Outbound investment - Post BEPS - Planning and Challenges

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18th June, 2016, Mumbai

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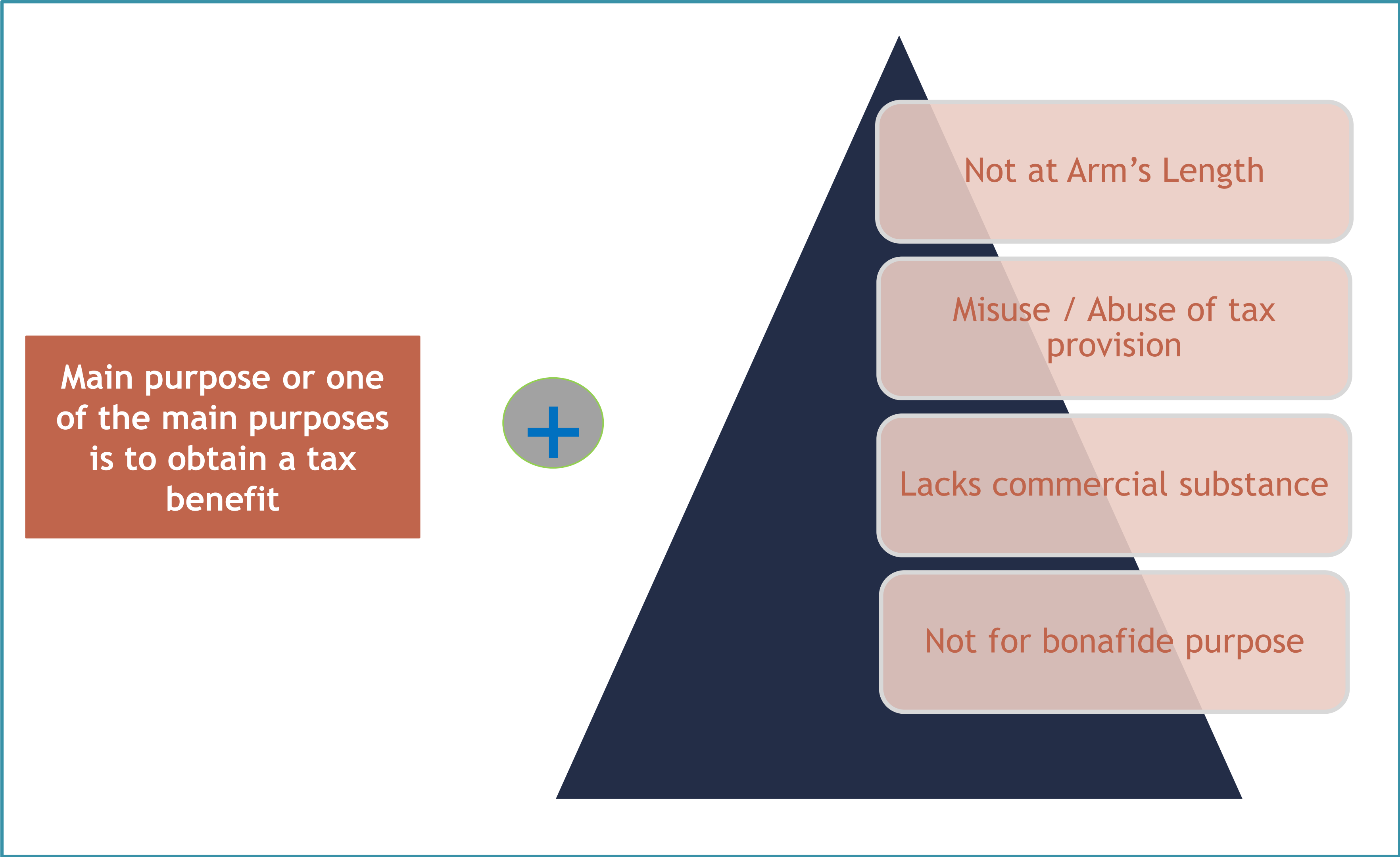
- International Tax Scenario - BEPS & GAAR
- Treaty Shopping
- Interest Deduction
- Hybrid Instruments
- Flipping control abroad
- Substance requirements
- Key take aways

Global Tax Scenario

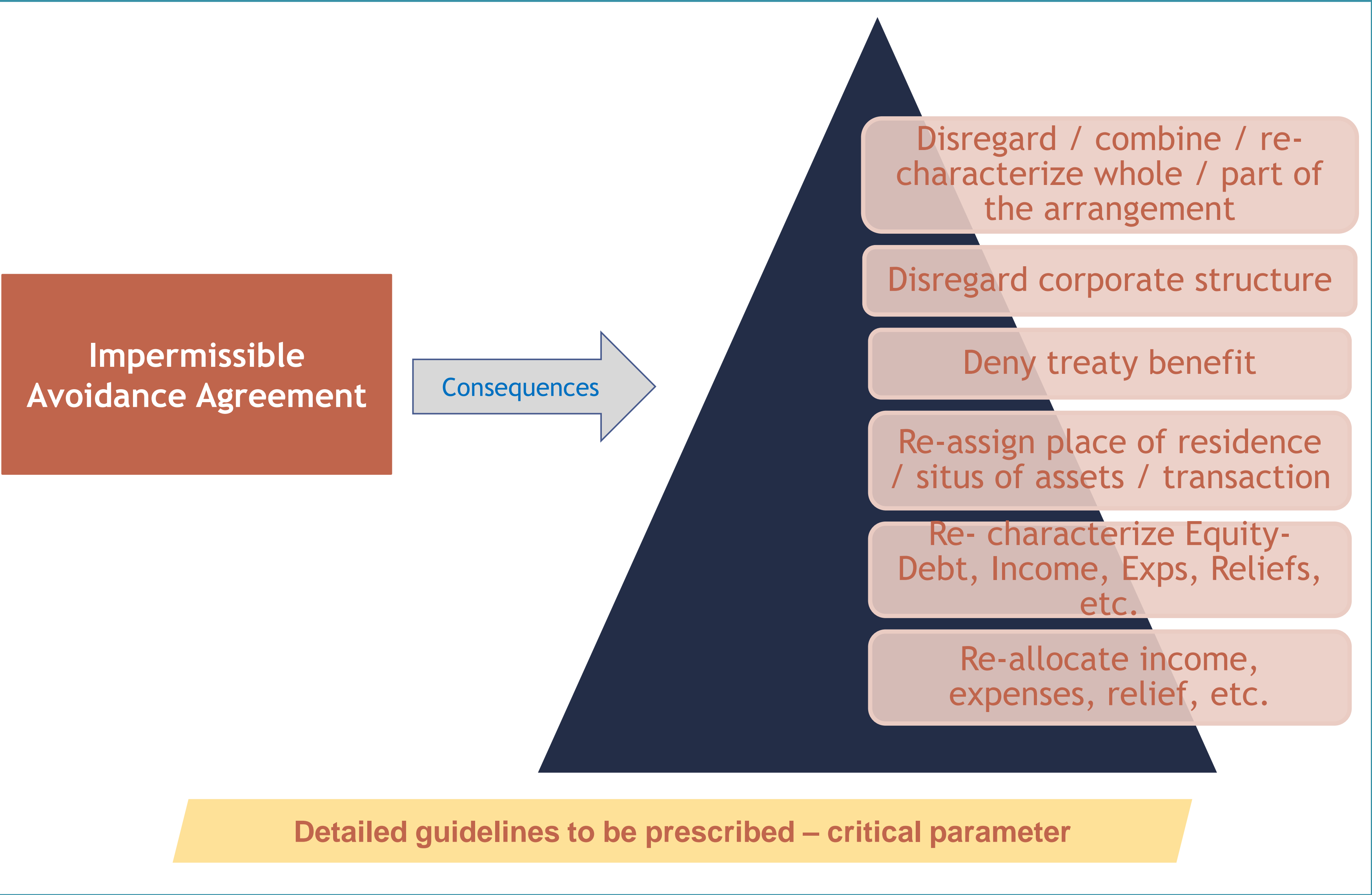
Global tax Scenario

- Governments are under extreme fiscal pressure as a consequence of the global economic crisis
- As a consequence, there is increased political focus on perceived tax avoidance by multinationals
- G20 countries (which includes India) are concerned that current international tax rules and frameworks are inadequate
- The OECD response to growing pressure was to release the Base Erosion and Profit Shifting (‘BEPS’) report
- There is a drive to develop a tax system that is fit for purpose for today’s multinationals and digital age
- India expected to associate with outcome of BEPS report

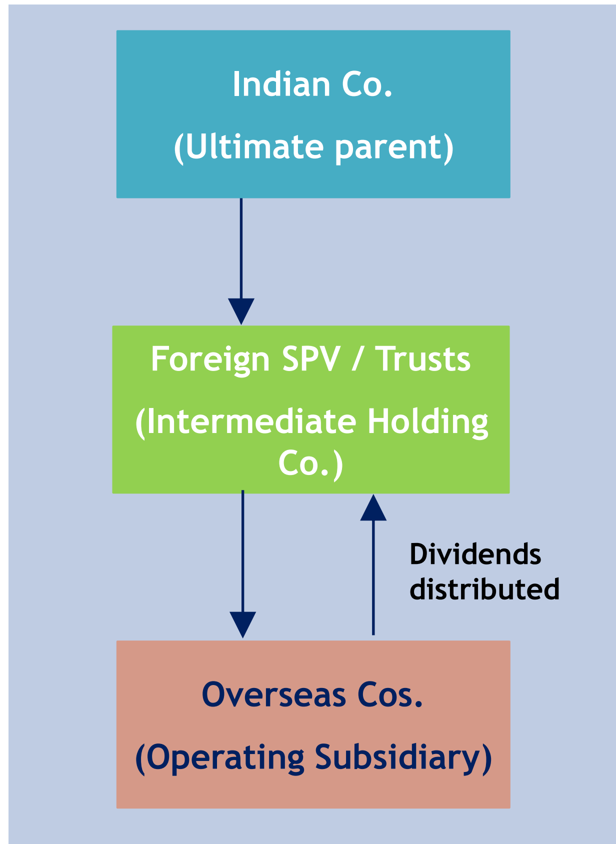
GAAR - Basic Provisions



GAAR - Basic Provisions



GAAR - Applicability to Outbound Investment



- Currently, Indian Co. is not taxed on dividends parked in Foreign SPV Co(s) / Private Trusts
- Under GAAR:
  - Can this corporate structure be disregarded - using 'look through' provision; or
  - Can Foreign SPV Co(s) / Private Trusts be treated as an Indian tax resident - shifting the 'place of residence'

Will the conclusion differ if SPV incorporated to avail low cost borrowing?

BEPS - Meaning

- ***"Base Erosion 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"*** - *OECD FAQs*
- Base Erosion refers to the reduction of companies that can be taxed and the amount of profits that a country can tax
  - Achieved by means of shifting residence to different country or causing profits to arise in different country (by transfer of intellectual property, etc.)
- Profit Shifting refers to aggressive tax planning strategies focussed on shifting profits out of high tax country to lower tax country

BEPS strategies may not necessarily be illegal
Increased globalisation enables companies to exploit gaps arising on interaction of domestic tax systems and treaty rules within the boundary of acceptable tax planning

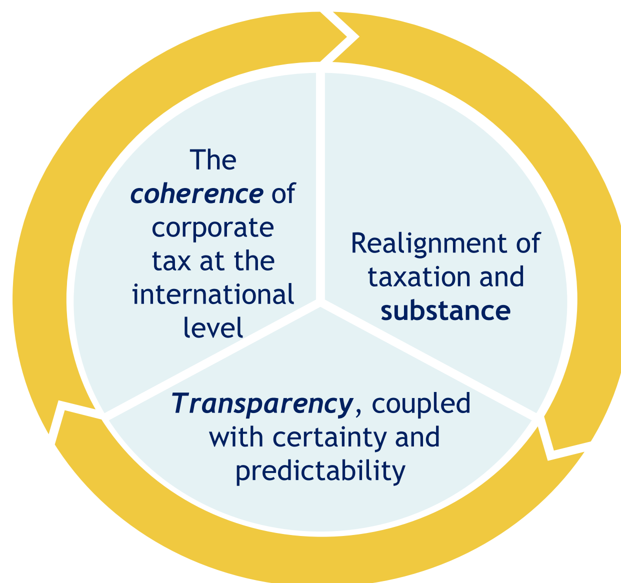
BEPS – In a nutshell

In a nutshell ...

On 19 July 2013 the OECD released an *Action Plan on Base Erosion and Profit Shifting* (BEPS) which was presented to the meeting of G20 Finance Ministers in Moscow..

The purpose of the Action Plan is *"to prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from activities that generate it."*

The report indicates that "no or low taxation is not per se a cause for concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it."



The Action Plan covers 15 specific Actions which are broadly to be achieved within a two year time frame (i.e. by the end of 2015).

Focus on key items

- Transfer pricing, hybrids, interest deductions, treaty abuse and the digital economy

Wide ranging actions, for example:

- Changes to the Model Tax Convention (e.g. in relation to hybrids, treaty abuse)
- Recommendations regarding the design of domestic law (e.g. CFC rules, interest deductions)
- Changes to the TP guidelines (e.g. in relation to ensuring TP outcomes are in line with value creation)

A number of the actions are linked, for example:

- The actions on CFCs, interest deductions, and hybrids will be closely linked

BEPS Timelines

June 2012
Project announced / started

February 2013
Document released 'Addressing Base Erosion and Profit Shifting'

July 2013
Release of Action Plan with 15 separate actions/work streams

September 2014
Project Completion of approximately 1/3 of Action Plan

September 2015
Completion of remainder action plan

2016 onwards
Monitoring, additional / ongoing actions

Action Item1*: Digital Economy

Coherence

- **Action Item 2*:** Hybrid mismatch arrangement
- **Action Item 3:** Controlled Foreign Company rules (CFC)
- **Action Item 4:** Interest deductions
- **Action Item 5*:** Harmful Tax practises

Substance

- **Action Item 6*:** Preventing tax treaty abuse
- **Action Item 7:** Avoidance of permanent establishment status
- **Action Item 8*:** Transfer Pricing aspects of intangibles
- **Action Item 9:** Transfer Pricing/risk and capital
- **Action Item 10:** Transfer pricing/high risk transactions

Transparency

- **Action Item 11:** Methodologies and data analysis
- **Action Item 12:** Disclosure rules
- **Action Item 13*:** Transfer pricing documentation
- **Action Item 14:** Dispute resolution

Action Item 15*: Multilateral Instrument

BEPS Hotspots and Actions

Hotspots

- Digital economy
- Hybrids
- Treaty abuse
- Dependence on specific PE exceptions
- Significant interest deductions
- Intangibles, and which group company has an interest
- Contractual allocation of risk and capital versus KERTS/Significant People Functions
- Does TP policy overall make economic sense?

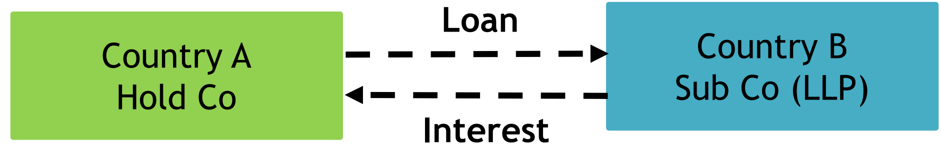
Actions

- Operational structures - does income reflect economic activity? Particular focus should be placed on the use and exploitation of intangibles
- Transfer pricing policy – is it fit for purpose? A renewed focus on APAs?
- Robust documentation and evidences to be maintained - especially qua conduct of parties
- International financing and organisational structures – are they sustainable in light of the BEPS recommendations?
- Consider potential impact on planning arrangements currently being contemplated

Transactions leading to BEPS

Hybrid Entities

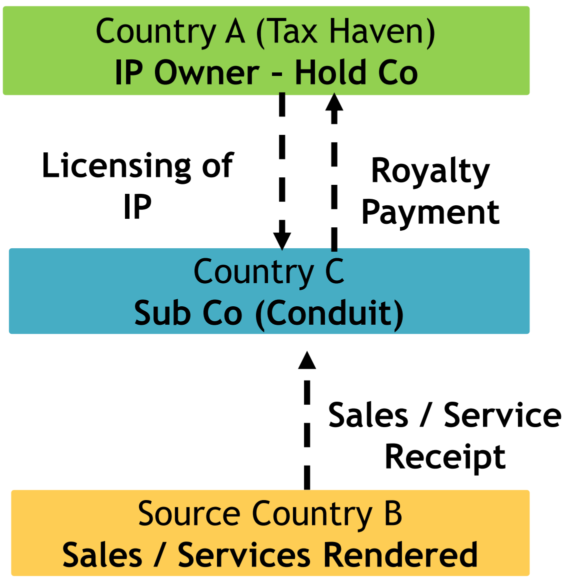
Country A treats Sub Co as transparent entity *- No tax on interest income since country A doesn't recognise income in hands of Hold Co received from Sub Co*



Country B treats Sub Co as non-transparent entity *- Deduction of interest paid to Hold Co allowed in Country B*

Conduit Companies

Country B doesn't have a treaty with Country A *(being a tax haven)*
Thus, conduit company interposed in country C, which has treaty with country B to reduce tax liability in country B



Income ultimately up streamed to Country A - No tax liability in C owing to no withholding tax under domestic laws of C or under treaty

Income from sales / services accrues in C but minimal tax liability due to deduction of royalty payments

Transactions leading to BEPS

- **Derivatives**
  - Fees for derivative contracts economically replace interest payments
  - However, withholding taxes avoided as such fees not subject to tax at source under domestic laws or treaty
- **Transfer Pricing**
  - Shifting of risks and hard to value intangibles to low tax jurisdictions by MNEs
  - Low risk manufacturing and distribution arrangements and contract R&D arrangements with principal located in low tax jurisdiction and service provider located in high tax jurisdiction
- **Circumvention of anti-avoidance Rules**
  - Channelling financing through an independent third party when thin capitalisation rules apply only in respect of borrowings from related parties
  - Replacing the existing parent company with a non-resident company located in a low / no-tax jurisdiction with no CFC regime
  - Use of hybrid entities to make income disappear in country of ultimate parent

Target Areas of BEPS Project

International mismatches in entity and instrument characterisation – hybrid mismatch arrangements and arbitrage

Application of treaty concepts to profits from digital goods and services

Tax treatment of related party debt-financing, captive insurance and other inter-group financial transactions

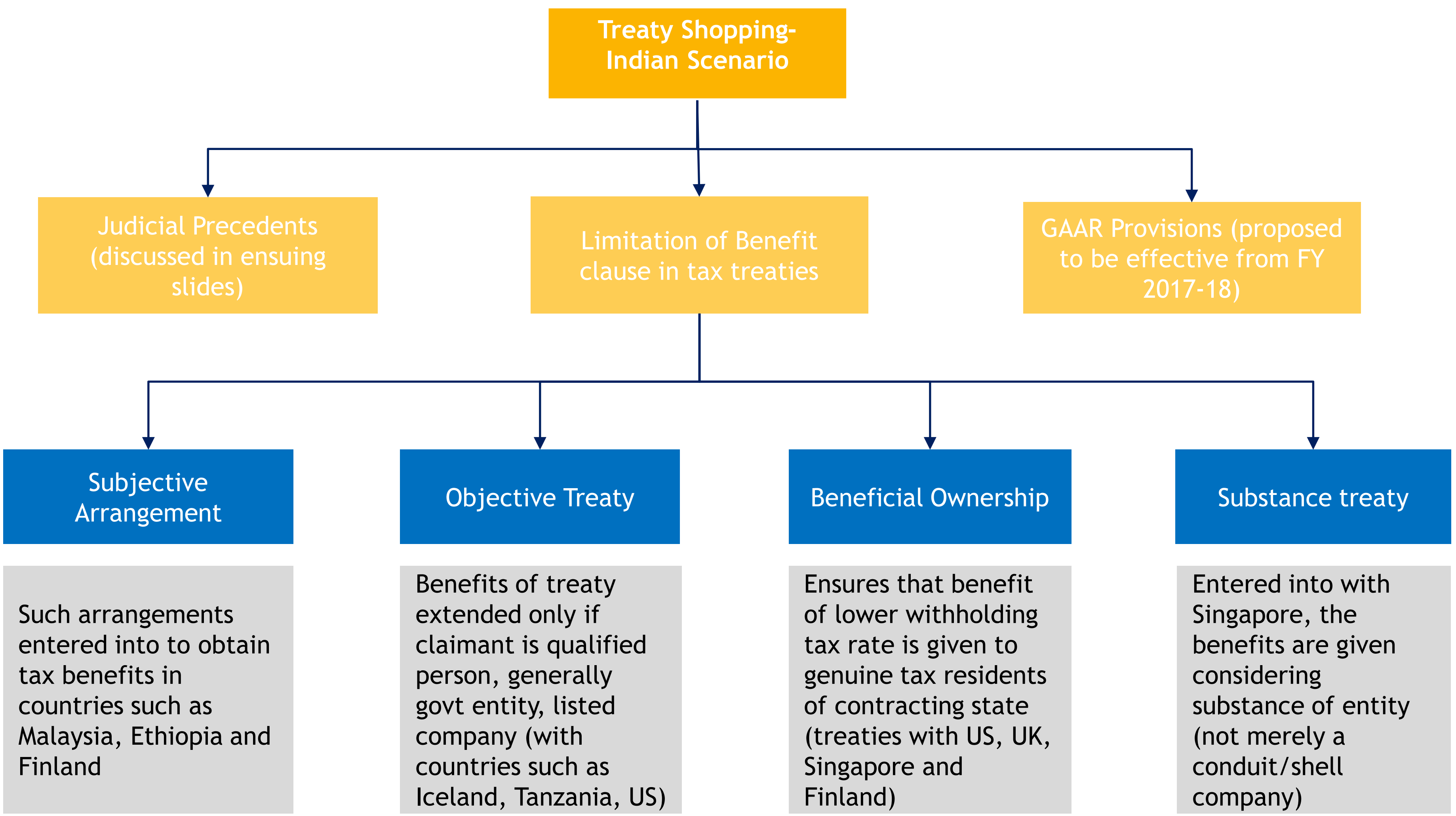
Transfer Pricing – Shifting of risks and intangibles, artificial splitting of ownership of assets

Effectiveness of anti-avoidance measures – GAAR, CFC regime, thin capitalisation rules, prevention of treaty abuse

Availability of harmful preferential regime

Treaty Shopping

Treaty Shopping - Indian Scenario



Treaty Shopping - Indian Decisions - Trilogy

Mc Dowell & Co. Ltd Vs. Commercial tax officer (SC) (TS-1-SC-1985)

- Where a transaction is structured in such a way that its sole purpose is to avoid tax, the same would be disregarded for determining tax liability
- Tax planning may be legitimate provided it is within the framework of law. Colorable devices cannot be part of tax planning and it is wrong to encourage resorting to dubious method

Union of India Vs. Azadi Bachao Andolan (SC) (TS-5-SC-2003)

- Hon'ble Supreme Court held that Tax residency certificate issued by Mauritius authority was to be taken as conclusive evidence of residency for applying tax treaties
- What is relevant is 'liability to tax' and not the factum of actual taxation to claim treaty benefit. It is worthless to argue that double taxation could arise only when tax had been paid in one contracting state.

Vodafone International Holdings B.V. Vs. UoI (SC) (TS-23-SC-2012)

- Revenue cannot start with the question as to whether the impugned transaction is a tax deferment / saving device but it should apply the 'look at' approach to ascertain true legal nature of transaction
- The authorities should invoke the ' substance over form' principle or 'piercing of corporate veil' test only after it is able to establish that the transaction is sham or tax avoidance

Companies to claim legitimate benefit of tax treaties instead of using sham transactions to avoid tax

Treaty Shopping - Vodafone decision – Key observations

- Tax planning within the framework of law is permissible unless it is a sham / colorable device
- Onus on the tax authority that the transaction is sham
- LOB and 'look through' provisions cannot be read into the DTAA
- In the absence of LOB and existence of an administrative circular, capital gains benefit cannot be denied at the time of divestment
- However, tax authority can deny DTAA benefit if it Mauritius company is without commercial substance or interposed to avoid tax (for eg round tripping transactions)
- True nature to be ascertained by **'looking at'** the legal arrangement actually entered into and carried out
- 'Timing test' relevant to determine the genuineness of the structure
- TRC to be accepted as conclusive for residency and beneficial ownership. However, to be ignored if DTAA used for fraudulent purpose of tax evasion.
- The Court held that there was no conflict between McDowells and Azadi Bachao

Treaty Shopping – BEPS Action

Recommendations for model treaty provisions and changes in domestic rules to prevent misuse of treaty benefits

- Specific anti-abuse rule in tax treaties based on limitation-of-benefit provisions recommended
- Add to tax treaties a more general anti-abuse rule based on the principle purposes of transactions or arrangements (the principal purposes test or 'PPT' rule)

Clarify tax treaties are not intended to be used to generate double non-taxation

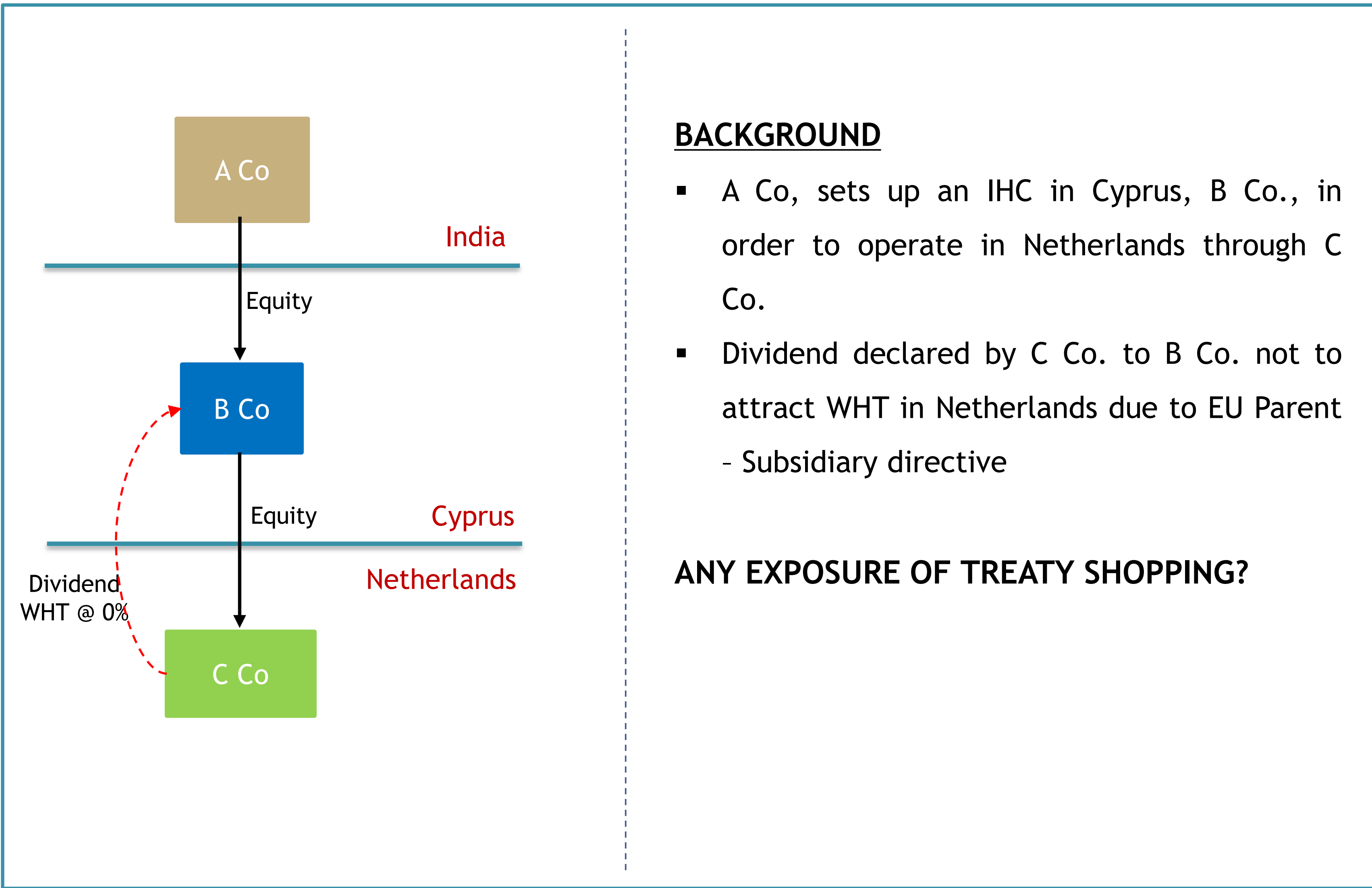
- Title / preamble of Model Tax Convention tax treaties to be reformulated to clarify that tax treaties are not intended to generate double non-taxation

Identify tax policy considerations for countries before deciding to enter into a tax treaty with another country

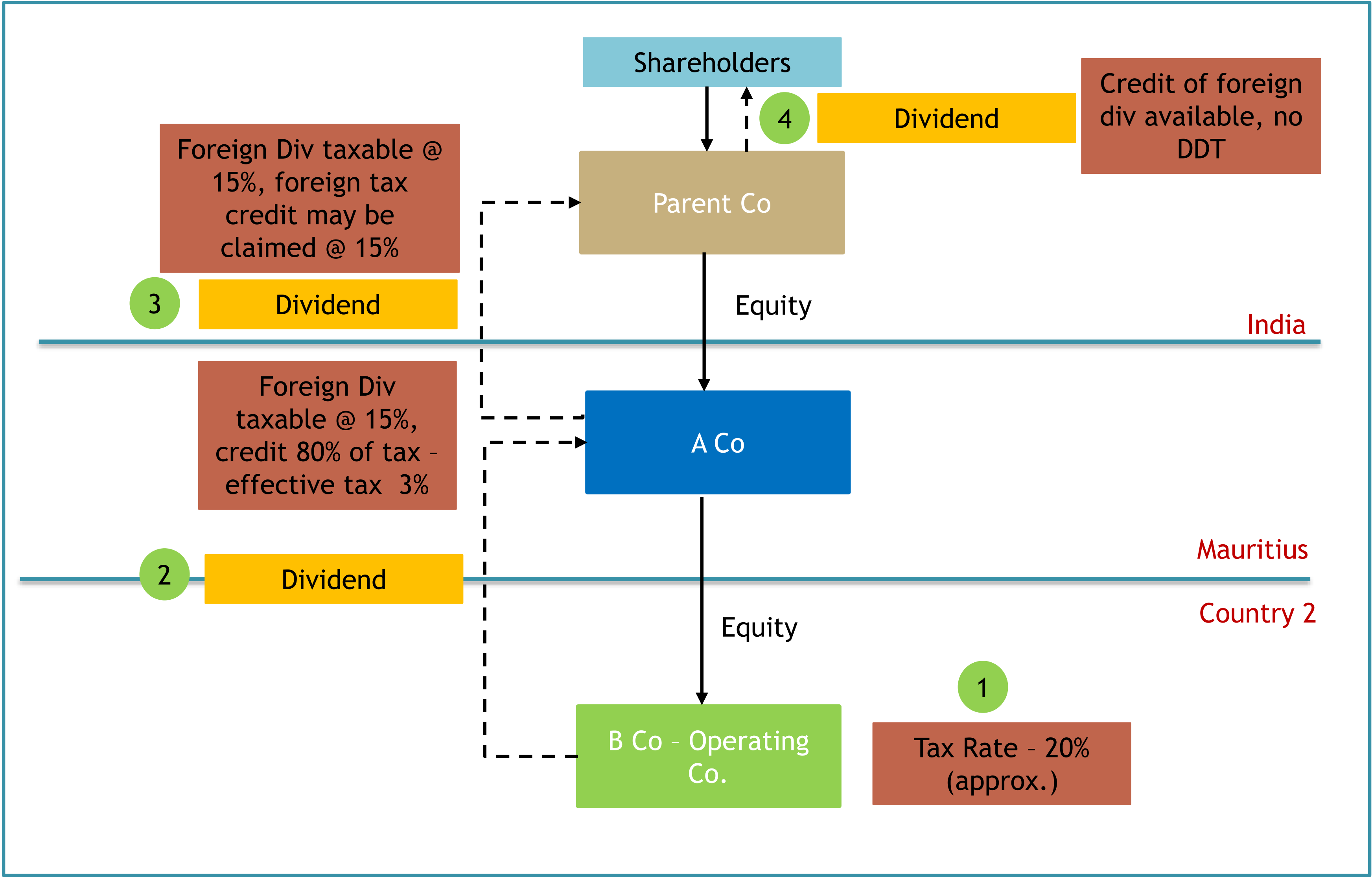
- Policy consideration to help countries deciding whether or not to enter into tax treaties with low or no-tax jurisdictions
- Countries to reconsider whether or not to modify treaty previously concluded in the event of change in circumstances raising BEPS concerns

Suggested modification in the preamble / title in Model Tax Convention would aid in interpreting that tax treaties are not intended to generate double non-taxation

Treaty Shopping - Case Study 1



Treaty Shopping - Case Study 2



Treaty Shopping – Case Study 2

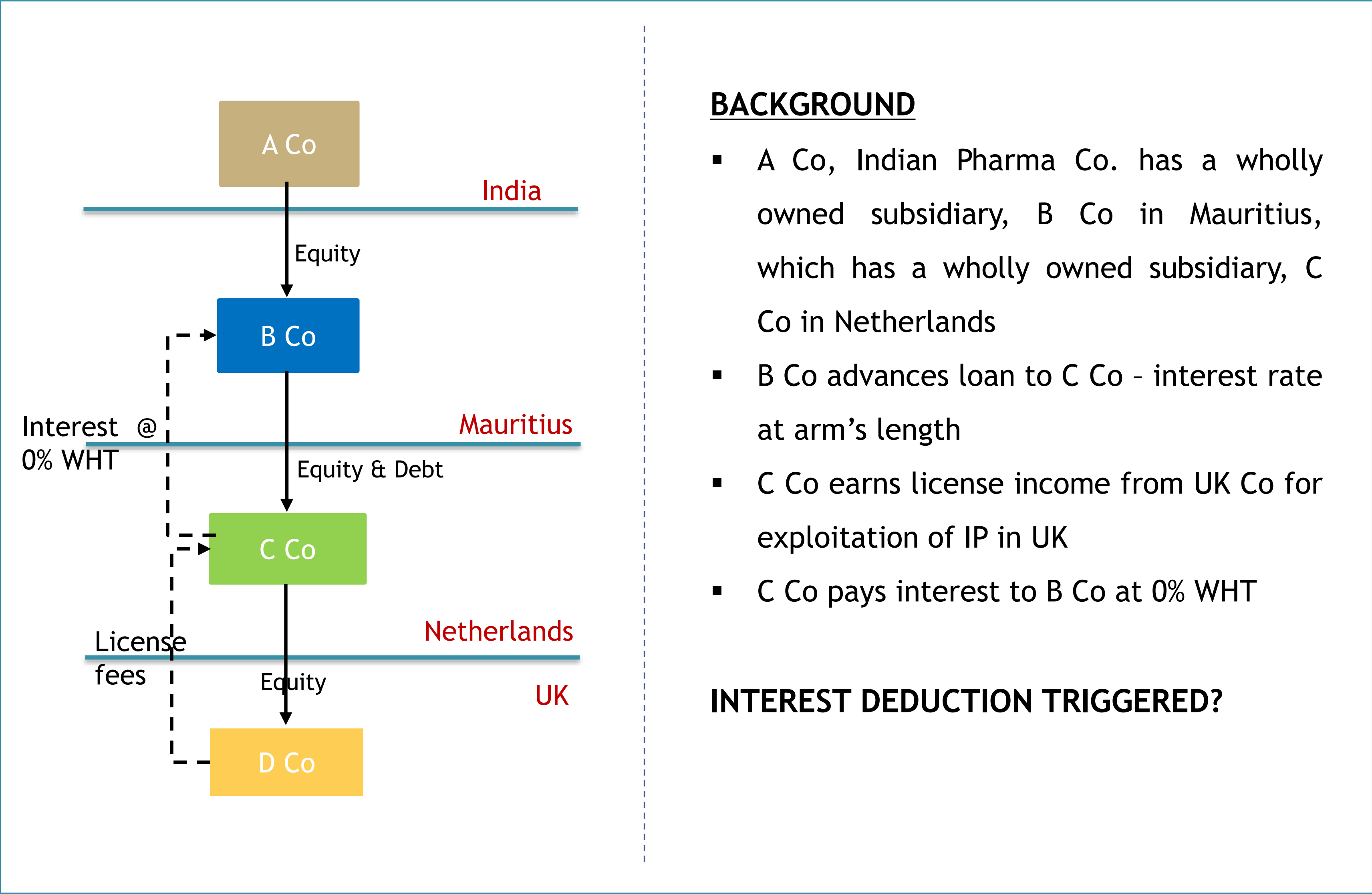
BACKGROUND

- Parent Co, India wishes to operate in Country 2
- Parent Co sets up a wholly owned subsidiary, A Co in Mauritius, which sets up a wholly owned subsidiary, B Co in Country 2
- B Co to pay corporate tax at applicable rates on income earned in Country 2 and distribute dividend to A Co
- A Co liable to tax @ 15% on foreign dividend, subject to availability of deemed tax credit @ 80% under domestic tax law of Mauritius, thereby effective tax rate being 3% in Mauritius
- A Co to distribute dividend to Parent Co
- Parent Co, India liable to tax @ 15% on foreign dividend u/s 115BBD. Foreign tax credit can be claimed @ 15% as per India-Mauritius Tax Treaty
- On distribution of this dividend to shareholders in India, credit of such foreign dividend available u/s 115-O, thus effectively no tax cost on receipt and distribution of dividend

ANY EXPOSURE OF TREATY SHOPPING?

Interest Deduction

Interest Deduction - Case Study 3

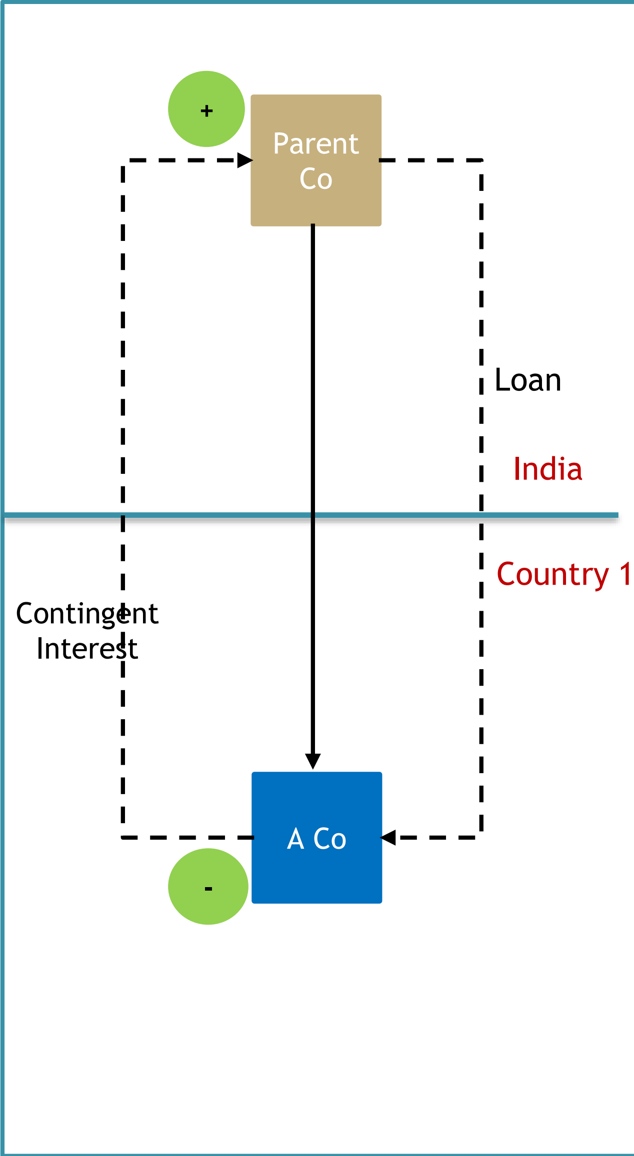


BACKGROUND

- A Co, Indian Pharma Co. has a wholly owned subsidiary, B Co in Mauritius, which has a wholly owned subsidiary, C Co in Netherlands
- B Co advances loan to C Co – interest rate at arm's length
- C Co earns license income from UK Co for exploitation of IP in UK
- C Co pays interest to B Co at 0% WHT

INTEREST DEDUCTION TRIGGERED?

Interest Deduction - Case Study 4



BACKGROUND

- Parent Co, India has a wholly owned subsidiary in Country 1, A Co
- Parent Co provides subordinated loan to A Co, which is to invest in an infrastructure asset, not expected to produce returns for a number of years
- Terms: Duration – 15 yrs, Interest payable at maturity or earlier at discretion of A Co and only if solvency requirements are met
- Loan is treated as debt under laws of both the countries
- Different tax treatment by Parent Co and A Co:
  - A Co claims deduction of interest each year on accrual basis
  - Parent Co. offers interest income only on actual receipt

WILL THE ACCRUED BUT UNPAID INTEREST TRIGGER ANY BEPS ACTION?

Hybrid Instruments

Hybrid Instruments - BEPS Action

Proposed general criteria for new provisions:

- Mismatch in the tax treatment of a "payment":
  - Broad definition of "payment": accrual of money/money's worth
  - Does not extend to "deemed" payments or those which do not create economic rights between parties
  - Non-inclusion: where payee does not reflect income (and not subject to CFC tax)
- Arrangement contains Hybrid element
- Hybrid element causes mismatched tax outcome
- Arrangement results in erosion of tax base of one or more jurisdictions
  - Timing differences are acceptable

Various "Design Principles" are proposed, including …

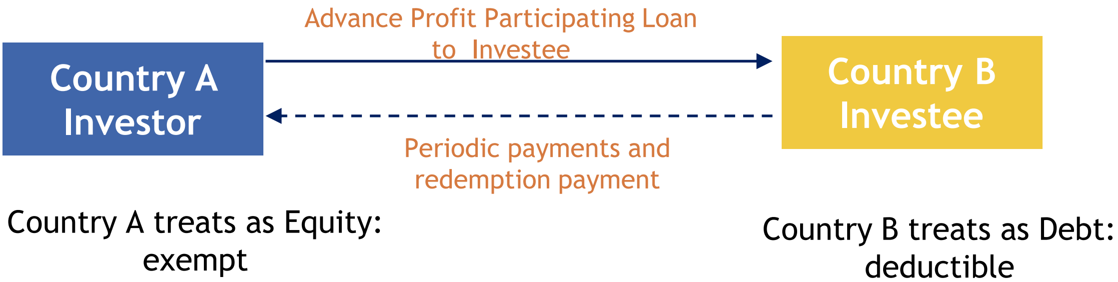
- Easy to administer and automatic application
- Focus on multilateral approach to target/eliminate the mismatch without requiring jurisdiction applying the rule to show it has "lost" tax revenues: no distinction between acceptable vs. not
- Be co-ordinated to avoid double taxation
- Linking and ordering rules required
- Minimise disruption under existing domestic law

3 Broad categories of Hybrid Mismatch Arrangements:

- Hybrid entity payments
- Hybrid instrument
  - Hybrid transfers (mismatched ownership rights)
  - Hybrid financial instruments (e.g. profit participating loan)
- "Reverse Hybrid" and "imported mismatches"

Hybrid Instruments - BEPS Action

Hybrid Financial Instrument

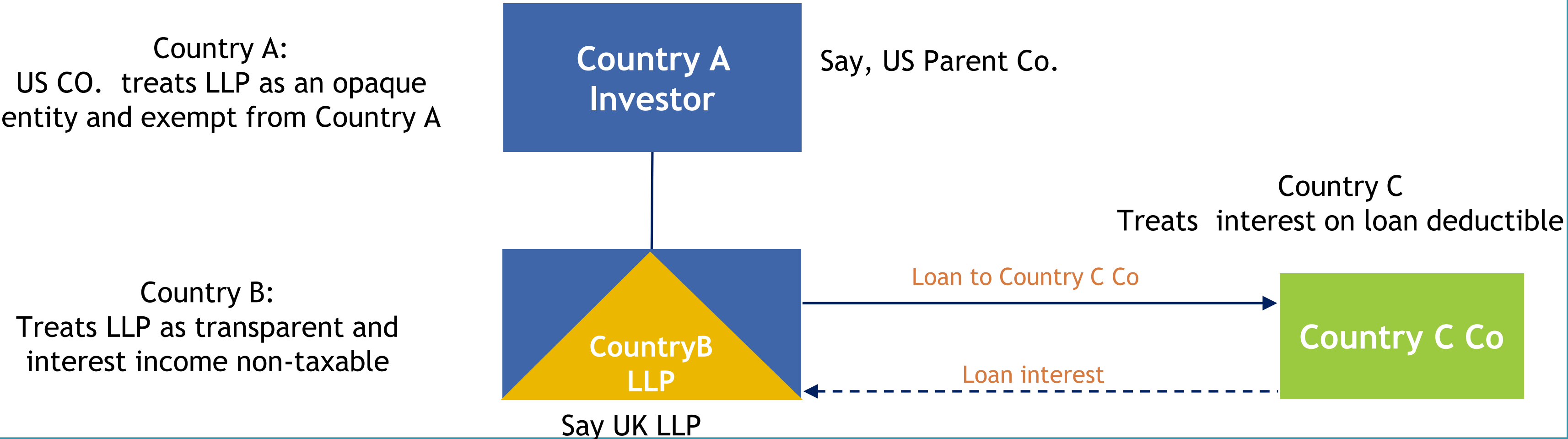


Country A treats as Equity: exempt

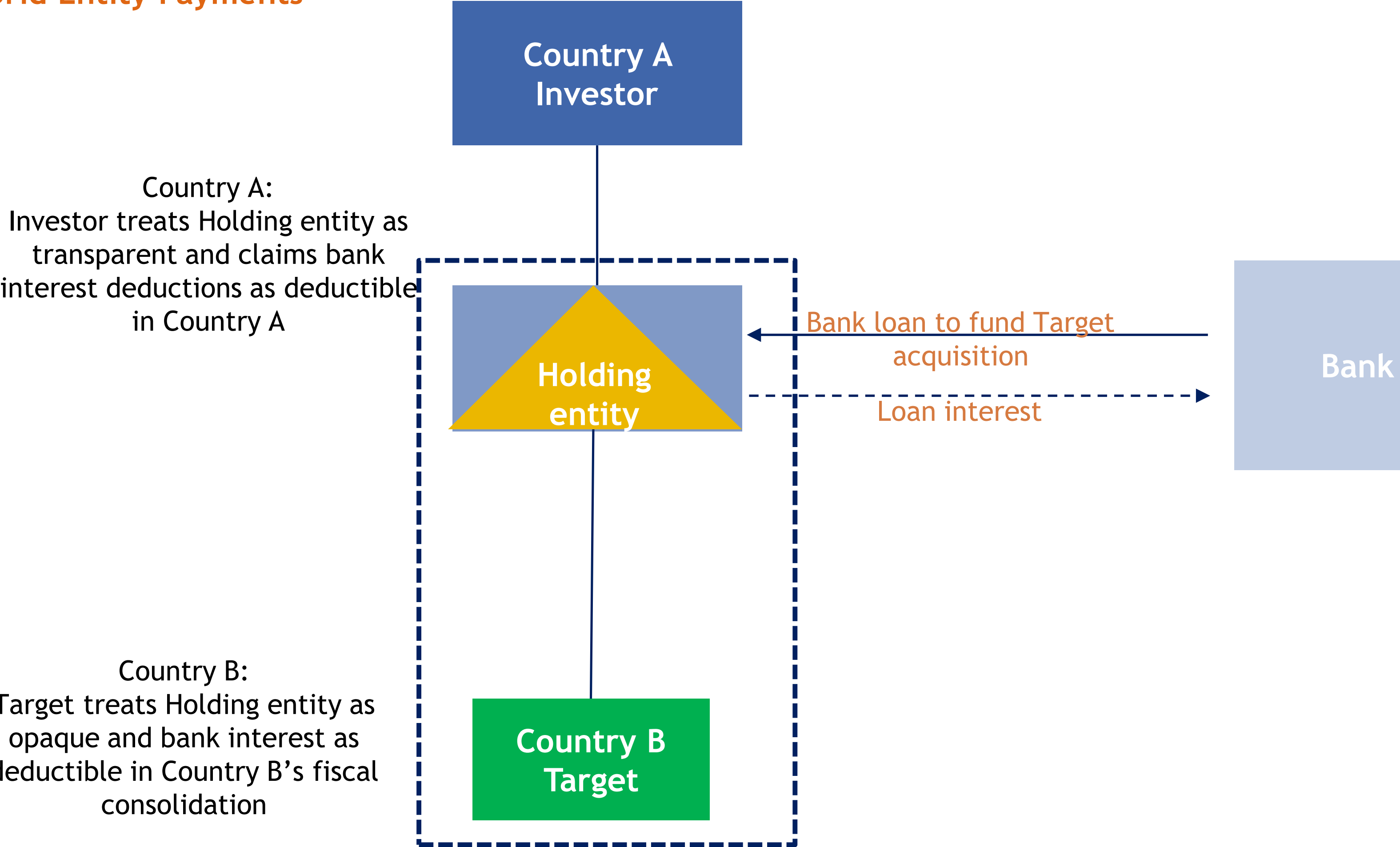
Country B treats as Debt: deductible

- Parent Co. holds in a Luxemburg CO. shares as well as hybrid instrument say Convertible Equity certificate or a Profit participating loan -
- Interest deduction in Luxemburg Co. as expense – No taxation in Parent CO. due to treatment of Instrument as equity

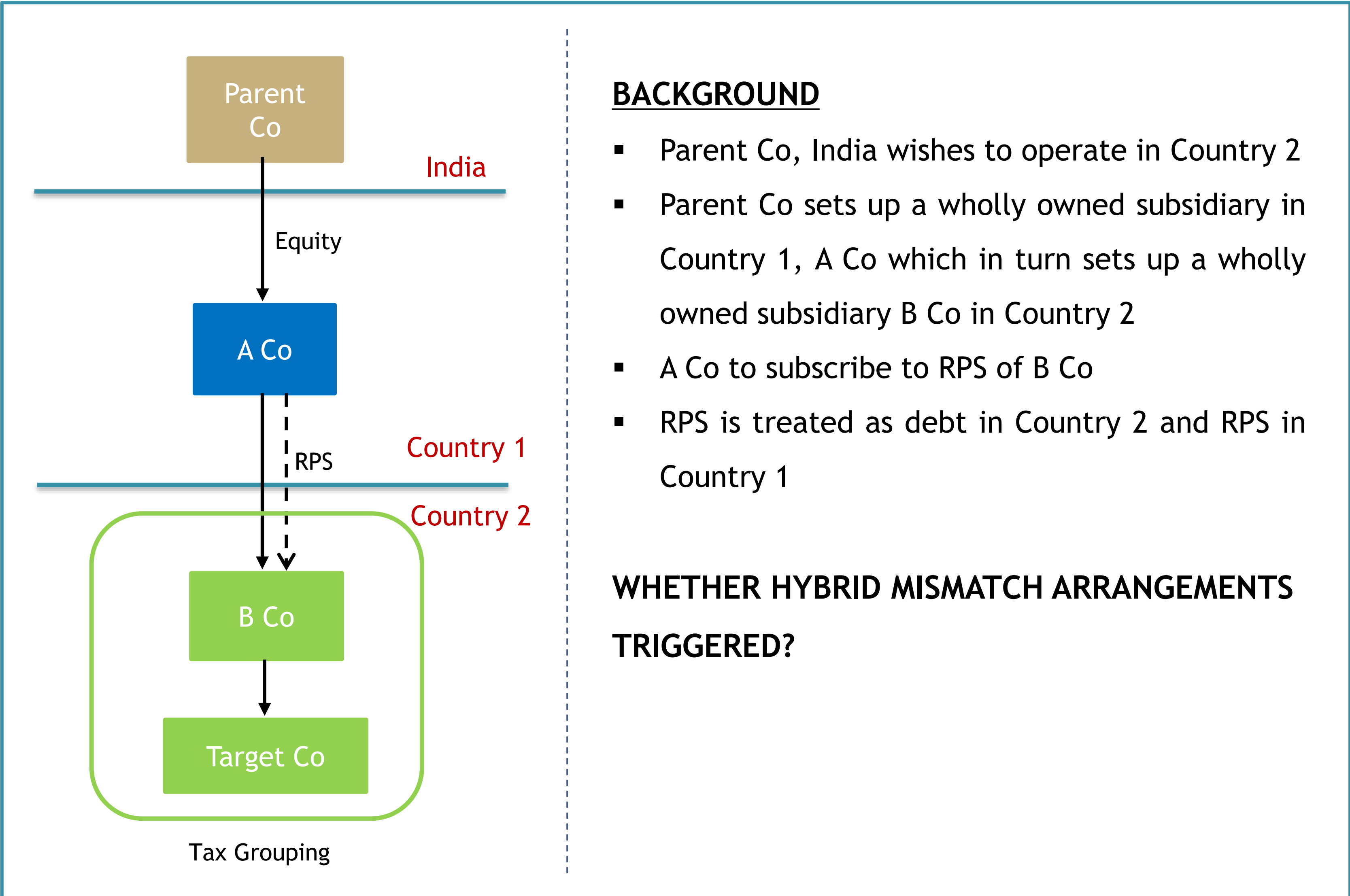
Imported Mismatch using Reverse Hybrid Entity



Hybrid Instruments – BEPS Action



Hybrid Instruments - Case Study 5



Flipping Control Abroad

Flipping Control Abroad - Re - Domiciliation

Many offshore jurisdictions allow companies to change their jurisdiction of incorporation or tax residency. The legislation usually permits the transfer of a company's "seat of incorporation" or "seat of management and control" into or out of the jurisdiction - a. process known as *redomiciliation*.

The alternative to re domiciliation is to liquidate the existing company or a share swap arrangement

Reasons :

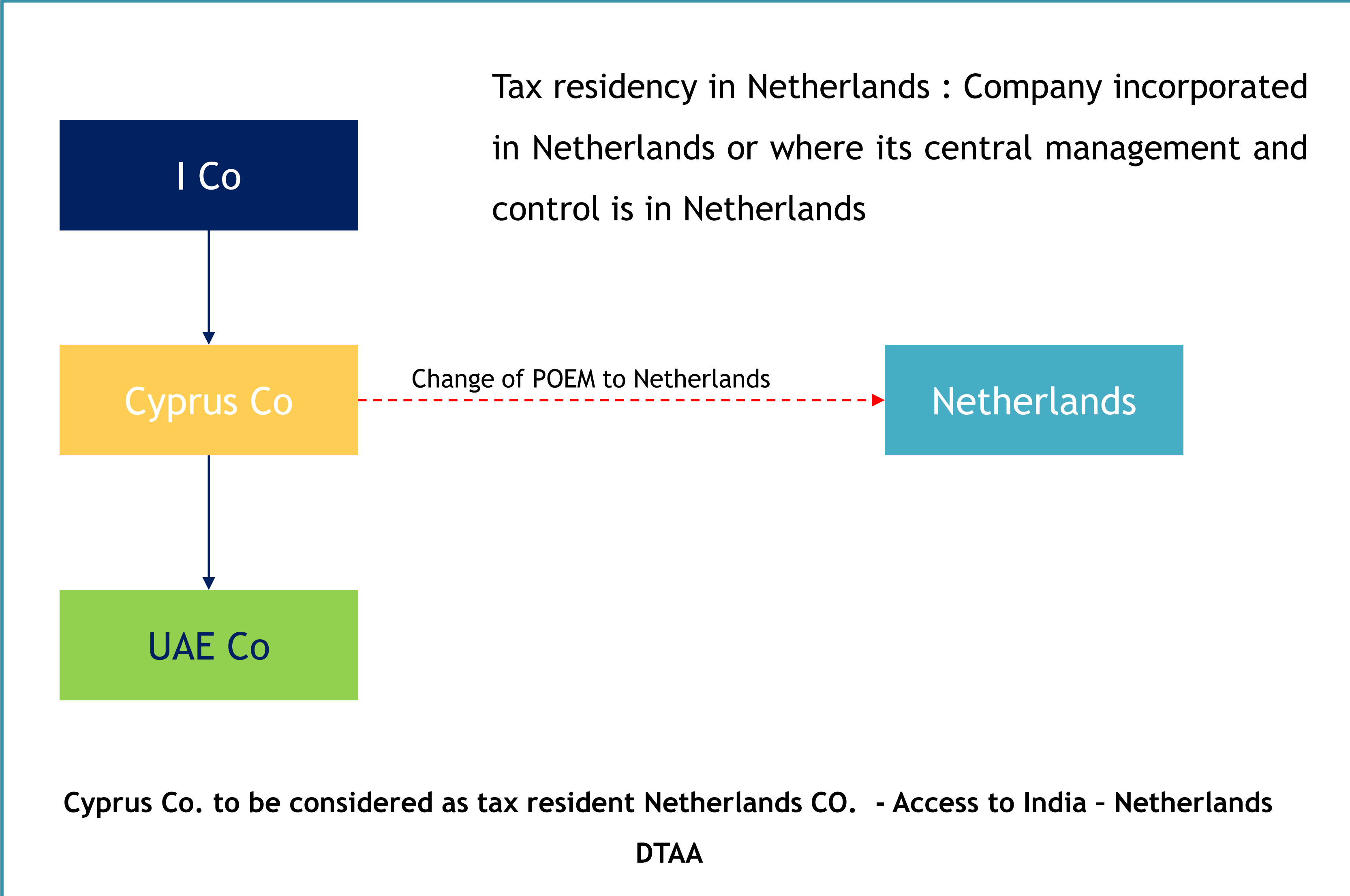
- Better Business Control
- Stream lining operations
- Planning for changes in laws and tax regulations
- Joining substance and shell to gain treaty benefits

Modes :

- Winding up and incorporation
- Transfer of Legal domicile
- Share for share exchange
- Merger and Migration – EU laws Stream lining operations
- Transfer of place of effective Management

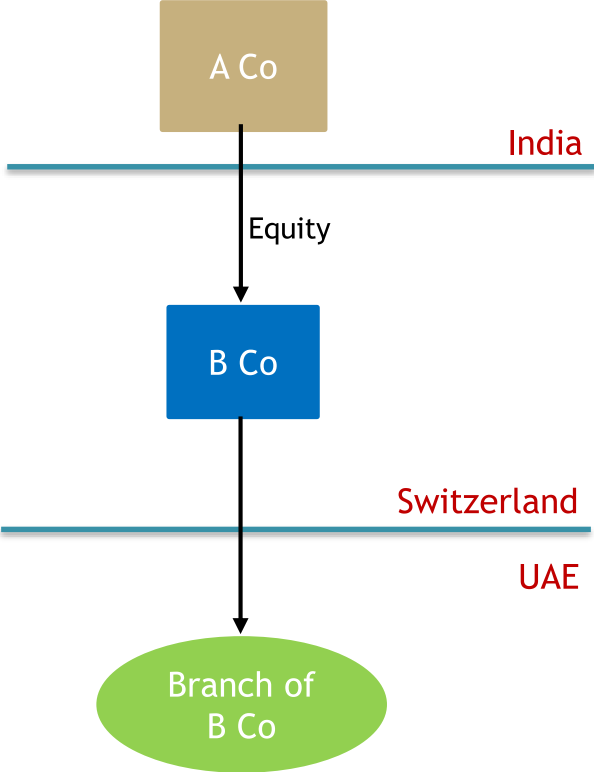
While e winding up, liquidation , share swap attract, tax inefficiencies, and may constitute a taxable disposal, and migration through merger is subject to local laws change in POEM may be most efficient

Flipping Control Abroad - Re - Domiciliation



Other Scenarios

CFC Impact - Case Study 6

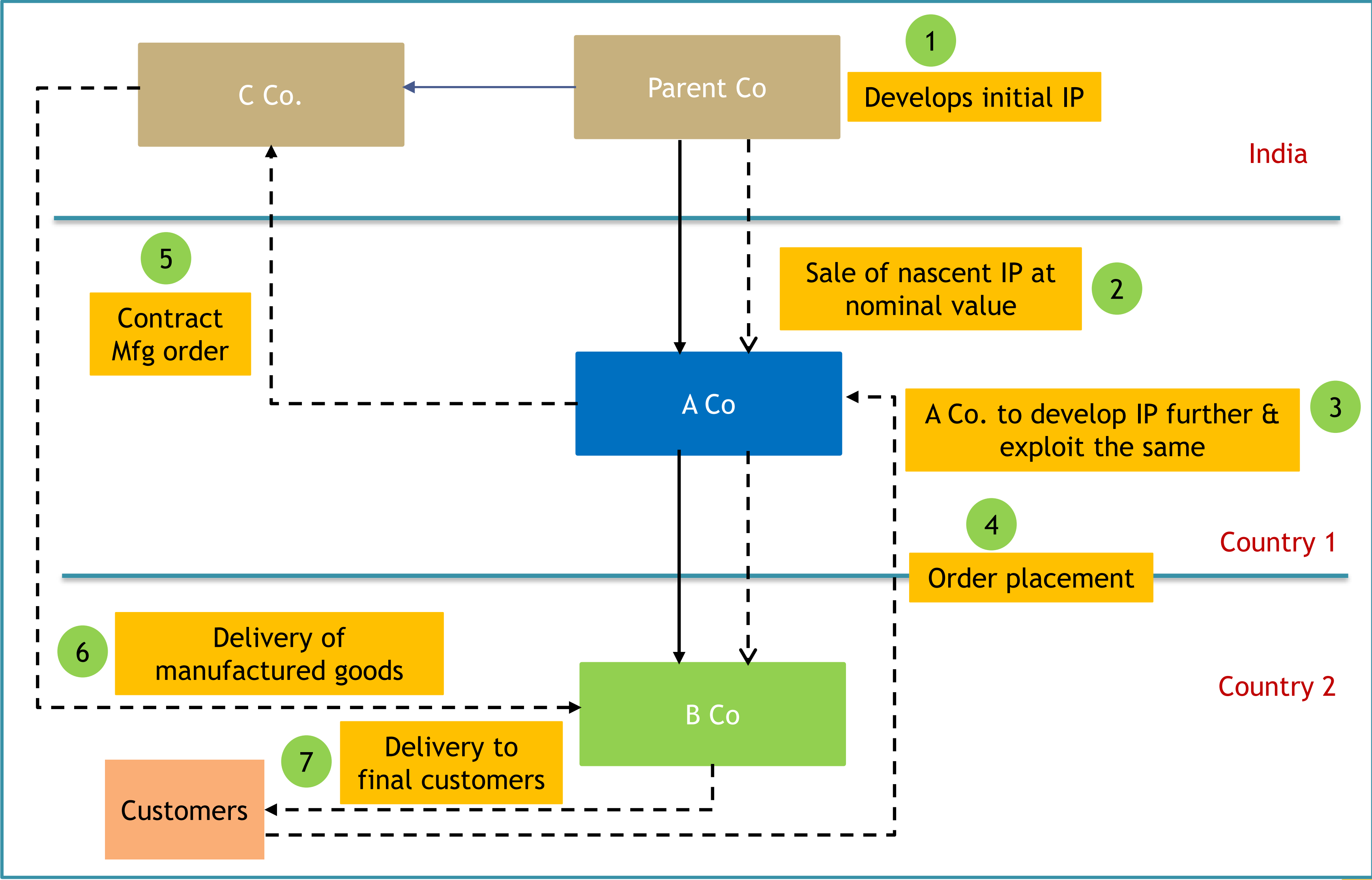


BACKGROUND

- A Co, Indian Pharma Co. sets up an IHC in Switzerland, B Co
- B Co operates through its branch in UAE
- Income earned by UAE branch is distributed to Switzerland Co and accumulated in Switzerland
- Income earned in UAE not to be taxed in
  - UAE, as income tax rate in UAE is Nil
  - Switzerland, as no income tax is levied on foreign branch in Switzerland

BEPS - CFC IMPACT ON THIS STRUCTURE?

Global structure - Case Study 7



Global structure - Case Study 7

BACKGROUND

- Parent Co, India develops initial IP. It plans to distribute products in Country 2
- Parent Co sets up a holding company in Country 1, A Co, which further sets up B Co in Country 2
- Parent Co to sell IP to A Co. at cost / nominal amount (IP at nascent stage, no assurance of future returns and / success at final product development stage)
- A Co. to develop the nascent IP acquired from Parent Co. and obtain orders from customers in Country 2
- A Co. to place order for such manufacturing in India to C Co., a contract manufacturer
- C Co. to manufacture the goods and deliver the same to B Co in Country 2, which is set up for distribution in Country 2 by A Co.

WHETHER BEPS TRIGGERED?

Substance Requirements

It all boils down to Substance !!!

The doctrine of substance over form well entrenched in Indian tax laws, - its application though not uniform and consistent as aggressively pursued by the revenue authorities.

"In the application of a judicial anti avoidance rule, the Revenue may invoke the "substance over form" principle or "piercing the corporate veil" test only after it is able to establish, on the basis of facts and circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidant."

"...we are of the view that every strategic foreign direct investment coming to India, as an investment destination, should be seen in a holistic manner. While doing so, the Revenue/Courts should keep in mind the following factors: the concept of participation in investment, the duration of time during which the Holding Structure exists; the period of business operations in India; the generation of taxable revenues in India; the timing of the exit; the continuity of business on such exit. In short, the onus will be on the Revenue to identify the scheme and its dominant purpose."
– Supreme Court in Vodafone

BEPS Action Plan- Action 5 on Harmful tax Practices

The interim report titled 'Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance' released by OECD on 16 September 2014 reflects consensus on the importance of having appropriate "substantial activity" requirements in preferential regimes and on the need for increased transparency.

- The 'substantial activity' factor looks at whether a regime "encourages purely tax-driven operations or arrangements" and states that "many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities.
- "Substantial activity requirement" to be considered as one of the key factors when determining whether a regime is potentially harmful.
- This means that a regime that meets the "no or low effective tax rates" test (key factor 1, which acts as a gateway test) will be considered harmful if there is no substantial activity in the country granting the regime.
- Nonetheless, determining the location of substantial activity is inevitably a subjective determination, making objective criteria difficult.

New substance requirements formulated in various jurisdiction - companies required to adhere to specific substance requirements for satisfying the substance test

Netherlands - Substance Requirements

- New Rules of 2014
  - ✓ Existing substance requirements for conduit finance companies apply at a wider scale starting 2014
  - ✓ Until 2013, substance requirements were only formally imposed on conduit finance/ license companies in light of an APA
  - ✓ Starting 2014 these requirements are also imposed on qualifying conduit finance / license companies that do not have an APA
  - ✓ As of 2014, these requirements are also imposed on holding companies but only if they want to obtain an advance tax ruling (ATR)
- For conduit finance/ license companies, the expanded scope of substance requirement is combined
  - ✓ with disclosure requirements – declare in the return that they meet the substance requirement
  - ✓ spontaneous exchange of information – contents of APA shared with relevant countries

Netherlands - Substance Requirements

- Dutch substance requirements
  - ✓ At least half of the statutory and authorized decision making directors live or are resident in Netherlands
  - ✓ The directors who live in Netherlands have necessary professional skills to carry out their responsibilities properly. These responsibilities include at a minimum independent decision making in relation to the transactions to be entered into by the tax payer (within the parameters of normal group involvement) as well as ensuring that such transactions are properly carried out. The tax payer can call upon qualified personnel (either internally or externally) to ensure that these transactions are properly carried out and recorded.
  - ✓ The Board decisions should be taken in Netherlands
  - ✓ The Bank account or the main account is maintained in Netherlands
  - ✓ The book keeping is in Netherlands
  - ✓ Registered office is in Netherlands
  - ✓ It is not tax resident in any other country (as far as taxpayer is aware)
  - ✓ Tax payer runs the real risk within the meaning of the law
  - ✓ Amount of equity appropriate to the required risk

Netherlands - Substance Requirements

Scope of New Rules

- Who are mainly (which is more than 70%) engaged in intercompany financing and/or licensing activities (or activities generating similar income, such as rental or leasing income)
- Who have received or accrued interest and/or royalty income (or similar income) from foreign group companies; and
- For which treaty benefits are claimed.

Consequences of not meeting the substance requirements

- Taxpayer obligated to report this in its annual Dutch corporate income tax return.
- In case of premeditation or gross negligence, a maximum penalty of €19,500 may be imposed.
- If the Dutch tax authorities conclude that the substance requirements are not met, they will spontaneously notify the foreign tax authorities.
- It is the common understanding that the information to be submitted to the foreign tax authorities is (initially) very limited.
- It is up to the foreign tax authorities to decide what to do with this notification. They may e.g., request additional information or may choose to ignore the notification.

Key Take Aways

Key Takeaways

- ✓ BEPS – Game changer in the coming years
- ✓ Domestic anti-abuse tax legislations being adopted globally
- ✓ Substance and Transparency – part of life
- ✓ Corporate Tax Rates may be reducing, but the base is increasing
- ✓ Fast changing global tax regimes
- ✓ Need for Longevity and flexibility in overseas structure
- ✓ Tax and Morality debate: Here to stay

Thank You