The BEPS Project: An Overview

According to the Organisation for Economic Cooperation and Development (OECD), BEPS (base erosion and profit shifting) refers to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations. Under the inclusive framework, more than 100 countries and jurisdictions are collaborating to tackle the BEPS and implement its measures. This has been one of the most far-reaching developments in the tax landscape in the recent times. There has been unprecedented cooperation to counter the double non-taxation or less than single taxation through various strategies that shift the tax base out of countries and this has culminated in the BEPS Actions Final Reports. The implementation of the recommended measures, through changes in domestic law and amendment of treaties through multilateral instruments, underscores the importance of understanding the rationale behind the suggested measures as articulated in these reports. Read on…

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Background

Base erosion and profit shifting ("BEPS") refers to strategies adopted by multinational enterprises ("MNE") which lead to double non-taxation or less than single taxation due to asymmetries in domestic and international tax rules or artificial separation of taxable profits from the jurisdiction where profits

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arise and the place where economic activities take place. The OECD-G20 Base Erosion and Profit Shifting Project was officially launched in July 2013 with the BEPS Action Plan being submitted to the heads of G20 nations. The Action Plan identified 15 actions to address the BEPS challenges in a time-bound manner. It was declared at the G20 meeting that *"countries should change rules that let companies shift their profits across borders to avoid taxes, and multinationals should report to tax authorities what tax they pay where"*.[1] The Project progressed at a stupendous speed and culminated in the adoption of final reports on the *Action Plans* in 2015.

Each Action Plan can be slotted into one of the three pillars of the BEPS Project: coherence, substance and transparency. The Action Plans seek to address various strategies of multinational enterprises to shift profits out of countries and erode their tax base. Several of these actions demand a response under the domestic law while some involve amending the existing double tax treaties. Various action plans are described in the following paragraphs:

Amendments to Domestic Law

Tax challenges of the Digital Economy (Action 1)

BEPS Action 1 Report identifies various policy challenges to taxing income from digital economy as (i) absence of extensive physical presence unlike the physical economy; (ii) attribution of value to information/data gathered and used across borders; and (iii) uncertainties behind current characterisation of income from digital economy as to whether the income is royalty or fees for technical services (FTS) or business profits, or whether services, rentals or FTS. It was widely felt that the global companies in the digital economy space were not paying income-taxes anywhere and there was a need to tackle such "stateless income" and restore source taxation.

Various potential options were discussed in the Report but the Report was inconclusive. The options were *(i)* a new nexus in the form of a significant economic presence, *(ii)* a withholding tax on certain types of digital transactions, and *(iii)* an equalisation levy. The Report did not recommend any of the options but left it to the countries to introduce any of them in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties. It was decided to continue further work in this area and revisit the same in the five years in 2020.

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Interest deduction limitation (Action 4)

This *Action* aims to identify solutions to address BEPS using interest and economically equivalent payments, minimising distortions to competitiveness of groups and distortions to investment in a country, avoiding double taxation and providing certainty of outcome. This *Action* contemplates introduction of provisions under the domestic law for limiting interest deductions. The Action recommends that the domestic rules should cover interest on all forms of debt and payments economically equivalent to interest which are linked to financing of an entity. Interestingly, the *Action* does not recommend that such provisions to be restricted to only payments to related/connected persons.

Section 94B was inserted in the Income-tax Act, 1961 with effect from 1st April 2018. In contrast to the recommendations of BEPS Action 4, Section 94B is limited to only payments to related parties. It is not a thin-capitalisation provision[2] as is generally understood as this limitation of deduction will be attracted even in a case where the assessee is appropriately capitalised though does not have adequate profits.

[1] Lough Erne Declaration of the G 8 in June 2013.
[2] Thin capitalisation situation is when an enterprise has a high debt to equity ratio, that is, the enterprise is "highly leveraged".

Countering Harmful Tax regimes (Action 5)

Based on a 1998 OECD Report on Harmful Tax Competition, BEPS Action 5 is concerned with the "race to the bottom" where every jurisdiction competes in providing benevolent tax regimes even where there are insufficient activities in that jurisdiction and aims to wean away the tax base of the competing jurisdiction(s). This Action recommends countering such harmful tax competition and suggests measures aimed at realigning taxation of profits with the *substantial activities* that generate them by adopting the "nexus approach". This approach uses expenditure as a proxy for activity. Another measure recommended by Action 5 is for improving *transparency* through spontaneous exchange of information on rulings related to preferential tax regimes.

A jurisdiction is defined as a harmful preferential tax regime if the regime shifts activity from another country to regime country, the level of activity in host country not commensurate with investment and income in that country and the relocation of the activity is because of the existence of the preferential tax regime. A peer review process is put in place to identify potentially harmful preferential tax regimes and to encourage countries to dismantle such regimes. India's regime for 'Special provisions in respect of newly established units in special economic zones' and 'Deductions in respect of certain incomes of offshore banking units and international financial services centre' have been found in peer review to be not harmful. The recently-introduced 'patent regime'[3] is also expected to be 'not harmful' considering the substantial activity and nexus requirements for being eligible for the tax concessions.

Transfer pricing (Actions 8 to 10 and Action 13)

BEPS Actions 8, 9 and 10 recommendations aim to assure transfer pricing outcomes are in line with value creation. The *Actions* focus on three areas. The first is in the area of intangibles where the *Actions* recommend that the legal owner of an intangible should be entitled to intangible-related returns only

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if, in relation to its development, enhancement, maintenance and protection, it performs and controls all important functions, controls functions outsourced to other enterprises who are paid at arm's length, provides all assets necessary and bears and controls all risks and costs. The second area is in respect of allocation of risk. The *Actions* recommend that the contractual allocations of risk are to be respected only when they are supported by actual decision-making and thus exercising control over these risks. The third is in respect of other high-risk areas, like addressing commercially irrational profit allocations resulting from controlled transactions, 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 in respect of management fees and head office expenses which are often used between MNE members to erode the tax base. The 2016 update of the OECD Transfer Pricing Guidelines for Multinational Enterprises incorporates extensively the discussions and the recommendations of the BEPS Actions 8 to10.

Action 13 has the objectives to remedy the asymmetry of information between tax payers and tax administrations, develop the "big picture" of MNE's global value chain, enhance transparency for tax administrations with global information about the MNE, enable high level TP risk assessments and allocation of audit resources, ensure taxpayers articulate consistent TP positions and to further the understanding, controlling and tackling BEPS behavior. Action 13 recommends standardised approach to further these objectives and introduces a three-tier documentation:

- A master file, which is a blueprint for all MNE group members containing organisational structure, description of business or businesses, intangibles, inter-company financial activities and MNE's financial & tax positions;
- A local file containing material transactions of the local taxpayer; and
- A country-by-country report which aggregates jurisdiction-wise information relating to global

[3] Section 115BBF of the Income-tax Act, 1961 (the "Act").

allocation of the MNE's income and taxes and indicators of location of economic activity within the group which would be useful for high-level risk assessment.

Section 286 was inserted in the Act with effect from 1st April 2017 to implement these recommendations contained in Action 13. In a recent development, the CBDT has recently issued draft rules for maintaining and furnishing of TP documentation in the Master File and Country-by Country Reporting.[4]

Amendments to Existing Double Tax Treaties

Several recommendations contained in the BEPS reports to be implemented require amendment into the existing bilateral double tax treaties. Since it was impracticable to renegotiate 3000 odd treaties bilaterally, a multilateral instrument (MLI) was drafted, which was signed by 68 countries on 7th June 2017 with 71 signatories till date. The MLI will not replace the existing treaties but the treaties have to be read together with the relevant MLI provisions. The various articles of the MLI deal with a recommendation in the Final Report on the BEPS Actions and, thus, relate back to the relevant Report. Since the MLI provisions have been dealt with in an earlier article,[5] this write up focuses on describing the important measures recommended by the Reports on these *Action Plans*.

Action 6 – Preventing Treaty Abuse

Treaty abuse, especially, treaty shopping, has been the concern of countries as it has been believed that these strategies lead to double non-taxation and less than single-taxation. The measures recommended by Action 6 to counter treaty abuse are (i) amendment of the title and preamble to tax treaty conventions; (ii) insertion of a Limitation of Benefits ("LOB") clause and/or (iii) insertion of a Principle Purpose Test ("PPT") clause. These measures provide multiple options to countries so as to give them flexibility to deal suitably with their unique circumstances as well as to not undermine their tax sovereignty.

The title and preamble of treaties are to be amended to include the express intention of the contracting states that the treaties are intended to eliminate double taxation without creating any opportunities for tax avoidance and/or evasion, including through treaty shopping arrangements. This measure is a minimum standard that countries are required to adopt. Article 6 of the MLI contains the relevant provisions.

The LOB rule aims to limit the persons who are entitled to treaty benefits to those residents (qualifying persons) who (i) have sufficient nexus to the residence state; (ii) carry out actual business activities; or (iii) are bona fide participants in the transactions/arrangements. The LOB rule is aimed at denying treaty benefits to a resident of a Contracting State who is not a qualified person based on the above and provides a list of those situations where the resident would be a qualified person.

The PPT rule denies treaty benefits where one of the principal purposes of that transaction or arrangement is to obtain a benefit, unless it is in accordance with the object and purpose of the relevant provision of the Convention. Similar guidance is contained in Article 1 OECD Model Commentary. This rule is akin to a general anti-avoidance rule (GAAR) and is aimed at strategies like conduit financing arrangements which may not get filtered through the LOB rule.

The LOB is an objective test while the PPT is subjective. Both the rules are standalone and a person has to pass both the tests to be entitled to benefits of the relevant treaty. Both these measures are contained in Article 7 of the MLI.

Action 7 – Artificial avoidance of PE Status

This Report has three focus areas. The first is to counter avoidance of PE through *commissionaire* arrangements or other similar strategies. These include cases where contracts are not concluded in the name of the foreign enterprise though they are performed on behalf of the foreign enterprise, or cases where contracts are substantially negotiated in a State but are not formally concluded in that State because they are finalised or authorised abroad, or where the authority to conclude contracts is with an "independent agent" who is closely related to the foreign enterprise on behalf of which it is acting. The Action recommends changes to Article 5 of the tax treaties which would result a PE being constituted where a person acting in a Contracting State on behalf of an enterprise and habitually concludes contracts or plays the principal role leading to the conclusion of contracts and these contracts are in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or for provision of services

[4] F No. 370142/25/2017-TPL dated 6th October, 2017 issued by the CBDT.
[5] Refer to pp.398 -406, *The Chartered Accountant*, Vol. 66, No. 3, September 2017, for a more detailed discussion on MLI.

by that enterprise. The policy objective that is being furthered by this Action is where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a taxable presence in that country. This change substantially widens the scope for constitution of a PE. The Article 12 of the MLI deals with this change.

The second focus area is to restrict the specific activity exemption available in treaties in respect of preparatory and auxiliary activities. The Report recognises that due to changes in business models, activities previously considered to be merely preparatory or auxiliary in nature may actually now be core business activities. The Report recommends taxation of core activities performed in a State by modifying Article 5(4) of treaties so as to ensure that each of the exceptions contained in that paragraph is restricted to activities that are otherwise of a "preparatory or auxiliary" character. Further, the Report also recommends modifying the treaties to clarify that, it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations so that each part falls in the exempted preparatory or auxiliary activities, in order to obtain benefit from the exceptions of Article 5(4). These changes to treaties are dealt with by Article 13 of the MLI.

The third area of focus is the practice of splitting up of contracts between closely related enterprises to avoid constituting a PE in cases of construction projects by keeping under the threshold of number of days specified in the treaties. Article 14 of the MLI implements this recommendation.

Action 14– Making Dispute resolution mechanisms effective

The BEPS Action 14 aims to strengthen the effectiveness and efficiency of the Mutual Agreement Procedure ("MAP") by minimising the risks of uncertainty and unintended double taxation through consistent and proper implementation of tax treaties and the effective and timely resolution of disputes. This Action adopts a minimum standard which will ensure that (i) the treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner; (ii) the administrative processes that promote the prevention and timely resolution of treaty-related disputes are implemented; and (iii) ensure that taxpayers can access the MAP when eligible.

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Article 16 of the MLI is to implement the minimum standards and best practices recommended under Action 14 for improving dispute resolution.

Economic double taxation results where an upward transfer pricing adjustment to taxable income of a taxpayer is made in one country and a corresponding downward adjustment in the income of the associated enterprise is not made by its country of residence. Several double tax treaties provide for the corresponding adjustment in Article 9(2) of tax treaties. However, several treaties do not have this provision. Some countries, including India, take the stand that they are not obliged to make corresponding adjustments or to grant access to the MAP with respect to the economic double taxation that may result from a primary transfer pricing adjustment where a provision in the treaty akin to article 9(2) is absent. BEPS Action 14 declares that such a position frustrates one of the primary objectives of tax treaties, which is elimination of double taxation, as well as prevents bilateral consultation under MAP to determine appropriate transfer pricing adjustments. These measures regarding corresponding adjustments are contained in Article 17 of the MLI.

Conclusion

Planning, especially in the context of tax, has become a bad word. Governments world over are tightening the tax rules and the BEPS project has provided a platform for coordinated efforts among the countries in this direction. Increased transparency globally due to the exchange of information between countries has taken the battle against tax avoidance to the doors of the multinational companies. The changes to domestic law and double tax treaties emanating from the BEPS Project are significant and far-reaching. The interpretation of treaties, especially now with the MLI, has become more challenging. One can expect further developments, especially in the taxation of digital economy, in the years to come. ■