZ area (say B) work independently. M/s India Chem Ltd. started taking new export orders from existing as well as new clients for unit A and gradually, the export from unit B declined. There has not been any shifting of equipment from unit B to unit A. The company offered lower profits from unit B in computation of income. Can GAAR be invoked on the ground that there has been shifting or reconstruction of business from unit B to unit A for the main purpose of obtaining tax benefit?

**Interpretation:**

The issue of tax avoidance through shifting/reconstruction of existing business from one unit to another has been specifically dealt with in section 10AA of the Act. Hence, the Revenue would not invoke GAAR in such a case.
(2) Impermissible Avoidance Agreement [Section 96]

(i) An impermissible avoidance arrangement (IAA) means an arrangement, the main purpose or one of the main purposes of which is to obtain a tax benefit and also any of the following tests is satisfied:

- creates rights, or obligations, which are not ordinarily created between persons dealing at arm’s length;
- results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act;
- lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part;
- is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bona fide purposes.

(ii) The purpose test of obtaining tax benefit and tainted element test as under clauses (a) to (d) above are twin conditions that satisfy an impermissible avoidance arrangement. The purpose test requires that the main purpose or one of the main purposes is to obtain tax benefit. The term “tax benefit” has been defined in section 102 clause (10) as under -

(a) a reduction or avoidance or deferral of tax or other amount payable under this Act; or
(b) an increase in a refund of tax or other amount under this Act; or
(c) a reduction or avoidance or deferral of tax or other amount that would be payable under this Act, as a result of a tax treaty; or
(d) an increase in a refund of tax or other amount under this Act as a result of a tax treaty; or
(e) a reduction in total income or
(f) an increase in loss,
in the relevant previous year or any other previous year.
(iii) **The first tainted element** refers to non-arm’s length dealings where an arrangement creates rights and obligations, which are not normally created between parties dealing at arm’s length. As there are specific transfer pricing regulations (SAAR) applicable to international transactions and certain specified domestic transactions, this tainted element is to be examined only in those transactions which are not covered by Transfer Pricing regulations and where the main purpose of the arrangement is to obtain tax benefit.

**Example -1**

**Facts:**
Y Tech Ltd. is a company resident of country C1. It enters into an agreement with Z Energy Ltd., an Indian company for setting up a power plant in India. It is a composite contract for an agreed price of US$ 100 million. The payment has been split in the following parts as per separate agreements

(i) US$ 10 million for design of power plant outside India (payment for which is taxable at 10% on gross basis)

(ii) US$ 70 million for offshore supplies of equipment etc (not taxable as no role is played by any PE in India. There are not subject to import duty)

(iii) US$ 20 million for local supplies and installation charges (taxable on net income basis)

It is found that the fair market value of offshore design is about USD 30 million; therefore it is under invoiced. On the other hand, offshore supplies were over invoiced. The arrangement resulted in significant tax benefit to the taxpayer. Can GAAR be invoked in such a case?

**Interpretation:**
The allocation of price to different parts of the contract has been decided in such a manner as to reduce tax liability of the foreign company in India. Both conditions for declaring an arrangement as impermissible are satisfied. (1) The main purpose of this arrangement is to obtain tax benefit; and (2) the transactions are not at arm’s length. Consequently, GAAR may be invoked and prices would be reallocated. However, determination of arm’s length price should be based on transfer pricing regulations under the Act.

(iv) **The second tainted element** refers to an arrangement which results in misuse or abuse of the provisions of the Act. It implies cases where the law is followed in letter or form but not in spirit or substance, or where the arrangement results in consequences which are not intended by the legislation, revealing an intent to misuse or abuse the law.
Example-2

Facts:

Under the provisions of a tax treaty between India and country F4, any capital gains arising from the sale of shares of Indco, an Indian company would be taxable only in F4 if the transferor is a resident of F4 except where the transferor holds more than 10% interest in the capital stock of Indco. A company, A Ltd., being resident in F4, makes an investment in Indco through two wholly owned subsidiaries (K Ltd. and L Ltd.) located in F4. Each subsidiary holds 9.95% shareholding in the Indian Company, the total adding to 19.9% of equity of Indco. The subsidiaries sell the shares of Indco and claim exemption as each is holding less than 10% equity shares in the Indian company. Can GAAR be invoked to deny treaty benefit?

Interpretation:

The above arrangement of splitting the investment through two subsidiaries appears to be with the intention of obtaining tax benefit under the treaty. Further, there appears to be no commercial substance in creating two subsidiaries as they do not change the economic condition of investor A Ltd. in any manner (i.e. on business risks or cash flow), and reveals a tainted element of abuse of tax laws. Hence, the arrangement would be treated as an impermissible avoidance arrangement by invoking GAAR. Consequently, treaty benefit would be denied by ignoring K and L, the two subsidiaries, or by treating K and L as one and the same company for tax computation purposes.

(v) The third tainted element refers to an arrangement which lacks commercial substance or is deemed to lack commercial substance. [Dealt with in detail below]

(vi) The fourth element refers to an arrangement which is entered into, or carried out, by means of, or in a manner which is normally not employed for a bona fide purpose. In other words, it means an arrangement that possesses abnormal features. This is not a purpose test but a manner test.
Example-3

Facts:
An Indian company, A Ltd., makes an investment of ₹ 1 crore in shares of a listed company on 1st January, 2020. After a year, the prices go up and fair market value of shares becomes ₹ 11 crore. If A Ltd sells these shares, the long term capital gains of ₹ 10 crore would be exempt but it would be liable to tax under MAT@ the applicable rate.

A Ltd. forms a partnership firm with another person with nominal partnership. It transfers its shares in the firm at a cost price. No capital gain arises as per section 45 of the Act. After a year, the firm sells these shares and realises the gains of ₹ 10 crore which is exempt from taxation and no MAT is payable. Subsequently, the firm is dissolved and share of A Ltd in the partnership firm is transferred back along with profits, which is exempt from tax under the Act.

Can GAAR be invoked in this case?

Interpretation:
The only purpose of forming a partnership and transferring assets to such firm and selling the shares is to save tax arising out of MAT liability of A Ltd. Further, there is no commercial substance in the formation of the partnership as it does alter the economic position of A Ltd in terms of business risks or cash flow. Moreover, the entire exercise is carried out in an abnormal manner. Even holding of shares by the partnership firm for a year or more is no significant economic risk to the company. Hence, GAAR may be invoked and the partnership firm may be disregarded and capital gains may be subject to MAT in the hands of A Ltd.

(3) Arrangement to lack commercial substance [Section 97]

Another alternate condition of an impermissible avoidance arrangement is that the arrangement lacks commercial substance or is deemed to lack commercial substance in whole or in part.

(i) Under section 97, certain arrangements have been deemed to lack commercial substance as under:

(a) the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or

(b) it involves or includes—

(1) round trip financing;

(2) an accommodating party;

(3) elements that have effect of offsetting or cancelling each other; or

(4) a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction; or

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(c) it involves the location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party.

(d) it does not have a significant effect upon the business risks or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained (but for the provisions of this Chapter)

(ii) Clause (a) is the codification of substance v. form doctrine. It implies that where substance of an arrangement is different from what is intended to be shown by the form of the arrangement, then tax consequence of a particular arrangement should be assessed based on the — substance of what took place. In other words, it reflects the inherent ability of the law to remove the corporate veil and look beyond form.

(iii) Sub-clause (i) of clause (b) deems an arrangement, which includes round tripping of funds, to lack commercial substance. For this purpose, the phrase round trip financing has been further defined. Round trip financing includes any arrangement in which, through a series of transactions—

(a) funds are transferred among the parties to the arrangement; and

(b) such transactions do not have any substantial commercial purpose other than obtaining the tax benefit (but for the provisions of this Chapter), without having any regard to—

(A) whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement;

(B) the time, or sequence, in which the funds involved in the round trip financing are transferred or received; or

(C) the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received.

Example-4

Facts:
Indco incorporates a Subco in a NTJ (Low Tax Jurisdiction) with equity of US $100. Subco gives a loan of US $ 100 to another Indian company (X Ltd.) at the rate of 10% p.a. X Ltd. claims deduction of interest payable to Subco from the profit of business. There is no other activity in Subco. Can GAAR be invoked in such a case?
**Interpretation:**

The arrangement appears to be to avoid payment of tax on interest income by Indco in case loan is directly provided by Indco to X Ltd. The arrangement involves round tripping of funds even though the funds emanating from Indco are not traced back to Indco in this case. Hence, the arrangement may be deemed to lack commercial substance.

Consequently, in the case of Indco, Subco may be disregarded and the interest income may be taxed in the hands of Indco.

(iv) Sub-clause (ii) of clause (b) deems an arrangement which includes an accommodating party to lack commercial substance. For this, the phrase “accommodating party” has been further defined. A party to an arrangement shall be an accommodating party, if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part, is to obtain, directly or indirectly, a tax benefit (but for the provisions of this Chapter) for the assessee whether or not the party is a connected person in relation to any party to the arrangement.

It means that where a party is included in an arrangement mainly for obtaining tax benefit to the taxpayer, then such party may be treated as an accommodating party and consequently the arrangement shall be deemed to lack commercial substance. Also, it is not necessary that such party should be connected to the taxpayer.

(v) Sub-clause (iii) of clause (b) deems an arrangement, which includes elements that have effect of offsetting or cancelling each other to lack commercial substance.

(vi) Sub-clause (iv) of clause (b) deems an arrangement, which disguises value, source or location etc. of funds, to lack commercial substance. In other words, such arrangements have an element of deceit as regards funds.
Example -5

Facts:
(i) X Ltd. is a banking institution in LTJ (Low Tax Jurisdiction);
(ii) There is a closely held company Subco in LTJ which is a wholly owned subsidiary of another closely held Indian company Indco;
(iii) Subco has reserves and, if it provides a loan to Indco, it may be treated as deemed dividend under section 2(22)(e) of the Act.
(iv) Subco makes a term deposit with X bank Ltd. and X bank Ltd., on the basis of this security, provides a back to back loan to Indco.

Say, India-LTJ tax treaty provides that interest payment to a LTJ banking company is not taxable in India.

Can this be examined under GAAR?

Interpretation:
This is an arrangement whose main purpose is to bring money out of reserves in Subco to India without payment of due taxes. The tax benefit is saving of taxes on income to be received from Subco by way of dividend or deemed dividend. The arrangement disguises the source of funds by routing it through X bank Ltd. X bank Ltd. may also be treated as an accommodating party. Hence, the arrangement shall be deemed to lack commercial substance.

Consequently, in the case of Indco, the loan amount would be treated as dividend income received from Subco to the extent reserves are available with Subco; and no expense by way of interest would be allowed.

In the case of X bank Ltd, exemption from tax on interest under the DTAA may not be
allowed as X Ltd. is not a beneficial owner of the interest, provided the DTAA has anti-avoidance rule of beneficial ownership. If such anti-avoidance rule is absent in DTAA, then GAAR may be invoked to deny treaty benefit as arrangement will be perceived as an attempt to hide the source of funds of Subco.

(vii) Clause (c) deems an arrangement to lack commercial substance where it involves the location of an asset or of a transaction or of the place of residence of any party and such location is without any substantial commercial purpose. It means if a particular location is selected for an asset or transaction or residence, and such selection has no substantial commercial purpose, then such arrangement shall be deemed to lack commercial substance.

Example -6

Facts:

(i) Y Ltd. is a company incorporated in country C1. It is a non-resident in India.
(ii) Z Ltd. is a company resident in India.
(iii) A Ltd. is a company incorporated in country F1 and it is a 100% subsidiary of Y Ltd.
(iv) A Ltd. and Z Ltd. form a joint venture company X Ltd. in India after the date of commencement of GAAR provisions. There is no other activity in A Ltd.
(v) The India-F1 tax treaty provides for non-taxation of capital gains in the source country and country F1 charges no capital gains tax in its domestic law.
(vi) A Ltd. is also designated as a permitted transferee of Y Ltd. Permitted transferee means that though shares are held by A Ltd, all rights of voting, management, right to sell etc., are vested in Y Ltd.

(vii) As per the joint venture agreement, 49% of X Ltd’s equity is allotted to A Ltd. and 51% is allotted to Z Ltd.

(viii) Thereafter, the shares of X Ltd. held by A Ltd. are sold to C Ltd., a company connected to the Z Ltd. group.

As per the tax treaty with country F1, capital gains arising to A Ltd. are not taxable in India. Can GAAR be invoked to deny the treaty benefit?

**Interpretation:**

The arrangement of routing investment through country F1 results in a tax benefit. Since there is no business purpose in incorporating company A Ltd. in country F1 which is a LTJ, it can be said that the main purpose of the arrangement is to obtain a tax benefit. The alternate course available in this case is direct investment in X Ltd. joint venture by Y Ltd. The tax benefit would be the difference in tax liabilities between the two available courses.

The next question is, does the arrangement have any tainted element? It is evident that there is no commercial substance in incorporating A Ltd. as it does not have any effect on the business risk of Y Ltd. or cash flow of Y Ltd. As the twin conditions of main purpose being tax benefit and existence of a tainted element are satisfied, GAAR may be invoked.

Additionally, as all rights of shareholders of X Ltd. are being exercised by Y Ltd instead of A Ltd, it again shows that A Ltd lacks commercial substance.

Hence, unless it is a case where Circular 789 relating to Tax Residence Certificate in the case of Mauritius, or Limitation of Benefits clause in India-Singapore treaty is applicable, GAAR can be invoked.

**Example -7**

**Facts:**

A Ltd. is incorporated in country F1 as a wholly owned subsidiary of company Y Ltd. which is not a resident of F1 or of India. The India-F1 tax treaty provides for non-taxation of capital gains in India (the source country) and country F1 charges no capital gains tax in its domestic law. Some shares of X Ltd., an Indian company, are acquired by A Ltd in the year after date of coming into force of GAAR provisions. The entire funding for investment by A Ltd. in X Ltd. was done by Y Ltd. These shares are subsequently disposed of by A Ltd after 5 years. This results in capital gains which A Ltd. claims as not being taxable in India by virtue of the India-F1 tax treaty. A Ltd. has not made any other transaction during this period. Can GAAR be invoked?
ANTI AVOIDANCE MEASURES

Interpretation:
This is an arrangement which has been created with the main purpose of avoiding capital gains tax in India by routing investments through a favourable jurisdiction. There is neither a commercial purpose nor commercial substance in terms of business risks or cash flow to Y Ltd in setting up A Ltd. It should be immaterial here whether A Ltd has office, employee etc in country F1. Both the purpose test and tainted element tests are satisfied for the purpose of invoking GAAR.

(viii) In section 97(4), the following factors are considered relevant but not sufficient for determining whether an arrangement lacks commercial substance or not, namely—

(a) the period or time for which the arrangement (including operations therein) exists;
(b) the fact of payment of taxes, directly or indirectly, under the arrangement;
(c) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.

(4) Consequence of impermissible avoidance arrangement [Section 98]

(i) If an arrangement is declared to be an impermissible avoidance arrangement, then the consequences may include denial of tax benefit or a benefit under a tax treaty. The consequence may be determined in such manner as is deemed appropriate in the circumstances of the case. Certain illustrations of the manner have been provided, namely:—

(a) disregarding, combining or re-characterizing any step in, or a part or whole of, the impermissible avoidance arrangement;
(b) treating the impermissible avoidance arrangement as if it had not been entered into or carried out;
(c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;
(d) deeming persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount;
(e) reallocating amongst the parties to the arrangement—
   (1) any accrual, or receipt, of a capital or revenue nature; or
   (2) any expenditure, deduction, relief or rebate;
(f) treating—
   (1) the place of residence of any party to the arrangement; or
   (2) the situs of an asset or of a transaction,
at a place other than the place of residence, location of the asset or location of the
transaction as provided under the arrangement; or

(g) considering or looking through any arrangement by disregarding any corporate structure.

(ii) It has also been provided that –

(a) any equity may be treated as debt or vice versa;
(b) any accrual, or receipt, of a capital nature may be treated as of revenue nature or vice versa; or
(c) any expenditure, deduction, relief or rebate may be recharacterised.

(5) Treatment of connected persons and accommodating party [Section 99]

(i) As per section 99, for the purposes of Chapter X-A, in determining whether a tax benefit exists—

(a) the parties who are connected persons in relation to each other may be treated as one and the same person;
(b) any accommodating party may be disregarded;
(c) such accommodating party and any other party may be treated as one and the same person;
(d) the arrangement may be considered or looked through by disregarding any corporate structure.

(ii) The term ‘connected person’ is defined in section 102 clause (4). Connected person means any person who is connected directly or indirectly to another person and includes -

<table>
<thead>
<tr>
<th>If Connected Person is an</th>
<th>A Company/ Firm/AOP/ BOI/HUF having substantial interest in the business of the person or any director/ partner/ member or any relative of such director/ partner/ member</th>
<th>A Company/ Firm/AOP/ BOI/HUF whose director/ partner/ member has substantial interest in the business of the person or family or any relative of such director/ partner/ member</th>
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<tr>
<td>Individual: any relative or who has substantial interest in the business of the person or any relative of such individual</td>
<td>A Company/ Firm/AOP/ BOI/HUF having substantial interest in the business of the person or any director/ partner/ member or any relative of such director/ partner/ member</td>
<td>A Company/ Firm/AOP/ BOI/HUF whose director/ partner/ member has substantial interest in the business of the person or family or any relative of such director/ partner/ member</td>
</tr>
<tr>
<td>Company any director or relative of such director</td>
<td>A Company/ Firm/AOP/ BOI/HUF having substantial interest in the business of the person or any director/ partner/ member or any relative of such director/ partner/ member</td>
<td>A Company/ Firm/AOP/ BOI/HUF whose director/ partner/ member has substantial interest in the business of the person or family or any relative of such director/ partner/ member</td>
</tr>
<tr>
<td>Firm/ AOP/ BOI any partner/ member or relative of such partner/ member</td>
<td>A Company/ Firm/AOP/ BOI/HUF having substantial interest in the business of the person or any director/ partner/ member or any relative of such director/ partner/ member</td>
<td>A Company/ Firm/AOP/ BOI/HUF whose director/ partner/ member has substantial interest in the business of the person or family or any relative of such director/ partner/ member</td>
</tr>
<tr>
<td>HUF Any member or relative of such member</td>
<td>A Company/ Firm/AOP/ BOI/HUF having substantial interest in the business of the person or any director/ partner/ member or any relative of such director/ partner/ member</td>
<td>A Company/ Firm/AOP/ BOI/HUF whose director/ partner/ member has substantial interest in the business of the person or family or any relative of such director/ partner/ member</td>
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any relative of such director/partner/member has substantial interest in the business of that other person

(6) Framing of guidelines under Income-tax Rules [Section 101]

The provisions of Chapter XA shall be applied in accordance with such guidelines and subject to such conditions as may be prescribed. The existing GAAR rules (2015) were amended by the CBDT on 22nd 2016. After the amendment, the applicable date of GAAR has been changed to April 1st 2017.

Some of the key recommendations that have found place in the rules are:

(i) Threshold of ₹ 3 crores in respect of tax benefit in a relevant assessment year arising in aggregate to all parties to the arrangement.

(ii) GAAR not to apply to Foreign Institutional Investors (“FII”) subject to satisfaction of certain conditions.

(iii) As per the new GAAR notification by CBDT, the investments made before 1st April 2017 will be grandfathered.

(iv) Where a part of an arrangement is declared to be an impermissible avoidance arrangement, the consequences in relation to tax shall be determined with reference to such part only. [Rule 10UA]

(7) Clarifications on certain issues relating to GAAR [Circular No.7 of 2017 dated 27-1-2017]

The provisions of Chapter X-A of the Income-tax Act, 1961 relating to General Anti-Avoidance Rule have come into force from 1st April, 2017. Certain queries have been received by the Board about implementation of GAAR provisions. The Board constituted a Working Group in June, 2016 for this purpose. The Board has considered the comments of the Working Group and the following clarifications are issued:

Question 1: Will GAAR be invoked if SAAR applies?

Answer: It is internationally accepted that specific anti avoidance provisions may not address all situations of abuse and there is need for general anti-abuse provisions in the domestic legislation. The provisions of GAAR and SAAR can coexist and are applicable, as may be necessary, in the facts and circumstances of the case.

Question 2: Will GAAR be applied to deny treaty eligibility in a case where there is compliance with LOB test of the treaty?

Answer: Adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies and the same are required to be tackled through domestic anti-
avoidance rules. If a case of avoidance is sufficiently addressed by LOB in the treaty, there shall not be an occasion to invoke GAAR.

**Question 3:** Will GAAR interplay with the right of the taxpayer to select or choose method of implementing a transaction?

**Answer:** GAAR will not interplay with the right of the taxpayer to select or choose method of implementing a transaction.

**Question 4:** Will GAAR provisions apply where the jurisdiction of the FPI is finalised based on non-tax commercial considerations and such FPI has issued P-notes referencing Indian securities? Further, will GAAR be invoked with a view to denying treaty eligibility to a Special Purpose Vehicle (SPV), either on the ground that it is located in a tax friendly jurisdiction or on the ground that it does not have its own premises or skilled professional on its own roll as employees.

**Answer:** For GAAR application, the issue, as may be arising regarding the choice of entity, location etc., has to be resolved on the basis of the main purpose and other conditions provided under section 96 of the Act. GAAR shall not be invoked merely on the ground that the entity is located in a tax efficient jurisdiction. If the jurisdiction of FPI is finalized based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefit, GAAR will not apply.

**Question 5:** Will GAAR provisions apply to (i) any securities issued by way of bonus issuances so long as the original securities are acquired prior to 1st April, 2017 (ii) shares issued post 31 March, 2017, on conversion of Compulsorily Convertible Debentures, Compulsorily Convertible Preference Shares (CCPS), Foreign Currency Convertible Bonds (FCCBs), Global Depository Receipts (GDRs), acquired prior to 1st April, 2017; (iii) shares which are issued consequent to split up or consolidation of such grandfathered shareholding?

**Answer:** Grandfathering under Rule 10U(1)(d) will be available to investments made before 1st April 2017 in respect of instruments compulsorily convertible from one form to another, at terms finalized at the time of issue of such instruments. Shares brought into existence by way of split or consolidation of holdings, or by bonus issuances in respect of shares acquired prior to 1st April 2017 in the hands of the same investor would also be eligible for grandfathering under Rule 10U(1)(d) of the Income Tax Rules.

**Question 6:** The expression "investments" can cover investment in all forms of instrument - whether in an Indian Company or in a foreign company, so long as the disposal thereof may give rise to income chargeable to tax. Grandfathering should extend to all forms of investments including lease contracts (say, air craft leases) and loan arrangements, etc.

**Answer:** Grandfathering is available in respect of income from transfer of investments made before 1st April, 2017. As per Accounting Standards, 'investments' are assets held by an enterprise for earning income by way of dividends, interest, rentals and for capital appreciation. Lease contracts and loan arrangements are, by themselves, not 'investments' and hence grandfathering is not available.
Question 7: Will GAAR apply if arrangement held as permissible by Authority for Advance Ruling?

Answer: No. The AAR ruling is binding on the PCIT / CIT and the Income Tax Authorities subordinate to him in respect of the applicant.

Question 8: Will GAAR be invoked if arrangement is sanctioned by an authority such as the Court, National Company Law Tribunal or is in accordance with judicial precedents etc.?

Answer: Where the Court has explicitly and adequately considered the tax implication while sanctioning an arrangement, GAAR will not apply to such arrangement.

Question 9: Will a Fund claiming tax treaty benefits in one year and opting to be governed by the provisions of the Act in another year attract GAAR provisions? An example would be where a Fund claims treaty benefits in respect of gains from derivatives in one year and in another year sets-off losses from derivatives transactions against gains from shares under the Act.

Answer: GAAR provisions are applicable to impermissible avoidance arrangements as under section 96. In so far as the admissibility of claim under treaty or domestic law in different years is concerned, it is not a matter to be decided through GAAR provisions.

Question 10: How will it be ensured that GAAR will be invoked in rare cases to deal with highly aggressive and artificially pre-ordained schemes and based on cogent evidence and not on the basis of interpretation difference?

Answer: The proposal to declare an arrangement as an impermissible avoidance arrangement under GAAR will be vetted first by the Principal Commissioner / Commissioner and at the second stage by an Approving Panel, headed by judge of a High Court. Thus, adequate safeguards are in place to ensure that GAAR is invoked only in deserving cases.

Question 11: Can GAAR lead to assessment of notional income or disallowance of real expenditure? Will GAAR provisions expand the scope of charging provisions or scope of taxable base and/or disallow the expenditure which is actually incurred and which otherwise is admissible having regard to diverse provisions of the Act?

Answer: If the arrangement is covered under section 96, then the arrangement will be disregarded by application of GAAR and necessary consequences will follow.

Question 12: A definite timeline may be provided such as 5 to 10 years of existence of the arrangement where GAAR provisions will not apply in terms of the provisions in this regard in section 97(4) of the Income-tax Act, 1961.

Answer: Period of time for which an arrangement exists is only a relevant factor and not a sufficient factor under section 97(4) to determine whether an arrangement lacks commercial substance.

Question 13: It may be ensured that in practice, the consequences of a transaction being treated as an 'impermissible avoidance arrangement' are determined in a uniform, fair and rational basis. Compensating adjustments under section 98 of the Act should be done in a consistent and fair manner. It should be clarified that if a particular consequence is applied in
the hands of one of the participants, there would be corresponding adjustment in the hands of another participant.

**Answer:** Adequate procedural safeguards are in place to ensure that GAAR is invoked in a uniform, fair and rational manner. In the event of a particular consequence being applied in the hands of one of the participants as a result of GAAR, corresponding adjustment in the hands of another participant will not be made. GAAR is an anti-avoidance provision with deterrent consequences and corresponding tax adjustments across different taxpayers could militate against deterrence.

**Question 14:** Tax benefit of INR 3 crores as defined in section 102(10) may be calculated in respect of each arrangement and each taxpayer and for each relevant assessment year separately. For evaluating the main purpose to be obtaining of tax benefit, the review should extend to tax consequences across territories. The tax impact of INR 3 crores should be considered after taking into account impact to all the parties to the arrangement i.e. on a net basis and not on a gross basis (i.e. impact in the hands of one or few parties selectively).

**Answer:** The application of the tax laws is jurisdiction specific and hence what can be seen and examined is the Tax Benefit' enjoyed in Indian jurisdiction due to the 'arrangement or part of the arrangement'. Further, such benefit is assessment year specific. Further, GAAR is with respect to an arrangement or part of the arrangement and therefore limit of Rs. 3 crores cannot be read in respect of a single taxpayer only.

**Question 15:** Will a contrary view be taken in subsequent years if arrangement held to be permissible in an earlier year?

**Answer:** If the PCIT/Approving Panel has held the arrangement to be permissible in one year and facts and circumstances remain the same, as per the principle of consistency, GAAR will not be invoked for that arrangement in a subsequent year.

**Question 16:** No penalty proceedings should be initiated pursuant to additions made under GAAR at least for the initial 5 years.

**Answer:** Levy of penalty depends on facts and circumstances of the case and is not automatic. No blanket exemption for a period of five years from penalty provisions is available under law. The assessee, may at his option, apply for benefit u/s 273A if he satisfies conditions prescribed therein.