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Letter from the Editor

Dear Readers,

At the outset, on behalf of the entire Editorial Committee, I wish you a very happy New Year, filled with good wishes, hope and a positive spirit.

I am pleased to present IFA WRC's first edition of the newsletter for the year 2017. This newsletter covers various contemporaneous topics such as 'An Indian and global perspective on the Patent Box Regime', 'Taxation of Global Families – Issues and Challenges', 'Recent updates on actions/ initiatives undertaken in area of Base Erosion and Profit Shifting' etc.

We hope you find this read timely and useful. Once again, wish you a very Happy New Year.

– By Paresh Parekh

About IFA

The International Fiscal Association (IFA), established in 1938 with its headquarters in the Netherlands, is the only non-governmental and non-sectoral international organization dealing with fiscal matters. IFA has played an essential role both in the development of certain principles of international taxation and in providing possible solutions to problems arising in their practical implementation. The membership of IFA now stands at more than 12,000 from 106 countries. In 62 countries, including India, IFA members have established IFA Branches. For further information on IFA and its activities, please visit the website www.ifaindia.in. Your feedback / suggestions are welcome.
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INDIA'S PATENT BOX REGIME (PBR)

BY KANNAN RAMAN, DIRECTOR, EY UK & VIPUL SONI, DIRECTOR, INDIAN MEMBER FIRM OF ERNST & YOUNG GLOBAL

'Knowledge is power' and in today's innovation based global environment it represents economic power. The Finance Minister also acknowledged in his budget speech that "Research is the driver of innovation and innovation provides a thrust to economic growth" while introducing PBR. The pace at which countries are reforming their research and development (R&D) incentives regime is unprecedented. For some, this means introducing completely new incentives; for others, it means making incentives more generous in a bid to foster growth. And for many countries, it means targeting their incentives more tightly, focusing their limited funds more narrowly on those sectors and activities they think will provide the greatest levels of support to their long term economic growth. India competes with approximately 16 countries having some form of preferential tax regimes for intellectual property differing significantly in their scope, requirements, benefits and mechanics. In this article we have analysed India's PBR vis-a-vis other countries and the impact of BEPS Action 5.

INDIAN PATENT BOX REGIME

In order to boost in-house R&D, India way back in 1997, introduced weighted tax deduction for specified expenditure under section 35(2AB) of the Income-tax Act ('Act') which is now being gradually phased out. However it lacked the tax incentives for commercialising the income earned from successful exploitation of R&D efforts. To encourage indigenous R&D activities and project India as a potential R&D hub, Central Government has recently introduced PBR for taxing royalty income earned by resident from exploitation of patents developed and registered in India at concessional rate of tax rate of 10% as against 30% (plus applicable surcharge and cess).

PBR is distinct from other tax incentives such as R&D tax deduction/credits. R&D deductions are provided at the front end of the innovation lifecycle, in the years when R&D expenses are incurred. In contrast PBR provide tax relief at a later stage of the innovation lifecycle, in the years when income is generated from exploiting IP. PBR is an incentive for commercialisation of innovation rather than for conducting research. This concessional tax rate benefit is available from 1st April 2016. Other conditions for claiming concessional rate are broadly analysed as under:

- **Eligible assessee:** The benefit of PBR is available to a person resident in India, who is the true and first inventor of the invention and who is a patentee in accordance with the Patents Act 1970. "Patentee" means a person who is entered on the register as the grantee or proprietor of the patent. Under the Patent Act even a foreign national can file application for registration of patent in India. Though a foreign national can be a patentee under the Patents Act, under the Income-tax Act, foreign national will be eligible to claim benefit of concessional tax rate only if foreign national is a "resident" under the Income-tax Act in the year when income from royalty is earned.

- 75% of expenditure on invention must be incurred in India: PBR mandates that 75% of expenditure on invention must be incurred in India. However there is no clarity on how 75% threshold is to be computed. Whether only direct expenditure has to be considered or even indirect expenditure is required to be considered. Say A Ltd, incurred cost of INR 50M in the first two years on invention of a new article. A Ltd had also incurred interest cost on borrowed capital which was used exclusively for this project. As market conditions for commercialisation were not favourable, management of A Ltd decided to write-off entire cost in the books of accounts in year 3. In 6th and 7th year, A Ltd incurred additional cost of INR 50M on same invention out of which 20 M was incurred outside India. In 7th year, A Ltd applied for patenting the invented article. The question for consideration is whether entire cost including amount already written off in the books is required to be considered. If a view is taken that cost incurred in 6th and 7th year is only to be considered, A Ltd may not meet 75% threshold. However if entire cost from inception is required to be considered, it would fit within 75% threshold test.

- **Deduction for expenses:** Downside of this regime is that no deduction of any expenditure incurred for earning of royalty income would be allowed while computing total income or while computing tax under section 115JB of the Act. It is quite possible that if expenditure to be incurred for royalty income is likely to be in excess of 2/3 of royalty income or there is likely to be loss in initial years such tax payer may not opt for this scheme.

- **Claiming benefit under this regime is optional:** Though claiming of benefit under PBR is optional for the eligible assessee, however having once opted the provisions are applicable for five years. The beneficiary can also elect to opt out of the PBR, however there are restrictions for electing back into the regime for the next five years, succeeding the year of opt out. Thus option has to be exercised very diligently. If Patentee does not opt/opts out of PBR, net royalty income earned after deduction of expenses would be taxable at 30% (plus applicable surcharge and cess).

• **Nature of Income:** PBR applies to income derived by way of Royalty. Royalty income would include consideration for i) transfer of all or any rights (including granting of a licence) in respect of patent or ii) imparting of any information concerning working of or the use of a patent or iii) use of the patent or iv) rendering of any services in connection with the said activities as referred in (i) and (iii). However, the concessional tax rate will not be available in respect of patent income that is embedded in the sales price of a product manufactured with use of patented process or patented article for commercial use. Even capital gains realized on the sale or disposal of patents falls outside the scope of the PBR.

• Any transaction with related party would have to comply with transfer pricing provisions.

GLOBAL PRACTICE:

India is not the first country to introduce tax incentives to encourage indigenous innovation. Ireland for first time in the 2000, introduced preferential regime which gained acceptance and was adopted by other countries such as France, Belgium, Hungary, Luxembourg, Netherlands, Spain, China and the United Kingdom with concessional tax rates ranging from 5 to 15%. These tax incentive are often also called as Innovation Box, Knowledge and Development Box or License Box regimes covering a broader class of intellectual property such as copyrights, trademarks, trade secrets, secret formulas or processes, know-how, and other forms of innovation. Countries may have narrow or broad categories of qualifying IP, including copyrights, trademarks, trade secrets, secret formulas or processes, know-how, and other forms of innovation. Comparative analysis of patent box regimes of few countries is tabulated in Annexure 1

CHALLENGES:

A) UNDER THE INCOME-TAX ACT:

• **Restricted Scope:** The scope of tax incentives granted for promoting research and innovations varies widely across the countries. It can be observed from Annexure 1 that India's patent box regime is quite conservative as compared to the peers which is something that the companies would take into consideration when making decision related to investment and R&D in India. The benefit is only restricted to intellectual property in respect of patents. Some countries also include trademarks, trade names, designs, processes and other types of marketing intangibles for concessional tax rate.

• **Gross vs Net taxation:** Few foreign regimes taxes IP income on a net basis whereas Indian regime provides for a tax rate of 10% on a gross basis. Further some of the foreign jurisdictions provide that if there is loss, then the loss can be carried forward and set-off against tax liability from patent box in the future years.

• **Development in multiple jurisdictions:** While the Indian PBR would encourage R&D in India and registration of patents in India, the requirement for the patents to be 'developed' and 'registered' in India may place certain limitations on the success of this regime where patents are developed simultaneously in various jurisdictions. Many MNC's companies increasingly operates numerous R&D units around the world which work closely for 24/7 R&D activity. As a result, creation of intangible involves on-going movement of knowledge and people between different entities of MNC's group of companies. To give an example software programmers working in India might be handing over the result of their days work to employee in Germany who will further develop the programme code and then hand it over to his colleague in US. Integration of R&D units many a times makes it difficult if not impossible to identify the individual contribution of local units to determine where the respective intangibles assets are developed.

• **Eligible Income:** Presently the scope of eligible royalty income excludes consideration for sale of product manufactured with the use of patented process or patented article for commercial use. The owner of patent may derive income from licensing it to related or unrelated parties. Profits may also be derived from selling products or providing services by licensing such patent. Expanding coverage of qualifying income to the aforesaid income rather than restricting scope would provide thrust to Make in India initiative of the Government by enabling deployment in manufacturing activities.

With such a stiff competition, if India intends to become a preferred destination for research and innovation it will have to enlarge the scope of PBR to include other forms of intangible property rights so that more eligible assessee's can benefit from it.

B) UNDER THE PATENT ACT, 1970:

• **Scope:** The Patent Act defines the term Invention to mean a new product or process involving an inventive step which is capable of industrial application i.e. capable of being made or used in an industry. However all industry applications are not Patentable. For instance, Patent Act does not consider any invention in relation to plants, animals in whole or in part, seeds, varieties and species of plants and animals, biological process for production or propagation of plants and animals as invention. Further business method or a computer programme per se or algorithms are not considered as inventions and hence not patentable in India. Though with development of technology, business activities have grown tremendously through e-commerce and related B2B and B2C business transactions such inventions are not patentable. As a result companies undertaking invention and commercialisation of technology in field of bio-technology, computer software are kept out of ambit of concessional tax regime.

● **Patent protection in India:** As per the 2016 survey of the Intellectual Property Index released by the Global Intellectual Property Centre of the United States Chamber of Commerce, India ranked 37 out of 38 economies for its intellectual property rights environment. The Index is based on 30 criteria critical to innovation including patent, copyright and trademark protections, enforcement, and engagement in international treaties. Survey results suggest patent protection in India remains outside international best practices. India has scored the least possible score of 1 out of 7 in protection of patents. The Indian laws will have to be strengthened to provide confidence to the innovators that their valuable data is not prone to theft and misuse in absence of laws governing the matter and mere provision of tax incentives will not incline the MNC's to shift their R&D to India.

● **Cumbersome registration process:** The patent registration process in India is cumbersome and typically takes about 5-7 years. According to information from the Controller General of Patents, Designs and Trademarks' office, the total number of patents pending as of April 1, 2016 stands at 2,37,671[1]. As per the guidelines of the Controller General of Patents there are seven steps to be followed before the patent is granted . However under the PBR the tax incentive cannot be claimed until patent registration is obtained since the condition is that the patent must be developed and registered. Due to such restrictions/shortcomings in the Indian Patents Act, 1970 many inventors may prefer registering patents outside India even when the same is developed in India. The requirement that patent must also/ be 'registered' in India in order to be eligible to a concessional tax rate shall result in denial of the benefits for such inventors.

BEPS ACTION PLAN 5 AND INDIAN PATENT BOX:

BEPS Action Plan 5 considered Patent boxes/Intellectual Property regimes as potentially harmful if it allowed taxpayers to derive benefits while engaging in operations that involve limited substantial activities. Such practices are used to "achieve low or no taxation by shifting profits away from the jurisdictions where the activities creating those profits take place". Action Plan 5 suggest that income arising from exploitation of patents/intangible property should be attributed and taxed in the jurisdiction where substantial R&D activities are undertaken rather than in the jurisdiction of legal ownership only.

For establishing such nexus OECD requires jurisdictions wishing to introduce an IP/patent regime to mandate that taxpayers that want to benefit from preferential tax regime must track expenditures, IP assets, and income to ensure that the income receiving benefits did in fact arise from the expenditures that qualified for those benefits. Threshold of 75% of the expenditure on invention must be incurred in India seems to be aligned with "substantive test" as suggested in Action Plan. The intent is that the tax benefit should be in respect of profits which commensurate with actual value creation within that jurisdiction. Key difference in Indian PBR vis-à-vis BEPS Action Plan 5 are summarised below:

a) Benefit of concessional regime under Action Plan 5 extends to other qualifying IP as also to income from the capital gains that may arise from the alienation of the patent rights. However under Indian PBR, Capital Gains or consideration for sale of product manufactured with use of patented process or patented article for commercial use is not covered.

b) The benefit under Action Plan 5 is restricted to income that is proportionate to the expenditure incurred which may limit the quantum of income eligible for concessional rate whereas under the Indian regime there is no limit on the income eligible for concessional rate once the eligibility conditions are satisfied.

c) Many of the current IP regimes applies to marketing-related IP such as trademarks, designs etc. However, under the nexus approach, the only IP assets that could qualify for tax benefits under an IP regime are patents and other IP assets that are functionally equivalent to patents, if those IP assets are both legally protected and subject to similar approval and registration processes and for copyrighted software. The Indian PBR regime is applicable only to Patents registered under the Patent Act, 1970.

d) The priority area of Action 5 is improving transparency through a framework for the compulsory spontaneous exchange of information on certain rulings. So far no such framework has been announced under the Indian PBR.

CONCLUSION:

The introduction of the Indian PBR despite its limited scope is a bold and a welcome move which will promote growth and innovation in the country. India needs to adopt best practice of other countries for creating an innovation friendly tax environment and for benchmarking. India has recently introduced a new National Intellectual Rights Policy, with a view to improve the intellectual property right protection environment in the country. Following the same the Government has also brought into force the Patent (Amendments) Rules 2016 amending the existing rules with a view to expedite patent processing and make patent rights enforcement more stringent, convenient and efficient. Such initiative indicates that the Indian Government is serious about creating a mutually beneficial IP ecosystem in the country. It is expected that with strengthening of allied laws and streamlining of the patent processes coupled with the current tax incentives for R& D expenditure, the new tax regime can provide powerful incentive to the companies to invest in India for undertaking R&D activities and to hold and monetise their R&D investment.

[1]http://timesofindia.indiatimes.com/city/bengaluru/India-has-1-92-lakh-active-researchers-2-37-lakh-pending-patents/articleshow/52226942.cms

Comparative analysis of PBR of few countries

Particulars	India	UK (Existing)[2]	UK (Draft)	Netherlands	Luxembourg	Belgium	France	Spain	Hungary
Preferential Tax Rate	10%	10%	10%	5%	5.84%	6.80%	15%	12%	9.50%
Year enacted	2016	2013	2016	2007	2008	2007	2001	2008	2003
Qualifying IP									
(d) Patents	✓	✓	✓	✓	✓	✓	✓	✓	✓
(e) Know how	×	×	×	×	×	✓	×	✓	✓
(f) Trademark	×	×	×	×	✓	×	×	×	✓
(g) Copyrights	×	×	×	×	Software Copyrights	×	×	×	✓
Applicable to existing IP	✓	✓	✓	✓ Post Dec 2006	IP developed post Dec 2007	✓ post Jan 2007	✓	✓	✓
Applicable to acquired IP	×	✓ Either further developed by group co or actively managed by UK Co itself	✓	✓ if further self-developed	✓, if acquired from non-AE's	✓ if further developed/ improved	✓ but should own it for 2 years to be eligible for regime	×	✓
Developed in respective jurisdiction	✓	×	×	×	×	×	×	×	×
Qualifying Income									
Royalty and license fee	✓	✓	✓	✓	✓	✓	✓ including sub-licensing of qualifying IP		✓
Inter-unit fair charge	×	✓	✓	×	✓	×	×	×	×
Includes embedded royalties?	×	✓	✓	✓	✓	✓	×	×	×
Capital gains	×	✓	✓	✓	✓	×	✓		✓
Outright transfer	✓	✓	✓	✓	✓	×	✓	✓	✓
Gross or net based	Gross	Net - based on specified adjustments	Net - based on specified adjustments	Net	Gross	Gross	Net	Net	Gross
Can R&D be performed abroad?	Not fully	✓	✓	✓	✓	✓	✓	✓	✓
Is there a cap on the benefit	×	×	×	×	×	Deduction limited to 100% of pre-tax income	×	Yes, six times the cost incurred to develop the IP	Deduction limited to 50% of pre-tax income

[2]In UK, patent box, benefits also extend to the period between application for patent and its actual grant

REVISED DRAFT OF INDIA CHAPTER IN UN TP MANUAL

BY HIMANSHU TANNA, SANAT BHAT, SHRADDHA BHATHIJA – SENIOR TAX PROFESSIONALS

Transfer pricing has become the top priority subject for the corporates in the fast changing business and tax environment. In order to maintain uniformity and parity in the transfer pricing principles applied by tax administrations and tax payers, guidelines have been issued by Organization of the Economic Co-operation and Development ('OECD'). The United Nations ('UN') has also provided guidelines in the form of manual to cater to the needs of the developing nations.

The UN Tax Committee formed a Subcommittee on transfer pricing ('TP') in 2009 which was mandated to prepare a practical manual on TP for developing countries. The Manual was adopted by the Committee in 2012 ('2012 manual').

Since then, there have been several changes in the transfer pricing landscape including Base Erosion and Profit Shifting ('BEPS') action plan papers released by the OECD which are also currently being adopted by various countries for aligning the domestic law. In wake of such dynamic changes in the transfer pricing landscape, the UN subcommittee has also issued a revised version of TP manual ('revised draft manual').

In order to reflect the practices and positions on transfer pricing in the developing countries, chapters on countries like India, Mexico, China, South Africa and Brazil have also been revised.

THE INDIA IMPACT

The India chapter contains India's position on some important TP issues, including issues pertaining to risks, intangibles, intra-group services, location saving advantages, financial transactions, dispute resolution etc. It can be observed that the revisions/ changes to the Indian chapter have been made to reflect the current positions being adopted in TP audits and to bring clarity on some issues where there exists large amount of litigation. The revised India Chapter also states that the guidance flowing from these final reports may be utilized by the Indian tax authorities as well as taxpayers in situations of ambiguity in interpretation of the law.

Some of the changes have been discussed in the ensuing paragraphs

RISK ANALYSIS

In the context of Arm's Length Price ('ALP') determination, India's position in 2012 manual considered risk analysis to be a by-product of performance of functions and exploitation or use of the assets employed over a period of time. In this context, India believed that it would be unfair to give undue importance to risk in determination of the arm's length price in comparison to functions performed and assets employed.

However in 2012 manual, India chapter considered identification of the risks and the party which bears such risks as important elements in comparability analysis i.e. the conduct of the parties being key factor in determining whether the actual allocation of risks conforms to the contractual risks. It further stated that the allocation of the risks would depend upon the ability to exercise control over such functions, key responsibilities, key decision-making and levels of individual responsibility for key decisions.

The above position of India on risk has also been majorly reinforced in the BEPS Action Plan 8-10 deliverable on 'Aligning transfer pricing outcomes with value creation'. In addition to above, the BEPS Action plan 8-10 deliverable has considered financial capability to bear the risk as an important factor in establishing whether the party actually bears the risk or not. The same also finds place in India chapter of revised draft manual. Further India has slightly changed its position on risk wherein it now considers risk as a factor which has to be understood together with the functions performed and assets employed in the ALP determination instead of just by product.

CONTRACT RESEARCH AND DEVELOPMENT ('R&D') SERVICES

On contract R&D, the revised draft manual continues the position stated in 2012 manual. It states that –

In the TP audits of certain contract R&D centres, the facts have emerged that the funds for R&D activities are provided by the parent entity which bears the financial risk of the R&D activities but the strategic decisions pertaining to the day to day activities and allocation of budgets to different streams of R&D activities are taken by Indian subsidiary companies.

Further, the revised draft manual goes on to state that the other important aspects of R&D activities, such as technically skilled manpower, know-how for R&D activities, etc. are developed and owned by the Indian subsidiaries. Accordingly, control over risks of R&D activities rests both with the Parent entity and the Indian companies, but the Indian companies control more risks as compared to its Associated Enterprises ('AE'). Therefore, the Indian tax authorities are of the view that a routine cost plus return may not be appropriate in such cases and the Indian subsidiaries should be entitled to a suitable return for their functions (including strategic decision-making and monitoring of R&D activities), use of their tangible and intangible assets and exercising control over the risks.

MARKETING INTANGIBLES

Marketing intangibles has been one of the most contentious issues when it comes to recent Indian TP litigation. The India chapter of 2012 manual had captured the issue and the approach of Indian tax authorities. The Indian tax authorities used the 'bright line test' to determine insignificant Advertising, Marketing and Promotion ('AMP') expenditure incurred by the Indian entities and thereby carried out an adjustment for the alleged non-routine expenditure incurred. Since 2012 manual, the issue has come up before various courts for examination and the Hon'ble courts have laid down the key principles in analysing the issue.

Accordingly, the revision to the India Chapter in revised draft manual mentions the need to undertake a detailed analysis of the functions performed, assets employed and risks borne ('FAR Analysis') to ascertain whether or not the foreign company is benefitting from the AMP spend in India and there exists an arrangement with foreign IP owner for the marketing functions undertaken by the Indian entity. The Indian tax authorities are also of the view that these expenditures provide a direct benefit (by way of increased revenue) and indirect benefit (by way of development of market in India as well as enhancement of exit value) to the brand owner and therefore the Indian entity needs to be compensated for the same.

The India chapter makes a reference to the guidance provided in BEPS Action Plans 8-10 deliverable on 'Aligning transfer pricing outcomes with value creation', with regard to marketing intangibles; the guidance contains a recognition of the implications of AMP activities of the distributor on development and enhancement of marketing intangibles. The guidance states that returns should be earned on performance of development, enhancement, maintenance, protection and exploitation ('DEMPE') functions in relation to the intangibles. The paper further states that, thorough functional analysis is required to determine whether the distributor should only be compensated only for promotion and distribution or also for enhancing the value of the trademarks and other marketing intangibles.

It has also been mentioned in the revised draft manual that the compensation if required to be paid, need not always be a separate and independent payment; it can be part of the price of another transaction. Depending on the individual case, the Profit Split Method ('PSM') may be considered to eventually better reflect value contribution rather than a net profit based analysis like the Transactional Net Margin Method ('TNMM').

The revised India chapter acknowledges that the process to make adjustments is complex, fact intensive exercise and not free from disputes. The efforts being made by the Indian tax authorities to bring uniformity in approach and the expected judicial verdict from the Indian Supreme Court is likely to bring more clarity in the process.

INTRA GROUP SERVICES

In respect of intra group services, the revised draft manual is broadly similar to the 2012 manual. Some of the issues recognized in the revised draft manual include whether the Indian entities availing the intra group services meet the need test and benefit test, whether there are any duplicate services availed by them, whether they have capacity to absorb the services etc.

With respect to the mark-up on such services, the revised draft manual has not provided any guidance but has recognized it to be a challenging issue.

There has been an interesting addition in the revised draft manual wherein it mentions the requirement of an overall ceiling on such payments in the form of percentage of the sales or revenue of the Indian entity which may help to curb base erosion issue.

LOCATION SAVINGS

India being a fast growing economy with certain geographical and economic advantages lead to the issue of location savings developing in India whereby Indian tax authorities have asked the multinational enterprises ('MNEs') to demonstrate actual benefit received at a group level due to having operations in India.

In respect of Location Saving Advantages ('LSAs'), the revised India Chapter identifies the following as the distinct benefits India provides i.e. highly specialized skilled manpower and knowledge, access and proximity to growing local/regional market, large customer base with increased spending capacity, superior information network, superior distribution network, incentives and market premium.

Further, post 2012, there have been few Indian Income tax Appellate Tribunal ('Tribunal') judgements which laid down some principles in respect of location savings. In the case of GAP International Sourcing (India) Pvt Ltd, the concept of location savings was dealt by the Tribunal and held that the intent of sourcing from low cost countries for a manufacturer/ retailer is to survive in stiff competition by providing a lower cost to its end-customers and therefore intangibles shall not be created by way of routine activities. Further, in the case of Watson Pharma Pvt Ltd it was held by tribunal that, where the assessee (engaged in contract R&D) as well as its AE operates in a perfectly competitive market no adjustments can be made and to determine ALP of transaction, local Indian comparables operating in similar economic circumstances have been considered.

The revised chapter defines advantages arising due to Location savings to be “location rents”.

The revised draft manual while recognizing location rents as a location saving advantage has also recognized the issue of quantification and allocation. It further mentions profit split method as an alternative method wherein profit shall be divided considering functional analysis of the parties and their bargaining power between the AEs.

However, it is a welcome change in the revised draft manual, wherein the Indian tax authorities have appreciated that if the Indian entity is earning a margin which is at arm’s length as compared to local comparables, it could be said that the LSA is subsumed in such net level return and may need not be remunerated independently. It is pertinent to note that the above principle is also upheld by the tribunal and inclusion of the same in the revised draft may be a respite for many who are facing litigation on this issue.

It has, however, been reiterated that in case local comparables are not available or in case the foreign AE has been adopted as ‘Tested Party’, the quantification and allocation of LSAs shall continue to be an issue. While there is no mention of the mechanism in the Indian chapter basis which one can compute LSA while treating foreign AE as tested party; it would be interesting to look at the China chapter which gives broad guidelines to compute and distribute LSA between two related parties. The China Chapter of the UN TP Manual has drawn the following example to illustrate quantification and allocation of LSA:

Four step approach on the issue of LSA – China Chapter
i. Identify if an LSA exists
ii. Determine whether the LSA generates additional profit
iii. Quantify and measure the additional profits arising from LSA
iv. Determine the transfer pricing methodology to allocate the profits arising from LSA

We can understand the above four step approach by the below illustration -

The Chinese taxpayer is engaged in providing contract R&D services to its foreign AE on a cost-plus mark-up basis. Owing to various LSA such as lower costs of labour, raw materials, land, rent etc. the total cost of Chinese taxpayer is 100 vis-à-vis average cost base of foreign companies providing similar services is 150. Average cost-plus margin/ ALP earned by such foreign comparable companies are 8%. LSA calculation would be as under

Difference between the cost base = 150-100 = 50 ……(A)
Multiplying the above with ALP = 50 * 8% = 4 …………(B)

The resulting profit as above (B) is on account of LSA accruing to Chinese taxpayer and it should earn a minimum of 12% [LSA in absolute terms plus arms’ length margin] i.e. (4 + 100 * 8%)

In addition to the lack of a specific framework by India, a certain level of uncertainty may also continue to exist for certain LSAs such as consumer preferences, inelastic demand for products etc., the statistical quantification of which is an ongoing challenge.

FINANCIAL TRANSACTIONS

The 2012 manual focused on the benchmarking of the loan transactions in a detailed manner. While the revised draft manual has continued to have detailed explanation, it has deleted the Indian tax authorities’ stand of considering prime lending rate as external CUP.

Further, in the case of corporate guarantees provided by Indian parents to overseas associated enterprises, India’s position is similar as that it was in the 2012 manual. The India chapter states that generally the corporate guarantee fee is benchmarked using CUP method. An interesting change in the India chapter is that it recognizes interest rate differential method to determine the ALP and also mentions the interest rate prevalent in the rupee bond markets in India post credit ratings adjustments.

OTHER CHANGES

In connection with the comparability adjustments, the 2012 manual while mentioning the risk adjustment to be one of the contentious issues, gave a detailed discussion on CAPM as a method for risk adjustment. The revised draft manual while removing the entire discussion on the CAPM - risk adjustment mentions that it is difficult to provide risk adjustment in the absence of any reliable, robust, and internationally agreed methodology of risk adjustment.

PARTING THOUGHTS

The revised draft manual provides guidance combining the practice followed by the Indian tax authorities, concepts laid down by the judicial precedents in India and the BEPS action plan deliverables. While, the change incorporated provides clarity on several issues to the tax payers, there are still certain issues where the revised draft manual is silent. The tax payers would do good to review its transfer pricing policies and existing litigation positions in light of above changes and also fast pace changes being implemented in TP landscape across the world to align with BEPS action plans.

TAXATION OF GLOBAL FAMILIES

BY SUSHIL LAKHANI – SENIOR TAX PROFESSIONAL

In this Article, an attempt is being made to identify some of the key tax (planning) issues facing wealthy global families i.e. where the family members are spread across jurisdictions as well as a family whose income & assets are spread across jurisdictions.

Tax planning for such families is much more difficult than for multi-national corporates mainly on account of the following factors:
(i) decisions in such families are not controlled by one directing mind;
(ii) tax-relevant events e.g. resident status, inheritances etc. are often uncontrollable and unexpected;
(iii) tax results stem from financial, political social, emotional & biological factors.

While the underlying goal of such families is efficiently holding , growing & passing on the family fortunes , the decision matrix of setting up holding structures , trusts or other entities in different jurisdictions is quite complex & the final decision would depend on weightages assigned to the following factors by the family:
i) Efficient holding
ii) Efficient succession
iii) Substance / DTAA Protection
iv) Limited public disclosure
v) Asset protection
vi) Exposure to regulatory changes
vii) Investor friendly regulatory framework
viii) Legal flexibility
ix) Reputable & convenient location
x) Cost of setting up & maintenance

I am briefly discussing in this article the following tax issues as ,in my view, these are the uppermost in the minds of global families:
(i) Country of tax residency & its implications;
(ii) Use of Trusts & Foundations;
(iii) "Creating" tax efficient structures for holding investments & intangibles and creating substance in off-shore entities;
(iv) Taxability abroad of an Indian HUF;
(v) Inheritance taxes.

COUNTRY OF TAX RESIDENCY & ITS IMPLICATIONS:

Another major strategic tax planning decision that members of global families have to continually make is that of their tax residential status. Taxability of their income & wealth as well as exposure of their wealth to inheritance tax depends a lot on their residential status in a particular country.

Generally, counties (other than those following territorial system of taxation) tax their residents on world-wide basis. The test of residence for individuals as well as for trusts, companies and other entities varies from country to country. Among the most common parameters for individuals are actual stay, citizenship & domicile. Article 4 of the Double Tax Treaties (DTAA) provide for a tie-breaker test where an individual is a resident of more than one country. The tie-breaker in Article 4 determines tax residency for dual-resident individuals by applying factors like permanent home, center of vital interests(i.e social & economic factors), habitual place of abode & nationality in a sequential manner. Thus, though an individual may be a tax resident of India or USA or any other country due to his period of stay, it is still possible for him / her to claim that he is a non-resident on applying the tie-breaker test under the DTAA.

Another factor which drives members of global families to select an "appropriate" country of residence for themselves is that this decision impacts the tax residency of trusts (where they are trustees/beneficiaries) and companies where they are part of management (eg under POEM). As a corollary, the migration of such individuals from one country to another could result in migration of these entities also.

Most countries insist on disclosure of assets, financial interests, beneficial interest etc in the tax returns by their residents. Also, the extent of such disclosures varies from country to country e.g. USA has an extensive disclosure requirements for its residents under FATCA, FBAR etc while India as yet does not provide for disclosure of being a beneficiary in discretionary trusts. These disclosure requirements are again a factor taken into account by the global families while selecting the "appropriate" country.

USE OF TRUSTS & FOUNDATIONS:

Holding of family fortune, investments & entities through discretionary & (to a lesser extent) through specific trusts set up in NIL / low tax jurisdiction seems to have been the preferred route by global families. The reasons for this are avoidance of inheritance taxes, avoiding of tax on income of such trusts or atleast deferral till distributions are made to the beneficiaries, flexibility of distribution of wealth depending on whether a family member does well in life or not or whether his / her marriage is stable or whether he / she has children or not etc etc.

If there has been one entity that has been extensively used in Anglo-saxon countries in international tax planning by global families, it is the offshore discretionary trust generally with an underlying offshore subsidiary company. This is due to the concept of separation of legal & equitable ownership something which is generally unknown in civil law countries. This separation of ownership meaning that the legal ownership can fall outside an individual's estate for inheritance tax, income tax & capital gain tax (subject to anti-avoidance legislative) which nevertheless being able to be enjoyed by the beneficiary & his family. The UK HMRC, the US IRS & tax authorities of many other developed countries have been gradually introducing anti-avoidance legislation to erode the benefits derived by offshore trusts.

Neverthless, trusts are still widely used both for tax & other purposes such as asset protection, off-balance sheet transactions, as an alternative to Wills, giving the spouse or parents the benefit of the asset for life but for the children to have the property ultimately, avoiding, an outright & immediate gift till a beneficiary becomes mature etc.

A foundation is an autonomous legal entity unlike a trust – it holds the assets in its own name for the benefit of beneficiaries specified by this founder. There is no separation of legal & beneficial ownership & accordingly are used more commonly in civil law countries. The main difference between trusts & foundations is that it is legally permitted for the founder / settlor to continue to control foundation assets during his lifetime unlike the strict legal position with respect to trusts (US IRS regards a foundation as a transparent structure).

Countries provide for varying criteria for determining tax residency of trust. From residency of trustees, to central management & control, to residency of beneficiaries, to situs of immovable property of the trust are some of these criteria. Indian Income Tax Act, 1961 does not include a trust in the definition of "Person" & as such there is a lack of clarity as to whether the residency tests applicable to individuals (i.e. period of stay of trustees/beneficiaries) or the control & management test applicable to "other entities" would apply to determine residential status of an offshore discretionary trust. While the Act provides that a discretionary trust is to be taxed as if its income were the income of an AOP, this, in my view, still does not mean that such trusts are AOP for the purpose of applying the test for determining resident status of discretionary trusts. There is a view that the status of the trust is derived from the status of the trustee(s) and the resident tests are to be applied accordingly. Another view I have come across is that status of trust is "Individual".

Again taxability in India of distribution by offshore discretionary trusts is a grey area. The preponderant view presently is that the beneficiaries can be taxed only in respect of distribution of current year's income of the trust & not in respect of the distribution by trust of past years' income which were capitalized (209 ITR 101 and 225 Taxmann 166).

Another grey area in respect of taxation of beneficiaries is application of provisions of Section 56 of Income Tax Act, 1961 to tax the beneficiaries in respect of the settlement.

One may also take note of the decision of Mumbai ITAT in Shri Mohan Manoj Dhupelia & Ors where the ITAT held that the off-shore trust had no substance & is sham & thus to be disregarded and brought to tax the entire funds of the trust as undisclosed income of the beneficiary.

"CREATING" TAX EFFICIENT STRUCTURES FOR HOLDING INVESTMENTS & CREATING SUBSTANCE IN OFFSHORE ENTITIES

While it may be possible to avoid world-wide taxation in a high tax country by planning tax residency appropriately, it may be difficult to avoid tax in that country on incomes "sourced" in that country. Generally, countries tax even their non-residents on incomes sourced from their country. Similarly, in respect of Capital Gains, the country in which assets are situated may continue to claim the taxiing rights on them. This thus, result in scope for double taxation as the resident country would also lay a claim to tax all income of its residents.

In view of this possibility of double taxation, holding structure for investments & intangibles are "created" keeping in mind the concessional taxation in the source countries under the DTAA network, under the domestic tax laws of different countries, the EU directives etc. In this process, at times, a myriad of intermediate holding companies & subsidiaries in different jurisdictions get incorporated for holding the investments made, loans given & intangibles of the global family. The bottom line is to increase the net effective income after tax when it finally reaches the hands of the ultimate beneficiary.

A number of countries have enacted anti-avoidance legislation (eg. GAAR, transfer pricing, thin capitalization etc.) in their domestic tax laws and have also introduced limitation of benefit (LOB) Article in their DTAAs to prevent undue advantage by non-residents through treaty shopping. These anti-avoidance measures necessitate that all the intermediate holding companies & subsidiaries created to hold investments, loans, intangible etc. be justified by way of commercial & economic substance. Requirement of substance in each of these entities and compliance with transfer pricing regulations is a major challenge facing the global families especially in the present times of transparency & exchange of information.

TAXATION OF INDIAN HUF'S OUTSIDE INDIA?

It may be pertinent to note that there has been an instance of a US tax authority having taken a view that an HUF is to be characterized a “Trust” for US tax purposes as the Karta has powers similar to those of a trustee & the Karta & other co-parceners are to be taxed accordingly in respect of the income of the HUF to the extent they are US residents. This view is incorrect in my opinion.

INHERITANCE / DEATH TAXES

While India does not have any Estate Duty / Inheritance Tax, quite a few countries have such a tax which gets triggered on death of an individual to tax his estate.

Traditionally, inheritance tax, wherever it exists, is levied as follows:
(i) Residents are taxed on their would which estate;
(ii) Non-residents are taxed only on part of their estate located in Situs Country;
(iii) Source counties also tax part of the estate of a non-resident that is received by his heirs residing in that country;
(iv) Donations / gifts given within a certain time limit before death may be taken into account for calculation of this tax.

The rates of inheritance tax are quite substantial e.g. Korea (10-50)%; Japan (10-50)%, USA (10-50)%. Also the definition of residency for this levy is generally narrower than for income tax (e.g. USA). Thailand has just introduced an inheritance tax with a moderate 5% rate. China has plans to introduce this tax . Further, notwithstanding the residence of the deceased, inheritance tax in some countries is generally levied in respect of immovable properties in the country of Situs of the property (e.g. Canada, USA).

Given the different potential jurisdictions claiming inheritance taxes as per their own system & a limited network of tax treaties which cover inheritance taxes, one of the biggest concern of a global family is to alleviate double taxation of assets by two or more countries on death of a family member.

TAX COMPLIANCES & INFORMATION EXCHANGE

In recent times & especially as a result of FATCA & BEPS, emphasis by most countries is on increasing tax compliances & providing information by their residents in respect of financial and other assets held globally. Countries have introduced asset-based reporting (e.g. FATCA, FBAR, CRS, AML, similar Indian rules relating to foreign accounts / assets / beneficial interests etc) & entity / event-based reporting (e.g. CFC’s, offshore trusts etc)

A glimpse of the disclosure requirements under US regulations is given below to illustrate the extent of disclosure an individual / entity is being required to give:
(i) Ownership in non-US corporations & partnerships & transfers of property to non-US entity;
(ii) Beneficial interest in or “ownership” of non-US Trusts;
(iii) Receipt of large “gifts” from non-US persons;
(iv) Under FBAR – US persons are required to report interests in non-US Accounts if exceeds USD 10,000;
(v) Under FATCA – US persons to report ownership interests in non-US financial assets. Reporting threshold under FATCA is far higher than for FBAR;
(vi) CFC regulations require reporting by US investors owning more than 50% in foreign companies for an uninterrupted 30 day period even in non-CFC companies;
(vii) Financial reporting required by US Directors & Officers of foreign corporations owned 10% or more by US persons;
(viii) Reporting required by US persons acquiring or disposing of stock in a foreign corporate that crosses 10% ownership threshold;
(ix) US persons must report distribution from or transfer of property to any non-US Trust;
(x) Reporting is also required by US persons regardless of whether distribution is received if a US person is considered “owner” of a foreign trust under Internal Revenue Code’s “Grantor Trust Rules”

CATCHING THE BEPS PULSE

BY PARESH PAREKH, PARTNER, EY INDIA & PRIYA BUBNA, MANAGER, EY INDIA[1]

With the ever evolving worldwide taxation landscape, the importance of being in sync with the world has moved to the forefront. This column provides a bird's eye view into some of the latest international developments in the Base Erosion and Profit Shifting ('BEPS') scenario. Specifically, this article captures some key updates on the OECD BEPS programme and changes proposed/implemented by various countries that have taken place in the past one month*.

1. OECD UPDATES

1.1. ADOPTION OF MULTILATERAL INSTRUMENTS

The Organisation for Economic Co-operation and Development ('OECD') countries lately had reached an agreement on the core content of the Multilateral Instrument and were in the process of further development. The Multilateral Instrument is a key part of the OECD's effort toward implementation of the tax treaty related BEPS measures into existing bilateral or regional tax treaties as quickly and consistently as possible.

On 24 November 2016, the OECD released the text and related explanatory statement of the multilateral instrument, which were formally adopted by approximately 100 countries, including OECD member countries, G20 countries and other developed and developing countries, at a ceremony hosted by the OECD following conclusion of the negotiations during the week of 21 November 2016. It is expected that the multilateral instrument will be open for signature as of 31 December 2016 and a first high-level signing ceremony will take place in the week beginning 5 June 2017.

The multilateral instrument, which will be applied alongside existing tax treaties and covers the following tax-treaty related BEPS measures, solely focussed on avenues to modify the modalities of provisions in the bilateral or regional tax treaties to align these with the BEPs measure:

- **Action 2:** Hybrid mismatch arrangements
- **Action 6:** Treaty abuse
- **Action 7:** Artificial avoidance of PE status
- **Action 14:** Dispute resolution

By adhering to the multilateral instruments, it is expected that countries shall meet the treaty related minimum standards agreed as a part of the OECD BEPS initiative. Having said the above, the multilateral instrument has been apparently designed flexibly to accommodate varying positions of multiple countries and jurisdictions such as by including the possibility of 'opting out' of provisions which do not specifically pertain to minimum standards, allowing countries to specify tax treaties to which the multilateral instrument shall be applicable etc.

In general, the multilateral instrument will only enter into force after five countries have ratified it and will apply to a specific tax treaty, after all parties to that treaty have ratified the instrument, and a certain period has passed to ensure clarity and legal certainty. Also interesting to watch will be consensus/ positions of countries on adoption of mandatory and binding arbitration as a process for treaty related dispute resolution.

1.2. GUIDANCE ON COUNTRY-BY-COUNTRY REPORTING ('CBCR')

An updated version of OCED's "Guidance on the Implementation of Country-by-Country Reporting" was released and subsequently agreed by all members of the BEPS Inclusive Framework on 5 December 2016 to enable consistent implementation of CbCR under OECD BEPS Action Plan 13.

One of the highlights of this guidance is the adoption of a flexible approach on CbCR notifications, which is in line with the minimum standard contained in BEPS Action Plan 13, as a result of which a country requiring notifications could either delay the notification date or adopt a soft landing approach in which notifications could be amended or updated without carrying penalties.

As regards voluntary filings from Multinational Enterprise ('MNE') groups having reporting fiscal years commencing on a date different than 1 January 2016, thus having a different date for CbC reporting, two new jurisdictions namely Nigeria and Hong Kong have been added to the list of jurisdictions accepting voluntary filing.

Further, the OECD has also launched a new site which provides country-wise information on CbCR implementation. At present, 48 countries' information is posted on the site. The following country-specific information has been provided:

* Discussion based on information readily available in public domain up to 21 December 2016 and based on secondary sources of information
[1]Assisted by Karishma Gajaria, EY

- whether a primary law is in place
- whether a secondary law is in place
- the fiscal year from which the CbCR requirements apply
- whether there is local filing and the year from which local filing would apply
- whether countries with a gap period, i.e. when CbCR reporting starts on a date different than 1 January 2016, accept voluntary filing

1.3. COUNTRY-BY-COUNTRY REPORTING NOTIFICATIONS UPDATE

Out of the 33 countries that require filing of CbCR from 1 January 2016, 13 have followed the OECD notification date, which requires constituent entities to notify the tax authorities of the reporting entity's identity by the end of the group's reporting fiscal year

(For example a group with a 30 June year-end would need to notify by 30 June 2017). Of these 13 countries, 5 countries, namely Belgium, Czech Republic, Finland, Netherlands and Sweden have adopted a more flexible approach by delaying notifications for calendar year-end groups until later next year.

Further, 8 jurisdictions, namely Austria, Bulgaria, Denmark, Ireland, Jersey, Luxembourg, Portugal and Spain, require notifications to be made by resident constituent entities belonging to calendar year-end MNE groups to their country's tax authorities by 31 December 2016.

1.4. DISCUSSIONS ON LATEST BEPS DEVELOPMENTS

In November 2016, the OECD conducted two regional meetings of the inclusive framework on BEPS. One, for francophone countries on 22 to 24 November 2016 and another for the Asia Pacific region on 29 November to 1 December 2016 to discuss the latest developments on the implementation work on BEPS, in light of the debates taking place in the Committee on Fiscal Affairs' Working Parties. The participants were also updated on the progress of the work on the toolkits aimed at addressing the specific needs of developing countries in implementing the BEPS measures. These discussions provided the ideal forum to obtain input into the work and on the priorities of the participating countries and their needs in relation to capacity building and training.

1.5. NEW MEMBERS OF THE INCLUSIVE FRAMEWORK ON BEPS

Following the first meeting of the Inclusive Framework on BEPS in Kyoto, Japan on 30 June - 1 July 2016, and subsequent regional meetings, more countries and jurisdictions are joining the framework. On 25 November 2016, Macau (China), Mauritius and Ukraine joined the BEPS Inclusive Framework and on 7 December 2016, Peru has been updated in the list of members, thus bringing the total number of countries and jurisdictions participating on an equal footing in the Project to 91.

As new BEPS Members, these three countries are committed to comply with the BEPS minimum standards, which are contained in Action 5 (countering harmful tax practices), Action 6 (preventing treaty abuse), Action 13 (transfer pricing documentation) and Action 14 (enhancing dispute resolution).

2. BRICS (BRAZIL, RUSSIA, INDIA, CHINA AND SOUTH AFRICA) NATIONS' UPDATE

The Heads of Revenue of the BRICS countries held a meeting on 5th & 6th December, 2016 in Mumbai, wherein contemporary tax issues including sharing of best practices to improve compliance, progress and issues arising out of CbC reporting implementation and the role of United Nations in becoming the voice of developing and emerging economies in setting international tax rules, were discussed.

In the meeting, BRICS nations welcomed the BEPS Action Plan initiative, urged its timely and consistent implementation and expressed their support for monitoring their implementation, particularly the implementation of four minimum standards. Further, the nations re-iterated their endorsement of the Common Reporting Standard ('CRS') for Automatic Exchange of Information ('AEoI') and resolved to tackle any issue that may delay its implementation.

3. KEY WORLDWIDE UPDATES (CAPTURED GEOGRAPHY WISE IN ALPHABETICAL ORDER)

3.1. AUSTRALIA – DIVERTED PROFITS TAX ('DPT')

The Australian Government released an Exposure Draft ('ED') of the proposed DPT laws on 29 November 2016 for public consultation. Intended to be enacted in early 2017, a short consultation window till 23 December 2016 has been provided.

In general, DPT laws took shape in various countries (although through different nomenclature) to tax alleged contrived schemes/ arrangements between parties or due to loopholes in tax laws which led to diversion of profits and consequent erosion of tax base in various countries. Through the ED released, the Australian Government proposes to apply DPT to an entity if:

- The relevant taxpayer is a significant global entity — that is, broadly, a member of a group with a global parent entity whose annual global income is at least AU$1 billion
- It can be reasonably concluded that a scheme (or any part thereof) was carried out by the taxpayer for the primary purpose of obtaining a) a tax benefit; or b) both - a tax benefit and reduction in foreign tax liability

• The relevant taxpayer obtains a tax benefit in connection with a scheme involving a foreign associate

Few exceptions have been carved out wherein an entity will be exempted from the applicability of DPT:

• In case of entities having turnover less than the de-minimis threshold of AU$25 million, provided none of their Australian related entities have artificially booked turnover outside Australia; or

• If the increase of the foreign tax liability is equal to or exceeds 80% of the Australian tax reduction; or

• If the transaction/ arrangement fulfils the 'economic substance test', i.e. where the income derived by an entity reflects the economic substance of the entity's activity in connection with the scheme.

The ED allows a higher penalty tax at the rate of 40% to be levied on entities in relation to profit shifting schemes which shall fall within the ambit of DPT. Further, the draft explanatory memorandum accompanying the ED also alludes to drawing reference from OECD BEPS Action Plans 8-10 while ascertaining the economic substance in the schemes.

It is observed that the proposals contained in the ED do not seem to substantially depart from the earlier DPT proposal released in the May 2016 budget. The category for 'exclusion' also seems minimal. It will be interesting to follow the developments on this once the public comments are received as well as Government's reactions to the same.

3.2. BELGIUM

3.2.1. CHANGES TO EUROPEAN UNION ('EU') PARENT-SUBSIDIARY DIRECTIVE

On 18 November 2016, the Belgian Parliament adopted the bill to implement the following:

• The 2014 and 2015 changes to the EU Parent-Subsidiary Directive introducing linking rules to combat hybrid mismatches and a general anti-abuse provision; and

• The amendments to the exit tax regime, to partially implement the exit tax provisions as included in the EU Anti-Tax Avoidance Directive (ATAD), introducing new rules for the collection of exit taxes due.

The provisions regarding the EU Parent-Subsidiary Directive are retrospectively applicable on income items paid or attributed as of 1 January 2016, while the exit tax provisions apply on transactions which occur as of the date of publication in the Belgian Official Gazette and linked to tax year 2017, i.e., financial year end closings as of 31 December 2016, and onwards.

3.2.2. TRANSFER PRICING DOCUMENTATION

Belgium introduced mandatory transfer pricing documentation and CbC reporting requirements in accordance with BEPS Action Plan 13 in June 2016. The requirements are applicable for financial years starting on or after 1 January 2016. On 2 December 2016, the implementation of the same was completed by way of issuing a Royal Decree.

Taxpayers are required to comply with the following documentation obligations with the Belgian tax authorities:
(a) **Master File** – 'Form 275.MF' should be filed annually within 12 months after the end of the financial year of the group.
(b) **Local File** – 'Form 275.LF' should be filed annually as an attachment to the income tax return.
(c) **CbC Reporting** – 'Form 275.CBC' should be filed annually by Belgian entities, which are the ultimate parent entity ('UPE') or surrogate parent entity ('SPE') of an MNE group with consolidated group revenue equal to or exceeding €750 million, within 12 months after the end of the group's financial year.
(d) **CbC reporting notification** – 'Form 275.CBC NOT' should be filed indicating whether or not the Belgian entity is the UPE or the SPE by the end of the financial year of the group. However, the first deadline for the notification has been extended to 30 September 2017.

3.2.3. INNOVATION DEDUCTION REGIME

On 2 December 2016, the Belgian Government formally announced the innovation deduction containing significant improvements compared to Belgium's previous intellectual property (IP) regime. The scope of the new innovation deduction has been widened to include other IP rights, including copyright protected software, orphan drug designations requested or acquired as of 1 July 2016 etc. Further, the invocation deduction has been brought in line with OECD's "modified nexus approach", which states that there must be sufficient substance and an essential link between the expenses, the patents, and the related patent income in order to benefit from a patent box regime.

The innovation deduction will be applicable retrospectively from 1 July 2016, with a five-year grandfathering period until 1 July 2021 optionally available for patent income earned upto 30 June 2021 in respect of self-developed patents requested before 1 July 2016 and improved patents and patent licenses acquired before 1 July 206. If the taxpayer opts for the patent income deduction during the grandfathering period, the taxpayer will not be able to apply the innovation deduction in relation to the relevant patent for the taxable periods ending prior to 1 July 2021.

Under the new regime, the deduction rate is increased to 85% of the net qualifying IP income resulting in an effective tax rate of 5.10%. The innovation deduction shall be calculated using the following formula under the 'nexus ratio':

Innovation deduction = (Qualifying expenditure x 130%) x (Net qualifying IP income x 85%). The innovation deduction is deducted from the corporate tax base. Any unused innovation deduction can be carried forward indefinitely.

3.3. BRAZIL

3.3.1. MUTUAL AGREEMENT PROCEDURE ('MAP')

On 10 November 2016, the Brazilian revenue authority published a Normative Instruction ('NI 1,669/16') which contains procedural and other rules on the MAP under treaties for the avoidance of double taxation. The NI adopts the minimum standard for the resolution of treaty related disputes under BEPS Action 14 but does not adopt the set of best practices set forth in BEPS Action 14, such as arbitration as a dispute resolution mechanism.

Separate forms have been developed for a Brazilian taxpayer to initiate a MAP. Under NI 1,669/16, a decision reached under the MAP cannot be appealed in either an administrative or a judicial court.

3.3.2. COUNTRY-BY-COUNTRY REPORTING

On 4 November 2016, the Brazilian Revenue Authority issued a proposed Normative Instruction ('NI') to issue CbCR rules in Brazil, which was open for comments of taxpayers and other interested parties until 21 November 2016.

As per the NI, CbCR is proposed to broadly follow OECD BEPS Action Plan 13, with some changes to accommodate the Brazilian tax regime. The first CbC report would be required for fiscal years beginning on or after 1 January 2016. The following entities are covered by the CbC reporting obligation under the proposed scheme:

- The resident Ultimate Parent Entity ('UPE') of the MNE group with consolidated group revenue greater than €750 million (or BRL 2.26 billion); or
- The resident Constituent Entity of the MNE group, that is not the UPE, and
  - the UPE is not required to file a CbC report in its country of residence; or
  - although required to file a CbC report, there is not a qualifying international agreement for automatic exchange of CbC reports with Brazil; or
  - there has been a "systemic failure" of the jurisdiction of tax residence of the UPE and the Brazilian Administration has notified the Constituent Entity, resident for tax purposes in Brazil, that there has been a "systemic failure" of the jurisdiction of the UPE's tax residence

Further, the NI requires any resident Constituent Entity of an MNE Group to notify the local tax administration about the identity and residence of the reporting entity, which could be a UPE, Surrogate Parent Entity or Constituent Entity, generally at the time of filing its corporate tax return (typically by the end of June of the year following the relevant fiscal year).

Non-compliance of CbC rules may lead to imposition of penalty of up to 3% of the underlying value of transactions.

3.4. DENMARK – COUNTRY-BY-COUNTRY REPORTING NOTIFICATION

From fiscal year ('FY') 2016, Danish entities which belong to a MNE group subject to CbC reporting requirements[2] must provide a notification to the Danish Tax Administration ('DTA') as to which group entity is responsible for filing the CbC report. A single Danish entity may also provide notification on behalf of other Danish entities, within the same MNE Group. The first CbC report is required to be filed for FY 2016, the notification for which should be provided before 1 January 2017.

The notification should include the full entity name, address, tax jurisdiction and tax identification number of the entity responsible for filing the CbC reporting and the full entity name, address and tax identification number for fellow Danish entities (on whose behalf notification is being provided). The same can be provided in English, Danish, Swedish or Norwegian.

Failure to comply with the above notification requirement leading to the DTA'S subsequent failure in obtaining or receiving the CBC report shall attract penalty/ result in sanctions However, in light of OECD's 'Guidance on the Implementation of Country-by-Country Reporting', to which Denmark has assented, it is expected the tax authorities will initially take a 'soft-landing' approach whereby the notification could be amended or updated without carrying penalties.

3.5. EUROPEAN UNION – NEUTRALISING HYBRID MISMATCH ARRANGEMENTS

The European Union ('EU') has already adopted the Anti-Tax Avoidance Directive ('ATAD') addressing hybrid mismatch arrangements, but that is limited to the hybrid instruments and hybrid entities between members of EU only.

It has been thus proposed by the European Commission, in response to the request made by the Economic and Financial Affairs Council of the European Union ('ECOFIN'), to address the hybrid mismatches involving member countries as well as non-EU members in order to make rules more consistent with guidelines issued by OECD's BEPS Action Plan 2, by amending the existing ATAD.

[2] Groups with consolidated revenue exceeding €750 million. Some groups may however not be required to submit a CbC report until later, due to delayed implementation of CbC reporting requirements in the jurisdiction of their ultimate parent company.

The proposal of the EC also addresses hybrid permanent establishment mismatches, hybrid transfers, imported mismatches and dual resident mismatches that were earlier not addressed by the ATAD.

This proposal was discussed by the ECOFIN at the meeting held on 6 December 2017. Member states could not reach an agreement on the same, however stable text for most provisions was agreed to, leaving just the following two issues to be resolved:

i. rules that would allow member states to apply limited exemptions; and

ii. the date of implementation

This proposal is expected to have a substantial impact on the EU taxation front since it has expanded the scope of the previous ATAD significantly by addressing mismatches with non-member countries as well.

3.6. FRANCE – DIVERTED PROFITS TAX ('DPT')

On 22 November 2016, the French Assemblee Nationale, in the course of discussions on the draft Finance Bill for 2017, proposed a diverted profits tax to be applicable from fiscal years starting on or after 1 January 2018. The DPT is proposed to be levied at the same rate same as the corporate income tax rate, i.e. 33.1/3%.

The newly introduced DPT is expected to apply to the portion of profits realised by a legal entity resident outside France, however, carrying out activity either:

- Through a permanent establishment ('PE') in France, i.e. a legal entity domiciled or established outside of France is related to an activity carried out in France being sales of goods or provisions of services (through another enterprise) and the former holds more than 50% of shares financial or voting rights in the latter; or
- A legal person or individual where no PE is declared, however it can be reasonably concluded that the activity of such legal person or individual aims at avoiding or reducing the tax burden that should be due in France; or
- Enterprises exploiting electronic platforms through which persons can be connected with a view to contracting for the sale, exchange or sharing of goods or services

The proposed DPT is still under draft stage and there may be changes before it is enacted by the end of December 2016.

3.7. GERMANY – COMBATING HARMFUL TAX PRACTICES

The German Ministry of Finance published a technical draft of an Act in line with Action 5 of OECD BEPS project to combat 'Harmful Tax Practices' with regards to 'Licensing of Rights'. The intention of introducing such a draft is to restrict the royalty payments made to related parties if such payments are already deriving benefits of preferential rate of tax in the recipient's jurisdiction, wherein such preferential treatment is not compliant with OECD. The draft law comes into force when the effective tax on such payments is less than 25%.

It must be noted that, the proposal does not cover royalty payments that are taxed at a lower rate because the recipient's jurisdiction is a general low tax jurisdiction, and not because of a preferential IP box regime. Further, the draft law is applicable to payments made to related parties, and does not affect royalties and similar payments made to third parties.

For the provisions of the draft law to be attracted, it is necessary that the IP under consideration is not derived as a result of substantial business and R&D activities carried out by the licensor. This reflects the 'Nexus approach' in line with OECD BEPS Action

Plan 5. Substantial business activities are deemed to not exist if the person receiving payments did not substantially develop the right in course of its ordinary business, particularly if it had been acquired or it was developed by another related party.

If these conditions are fulfilled, the percentage of non-deductible royalties is calculated as follows:

Non-deductible royalties = (25%-effective tax rate at recipients level in %) 25%

The proposed rules in this regard shall be applicable to royalty payments arising post 31 December 2017. However, the draft will be subject to intense discussions before it finds place in the final law.

3.8. INDIA

3.8.1. MUTUAL AGREEMENT PROCEDURE ('MAP')

The Minister of State, Finance, India, in a written reply in the Lok Sabha, had stated that the Indian Government has proposed to disclose the number of disputes negotiated through MAP under tax treaties along with the time taken to resolve disputes, in view of the BEPS Action Plan 14 mandate.

As per the BEPS Action 14, all participating countries shall have to provide details including the number of cases pending under MAP, number of cases resolved fully to eliminate double taxation, number of cases that could not be resolved, etc., pertaining to tax disputes being negotiated under the MAP Article of tax treaties. Moreover, the details are to be provided in agreed upon templates to capture information about various cases and outcomes of those cases.

It is expected that disclosure of MAP details will bring more transparency in the working of Competent Authorities of all participating countries and would result in quicker resolution of problems arising due to double taxation.

3.8.2. INDIA-US BILATERAL ADVANCE PRICING AGREEMENT ('APA')

The Indian tax authority announced that India and the United States (US) have reached an agreement on the terms and conditions of the first bilateral APA between the countries. The verbal agreement between the two governments on terms and conditions for this bilateral APA concluded approximately six months after the application was filed with the Internal Revenue IRS. The written agreement should be finalized in the next two months.

It is understood that the mark-up on total cost to which the countries agreed is lower than the rate that was offered in the Indian unilateral APA process, as is expected in a bilateral negotiation process. The APA should be eligible for an expedited renewal process in the future.

Many companies that have already filed unilateral APAs in India are now converting those unilateral APAs to bilateral APAs, while others have filed new APA applications in both countries. For those filing new APA applications, it is important to submit the Indian application before 31 March 2017, in order for the APA term to start as of 1 April 2017 (tax year ending 31 March 2018). US taxpayers wishing to include the 2016 tax year in a bilateral APA request will need to submit their applications to the IRS APMA program before filing their 2016 income tax returns.

3.9. IRELAND - COUNTRY-BY-COUNTRY REPORTING NOTIFICATION

Effective from January 2016, MNEs having annual consolidated revenue which exceed

Euro 750 million are required to comply with Ireland's new CbC reporting requirements. Entities are required to report data on revenues, profits, taxes paid/accrued, employee numbers along with other data on a country-by-country basis for the group to Revenue Commissioners before 1st January 2017.

Subject to the guidelines of OECD's BEPS Action 13, it is mandatory for Irish UPEs or Surrogate Parent Entities or Constituent Entities to provide an annual notification to the Revenue Commissioners confirming the identity and tax residence of the CbC Reporting entity by the last date of the fiscal year to which the CbC report relates. Subject to certain specified conditions, the Irish Revenue Commissioners shall also accept voluntary CbC report filed by UPEs of an MNE group in its resident country – thereby no necessitating filing of CbC reports by the Constituent Entities under the secondary filing mechanism.

3.10. ISRAEL

3.10.1. INNOVATION BOX REGIME

As a measure of encouraging MNEs to consolidate their intellectual property ('IP') and profits in Israel along with existing Israeli research and development ('R&D') functions, the Israeli Government introduced an 'Innovation Box regime' with effect from 1 January 2017, which aims at providing tax benefits for certain industrial companies.

For a company to qualify for the aforementioned regime, the following conditions need to be satisfied:

i. The company should have invested at least 7% of the last three years' revenue in R&D, or spent Israeli New Shekel ('ILS') 75 million as R&D expense; and

a. Have at least 20% R&D employees (or more than 200 R&D employees); or

b. Venture capital investment of ILS8 million was previously made in the company; or

c. Have average annual growth over three years of 25% in sales or employees

Further, companies not meeting the above criteria may still be eligible for the innovation box regime at the discretion of the Israeli Innovation Authority in the Economy Ministry.

The insertion of a 'stability clause' has also been approved so as to encourage MNEs to invest in Israel, thus the tax incentives will be applicable for companies for a 10 year period under a ruling process.

The tax rate on IP-based income and on capital gains from future sale of IP will be as under:

- For qualifying Israel companies that are part of a group with global consolidated revenue of over ILS 10 billion, approximately US$2.5 billion – 6%
- For other qualifying companies with global consolidated revenue below ILS 10 billion - 12%

Current tax incentives available to certain R&D centres and industrial companies located in Jerusalem or in certain northern or southern parts of Israel, i.e. a reduced rate of tax of 9% has been further reduced to 7.5% for such locations.

The above law is intended to be in line with OECD's 'nexus approach' so as to ensure that companies are benefitting from the above regime to the extent qualifying R&D expenses are incurred having regard to the fact that Israel has been home to multiple R&D centres on large MNEs – thus creating a BEPS compliant environment by also integrating Israeli developed IP with global MNE structures.

3.10.2. CORPORATE TAX RATES

The standard corporate tax rate was reduced from 25% to 23% by way of an amendment to the Income Tax Ordinance. The reduction in the tax rates will be phased, i.e. the rate will reduce to 24% from 1 January 2017, and the same will be reduced further to 23% starting 1 January 2018.

In addition to the above, the withholding tax rates on interest, royalties, or consideration from capital gains paid to corporations, which are generally based on the standard corporate income tax rate, will also be reduced to 24% as of 1 January 2017, and to 23% as of 1 January 2018.

3.11. JAPAN – FREQUENTLY ASKED QUESTIONS ('FAQS') ON TRANSFER PRICING DOCUMENTATION

The National Tax Agency, Japan, has issued select FAQs and answers regarding transfer pricing documentation/ local filing requirements in Japan. The FAQs are expected to have greater relevance for MNEs which are headquartered outside Japan but have subsidiaries or branches in Japan.

One of the key areas of concern in Japan is whether tax authorities will resort to 'presumptive taxation' for examination of companies by presuming prices based upon use of 'secret comparables'. In this regard, the FAQs clarify that where local files are prepared based on inaccurate information, the same shall be treated as not having been filed at all. However, if the amended local file is not submitted within the prescribed deadline, 'presumption taxation' using 'secret comparables' can be used.

The above clarification reflects strong intent of the Japanese tax authorities towards use of 'presumptive taxation' in future.

3.12. LUXEMBOURG – COUNTRY-BY-COUNTRY REPORTING

On 25 May 2016, the Luxembourg Parliament ('Parliament') issued a Directive 2016/881/EU which dealt with mandatory automatic exchange of information in the field of taxation, given the developments in the OECD BEPs area. In order to give effect to the said directive, on 13 December 2016, the Parliament adopted the draft law n07031 on CbC reporting.

The above law is largely in line with the earlier draft that was introduced before the Parliament, barring one major change, i.e. the penalty of Euro 250,000 (proposed in the earlier draft) for failure to file or late filing of the CbC report has now also been extended to failure to notify/ late notification to the Luxembourg tax authorities in respect of the group's ultimate parent entity or a surrogate parent entity responsible for filing of CbC report on behalf of the Group.

The notification deadline for the first year of filing of CbC report is 31 December 2016. However, it is expected that the same may be extended once the law (currently draft) is published in the Official Gazette.

3.13. NETHERLANDS – COUNTRY-BY-COUNTRY REPORTING

As per Dutch country-by-country rules, Dutch constituent entities of an MNE group are required to notify the local tax administration about identity and residence of the entity which shall be required to file a CbC report on behalf of the MNE group. As a general rule, this notification is to be made by the last day of the reporting fiscal year. However, for MNE groups with a reporting fiscal year ending on or before 31 August 2017, the above notification deadline has been extended to 1 September 2017. Post 31 August 2017, the general notification shall be applicable.

In addition to the above, the Dutch tax authorities announced that:

- a software tool has been developed to submit notifications and a proposal shall be issued to make the use of the tool mandatory
- a proposal shall be drafted stating that Netherlands agrees with the OECD guidance on voluntary filing and thus no secondary reporting will be triggered when an MNE group opts to voluntarily file a CbC report

3.14. NEW ZEALAND – TAX POLICY WORK PROGRAMME

On 8 November 2016, the New Zealand Ministry of Revenue released an updated tax policy work programme (2016-17), which covers New Zealand's approach of working on BEPS initiatives. The same is proposed to include anti-hybrid mismatch rules, interest limitation rules in light of Action 4, and other measures that address BEPS and may be appropriate for New Zealand, such as diverted profits tax adopted by UK and Australia.

The Tax policy work programme also highlights that New Zealand will sign the multilateral instrument, which will amend its network of tax treaties to insert a new anti-treaty abuse article, a new permanent establishment definition, anti-hybrid entity rules and dispute resolution articles.

3.15. NORWAY – COUNTRY-BY-COUNTRY REPORTING REGULATIONS

Following the adoption of CbCR rules enacted on 2 December 2016, the Norwegian Ministry of Finance, on 9 December 2016, issued CbCR regulations in line with the recommendations under BEPS Action Plan 13. These regulations will be applicable from financial years starting on or after 1 January 2016.

3.16. PAPUA NEW GUINEA - COUNTRY-BY-COUNTRY REPORTING

Vide its Income Tax (2017 Budget), Amendment Bill, the Treasury of Papua New Guinea proposed to introduce CbC reporting for fiscal year starting from 1 January 2017. The CbC report would be required to be filed within 12 months after the last day of the reporting fiscal year by ultimate parent entities ('UPE') of MNE groups whose total consolidated group revenue is greater than 2M Kina, i.e. approximately 0.56 million Euro. Any entity, not being the

UPE, of the group, that is resident in Papua New Guinea would have to prepare and file the CbC report in the following cases:

- If the UPE is not resident in Papua New Guinea, and it is not obligated to file a CbC report in its country of residence; or
- although obligated to file a CbC report there is not an exchange of information instrument in place with Papua New Guinea; or
- there has been a systemic failure

Further, a group entity in Papua New Guinea will need to notify its tax authorities whether or not it is the reporting entity or the identity and the tax residency of the reporting entity, by the last day of the reporting fiscal year of such MNE group.

3.17. SAUDI ARABIA – MULTILATERAL COMPETENT AUTHORITY AGREEMENT ('MCAA')

As per OECD's announcement on 2 November 2016, the Kingdom of Saudi Arabia ('KSA') has joined the Common Reporting Standard ('CRS') MCAA and has committed to the first exchange of financial account information by September 2018.

As a result of the above, information, which was earlier not accessible by the tax authorities, will now be automatically exchanged amongst them. A range of financial institutions, including businesses across the banking, wealth and asset management and insurance sectors will be covered under the scope of the CRS. Accordingly, reporting KSA financial institutions will be expected to collect and retain the tax residence information of their account holders, i.e. both- entities and individuals, personal details including their Tax Identification Numbers, and financial details including account balances and any amounts paid or credited to the account held. It is expected that, since KSA is committed to the first exchange of information by 2018, reporting KSA financial institutions will have new customer on-boarding procedures in place from 1 January 2018.

As of now, there are 86 other jurisdictions as signatories of the MCAA and over a 100 companies have committed to adopting the CRS early in 2017, or in 2018.

3.18. SWITZERLAND

3.18.1. SPONTANEOUS EXCHANGE OF INFORMATION

On 23 November 2016, the Swiss Federal Council adopted the administrative regulations required for the implementation of spontaneous exchange of information on tax rulings with effect from 1 January 2017. Accordingly, the first exchange of information with selected partner states can begin in 2018

3.18.2. MULTILATERAL COMPETENT AUTHORITY AGREEMENT ('MCAA')

The Swiss Federal Council also adopted the dispatch on the MCAA on exchange of CbC Reports along with the corresponding federal act required for its implementation in Switzerland, subject to the approval of the Swiss Parliament.

If a referendum is not held, the CbC MCAA and the federal act may become applicable by the end of 2017, pursuant to which MNCs in Switzerland would be required to file a CbC report for fiscal years starting from 1 January 2018.

3.19. UNITED KINGDOM

3.19.1. UK FINANCE BILL 2017 – DRAFT CLAUSES

The draft clauses for the UK Finance Bill, 2017, was published by the UK Government on 5 December 2016. This same is open for consultation until 1 February 2017.

The draft clauses present the following key developments:

- Specific provisions have been added to the revised Patent Box rules which had been introduced in the Finance Act 2016. The same cover the case where two or more companies undertake R&D collaboratively under a cost sharing agreement and will be effective from 1 April 2017;
- New rules, which restrict interest deductions, in line with Action Plan 4 have been proposed (the same have been explained in detail below); and
- Two minor changes have been made to the hybrid mismatch regime in relation to:
    - treatment of amortization deductions; and
    - permitted period claims

3.19.2. LIMITING INTEREST DEDUCTIONS

The draft legislation released by the UK government, on 5 December 2016, seeks to bring UK regulations on interest deductions in line with the OCED's BEPS Action Plan 4 by repealing the current Debt Cap rules. The said rules will be applicable on interest expenses accruing on or after 1 April 2017.

The new rules will not apply to groups whose interest expenses are less than GBP 2 million per annum. However, where the UK tax-interest is greater than GBP 2 million, the group is required to calculate its taxable profit in UK before interest, capital allowances and deductible amortization of intangible assets, i.e. the EBITDA and then apply the 'fixed ratio rule' whereby the deduction on account of interest would be limited up to 30% of the group's tax-EBITDA.

As an alternative, a 'group ratio' may also be calculated based on the group's global accounts. The formula for computing the same is:

$$\text{Group Ratio} = \frac{\text{Qualifying net group interest expense}}{\text{Group's accounting EBITDA}}$$

Accordingly, tax-interest of the UK-group can be deducted up to the group ratio applied on the UK tax-EBITDA, even in cases where that may result in an amount higher than the fixed ratio rule.

Further, a modified debt cap rule is inserted which sets an umbrella limit, namely groups cannot deduct more net Tax-Interest in the UK than their global adjusted net group interest expense.

As per the new rules, carry forward of excess tax-interest that cannot be deducted and addition of the same to tax-interest in the future is allowed indefinitely. Moreover, spare capacity that is unused in a given period can now be carried forward for five years rather than the three years as proposed earlier.

3.19.3. HYBRID AND OTHER MISMATCHES

On 9 December 2016, draft guidance on hybrid and other mismatches was published by HM Revenue and Customs. The draft guidance has been introduced to provide clarity and understanding on the application of the hybrids mismatch legislation, which is effective from 1 January 2017.

The draft legislation enumerates examples contained in the final report on BEPS Action Plan 2, with additional draft examples dealing with hybrid transfers and permanent establishments.

3.20. UNITED STATES – DRAFT FORM FOR COUNTRY-BY-COUNTRY REPORTING

On 8 December 2016, the Internal Revenue Service ('IRS') released a new draft form for the purposes of CbCR and posted a link of the same on the IRS website. It is the ultimate parent entities of MNE groups in US who are the intended audience for this form.

The new form is divided into the following two parts:

1. Form 8975 – which requests information that includes inter alia the name of the filer and certain additional information regarding the MNE group.
2. Schedule A to Form 8975 – which is required to be completed for each tax jurisdiction of the MNE group in which the US MNE group has a constituent entity.