



Cross border businesses after BEPS - will they have to realign?
Patents & intangibles, digital economy (equalization levy) & hybrid mismatches

International Fiscal Association

17th June, 2016, Mumbai

Chairman

Mr. V. Lakshmikumaran *Lakshmikumaran & Sridharan Attorneys*

Panellists

Mr. David Bradbury *OECD*

Mr. Padamchand Khincha *H C Khincha & Co*

Ms. Shefali Goradia *BMR Advisors*

Mr. Subhankar Sinha *Siemens Ltd, India*

AGENDA FOR THE SESSION

Time	Time count	Panel Member	Subject
12:00 to 12:07	7 mins	Chairman	Opening Remarks
12:07 to 12:22	15 mins	Mr. David Bradbury	Introduction to Digital Economy and work by OECD. Various conceptions and misconceptions on BEPS Action Plan-1
12:22 to 12:32	10 mins	Ms. Shefali Goradia	Broad concerns on Digital Economy
12:33 to 12:43	10 mins	Mr. Padamchand Khincha	Equalisation Levy
12:44 to 12:59	15 mins	Mr. Lakshmikumaran	IP Regimes
13:00 to 13:15	15 mins	Mr. Subhankar Sinha	Hybrid Mismatches
13:16 to 13:26	10 mins	Panel	Question & Answers
13:27 to 13:30	3 mins	Mr. Lakshmikumaran	Concluding remarks

Addressing the Tax Challenges of the Digital Economy

David Bradbury

Head of the Tax Policy and Statistics Division
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17 June 2016



Tax challenges of the digital economy

Outline of the Action 1 report

- What is the Digital Economy?
- BEPS in the Digital Economy
- Tackling BEPS in the Digital Economy
- Broader Tax Challenges in the Digital Economy
- Options to Address these Broader Tax Challenges
- Conclusions and Next Steps

Key findings

Impossible to ring-fence the digital economy for tax purposes

Digital economy has key features and fosters business models that raise related but different issues

No unique BEPS issues, but the digital economy exacerbates BEPS concerns

- Addressed across the BEPS Project, including within the work on permanent establishment, transfer pricing and CFC rules

Considered broader tax challenges and potential approaches

- Nexus and data challenges analysed with potential options, including Significant Economic Presence, WHT & Equalisation levy

BEPS Measures addressing the direct tax challenges

Key measures expected to address BEPS concerns exacerbated by the digital economy. In particular:

Permanent Establishment (Action 7):

- agency PE definition
- preparatory and auxiliary activities

Transfer Pricing (Actions 8-10):

- delineation of actual transaction
- intangibles
- special approach on hard to value intangibles (HTVI)
- scope of guidance on profit splits

Controlled Foreign Company rules (Action 3):

- coverage of income from digital sales

Broader challenges of the digital economy

Direct tax

- Nexus and the ability to have a significant presence without being liable to tax
- Data and attribution of value created
- Characterisation of Income derived from new business models

Indirect tax

- Collection of VAT on B2C sales
- Exemptions for low value imports

Other potential options considered

Nexus and data challenges analysed with potential options and related technical issues:

- **Significant economic presence (SEP)**
- **Withholding Tax**
- **Equalisation levy**

These options were **not adopted** as international standards.

Countries could introduce them in **domestic laws** as additional safeguards against BEPS, **provided they respect existing treaty obligations, or in their bilateral tax treaties**

Significant Economic Presence

Taxable presence in a country when a non-resident enterprise has a **significant economic presence** (SEP) on the basis of factors that evidence a **purposeful and sustained interaction with the economy** of that country via technology and other automated tools.

A new nexus based on:

- Revenue factor: *scope (transactions covered), level of threshold; administration of the threshold*
- Digital factors: *a local domain name; local digital platform; local payment options*
- User-based factors; *monthly active users; online contract conclusion; data collected*

Income attributable to the SEP

- Existing rules (difficult and would require major changes)
- Fractional apportionment
- Modified deemed profit methods

WHT on digital transactions

Withholding tax on payments by residents (and local PEs) of a country for goods and services purchased online from non-resident providers.

Scope: same issues as SEP in determining the transactions covered

Standalone gross-basis:

- final withholding tax on certain payments made to non-resident providers of goods and services ordered online
- not a good proxy for net income
- EU and Trade issues

Collection: May work for B2B; intermediaries in B2C context.

Equalisation levy

- This approach has been used by some countries in order to ensure equal treatment of foreign and domestic suppliers.
- For example, in the area of insurance, where it is intended to address a disparity in tax treatment between domestic corporations engaged in insurance activities where they are wholly taxable on the related profits, and foreign corporations that sell insurance but are not.
- Should only apply where there is a significant economic presence in a country (SMEs).

Scope

- All remote sales or just digital transactions?
- Target the levy to cases where the business maintains a **significant economic presence**
- Limit the scope to transactions involving the **conclusion through automated systems of a contract for the sale (or exchange) of goods and services between two or more parties effectuated through a digital platform**
- Try and tax the value considered to be directly contributed by customers and users (one option would be to impose a charge based on the average number of MAU), but these measures may prove to be challenging

Equalisation levy (2)

Potential trade and other issues

A levy that applied only to non-resident enterprises would raise substantial questions on trade agreements and EU law.

One option would be to impose the tax on both domestic and foreign entities with consideration given to ways to mitigate the potential impact of applying both the corporate income tax and the levy to domestic entities and foreign entities taxable under existing corporate income tax rules.

Relationship with corporate income tax

Risk that the same income would be subject to both corporate income tax and the levy. To avoid double taxation in a country:

- Structure the levy to apply only to income that would otherwise be untaxed or subject only to a very low rate of tax.
- Permit crediting of levy against taxpayer's domestic corporate income tax.

VAT challenges of the digital economy

Remote digital supplies to exempt businesses & multiple location entities

- Addressed by the OECD's Guidelines on place of taxation for B2B supplies of services and intangibles (completed in January 2014)

Collecting VAT on cross-border supplies from non-resident suppliers, especially in B2C trade: remote supplies to consumers and low value imports

Determining place of taxation of B2C supplies of services & intangibles

- Part of the OECD International VAT/GST Guidelines
- Level the playing field between domestic & foreign suppliers and facilitate the efficient collection of VAT due on these transactions
- VAT will apply based on where the consumer lives
- Simplified registration and compliance regime recommended to facilitate compliance by non-resident suppliers

Low value imports – report in Annex C

Next steps

Monitor developments, impact of BEPS measures, and analyse data which become available

Future monitoring work will **inform** whether further work on the three options should be carried out multilaterally

Detailed mandate to be developed during 2016 in the context of designing an inclusive post-BEPS monitoring process

Publish report reflecting the outcome of the continued work in relation to the digital economy **by 2020**

Conclusion

Digital Economy – Broad Challenges

Shefali Goradia

BMR Advisors

17 June 2016



Digital Economy - Some business constructs

E-commerce

Sale and purchase of goods and services over computer networks

App Stores

Digital distribution platform for software

Free model / Premium model / Freemium model

Cloud Computing

Standardised, on-demand, online computer services

Online Advertising

- Display of ads
- Appear amongst search results
- Free digital content to view paid ads
- Ads on social media sites

Payment services

- Cash payment solutions (settlement agencies)
- E-wallets (Bitcoin)
- Mobile payment solutions for in-app payments

High frequency trading

Huge volume of trades conducted at high speed through complex computer algorithms (co-location)

Digital Economy - Challenges and perspectives

- Increasingly difficult to identify source and destination of goods / services
 - Borderless and intangible nature of internet
 - Anonymity in identity and location of parties
 - Dis-intermediation
 - Online delivery
- Divide in developing countries and developed countries
 - Developing countries have large customer base - demand shift towards origin based and consumption based tax
 - Developed countries are encountering heavy tax planning - such as IP jurisdictions

Unique features of digital businesses (1/3)

- **Mobility of intangibles:** Easy to shift legal ownership between associated enterprises - not necessarily to entity which developed the intangible
- **Mobility of users:** Customers may use services remotely while travelling across borders. For example, an individual can reside in one country, purchase an application while staying in a second country, and use the application from a third country
- **Mobility of business functions:** No need for location in place of operations or place of customers - global operations can be managed on an integrated basis

Unique features of digital businesses (2/3)

- **Reliance on data:** Collection of massive amount of data is now possible - leads to improvement in product and services. eg, by recording internet browsing preferences, location data etc
- **Network effects:** Decisions of users may have a direct impact on the benefit received by other users. eg, when additional people join a social network, the welfare of the existing users is increased, even though there is no explicit agreement for compensation between users

Unique features of digital businesses (3/3)

- **Multi-sided business models:** Where various persons interact through an intermediary and the decision of each person affects the outcome for the other. For example, a card payment system will be more valuable to customers if more merchants accept the card or an operating system is more valuable to end users if more developers write software for it, and more valuable to software developers if more potential software purchasers are using the operating system

Issues in digital economy - nexus and characterisation (1/2)

Reduced need for physical presence combined with artificial avoidance - augment nexus concerns

No substantial presence warranted

- Only offices undertaking activities like purchase, storage, delivery falling within preparatory or auxiliary
- Is storage and delivery an auxiliary function in the context of e-tailing?

Remote interactions with customers

- No need for sales office
- Communicating via phone, emailing, fax etc

People replaced by software

- Software undertaking automated function - no PE under OECD principles
- Eg, high frequency trading

Artificial avoidance

- Placing server in low-tax jurisdiction - reduced latency may still be achieved by caching content locally
- Fragmentation of activities to fit within the exception rule

Issues in digital economy - nexus and characterisation (2/2)

Characterisation issues are magnified in digital transactions

Rights acquired could vary based on contract

Purchaser of digitized photograph could obtain (a) right to use single copy, (b) right to make several copies for use in a report, (c) right to reproduce in a mass-circulation magazine

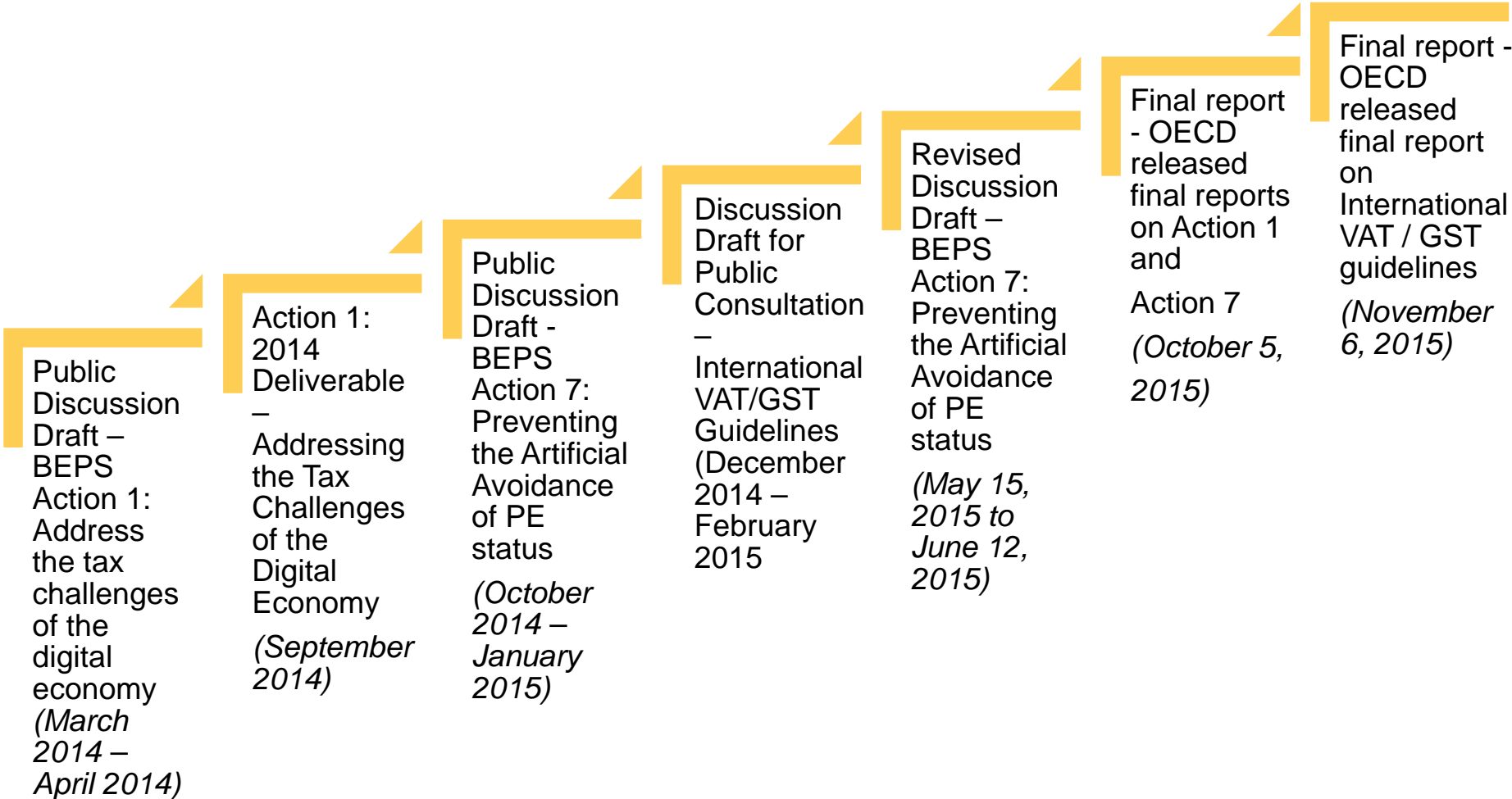
Digitization allows perfect duplication

Purchaser of 10 physical books would be replaced by purchasing one copy and acquiring the right to make 9 additional copies - royalty income or merely a substitute for purchase of 10 copies

Delivery is in intangible manner

If A pays X for live broadcasting and B pays A to buy the recorded performance and broadcasts it in a month, is the economic nature of two transactions any different?

Work done under BEPS - digital economy and PE



Digital presence - justified? (1/2)

- New nexus based on “significant digital presence”
 - Nexus based on consumption activity rather than value generation activity
 - Radical departure from long standing principles - likely to cause theoretical and practical challenges
 - Is this contrary to principle of non ring-fencing digital economy?

Digital presence - justified? (2/2)

- Is a nexus in market jurisdiction justifiable - is this a culmination of inability to resolve CFC concerns in residence jurisdiction?
- Are we moving from 'sufficient nexus' to 'mere nexus'?
- Need to correct attribution rules - once market jurisdiction has collected due taxes under appropriate transfer pricing, nexus issue should not arise
- Is there a stable conclusion for digital economy yet? - do suggested PE modifications address concerns in digital economy?

Conclusion

EQUALIZATION LEVY CERTAIN ASPECTS

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17 June 2016



Digital economy

- Digital economy forms a significant part of the economy.
- Digital economy is the result of a transformative process through revolution in internet, communication & technological progress.
- Digital means of communication and social interaction are giving rise to new business models

Equalization Levy (1/5)

- Emergence of digital enterprises pose challenges to the application of present international tax rules.
- Differences in tax burden faced by the traditional businesses and digital enterprises.
- Lack of tax neutrality can distort the market in favor of digital enterprise.
- Tax advantage faced by multinational digital enterprises impacts growth of digital industry in India

Equalization Levy (2/5)

- 'Equalization Levy' represents an action of ensuring tax neutrality.
- Levy is on gross payment for digital transactions, but not on income.
- Levy designed to be outside the Income tax Act, 1961.
- Levy is outside the purview of the limitations imposed by tax treaties.

Equalization Levy (3/5)

- Compliance will be by way of deduction of levy by the payer.
- Levy represents tax on non-resident enterprise's significant economic presence in a country.
- Levy on B2B beyond a threshold and not B2C or C2C transactions
- Equalization levy represents one of the three options in BEPS Action Plan 1, of addressing challenges of digital economy.

Equalization Levy (4/5)

- Equalization levy chosen in India as a “default option”
- Committee recommends not to wait for further work of the Task Force on Digital Economy.
- Committee sceptical whether any “Determinable outcomes” from such work can be anticipated in the foreseeable future

Equalization Levy (5/5)

- Committee of the opinion that the adoption of a recommendation that will completely harmonize international taxation on digital economy would take a long time.
- Equalization levy suggested as a “practical and pragmatic” solution to address the challenges.
- Committee recommends GAAR and TP provisions should not be applicable to transactions subject to equalization levy.
- Committee believes levy is Constitutionally valid.

Characteristics of the Proposed 'Equalization Levy'

- Levy on payments to foreign beneficial owner for digital services.
- Equalizing tax burden without disturbing the existing tax treaties.
- Levy is to provide greater clarity, certainty and predictability in characterization of payments
- To minimize costs of compliance and administration and minimize tax disputes.
- 'Equalization Levy' on gross payments would be a full and final tax.

Possible grounds of criticism (1/2)

- Additional tax affecting ease of doing business in India
- Tax burden to fall on Indian businesses.
- May affect adversely the competitiveness of Indian digital businesses.
- Rates of levy likely to increase, coverage of services likely to widen.

Possible grounds of criticism (2/2)

- Not a sound approach with India at the fastest growing service economy.
- May invite “retaliation” measures
- If no foreign tax credit, would amount to double taxation

Conclusion

TOPIC

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For discussion

- BEPS recommendation on reducing harmful tax regime on IP creation
- India's patent box programme and its compatibility to BEPS
- Difference in Indian Tax Law and IP Law

BEPS recommendation on reducing harmful tax regime on IP creation

Need for BEPS on IP

- IP intensive industries are key growth drivers of economy and employment
- To attract/ retain economic activity in their jurisdictions, states adopted 'race to the bottom of tax rate approach'
- Various such actions by OECD members included
 - Netherland's Innovation box regime
 - Switzerland's License Box regime
 - Colombia's Software regime
 - UK's Patent Box regime
- Resulted in 'Harmful Tax Practice'

Harmful Tax Practice - BEPS

- Offering tax preference in comparison with general principles of taxation in relevant country
- Regime is ring-fenced from domestic economy
- The regime encourages purely tax driven arrangements, without substantial activities.
- It is promoted as 'tax minimisation vehicle'
- The regime is Opaque and no exchange of information
- Existence of secrecy provisions

Nexus Test *as per BEPS Action Plan 5*

- Preferred over 'Value Creation approach' and 'TP approach'
- Primary question - Whether the IP regime makes its benefits conditional on extent of R&D activities of beneficiary taxpayer?
- Nexus Test is an amalgam of
 - Front end approach - expenditure incurred in creation of IP
 - Back end approach - income earned after creation of IP
- Proportion of expenditure acts as proxy to determine substantial activities

India's Patent Box regime and compatibility with BEPS

Section 115 BBF

Eligible assessee

-----> *10%*

Income by way of **royalty** in
respect of a patent **developed and
registered** in India

Compatible with BEPS 5 ... ?

Compatibility of Indian regulation with BEPS

BEPS criterion	Requirements	Section 115BBF
Qualifying tax payer	Only to resident taxpayers and PEs	Explanation (b) – available to resident patentees being true and first owners
Eligible asset	Patent and functionally equivalent	Patent, as per section 2(1)(m) of the Patents Act 1970
Qualifying expenditure and restriction on outsourcing	Incurred by taxpayer and directly connected with IP	Explanation (a) – 75% expenditure to be incurred in India by taxpayer
Qualifying income	Should only include income derived from IP	Sub-section (1) – only royalty is eligible



Compatibility of Indian regulation with National Programme

- Beneficial treatment would be available only if
 - 75% of expenditure of development is incurred in India
 - The patent would have to be registered in India
- The scheme is thus in line with the National Programme of “Make in India”

Difference in Indian Tax Law and IP Law

Patentee - can an R&D company qualify?

IT Act

"patentee" means the person, being the true and first inventor of the invention, whose name is entered on the patent register as the patentee, in accordance with the Patents Act, and includes every such person, being the true and first inventor of the invention, where more than one person is registered as patentee under that Act in respect of that patent;

Can a company or any other artificial person be eligible for being taxed under patent box regime?

Indian Patents Act, 1970

Section 6: Persons entitled to apply for patents.

an application for a patent for an invention may be made:

- by any person claiming to be the true and first inventor of the invention;
- by any person being the assignee of the person claiming to be the true and first inventor in respect of the right to make such an application;

Income from other rights of a patentee covered?

IT Act

"royalty", in respect of a patent, means consideration for

- (i) transfer of all or any rights (including the granting of a licence) in respect of a patent; or
- (ii) imparting of any information concerning the working of, or the use of, a patent; or
- (iii) use of any patent; or
- (iv) rendering of any services in connection with the activities referred to in sub-clauses (i) to (iii);

Would consideration received for alienation of any of his other rights be covered under the patent box regime?

Indian Patents Act, 1972

47. Rights of a patentee

(a) In respect of product patent, prevent 3rd parties from

- making,
- using,
- offering for sale,
- Selling, or
- importing for those purposes that product in India;

(b) In respect of process patent, prevent 3rd parties from

- using that process,
- offering for sale,
- Selling, or
- importing for those purposes the product obtained directly by that process in India

Conclusion



Hybrid Mismatches

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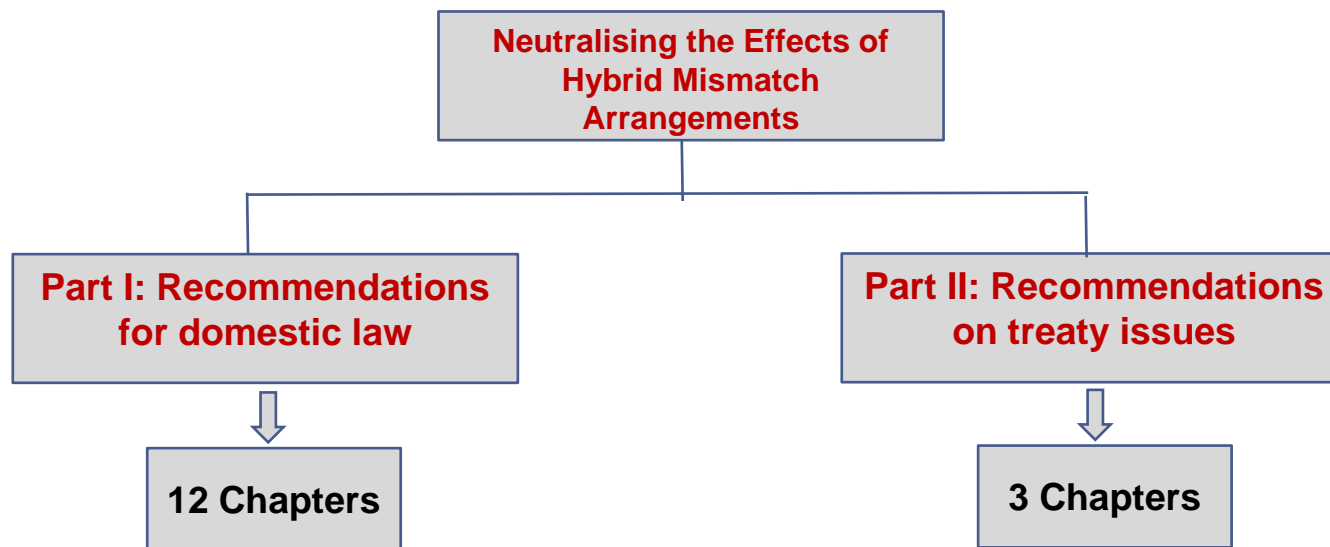


Action 2: Hybrid Mismatch Arrangements

- **Hybrid Mismatch Arrangement** → an arrangement designed to exploit differences between various tax jurisdictions through use of a hybrid entity or a hybrid instrument
- **Hybrid Entity** → an entity that is treated differently under rules of two different tax jurisdictions e.g. company in one, partnership firm in other
- **Hybrid instrument** → an instrument characterized differently by two tax jurisdictions e.g. debt in one, equity in other
- **Hybrid Transfer** → transfer of any financial instrument which is hybrid or transfer between entities either or both of which are hybrid entities
- BEPS proposals are directed at structures involving hybrid entities or instruments that give rise to:
 - Deduction in one jurisdiction with no inclusion of corresponding income in another jurisdiction (**D/NI outcome**)
 - Deduction in two jurisdictions (**DD outcome**)

Action 2: Overview

- ❖ Report split into two parts:



- ❖ 454 pages

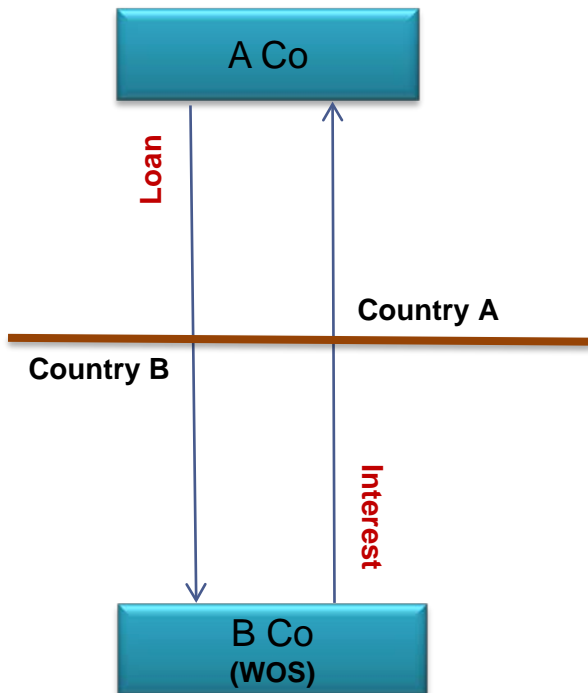
- ❖ 80 examples

Action 2: Scope

In order to neutralize effects of hybrid instruments & entities, OECD's suggestions are as follows –

- To make changes in domestic law provisions *to prevent exemption or non-recognition* for payments that are deductible by payer
- To make changes in domestic law provisions *to deny deduction* for a payment that is not includible in income by recipient
- To make changes in domestic law provisions *to deny deduction* for a payment that is also deductible in another jurisdiction
- To make changes to Model tax Convention to ensure that hybrid instruments & entities (as well as dual resident entities) are not used to obtain undue treaty benefits
- Where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure

Hybrid Mismatch Arrangement - D/NI Outcome



Facts:

A Co (resident in Country A) owns 100% shares in B Co (resident in Country B). A Co has given loan to B Co bearing interest at prevailing market rates.

Loan treated as debt instrument under Country B laws but as equity under Country A laws. While Country B allows deduction of such interest paid, Country A exempts foreign dividends received.

Suggestions:

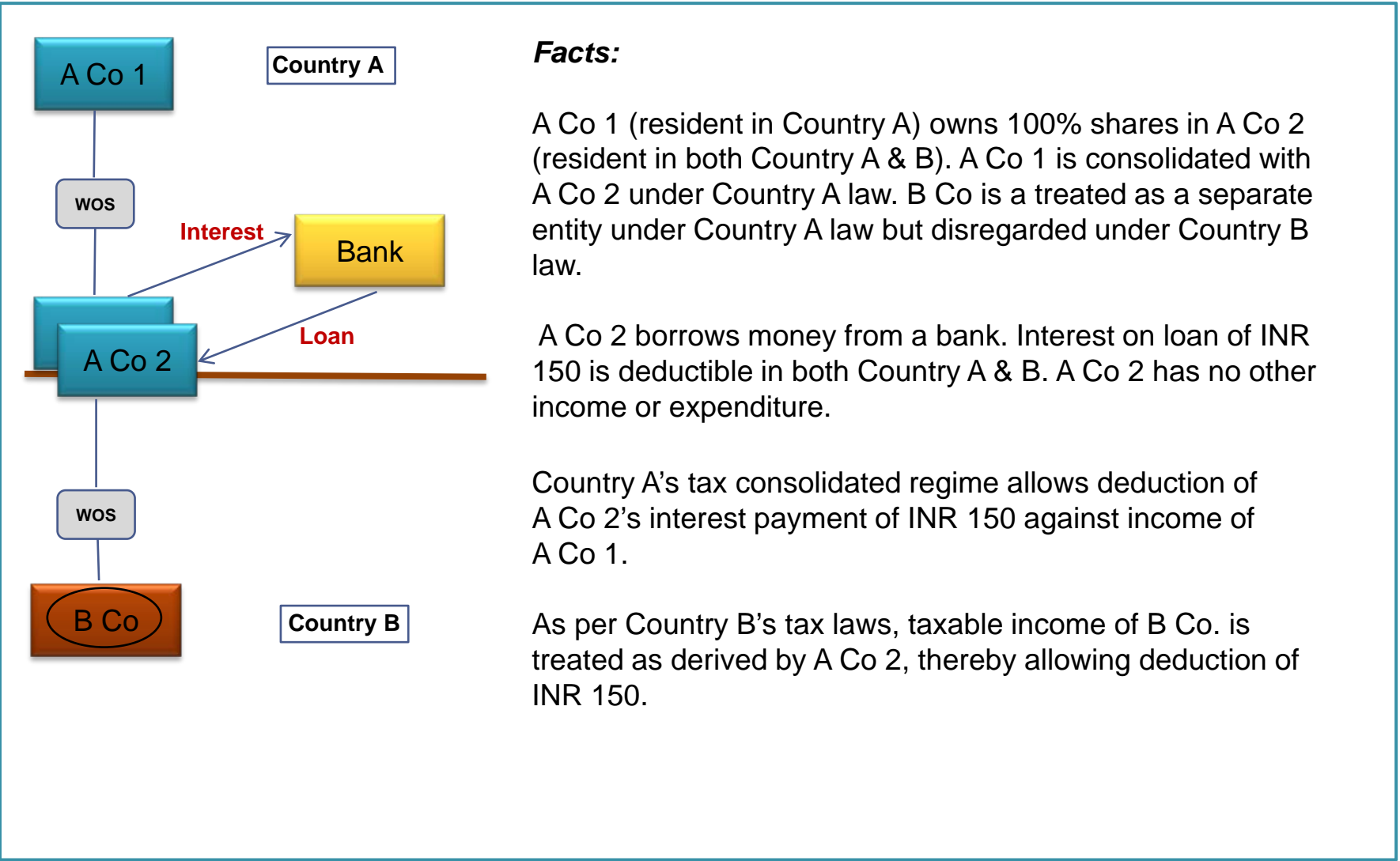
Country A should deny dividend exemption where payment is a deductible expense in payer country (*Ideal scenario*)

If Country A does not amend its law, then:

- *Primary Recommendation:* Country B should disallow claim of interest expense of B Co.
- *Defensive rule:* Country A should tax dividend income

Rule applies where mismatch can be attributed to terms of instrument ... mismatch solely attributable to status of taxpayer or circumstances in which instrument held excluded

Hybrid Mismatch Arrangement - DD Outcome ...



Facts:

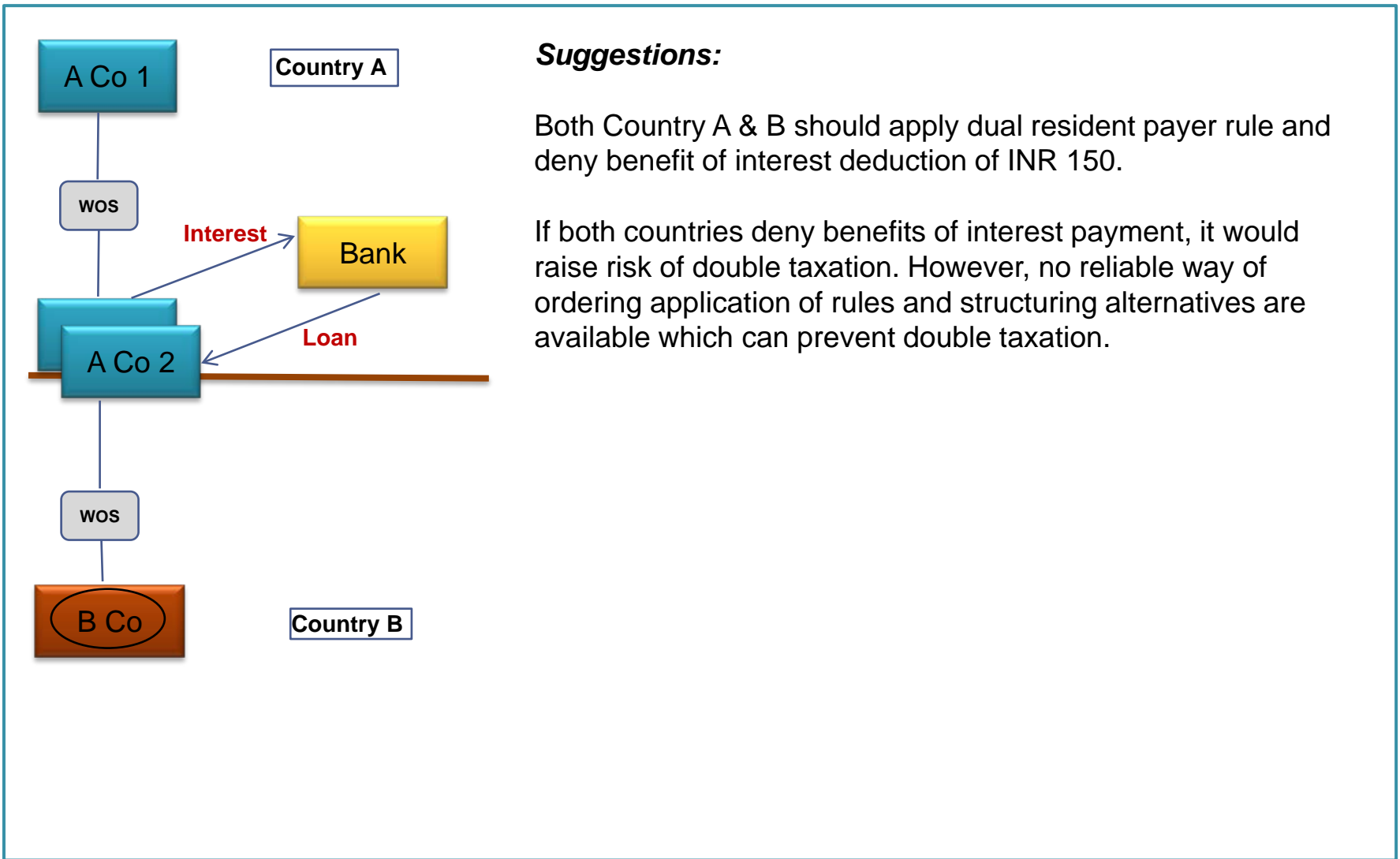
A Co 1 (resident in Country A) owns 100% shares in A Co 2 (resident in both Country A & B). A Co 1 is consolidated with A Co 2 under Country A law. B Co is treated as a separate entity under Country A law but disregarded under Country B law.

A Co 2 borrows money from a bank. Interest on loan of INR 150 is deductible in both Country A & B. A Co 2 has no other income or expenditure.

Country A's tax consolidated regime allows deduction of A Co 2's interest payment of INR 150 against income of A Co 1.

As per Country B's tax laws, taxable income of B Co. is treated as derived by A Co 2, thereby allowing deduction of INR 150.

... Hybrid Mismatch Arrangement - DD Outcome



Suggestions:

Both Country A & B should apply dual resident payer rule and deny benefit of interest deduction of INR 150.

If both countries deny benefits of interest payment, it would raise risk of double taxation. However, no reliable way of ordering application of rules and structuring alternatives are available which can prevent double taxation.

Action 2: Issues

- Final recommendations do not include any specific start date or transition rules
- No grandfathering of existing arrangement
- Automatic application of measures ... no motive or purpose test ... potential for unintended consequences
- Considerable complexity in how countries should apply prescribed rules to MNCs
- A completely new approach for Revenue ... traditionally they have not paid much attention to position of taxpayers in other countries

Conclusion
