Evolving global tax policy trends: Outlook for India

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Foreword

In today's environment of intense global competition for foreign investment, tax is playing a significant role in location decisions. The global tax dynamics are witnessing interesting changes. While the investors look for a low or moderate burden of tax and responsive tax administrations that provide certainty of treatment, the emerging economies are flexing their muscle in the global arena and expect the foreign investors to make their 'fair share' of tax contribution.

Around the world we are seeing heightened efforts to address "unacceptable" tax avoidance by the multinationals and, to some degree, wealthy individuals. The debate over base erosion and profit shifting (BEPS) has become an important agenda for many OECD and non-OECD jurisdictions. The substantive tax issues involved in this debate are complex and multi-faceted, involving core elements of the international tax system. The public debate is not focused on whether companies comply with applicable tax laws and regulations but rather on whether they follow the "spirit" of the law or whether they pay a fair share of tax. The OECD BEPS discussion is also focused on developing an approach for increased information reporting by MNCs to tax authorities, including information on income and taxes on a country by country basis.

Transfer pricing continues to be a significant source of tax risk for MNCs and tax authorities and a significant compliance and tax administration issue in countries around the world. As transfer pricing is subject to substantial controversy and litigation, there is an increasing Interest in alternative dispute resolution mechanisms, particularly Advance Pricing Agreements and safe harbours.

India is committed to the OECD BEPS Action Plan. Like other jurisdictions, India is implementing anti-abuse provisions (e.g. GAAR) to counter perceived or potential tax avoidance. In the coming years we may see increased attempts to review the global value chain of the MNCs to assess value creation in India, requiring taxpayers to have stronger and improved documentation. The multiple changes in a short time frame may give rise to more controversy and dispute.

Another noticeable trend is that post the global financial crisis, countries are seeking to raise revenues and the tax of choice has been VAT. This has led to an increase in the role of indirect taxes. In the Indian context, while we still await the implementation of the GST, the State VAT seems to be unraveling with more States increasing the tax rates guided by revenue compulsions.

These emerging trends in global taxation obviously have implications for India's tax policy and raise many sensitive and challenging issues. Through this Paper, we have explored some key tax trends. We also want to echo the persistent and growing voices of MNCs and Indian corporates alike for a stable, certain and less litigious tax environment in India to ensure that investors in the Indian economy are well positioned to plan their investments and estimate tax outcomes in a reasonable and consistent manner. We hope that our insight will bring a fresh perspective and understanding of the evolving tax landscape around the world and in India.

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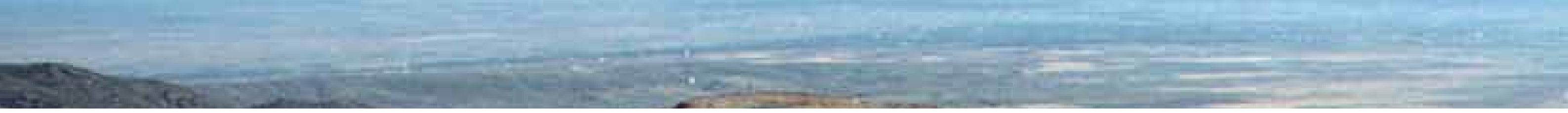
Content



1. OECD Action Plan on base erosion and profit shifting in the Indian context

Introduction

"Fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it"

– This statement embodies the essence of the OECD BEPS Action Plan.

The OECD embarked upon the BEPS project in 2012 drawing significant importance from G8 and G20 that endorsed and egged the project. There is a strong linkage of this project with the international tax reform and "the fair tax" debate making headlines in various countries. The fact that this is as much a tax policy matter as it is political, is evident from the attention that this is drawing from the highest levels in the government of developed countries. The project identified the following "key pressure areas" that are contributing to BEPS:

1. International mismatches in entity and instrument characterization
2. Application of treaty concepts to profits derived from delivery of digital goods and services
3. Tax treatment of related-party debt financing, captive insurance, and other intra-group financial transactions
4. Transfer pricing, particularly in relation to shifting of risks and intangibles, artificial splitting of ownership of assets between legal entities, and transactions between related party entities that will rarely take place between independent entities
5. Effectiveness of anti-avoidance measures, in particular GAARs, CFC regimes, thin capitalization rules, and rules to prevent tax treaty abuse
6. Availability of harmful preferential regimes

In July 2013, based on the recommendations of the G20 Finance Ministers, the OECD launched an Action Plan on BEPS, identifying 15 specific action steps needed in order to equip governments with the domestic and international instruments to address this challenge.

The BEPS Action Plan was fully endorsed by the G20 Finance Ministers and Central Bank Governors at their meeting in Moscow in July 2013 as well as by the G20 heads of state at their meeting in Saint Petersburg in September 2013. Major developing countries including China and India, are also actively participating in the BEPS project. The BEPS Action Plan is aimed to be delivered within the coming 18 to 24 months. One of the key messages from the plan is a call for "concerted" action. It is important that any attempt to remedy the issue of BEPS is not met with more chaos.

Alex Postma, Partner and Global Leader – International Tax Services makes the following observations on two important aspects of BEPS action plan, i.e., the role of media and the risk of disparate action: *"An important risk emanating from the fair tax debate is the trial-by-media element that has surfaced over the last few months. Tax is a very complex area and the media and some of the politicians in my view take too simplistic views. Nevertheless this is the reality and companies and especially tax directors need to become more educated around what is in the public domain about them. Not all messaging is consistent and entirely accurate, especially around social media, job advertisements and announcements of business deals. Setting proper policies around this could be useful.*

Another risk is countries taking unilateral action to secure their tax base. This is likely no more a potential risk but a certainty. Countries are already taking unilateral action without there being consensus: look at the recent legislation in Mexico and France; Irelands on boarding of off shore companies; the tax haven list issued by Colombia; anti-treaty shopping provisions in Vietnam and that is just in the last month."

The relevant extracts from the Action Plan are enclosed in the **Annexure A.**

BEPS Action Plan

In summary, the BEPS Action Plan targets the following areas:

- Action 1 – Address concerns with respect to the digital economy
- Action 2 to 5 – Establish international coherence of corporate income taxation
- Action 6 and 7 – Restore the full effects and benefits of international standards
- Action 8 to 10 – Assure that transfer pricing outcomes are in line with value creation
- Action 11 to 14 – Ensure transparency while promoting increased certainty and predictability
- Action 15 – Address the need for swift implementation

The above action steps are explained in brief below:

Action 1 – Address concerns with respect to the digital economy

- It is proposed to identify the main difficulties in applying the current international tax rules to the digital economy and to develop detailed options to address these difficulties. The plan calls for the examination of:
    - Potential for a digital presence in a country without creation of taxable nexus
    - Attribution of value created from the generation of marketable location-relevant data through the use of digital products and services
    - Characterization and sourcing of income from new business models
    - Methods to ensure the effective collection of VAT/GST with respect to cross-border digital delivery

Expected output is a report identifying issues and possible actions to address them. The target date is September 2014.

In the Indian context the characterization of "technology transactions" as royalty or fee for technical services remains a contentious issue. Recent amendments have enlarged the definition of "royalty" as well as increased the withholding tax rate under the domestic tax laws to 25%. India has also maintained its differences with OECD on its interpretation of royalty.

Issues relating to digital economy have also hogged the limelight of global tax policy for many years. **Channing Flynn,** Partner – International Tax and Global Tax Technology Sector Leader, EY- US says, "*The digital economy has grown exponentially in size over the last decade and the pace of change and evolution in technology will only continue to accelerate. As we have seen, the OECD BEPS report lists the taxation of the digital economy as its first area of study. Jurisdictions around the world including India, France, China, Germany, Italy, Australia, the United States, the UK and Ireland are all openly and deeply immersed in the debate about the appropriate taxation approach to the digital economy and its current manifestations including online advertising, cloud computing, big data, and online collaboration/development*.

The confluence of these factors and many others require multinationals that digitally access or provide content and services to fully understand the tax consequences of their transactions from a cash tax and tax risk perspective. Whether focused on withholding tax, indirect taxation, or nexus / PE issues, the digital economy provides significant opportunities for companies to link together the business, legal and tax consequences to ensure all known uncertainties and opportunities are identified in these quickly evolving business models. EY's recently released Worldwide Cloud Computing Tax Guide is a perfect example of an approach to analyzing the specific arrangements confronted in a digital economy environment (www.ey.com/cloudtaxguide)."

Action 2 – Neutralize the effects of hybrid mismatch arrangements

- It is proposed to develop model treaty provisions and recommendations on the design of domestic rules to neutralize the effect of hybrid instruments and entities.
- This will include:
    - Changes to the OECD Model Treaty that prevent granting treaty benefits in inappropriate circumstances
    - Recommended domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer
    - Recommended domestic law provisions that deny a deduction for a payment that is cannot be included in income by the recipient
    - Recommended domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction
    - Guidance on coordination or tiebreaker rules if more than one country seeks to apply such rules to a transaction or structure.

Expected output is changes to the OECD Model Treaty and recommendations on domestic rules. The target date is September 2014.

Action 3 – Strengthen Controlled Foreign Corporation (CFC) Rules

- This Plan asserts that CFC rules address BEPS by discouraging the shifting of income from a resident enterprise to a non-resident affiliate.
- It also asserts that CFC rules affect the source country positively by reducing any incentive to shift profits into a third, low-tax jurisdiction.
- It is proposed to develop recommendations regarding the design of CFC rules.

Expected output is recommendations on domestic rules regarding design of CFC rules. The target date is September 2015.

Action 4 – Limit base erosion via interest deductions and other financial payments

- It is proposed to evaluate the effectiveness of different types of limitations and develop recommendations regarding best practices in the design of rules to prevent BEPS through the use of interest expense and other economically-equivalent financial payments.
- Transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives, captive and other insurance arrangements.

Expected output is recommendations on domestic rules and changes to the OECD Transfer Pricing Guidelines. The target dates are September and December 2015, respectively.

Action 5 - Counter harmful tax practices more effectively, taking into account transparency and substance

- It is proposed to refocus the work of the OECD's Forum on Harmful Tax Practices to develop more effective solutions to harmful tax practices, with a priority on improving transparency and on requiring substantial activity for any preferential regime.
- This work will include a focus on compulsory spontaneous exchange of information on rulings related to preferential regimes.
- Engagement with non-OECD members is also proposed.

Expected output is a report on the review of member country regimes, a report on strategy to expand participation to non-OECD member countries and revision of existing criteria with respect to harmful tax practices. Target dates range from September 2014 to December 2015.

Action 6 – Prevent Treaty abuse

- It is proposed to develop model treaty provisions and recommendations on the design of domestic rules that will:
    - Prevent the granting of treaty benefits in inappropriate circumstances
    - Clarify that tax treaties are not intended to be used to generate double non-taxation
    - Identify tax policy considerations that countries should take into account when determining whether to enter a tax treaty with another country

Expected output is changes to the OECD Model Treaty and recommendations on domestic rules. The target date is September 2014.

Action 7 – Prevent artificial avoidance of permanent establishment (PE) status

- It is proposed to develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and under the exceptions for preparatory and ancillary activities.
- This work will also address related profit attribution issues.

In the Indian context what is relevant is that the Indian treaties generally provide for a low threshold for PE, consistent with its tax policy objective of increased source-basis taxation. Furthermore, India's reservations to OECD's PE interpretations, especially regarding, ecommerce is well known. It will be interesting to watch how OECD balances its need to prevent PE avoidance and at the same time eliminate/contain the risk of double taxation and increased compliance burden.

It is interesting to contrast the US government's reactions to BEPS action plan, instead, as observed by **Jeff Michalak**, Americas Director, International Tax Services, *"While the fair taxation debate rages outside of the United States focusing on foreign multinationals and investee country tax base erosion, the US government is less concerned about base erosion by foreign parented multinationals investing into the US and, instead, focused on US multinational erosion of their home country US tax base. The proposed solutions being suggestions to strengthen US CFC legislation targeted at income earned in jurisdictions without adequate business substance and taxed below a minimum threshold. Coincidentally, strengthening CFC legislation is consistent with the OECD BEPS project proposals. With respect to the BEPS project in general, the US has expressed skepticism for the need for wholesale change in international taxation standards and policies and has promoted a more measured approach. US government officials have made public statements in support of both the current standard for permanent establishment and the arm's length standard as well as dismissing the need for separate rules addressing the digital economy while strongly supporting increased taxpayer disclosure requirements and treaty anti-abuse provisions.*

US multinationals have been in the cross-hairs of much of the public debate on fair taxation outside of the US as well as the focus of US government attention on their global tax

planning strategies. As a result, US multinationals have been very engaged in helping to define the issues and explaining the business implications of possible changes within the US as well as with the OECD and individual member country governments. Despite these efforts, US multinationals are preparing for change. Although specifics are unknown, the consensus is that both US and international changes will undoubtedly be focused on increased transparency and an emphasis on aligning earnings and taxation rights with the location of business substance. US businesses are reviewing their current business models and tax planning strategies to identify risks introduced by possible changes in international taxation. They are identifying and evaluating alternatives that may be more consistent with possible future changes and therefore more sustainable over the long term."

Action 8 – Intangibles

- It is proposed to develop rules to prevent BEPS involving the movement of intangibles among group members.
- This will involve:
  - Adopting a broad, clear definition of intangibles
  - Ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in line with value creation
  - Developing rules for transfers of hard-to-value intangibles; and
  - Updating guidance on cost contribution arrangements

Expected output is changes to the OECD Transfer Pricing Guidelines and possibly to the OECD Model Treaty. The target dates are September 2014 and September 2015 respectively.

Action 9 – Risks and capital

- It is proposed to develop rules to prevent BEPS involving the transfer of risks among, or allocation of excessive capital to, group members.
- This will involve developing rules to ensure that "inappropriate returns" will not accrue to an entity solely because it has contractually assumed risks or has provided capital.

Moreover, it will require the alignment of returns with value creation.

Expected output is changes to the OECD Transfer Pricing Guidelines and possibly to the OECD Model Treaty. The target date is September 2015.

Action 10 – Other high risk transactions

- It is proposed to develop rules to prevent BEPS being involved in transactions, which will not (or will only very rarely) occur between third parties.
- This will involve:
  - Adopting rules to clarify the circumstances in which transactions can be re-characterized
  - Clarifying the application of transfer pricing methods (profit splits in particular) in the global value chain context
  - Providing protection against common types of base-eroding payments such as management fees and head office expenses

Expected output is changes to the OECD Transfer Pricing Guidelines and possibly to the OECD Model Treaty. The target date is September 2015.

Action 11 – Establish methodologies to collect and analyze data on BEPS and the actions to address it

- It is proposed to develop recommendations on indicators of the scale and economic impact of BEPS and to ensure that tools are available to evaluate the effectiveness and economic impact of actions taken to address BEPS on an ongoing basis.
- This may involve:
  - Developing an appropriate economic analysis
  - Assessing existing data sources
  - Identifying new data that should be collected; and
  - Developing methodologies based on aggregate data (such as foreign direct investment and balance of payments) and micro-level data (financial statement and tax return data)
- This work will take into consideration the need to respect taxpayer confidentiality and the cost for both tax administrations and businesses.

Expected output is recommendations on what data to collect and methodologies on analyzing such data. The target date is September 2015.

Action 12 – Require taxpayers to disclose their aggressive tax planning arrangements

- It is proposed to develop recommendations on the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures. It will
  - Take into consideration the costs for tax administrations and businesses and draw on experiences of countries that have such rules in place
- The work will use a "modular design" allowing for consistency and for country-specific needs and risks.
- One focus area will be international tax schemes and exploration of use of a broad definition of "tax benefit" to capture such transactions.
- The work will be coordinated with work on cooperative compliance and will involve the design and implementation of enhanced information sharing models for tax administrations to use.

Expected output is recommendations on domestic rules. The target date is September 2015.

Action 13 – Re-examine transfer pricing documentation

- It is proposed to develop rules on transfer pricing documentation to enhance transparency for tax administrations
  - Will take into consideration the compliance costs for business
  - May include a requirement that MNCs provide "all relevant governments with needed information on the global allocation of income, economic activity and taxes paid among countries according to a common template."

Expected output is changes to the OECD Transfer Pricing Guidelines and recommendations on domestic rules. The target date is September 2014.

Consistent with action items 13, the OECD work on transfer pricing will lead to heightened focus on substance with a shift from transaction focus to "acceptable" form mirroring third party transactions. Increased focus has been brought to transparency and reporting. The White Paper on TP documentation released calls for transparency so that the tax authorities can assess risk for the following transactions:

- Significant transactions with a low tax jurisdiction
- Transfers of IP to related parties
- Business restructurings
- Specific types of related party payments
- Year on year loss making
- Poor or non-existent documentation
- Excessive debt

The primary area of focus of this action step on the re-examination of TP documentation will be on the following:

- Increased access to information is the primary political imperative of the BEPS project
- Increased reporting not directly about dividing taxing jurisdiction, so consensus among the OECD and countries is easier to reach
- Increased reporting seeks to address what many tax authorities see as a highest priority corporate tax issue and key audit focus (transfer pricing and PE risk)
- Adoption and enforcement of increased reporting requirements by countries does not necessarily require changes in legislation or regulation; and
- The OECD will issue a template for country by country reporting by September 2014, which many countries are expected to implement

Action 14 – Make dispute resolution mechanisms more effective

- It has proposed to develop solutions to address obstacles that prevent countries from solving treaty-related disputes under the mutual agreement procedure (MAP), including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.

Expected output is changes to the OECD Model Tax Convention. The target date is September 2015.

Action 15 – Develop a multilateral instrument for amending bilateral treaties

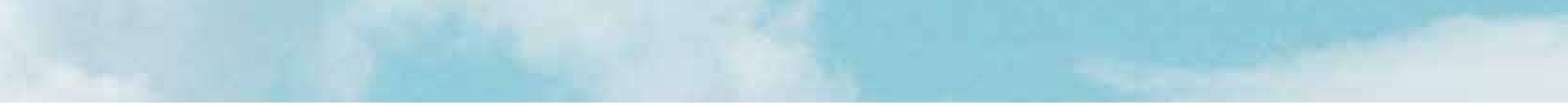
- It is proposed to analyze the tax and public international law issues related to the development of a multilateral instrument that will enable jurisdictions to implement measures developed in the OECD's work on BEPS and to amend bilateral tax treaties.

- The Action further proposes that interested parties will develop a "multilateral instrument designed to provide an innovative approach to international tax matters" that will reflect the "rapidly evolving nature of the global economy and the need to adapt quickly to this evolution."

Expected output is a report on relevant public international law and tax issues and a multilateral instrument. The target dates are September 2014 and December 2015, respectively.

Recommendations:

- The Action Plan is ambitious in its scope and a significant amount of work will be required over the next two and a half years.
- Significant work at the individual country level will be required to determine whether, when, and how to implement recommendations developed by the OECD as part of the Action Plan.
- Companies should:
  - Identify the aspects of the Plan that have the greatest potential impact on their business models
  - Stay informed about ongoing developments in the OECD and in the countries where they operate or invest
  - Prepare for increased reporting
  - Review current business models and structures against specific target areas
  - Determine how to participate most effectively in discussions regarding the BEPS project and the underlying international tax policy issues, both with the OECD and with policymakers in the countries where they operate or invest;
  - Proactively manage global controversy through MAPs, APAs and private rulings
  - Consider potential realignment/ restructuring in light of current tax environment and potential changes
  - Factor the new tax policy environment into ongoing and future projects



2. General Anti-Avoidance Rule and tax planning

Introduction

The globalization of business and the mobility of capital, continue to challenge tax administrators who worry about the potential exploitation of what is perceived to be unintended tax benefits. Emerging markets such as Chile, China and India are making headlines by widening their tax net and, in some cases, disregarding holding company entities in low tax jurisdictions and some countries that are enacting reforms aimed at increasing their competitiveness are at the same time considering anti-avoidance measures that may actually increase uncertainty.

Anti-avoidance rules are divided into two main categories — "general" and "specific." Tax law, designed to deal with a specific concern, are termed as either specific anti-avoidance rules (SAARs), or less commonly, targeted anti-avoidance rules (TAARs). A general anti-avoidance rule (GAAR) is a set of broad principle-based rules within a country's tax code is designed to counteract the perceived avoidance of tax. GAAR is a concept within law that provides the taxing authority a mechanism to deny tax benefits when arrangements are believed not to have any commercial substance or purpose other than to generate the tax benefit(s) obtained.

The recent focus on tackling "tax abuse" can also be attributed to the rising deficits and falling tax revenues that have resulted from the global financial crisis. Governments have been spurred to action by multilateral organizations, including the G20, the Organisation for Economic Co-operation and Development (OECD) and the European Commission. Tax activist groups have turned a spotlight on tax havens, high-net-worth individuals and, now, the seemingly low effective tax rates reported by some multinational companies. A series of steps, including increased information exchange, expanded disclosure requirements, and joint and simultaneous tax audits have been put in place to address what countries view as unacceptable aggressive tax planning. Many countries are now taking a different and more dramatic approach. Countries such as the UK, India and China have either proposed or adopted wide anti-avoidance statutes that empower authorities to challenge what they perceive to be "aggressive" tax planning or "treaty abuse." While the concept of addressing tax avoidance transactions with either a SAAR or a GAAR is hardly new, the increasing resort to such rules by many governments in an effort to combat what they perceive to be widespread tax avoidance is predictable in the current climate. This recent wave against aggressive tax planning is evident from following table[1]:

GAAR Introduction timelines:

1915	Australia	1990	South Korea
1924	The Netherlands	1997	Italy
1941	France	2006	South Africa
1977	Germany	2008	China
1981	Sweden	2008	Indonesia
1988	Singapore	2012	Belgium (revised)
1988	Canada	2012	UK (proposed)
1988	Brazil	2015	India (proposed)
1989	Ireland		

Evolution of GAAR in India's legislature

Historically, India did not have GAAR in the Income Tax law (ITL). Therefore, the tax authorities generally relied on anti-avoidance principles contained in judicial precedent as well as the SAARs in ITL to counteract tax avoidance. In general, tax authorities regarded tax planning arrangements as "shams" or "colorable devices" based on principles enunciated in judicial precedents.

With increasing foreign investments into India came sophisticated investment and operating structures including those in jurisdictions with which India had favorable tax treaties. A case in point was investment in India through a holding company located in jurisdiction such as Mauritius through which India has received substantial part of its FDI. Under Article 13(5) of the India-Mauritius Tax Treaty, the right to tax capital gains from alienation of property (including shares of an India company) vest with Mauritius. Provisions similar to the Mauritius Treaty, existed in the India-Singapore tax treaty (subject to satisfying limitation on benefits test), India-Cyprus, India- Netherlands (if shares are sold to non-resident).These states have been abundantly used as holding company jurisdictions. Holding company structures have more recently been attacked by tax authorities, as the tax authorities perceive them to be tax avoidance arrangements, especially in cases where they are shell/conduit entities.

1 EY thought leadership titled "GAAR rising – Mapping tax enforcement's evolution" dated February 2013

In the context of capital gains tax exemption under India-Mauritius treaty, use of treaties to claim tax exemptions surfaced before the Supreme Court (SC) in a much celebrated decision in the case of Azadi Bachao Andolan[2]. Despite the sound and fury of tax authorities over the so called "abuse" of "treaty shopping," the SC held that it may have been the intention of both the countries to permit treaty shopping at a time when the treaty was entered into. At a later point in time, the SC in case of Vodafone[3] reiterated the Azadi Bachao Andolan principle and held that the treaty may only be ignored if a taxpayer used it for fraudulent purpose of tax evasion.

The seeds of the legislative intent to introduce a GAAR, were first seen in Direct Tax Code 2010 (DTC 2010). DTC 2010 contained a GAAR, which was justified as necessary, since according to the Government, increasingly sophisticated forms of tax avoidance were being adopted ever since the Indian economy was liberalized. After the introduction of DTC 2010 in the Indian Parliament, the Bill was referred to the Standing Committee on Finance (SCF) for further examination, which recommended that the GAAR provisions should be made more precise, and cautioned that lack of certainty could make foreign investors wary of investing in India. Although, DTC, which proposed to replace ITL, was not enacted, some of its key provisions were fast-forwarded into the ITL, with the introduction of GAAR and indirect transfer rule through Finance Act 2012 (FA 2012). GAAR was to be effective 1 April 2013 (i.e., tax year 2013–14 onwards).

There were several conceptual and implementation concerns, which questioned India's attractiveness as an investment destination. India's tax administrative body, i.e., CBDT constituted an internal group to review the concerns. CBDT issued a report containing recommendations on the scope of GAAR and its implementations. The report was not received well. It lacked the touch of independence and objectivity, since it came from the Tax Authority, and did not accurately reflect the concerns that would have been addressed if a wider stakeholder consultation had taken place.

Shortly after the legislative proposals by FA 2012 — and in response to strong criticism from the domestic and global business communities — the Government of India ((GoI) formed an Expert Committee (EC) under the Chairmanship of Dr. Shome to vet and rework the guidelines based on comments from various stakeholders and the general public. The EC report, which was submitted on 1 September 2012, contained a number of recommendations. The Committee's suggestions and amendments were evaluated by the GoI, and the proposals, which merited acceptance of the GoI were considered in revising ITL through amendments by Finance Act, 2013 (Finance Act 2013).

Furthermore, the CBDT on 23 September 2013 issued Rules (GAAR Rules) on the application of GAAR and which outlined some of the procedural aspects.

2 (2003) 263 ITR 706
3 (2012) 341 ITR 1

Expert Committee recommendations

The EC's report contained recommendations on the amendments that should be carried on the ITL, and the rules and clarifications that should be issued by the government in implementing GAAR. It recognizes that it is crucial for India to balance the concern of protecting its tax base, with that of high compliance costs on taxpayers and uncertainty on the overall investment environment. The EC also provides illustrations on cases where GAAR should or should not be invoked along with reasons for their view. The key recommendations of the EC are as below:

EC on concepts of tax evasion, tax mitigation and tax avoidance

The EC differentiated between concepts of tax mitigations, tax evasion and tax avoidance. According to the EC, while tax mitigation (e.g., claiming a tax incentive by meeting conditions in the ITL) should not give rise to an anti-avoidance issue, tax evasion (e.g., illegal, fraudulent, misrepresentative actions) can be countered even without a GAAR. It is in specific tax avoidance cases that GAAR may become applicable. According to the EC, tax planning with the sheer objective of obtaining a tax benefit without support of commercial, economic or business purpose or consequence should be targeted by GAAR.

Negative list of situations in which, according to EC, GAAR cannot be invoked

The EC recommended publishing of negative list of situations where GAAR will not be triggered, for instance:

- Where a taxpayer selects an option in law e.g., chooses to fund operations through loan instead of equity or sets up a branch in India vis-a-vis a subsidiary
- When a Court has approved a business reorganization such as a merger or demerger as per the ITL
- Transactions within a Group, which do not result in loss of revenue to the GoI

Emphasis of EC on acceptance by GoI and tax administration of overarching principle for applicability of GAAR

- The EC has recognized the apprehension that GAAR may be widely invoked by Tax Authorities whenever a tax benefit is perceived to have been taken by the taxpayer whether or not the arrangement represents impermissible tax avoidance.
- As an overarching principle, it should be accepted that case of tax avoidance should be brought under GAAR, only if it is an abusive, artificial or contrived arrangement.

EC recommended deferment of GAAR

Recognizing GAAR to be an extremely advanced instrument of tax administration for which intensive training of tax officers is required, the EC recommended that GAAR should be deferred for three years on administrative grounds and be made applicable from Tax Year 2016–17.

EC on evaluation of Impermissible Avoidance Arrangement

The EC recommended that GAAR may be triggered only when the main purpose of an arrangement is to obtain a tax benefit. EC did not favor a provision under which GAAR could be applied even where one of the main purposes of the arrangement was to obtain a tax benefit. Through an illustration, the EC explained that – where investors from various countries pool their resources and form a special purposes vehicle for commercial reasons in a tax favorable jurisdiction to invest in Indian equities to earn capital gains, GAAR may not be invoked as formation of the SPV in an efficient jurisdiction was the main purpose of the arrangement and obtaining tax benefit was not.

EC recommends grandfathering of existing investments

- All "investments" made by a resident or a non-resident as on the date of commencement of GAAR provisions should be grandfathered so that on exit (sale of such investments), GAAR provisions are not invoked for examination or denial of tax benefit.
- Grandfathering of "arrangements" existing as on the date of introduction of GAAR would confer protection in perpetuity, which is not desirable.

Certain other recommendations, if EC include:

- A GAAR approving panel whose approval should be obtained prior to invoking GAAR, should be an independent body.
- When SAAR is applicable on a specific aspect, GAAR should not be invoked.
- GAAR should not apply to FIIs that choose not to take any benefit under a tax treaty. GAAR should also not apply to non-resident investors in FIIs.
- Monetary threshold of INR30 million (approximately of tax benefit in the arrangement will be required in order to apply the provisions of GAAR).

Recommendations of EC, which have since been accepted by GoI

The GoI has since accepted many of the recommendations made by the EC. Following are key recommendations accepted by the GoI. Some of the recommendations were given effect by amending the provisions of ITL and some formed part of Rules prescribed by the GoI.

1. The EC report had recommended the deferral of GAAR provisions until tax year 2016–17. The GoI has partially accepted the recommendations, with GAAR being effective 1 April 2015 (i.e., tax year 2015–16 onwards). The GAAR Rules further make it clear that GAAR applies to all tax benefits obtained on or after 1 April 2015, and not prior to that date
2. In deference to recommendation of EC provisions of GAAR will be applied only if the main purposes of the arrangement was to obtain a tax benefit.
3. The GAAR Rules issued recently, also incorporate some of the recommendations of Dr. Shome. For instance :
    - Non-resident investors in FIIs as well as investors in off-shore derivative instruments issued by FIIs will not be subject to GAAR.
    - FIIs who choose not to claim treaty benefits, will be exempt from application of GAAR
    - Monetary threshold of INR30 million of tax benefit, for triggering GAAR

Unimplemented recommendations of EC

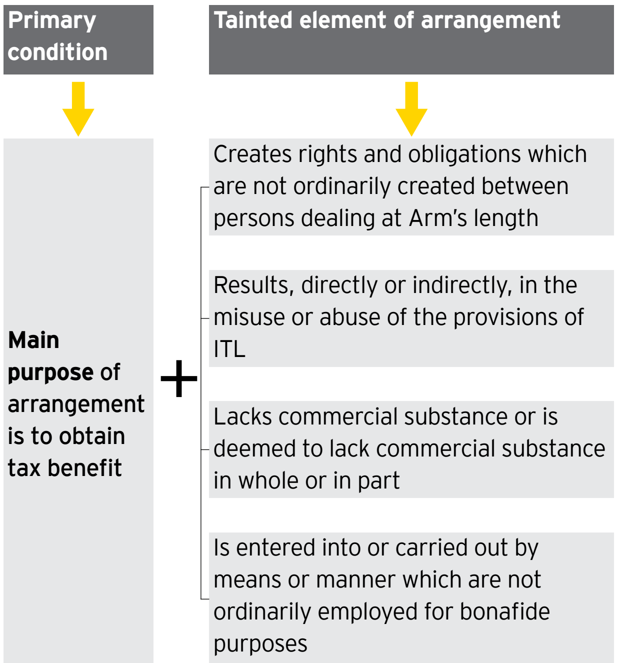
While many of the recommendations of the EC were accepted by the GoI, the following recommendations of the EC are still awaiting consideration of the GoI. To recollect the EC had recommended that:

- There should be clear expression that as an overarching principle specifying that GAAR can apply merely to abusive or highly aggressive/contrived arrangements as a pre-condition to applicability of GAAR.
- That, GAAR will not to apply if SAAR applies.
- That, Revenue will provide illustrative negative list of arrangements where GAAR will not be applied (e.g., taxpayers can opt for one of the two commercial alternatives; court approved scheme; etc.).
- That, tax deductor will be allowed to remit funds without inquiry into GAAR if he furnishes undertaking to pay tax at a later date if GAAR provisions are invoked
- That, monetary threshold to be calculated w.r.t. tax alone (without interest, etc.) and in case of tax deferral, tax benefit to be determined w.r.t. NPV of money.

Snapshot understanding of Current GAAR provisions

GAAR provisions as introduced by FA 2012 were amended through the Finance Act, 2013 (FA 2013) and through the GAAR Rules, after considering some (not all) of the Committee's recommendations. The Chapter will take effect from 1 April 2016 (i.e., tax year commencing on 1 April 2015) and accordingly will apply to tax benefits obtained on or after 1 April 2015. The following is a gist of the GAAR provisions as they currently stand:

- The tax authority could invoke GAAR if the taxpayer has entered an arrangement, the main purpose of which is to obtain a tax benefit and together therewith the arrangement also satisfies at least one of the tainted elements, i.e, where it is established that the arrangement is not at arm's length; or it resulted in the misuse or abuse of provisions of tax laws; or it lacked commercial substance; or, it is carried out in a manner not ordinarily employed for bona fide purpose.
- Provisions of GAAR may be applied to any step in, or part of the arrangement. Rules also clarify that, where a part of an arrangement is controlled by GAAR, the tax consequences will be determined with reference to such infected part only.
- Conditions for applicability of GAAR can be summarized pictorially as under:



Brief understanding of tainted elements of arrangement

The application of tainted elements involves subjective considerations. For preliminary and initial understanding of these conditions, one may refer to guidance, which is contained in the report of EC. With respect to the tainted element tests, the EC commented as under:

- On arms' length dealing test:
  To test this, EC explains that Tax Authority should obtain the opinion of transfer pricing officers to ascertain whether rights or obligations are at arm's length. By way of illustration, EC provides an example of a case where a composite consideration paid to a non-resident is split up between taxable payments and non-taxable payments. According to the EC, where prices have been allocated to different parts (taxable and not taxable) of the contract with the main purpose of reducing tax liability, GAAR may be invoked for re-allocation of prices, based on a transfer pricing analysis.

- Misuse or abuse of law:
According to the EC, where the taxpayer does not follow the law in spirit or substance, or where the arrangement results in consequences not intended by legislations; there is misuse or abuse of law. It illustrates a case, where a loan granted by a foreign bank is assigned by it to an affiliate in a tax favorable jurisdiction, mainly to avoid withholding tax on interest payments, the assignment is an abuse of treaty law and GAAR may be invoked.

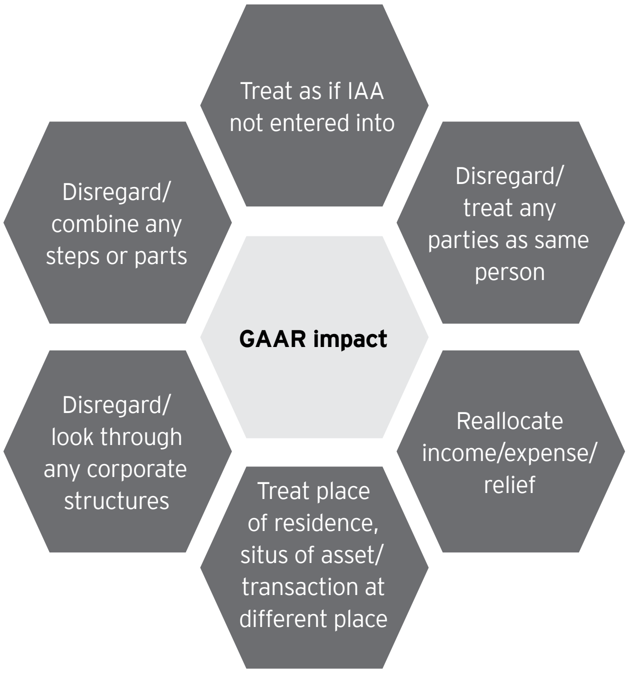
- Commercial substance test:
The EC inter-alia recommended defining the term "lacks commercial substance" on the same lines, as DTC 2010 provision. The definition gives due regard to the presence of significant business risks or net cash flow impact on a party to the arrangement etc., to determine whether an arrangement lacks commercial substance or not. As EC illustrates, where an investor interposes a holding company in a tax favorable jurisdiction, but all rights of voting, management and right to sell an Indian investment vest with the investor parent company, the structure lacks commercial substance.

- Bonafide test:
The EC considers that this element is triggered when an arrangement contains abnormal features. The EC illustrates through an example where equity investment into an Indian company is disguised as loan. Interest payment is based on the rate of return/profit of the borrower, which may reflect that, in substance, loan is equity investment. The EC recommends that interest payment requires recharacterization as dividend leading to disallowance of expenditure and payment of DDT, though the recipient of interest may still be subjected to tax on interest.

Consequences of GAAR

- The invocation of GAAR can have wide implications. The provisions empower tax administrators to cancel or otherwise disallow benefits that are obtained using an improper scheme, transaction or arrangement. In some cases, the tax authority will recharacterize the arrangement or transaction consistent with its determination regarding the substance. See pictorial description below for brief enumeration of the consequences:

- Beneficial provisions of tax treaty may be not available if GAAR is invoked. In other words, GAAR will override applicability of a tax treaty;



Consequences are inclusive; AO can determie any other consequences as deemed appropriate

Other provisions

- The burden of proving that GAAR should be applicable is on the Tax Authority, and the taxpayer is entitled to rebut/challenge this action.

- A resident or a non-resident can file an application to AAR to determine whether the arrangement proposed to be undertaken by them will fall under the purview of an IAA as per the GAAR provisions.

- In respect of procedural matter, ITL provides that, on satisfaction of the conditions of invoking GAAR at any stage of assessment or reassessment proceedings, the Tax Authority can make a reference to the Commissioner. The Commissioner, if he is satisfied that GAAR is required to be invoked, should issue a notice to the taxpayer for submitting objections. Where no objections are received within the prescribed time, the Commissioner can issue such directions as he may deem fit for applying GAAR. However, if the taxpayer object to invoking GAAR and the Commissioner is not satisfied with the taxpayer's explanations, he would need to refer the matter to an Approving Panel. The Approving Panel will either declare an arrangement to be impermissible or otherwise, after examining the relevant material and making further inquiry.

- The Rules provide for mode, manner, form and time limit for the various steps involved in the procedure for invoking GAAR. Pictorial depiction of procedure is given in Annexure B.

Uncertainty ahead!

Learnings from country experiences suggests that countries that once used GAAR only reluctantly, and in the most extreme circumstances, are beginning to use it more extensively than it was originally designed to be used. In countries without a GAAR, tax authorities are increasingly challenging business arrangements on the grounds that they lack substance, even if such arrangements comply with the applicable law. The proliferation of anti-avoidance rules amplifies the uncertainty global businesses already feel as they operate in this intensely interconnected and interdependent economy.

Assessing the impact:

With GAAR now being introduced in several countries around the globe, clearly the ability to plan and execute transactions with a high degree of certainty will be reduced where governments rely on the catchall properties of a GAAR.

Anti-avoidance rules typically apply by focusing on the substance of a transaction or arrangement. When insufficient substance is present, GAAR may allow the tax authority to change the tax result of a transaction or of steps within the transaction that it finds objectionable.

Companies may now ask themselves and their tax directors following key questions regarding those transactions that could potentially result in the application of a GAAR regime.

1. Does the transaction/structure have a valid commercial purpose?
2. Is the transaction/structure unique and complex?
3. Could the transaction/structure be undertaken in a different manner, without attracting the potential application of GAAR?
4. Is the transaction/structure defendable in the public eye?
5. What is the corporation's tax risk profile both globally and locally?
6. How comfortable is the corporation with litigation if it is required to defend the transaction/structure?

Contemporaneous documentation can be valuable in defending a company's position against a GAAR challenge. Making sure there are documents that set out the intended purpose of the overall transaction, as well as each step within the transaction, can significantly enhance a taxpayer's position in forestalling or defending against such a challenge.

Additionally, documentation outlining the consideration of alternative options in relation to the transaction settled upon is critical in demonstrating that the final position taken was the only one that could reasonably be carried out to obtain the commercial objectives sought, and that there were no transactional steps taken that were explicable only in the context of obtaining a tax benefit.

Taxpayers wishlist:

Some of the concerns of the taxpayers have been already addressed by the GoI. There seem to be sincere efforts to relieve the concerns. The taxpayers do, however, continue to be concerned on certain facets — particularly, on the quality and perception of tax administration. The major items of agenda on the taxpayer's wishlist are:

- In keeping with the recommendation of the Dr. Shome Committee, there may be a clear emphatic signal to the tax administration that GAAR is meant to be applied as an exception to target complex, this is what the Dr. Shome panel refers to as the overarching principle. GAAR is not meant to target tax planning initiatives nor should it kill the choice available to a taxpayer to adopt a methodology of doing business when one of the two permissible methods leaves the taxpayer with a lower burden of tax.
- Ascertainment of main purpose being to obtain tax benefit may involve substantial subjectivity. The threshold will not be easy to define or implement. Keeping in view the objective of the chapter, GAAR may be invoked only when the sole or dominant purpose of an arrangement is to obtain tax benefit. Furthermore, years back, the Supreme Court, in the case of McDowells, expressed a view that impermissible tax avoidance is one where a part or step of an arrangement has been inserted merely with a view to obtain tax benefit without any commercial significance attached to the part or step; as if, the part or step of arrangement will not have been inserted had it not been for tax benefit. Consistent therewith, at least in relation to examination of a part or step of an arrangement, it may be provided that the part or step will be subject to GAAR only if the sole purpose thereof is to obtain tax benefit.

- The tax administrators may be fully apprised of their limitations on power through the medium of multiple examples, which form part of a Circular that is binding on tax administrators. The illustrations should be drafted pragmatically in consultation with the business community.

As supplementary expectations, one would wish — (a) It may be clarified that SAAR will override GAAR; (b) Court approved schemes will be kept out of GAAR; (c) All arrangements and steps up to February 2012 will be kept out of GAAR

Concluding thoughts

Defending a GAAR position is not merely a matter of technical argument. Rather, it is an objective analysis of the evidence and facts in relation to a particular transaction. The manner in which a corporation engages with a tax authority seeking to invoke GAAR during an examination is therefore, critical. If the process is not managed appropriately from the outset, the opportunity to strongly defend a position may be reduced or lost, which in turn could adversely affect future settlement negotiations or future litigation. With this in mind, it is important to determine an appropriate strategy from the outset, paying close regard to the process that is used by the tax authorities for invoking GAAR, as well as the corporation's rights and obligations as a taxpayer throughout the process.

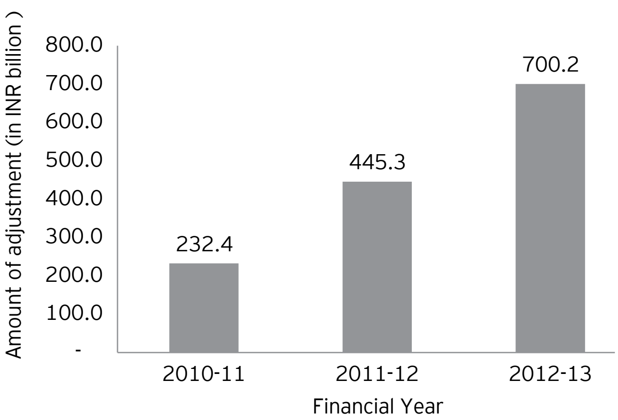
3. Multiplying transfer pricing disputes : issues and way forward

Introduction

The Indian Transfer Pricing (TP) regulations have evolved regularly, since its introduction in 2001. Several changes have been made to the regulations especially since 2010. Some of these changes were made to nullify the impact of adverse rulings of the tribunal, and were made in the form of clarifications and explanations. The impact of these changes is material and has resulted in an expansion of the scope of operation of TP rules. The ambit of the TP provisions has been extended to cover certain domestic transactions also. The definition of international transaction has been clarified to include a wide variety of flows. An alternate dispute resolution mechanism was brought in to ease the pain of taxpayers facing TP adjustments. Controversy management options such as safe harbour rules and Advance Pricing Agreements (APAs) have been inducted. These adjustments, individually and collectively impact the approach of tax authorities and taxpayers to transfer pricing.

Over the last few years there has been a substantial increase in quantum of transfer pricing adjustments cutting across various industries. Its vexatious nature is evidenced by the fact that adjustments of approximately INR 700 billion[4] were alone proposed in the audit concluded in financial year 2012-13.

Adjustment made by tax authorities on account of transfer pricing



The Indian TP journey has been dotted with many controversies to the extent that the government also realizes the futility of endless litigation. With increasing litigation, taxpayers are spending less time on their business and more time on resolving litigation. Introduction of the dispute resolution panel (DRP) in 2009 with three senior revenue officials as an alternate dispute resolution mechanism seemed to be a step in the right direction. It was expected to yield succour to the weary taxpayer as a time bound program that will cut litigation at some stage. While the DRP has passed orders moderating the initially proposed TP adjustment, the relief granted has been too meagre to reduce ongoing disputes. The efficacy of the vehicle is still under debate since the laws now permit the tax department to appeal, thereby, ensuring that one of the parties can carry the dispute forward.

Alternate dispute resolution mechanism in India

With an aim to reduce litigation on transfer pricing related matters, the Government of India (GoI), in the recent past, has taken steps in the right direction by introducing APAs and safe harbour provisions as alternate dispute resolution mechanism in addition to existing Mutual Agreement Procedures (MAP) program.

Advance Pricing Agreements (APAs)

Bringing in an APA regime has been a welcome step and a silver lining in the dark clouds. An APA is a binding agreement between the taxpayer and the tax authority to determine, in advance, a set of criteria that will govern the transfer prices for covered inter-company transactions for a fixed period of time. These include unilateral APAs (agreement between the taxpayer and tax administration of one country), bilateral APAs (agreement between the taxpayer, the domestic tax administration and a foreign tax administration) and multilateral APAs (agreement between the taxpayer and multiple tax administrations).

Globally, APAs are seen as special vehicles for dispute resolution that can help in attaining certainty on transfer pricing matters. Proactive agreement on transfer pricing methods and price for various transactions for a fixed period of time is expected to typically reduce the burden associated with annual audit examinations and litigation, which are generally time consuming and expensive. Bilateral or multilateral APAs additionally carry the advantage of mitigating economic double taxation by providing a two-sided or multi-sided resolution of a potential transfer pricing dispute. APAs therefore, offer taxpayers an opportunity to resolve their transfer pricing issues in a collaborative and

4 As per a written reply filed by Minister of State for Finance, Shri J D Saleem in Lok Sabha recently, the total quantum of TP adjustments has increased multifold from INR 232 billion in FY 2010-11 to INR 700 billion crores in FY 2012-13

cooperative setting and attain surety on their intra-group pricing.

Safe Harbour rules (Rules)

Furthermore, the GoI has recently announced safe harbour rules (Rules) for specific industries and transactions. Safe harbours are defined as "circumstances under which the income-tax authorities shall accept the transfer price declared by the assesse." This encourages taxpayers to voluntarily select the safe harbour and offer the specified profit margin to tax in India. These rules have been announced after public consultation with key stakeholders and demonstrate a consultative approach on the part of the GoI.

The safe harbour rules were announced by the GoI on 18 September 2013. These Rules will be applicable for five years beginning from financial year (FY) 2012–13. The Rules provide minimum operating profit margins in relation to operating expenses a taxpayer is expected to earn for certain categories of international transactions, such as provision of software development services, information technology-enabled services, (ITES), knowledge process outsourcing (KPO) services, contract research and development (R&D) services, manufacture and export of automotive components that will be acceptable to the Tax Authority. The Rules also provide acceptable norms for certain categories of financial transactions such as intra-group loans granted or guarantees provided to non-resident affiliates of an Indian taxpayer.

Key areas under dispute affecting

Selection of comparables

The selection of comparables is the key for any transfer pricing analysis. Finding appropriate comparables is the biggest challenge being faced not only by taxpayers but also the tax authorities. Furthermore, the selection of comparables is a very subjective exercise, which could lead to difference of opinion between tax payers and tax authorities.

Change in approach

The Indian tax authorities, as well as tax payers, keep changing their methodology being used to benchmark the transactions. This increases confusion when multiple years end up in litigation with different approaches in different years. Rule of consistency in terms of comparables and method, could certainly help curb some unwarranted litigation.

Capital transactions

The FA 2012 has provided clarifications basis which capital transactions such as issue of share capital, preference shares are also covered under the definition of international transaction and thereby, attract transfer pricing provisions. In the recently concluded audit, the tax authorities have aimed to tax the FDI made by the foreign company in the form of contribution to equity shares of the Indian subsidiary. High profile cases such as Shell India and Vodafone (being in the news recently), wherein adjustments to the tune of INR150 billion and INR13 billion, respectively has been proposed by Indian tax authorities.

Marketing intangibles

The tax authorities are contending that Indian subsidiaries of MNCs undertaking advertisement expenses are promoting the brand of the MNC and, in doing so, is providing a service to its group company for which it should be remunerated. However, tax payers contend that such advertisement is required for updating customers on products/solutions, which the tax payer has to offer. These being an integral activity in sale of products in India, is inevitable for any business.

Trends

Global

Globally, transfer pricing continues to be a significant source of controversy between the world's tax authorities and multinational enterprises (MNEs). With the increasing pace of globalization, businesses have been working hard to adapt through better managing their cross-border activities.

Based on EY's 2013 Global Transfer Pricing Survey, 47% of parent companies reported that they have experienced double taxation as a result of a transfer pricing adjustment. To mitigate double taxation, 28% of companies said they had referred a transfer pricing matter to competent authority in the past three years. When applied, Mutual Agreement Procedures or arbitration are usually effective means of mitigating double taxation arising from transfer pricing adjustments. 23% of parent respondents reported suffering double taxation in spite of the application of Mutual Agreement Procedures or arbitration. Despite its effectiveness, the competent authority process is showing increased signs of strain. Tax authorities are struggling

to cope with the volume of transfer pricing controversy generated by increasing global trade and broader, more stringent enforcement of transfer pricing standards.

APAs are also seen as an effective dispute resolution option; however, an increased risk environment and resulting double taxation concerns may be driving increased interest in the APA process. Among the parent companies surveyed 26% reported using an APA in 2012. The level of satisfaction with the APA process remains high; however, the length of the APA process was a primary source of dissatisfaction for taxpayers. Some industries favor the use of APAs more than others. The use of APAs is highest in industries that, as a result of high profit levels, complex value chains or dependence on intellectual property, are subject to frequent tax authority challenge. These primarily include industries such as pharmaceutical, oil and gas and automotive.

India

The increase in litigation in India on transfer pricing issues has caught the attention of the world. With investors world over being cautious of the aggressive (and at times irrational) approach being adopted by Indian tax authorities, radical steps were required to boost foreign investors' confidence. Accordingly to this end, the GoI introduced safe harbour provisions and APA program.

The Indian APA program has received an overwhelming response with more than 140 applications being filed in the first year and lot of applicants looking to applying in the second round. During discussions, the APA authorities have displayed an open mind with a positive intent to find an amicable solution for taxpayers.

However, domestic litigation is here to stay. No real mechanism (besides MAPs) is in place to address the root cause of transfer pricing-related issues and thereby, reduce the level of litigation for tax payers.

Challenges

While the introduction of safe harbour rules is a step in the right direction, the safe harbour margins appear to be high and do not reflect the economic environment. Continued insistence on such high margins will erode competitiveness of the Indian contract service provider, and shift work away to other preferred jurisdictions. This is further complicated by prescribing higher margins for companies with higher turnover — a relationship not empirically proven and economically unviable. These margins will more like than not be subject to challenges in the other jurisdictions, which is party to the transaction and could lead to double taxation.

Introducing an artificial segregation within the software services industry and IT-enabled services industry is expected to intensify legal disputes. The definition of terms like BPO and KPO or software services and contract R&D in the rules are not supported by any expert analysis. Arguably, there could exist significant overlap between these activities. Financial transactions are fact-sensitive and it may not be conducive for taxpayers to apply the Rules as they are.

The interest rates and guarantee commissions seem excessive. The Rules do not phase out transactions, which have taken place in earlier years. This may deter taxpayers from adopting these rates, for fear that they may jeopardize their ongoing litigations.

The Indian APA program seems to be the only redressal forum and expectedly received an overwhelming response. However, considering the past, a large number of taxpayers are awaiting the results from the first batch of APAs before making a decision to file for an APA. Accordingly, the real success of the Indian APA program will be tested by the ability of the Indian APA authorities to close a few APAs, which will set the mood for other tax payers.

Moreover, the stance of the GoI that MAP proceedings and bilateral APA program cannot be entered into if India's DTAA with a country does not contain Article 9(2), further reduces the scope and reach of MAPs and APAs.

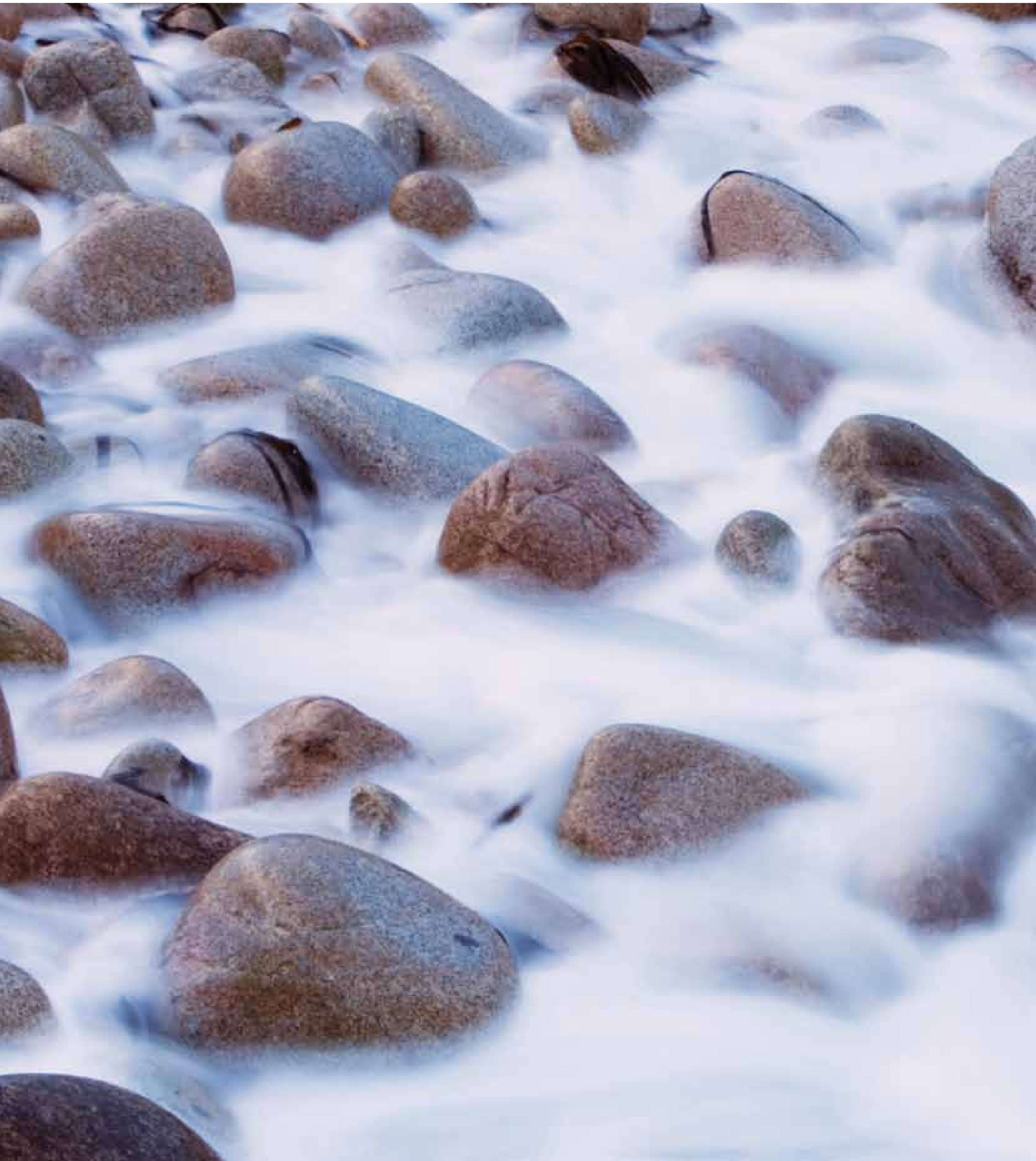
Recommendations

Introduction of safe harbours is a taxpayer-friendly measure. The Central Board of Direct Taxes (CBDT) has clarified that the safe harbour rates will not apply to normal assessments. However, the GoI could have used this as an opportunity to simplify the compliance rules for taxpayers. Safe harbour rules continue to impose the burden of maintaining transfer pricing documentation on taxpayers opting for it. Excluding taxpayers transacting with low tax or no tax countries from the ambit of safe harbour rules creates a further exception. The GoI will do well to address in an appropriate manner some of the concerns still persisting in the minds of taxpayers. A well administered safe harbour regime with unambiguous rules is in the interest of the entire country and will arrest the increase in TP litigation and boost investor confidence.

While most of ADR's processes introduced by the GoI aim to reduce litigation for future years, steps are required to help resolve the existing litigation (which is pending before various levels). Given the ever increasing volume of litigation, the GoI needs to explore the option of given powers to tax authorities to enter across the table discussions/dialogs with tax payers to arrive at an amicable settlement and thereby resolving the litigation. While providing a boost to the confidence of foreign investors, it will also ensure that the adjustments made by tax authorities are actually realizable and thereby improve the actual tax collections of the tax administration.

In an increasingly, dynamic environment, a taxpayer now needs to carefully consider his options of dispute resolution and controversy management and determine the comparative benefits of electing the safe harbour, engaging in domestic litigation or pursing an APA / MAP.

4 Indirect taxation : Topical issues affecting businesses



Recent Apex Court judgements have unsettled landscape in indirect taxes

Two recently pronounced Supreme Court judgements namely the Fiat India Private Limited case, which deals with excise valuation and L&T judgement, which deals with treatment of Value Added Tax (VAT) on sale of immovable property entered prior to construction have completely changed the complexion of settled indirect tax principles leading to considerable business disruptions, potential liabilities, and further protracted litigations.

An excise valuation judgement, which will have an impact on the manufacturing industry

The Honorable Supreme Court, in the case of Commissioner of Central Excise, Mumbai v. Fiat India Private Ltd., dealt with facts wherein for a period of time cars were sold below the cost of manufacture and excise duty was discharged on such values. The issues before the apex Court were the following:

- Whether the value declared for excise duty, which was admittedly below the cost of manufacture can be considered as "normal price"
- Whether the sale of cars at a price lower than cost of manufacture to compete and penetrate the market can be regarded as "extra commercial consideration"

It is important to note that the above case was covering both periods prior to introduction of the concept "transaction value" and beyond, under the excise law.

The apex court under these circumstances has held that selling a product at a price below cost of manufacture for a reasonably long period of time rather a one-time transaction does not satisfy the conditions envisaged as "normal price," ordinarily sold and that price is the sole consideration. The facts that the cars were sold at a price below manufacturing cost for a reasonable period of time and not a one-time transaction was the basis for distinguishing the well-settled principle in the apex court's case of Commissioner of Central Excise v. Guru Nanak Refrigeration Corporation pronounced in March 2003.

The Supreme Court further ruled that even after the introduction of transaction value and the amendment of the relevant section, price is not the sole consideration as the penetration of market by sale of cars below cost of manufacture for a reasonable period of time constitutes extra commercial consideration.

The apex court's judgement has opened a Pandora's Box and could result in substantial litigation across the manufacturing industry.

The automotive industry, among others, had several rounds of representations and discussions with revenue authorities at highest levels following this development. The policy makers have, at several forums, mentioned that that they are looking at the issue and will come out with suitable clarifications, which till date is awaited.

Notwithstanding such interactions, the excise authorities in the interim are seeking information from manufacturers, particularly the automotive sector, to begin with on products/SKUs being sold below cost of manufacture. In some cases, cost audits have been initiated and in some even notices have been issued. This has led to widespread concerns across industry of what is in store in the future on this issue.

To begin with what's worrisome is the ratio of this apex Court judgement being applied across the board for enquiries ignoring the specific facts of the case. The judgement's ratio is based on specific facts and circumstances and it is therefore important for the industry to distinguish their facts vis-à-vis the case wherever applicable. Furthermore, even in cases where details of costs of manufacture are being sought after the judgement, the first argument should be on the basis of legal provisions envisaged under the excise valuation rules. Even where computation is being provided it is extremely important to understand the costs and how are they computed to arrive at cost of goods manufactured.

An immediate solution could be a clarification from the revenue authorities on the applicability of this judgement in specific circumstances. This will at least temper across the board enquiries, audits and actions being initiated by the excise field formations, which in turn may lead to protracted litigation.

Applicability of VAT on any agreement to sell immovable property entered prior to construction will fall within the purview of the term "works contract"

In another recent judgement of the larger bench of the Supreme Court in case of L & T Limited v. State of Karnataka, while reconsidering the judgment of the division bench of the Supreme Court pronounced in the case of K Raheja Development Corporation, the apex Court held that any agreement to sell immovable property entered prior to construction will fall within the purview of the term

"works contract," and that state governments are within the legislative power to levy VAT on such contracts.

This issue has been contentious. The Raheja Development Apex Court judgement in 2005, which was with respect to real estate transaction structures in South India, wherein sale of land was separate from sale of flats unlike in most other parts of India. This issue was also litigated in recent years by the real estate sector in Maharashtra, and in 2012 the Bombay High Court ruled that such real estate transactions wherein an agreement to sell immovable property was entered prior to construction is subject to levy of VAT as "works contract." In fact in recent months, states such as Haryana have sought to issue trade notices to bring under purview such agreements to sell immovable property entered prior to construction within the purview of VAT as "works contract."

The L&T Apex court judgement has considered both the above judgements in arriving at the conclusion that states have the power to levy VAT on such transactions as "works contracts."

In the facts of this case, the main object/substance of the tripartite agreement was to sell and convey fraction of land with a fully constructed apartment.

It is important to note that the facts of the case were as under:

- At no point construction was for and on behalf of the purchaser
- The apartment was to be sold as an apartment and not as an aggregate of its component parts
- Agreement for sale was an agreement to transfer immovable property with no element of works contract
- The developer does not construct on behalf of the apartment owner, and the owner has no say in conceptualising the project or any control
- The ownership of materials used in construction in such cases remain with developer and that the accretion to the goods happens in the hand of the developer

All the above facts generally alluded that such an activity cannot be treated as a works contract. Settled arguments that in a conventional sale of property, goods get transferred as intended by parties, while in a works contract property in goods are transferred through accretion have all been negated in coming to the conclusion by the Supreme Court.

The apex court observed that though the ultimate transaction between parties' maybe a sale of flat, it cannot be said that characteristics of works contract are not involved in such transactions. Hence, when a contract comprises both a works contract and transfer of immovable property it does not denude it of its character of "works contract" and that Article 366(29-A (b)) contemplates situations where goods may not be transferred in the form of goods but maybe transferred in some other form, which can even be in the form of immovable property.

The judgement will result in VAT authorities looking for recoveries from industry within applicable limitation period as the judgement is on existing law with retrospective implications. Furthermore, this judgment is likely to trigger new valuation issues as the Court has held that only the value addition made post execution of an "agreement to sell" an under construction flat will be subject to levy of VAT giving rise to practical difficulties in implementing at the ground level.

In situations where possession has been handed over by the developers against full and final settlements the taxes may have to be borne by the developer as they may or may not have any recourse. With all these ground realities the industry will look for a practical solution such as in Maharashtra where a composition scheme with low tax incidence of 1% is an option. This judgement can even embolden some states to fix higher composition rates.

It is also important for the real estate industry to examine practically as to whether they can opt to claim input credits and whether that will be more favorable vis-à-vis composition option.

Service tax Voluntary Compliance Encouragement Scheme (VCES) and introduction of punitive provisions under customs, excise and service tax laws

The FY14 Union Budget laid the ground for introduction of VCES under service tax to cover within its ambit, potential tax payers who have been non-compliant and have escaped the tax net either intentionally or otherwise. The pressure on revenue collection in a slowing economy, coupled with the compulsion of managing fiscal deficit, could have been the rationale for introduction of such a scheme.

This was equally balanced by the introduction of punitive provisions across customs, excise and service tax laws suggesting a time tested carrot and stick approach to send a strong message to defaulters.

Indirect tax statutes have traditionally defined offences, which are punishable with imprisonment and fine, are akin to offences under criminal law. Such offences, which are typically cases entailing recovery of taxes, confiscation of goods and imposition of penalty, involve parallel proceedings for criminal prosecution. While the criminal jurisprudence in tax cases has constantly undergone legislative changes and read down by the courts during the last decade, the Finance Act, 2013 passed by the Parliament has now given more teeth to revenue authorities to prosecute individuals and corporations for offences under tax statutes.

The most important aspect of the Finance Act, 2013 is the introduction of new provisions in the Finance Act, 1994 for arrest and prosecution in cases involving service tax. Unlike the Customs Act, 1962 (Customs Act) and the Central Excise Act, 1944 (Central Excise Act), there was no scheme for criminal prosecution under the earlier service tax regime. However, the Customs Act and the Central Excise Act have also been amended now to specify the conditions, which shall determine the extent of punishment and the nature of the offence.

These amendments appear to have been occasioned by the judgment of the Supreme Court in the case of Om Prakash v. Union of India, in 2011, wherein the Court examined the earlier provisions of the Central Excise Act and the Customs Act, and evaluated the nature of the offences vis-à-vis other criminal statutes and the Code of Criminal Procedure (Cr. PC). Offences under the pre-amendment provisions of the acts were all non-cognizable offences, i.e., arrest could not be made without a warrant. The Cr. PC mandated that offences punishable with more than seven years imprisonment were cognizable in nature. The Apex Court held that offences under the respective tax statutes will continue to be non-cognizable even where the Cr.PC treats certain offences as cognizable offences.

Unlike other coercive actions such as recovery through attachment of property or garnishee notices, criminal prosecution threatens the personal liberty of the person involved and the higher risk, since arrest can be done at any stage of the proceeding.

After the amendment, all offences under the Customs Act, except those which involve goods worth more than INR10 million or the duty evaded is more than INR5 million, are non-cognizable offences. Similarly, under the Central Excise Act, where duty leviable is above INR5 million and involves the evasion of payment or mis-utilization of input credit, the offence is cognizable and all other offences are non-cognizable. Under the Finance Act, 1994, where the evasion of service tax or mis-utilization of credit exceeds INR5 million, the offence is cognizable and other offences are non-cognizable. Therefore, one of the most significant effects of the amendment is that certain offences have been notified for the first time as offences for which a warrant is not required for arresting a person.

The requirement of a warrant of arrest is one of the parameters for identifying the nature of the offence. The other factor is whether the offence is bailable or not. An accused person can be released on bail in the case of a bailable offence while the Magistrate before whom the accused person is produced will have the discretion to grant bail in the case of non-bailable offences. Circulars were issued by the Central Board of Excise and Customs (CBEC) in September 2013 separately dealing with Customs, Central Excise and Service Tax wherein the classification of offences has been done on this basis.

A non-bailable offence is broadly determined under all three statutes by INR5 million rule.

- In excise cases, it is where the duty evaded is above this pecuniary limit the offence becomes non-bailable
- When more than INR5 million service tax has been collected but not deposited by a service provider, it is a non-baliable offence
- In cases of customs duty evasion above INR5 million or drawback/exemption above INR5 million, the offence is non-bailable

All other offences are bailable offences, i.e., a person can be released on bail by the officer arresting such person on furnishing a bail bond.

It is pertinent that an allegation of tax evasion may not be crystallized in a show cause notice or in an adjudication order before an arrest is made. Therefore, the quantum of the tax/duty involved in the contravention may be even on a presumptive basis and once the figure is INR5 million or above, the requirements of furnishing a warrant of arrest and release on bail are inapplicable.

The recent CBEC circulars throw light on what revenue authorities also perceive as offences warranting arrest and prosecution. Although very broad stipulations are contained in these circulars, it appears that arrest should be

necessitated by prevailing circumstances to ensure proper investigation of the case and to prevent the accused person from absconding. These may be some of the important mitigating conditions forming a valid case for bail.

Even though the new and amended provisions have structured the scheme of arrest and prosecution under these tax statutes, it is noted that in the decision of the apex court in Om Prakash's (supra) case that the main object of the enactments is the recovery of duties and not really to punish for infringement of its provisions. This is an important differentiator from other criminal offences and is also an important ground to dropping of criminal proceedings.

State VATs unravel, while awaiting GST

Where are we on GST?

The "game changer" indirect tax reform — the Goods and Services Tax (GST) — has been keenly awaited by the industry. Unfortunately, the debate about the design of GST continues to be guided by political motives rather than its economic merit. The Parliamentary Standing Committee on Finance, to whom the Constitutional (Amendment) Bill (Bill) for GST was referred for examination, presented its report in August 2013. The report provided an extremely balanced view of the economic and political considerations surrounding the GST. It fairly succeeded in balancing the objectives of fiscal autonomy of the states and harmonization of taxes across the country. It emphasised the need to leave the GST design features at the discretion of the GST Council, rather than binding them under the Constitution. Importantly, it brought out the need for including all goods and services under the GST.

All these recommendations are indeed visionary. However, while the Central Government has accepted the Parliamentary Committee's views, the states continue to object to some of the design elements. For instance, at the most recent meeting of the Empowered Committee of State Finance Ministers (EC) held in October 2013, the Centre tabled the revised Bill reflecting the Parliamentary Committee's recommendations. Some of the states have again expressed disagreement with the inclusion of petroleum and alcohol within the scope of GST. Industry has been advocating the need for inclusion of all sectors, including petroleum and alcohol in the GST base to have increased economic efficiency. This is really surprising considering the fact that there was an emerging consensus in recent months on such inclusions provided the states had the opportunity of levying additional taxes on petroleum over and above GST.

Given the current state of affairs, it is evident that GST will be implemented only by the new government after the general elections scheduled in the first half of the next year.

However, parallely, both the Centre and state governments have been working on finalizing the threshold limits for levy of GST, the Revenue Neutral Rate (RNR) and the design for levying tax on inter-state transactions (IGST). It appears that they are close to agreeing on a revenue threshold of INR2.5 million for other than special category states such as the North-eastern states who may have a lower limit of INR1 million.

Agreement on the threshold for levying GST and the items to be exempted from GST is critical to determine the RNR. At the next meeting of the EC, deliberations are expected on the reports of the sub-committees on the IGST as well as on the thresholds/exemptions.

The sub-committee on determining the RNR is yet to finalize its recommendations pending the decision on the thresholds and exemptions and more time will be required to get the Centre and the states to agree to the rates.

While GST implementation continues to get delayed it is interesting to examine how the State VAT regimes have evolved in the last few years.

State VAT regime – current status

While the discussions on GST continue, the industry was hoping that the states would utilize this time constructively in developing the infrastructure for GST and harmonizing their existing VAT systems to align with GST designs being discussed.

But the ground reality is that states, guided purely by local revenue compulsions, have steadily increased VAT rates with the peak rate going up to 15% and lower rates moving from 4% to 5%. They have also expanded the exemption list and imposed a variety of restrictions to block or reduce input tax credits. These changes are not only against established principles of VAT but also deviate from the broad objectives of GST namely:

- Establish India as a single market with free flow of goods and services
- Bring about uniformity in tax rates, rules and procedures
- Have an economically efficient tax which promotes growth and investment

Uniform VAT rates, rules and procedures: a mirage

When VAT was introduced in 2005, the new regime did attempt a very substantial harmonization across states. It provided for uniform tax rates and base, an input tax credit system to prevent "tax-on-tax," and common/streamlined policies and procedures for compliance.

However, thanks to numerous deviations from this harmonized model since its inception, it has now degenerated into a tax maze of 30 plus VAT regimes.

The return forms, annexures to return forms, tax payment due dates, are all different for different states. Complying with these different systems has become a nightmare for the industry and even automation has failed to provide the requisite relief. Such is the level of complexities that for some large businesses, even world class ERP systems are not fully successful in automating VAT compliance.

Even the definitions in the VAT laws vary across states. A case in point is the definition of capital goods for input tax credit purposes. Capital assets in Maharashtra have the same meaning as under the Income Tax Act, 1961. In contrast, Gujarat defines capital goods to mean plant and machinery meant for use in manufacture and such other goods, as may be notified by the State Government from time to time. It is therefore, possible for a product to be a capital asset in Maharashtra, which may or may not be the case in Gujarat.

Even the basis of levying the tax is different in different states. For example, in the case of a dealer engaged in sale of imported goods in Delhi, the taxable value of VAT is the higher of the sale price agreed with the customer or the import price on which the customs duty has been paid. This is a complete deviation from the transaction value concept, which was meant to be the basis for all transactions. Internationally, VAT is payable on the value agreed to be paid by the buyer to the seller irrespective of the cost of purchase, manufacture, or the import price.

Furthermore there are inconsistencies in classifying a specific product under various VAT laws; this issue is compounded by the fact that unlike excise and customs, VAT laws do not follow any structured classification nomenclature. Some states have attempted albeit with little success. This has led to litigation in various states besides ending up with varying rates of taxes. Moreover, from a perspective of tax base, various states have their own versions of exclusions/inclusions in the taxable value, e.g., freight, insurance, service tax etc., being either part of VAT base or otherwise.

Rates, as we have discussed, have equally seen wholesale changes with no consistencies. For instance, the sale of cars attracts a VAT rate of 12.5% in Maharashtra, 15% in Gujarat, 14.5% in Andhra Pradesh and 14% in Rajasthan. Many states have introduced additional taxes and surcharges, which earlier had been subsumed in VAT leading to further increase in effective tax rates.

As regards the uniformity in the rules and procedures, introduction of e-filing of returns by almost all states is the only positive development.

Restricted input tax credits: new tool for VAT revenue augmentation

The states have imposed a variety of restrictions on input tax credit claims. For example, Maharashtra does not allow any input tax credit on purchase of cars to car leasing companies, even though car leasing charges are fully subject to VAT. This results in double taxation of leased vehicles, and is against the established principle of allowing input tax credit to the lessor if full VAT is paid by him on the lease rentals charged to his customers. The car leasing industry in Maharashtra is at a disadvantage as compared to other states.

Another example is that of restriction on the input tax credits in respect of inter-state sales. States such as Gujarat have restricted the input tax credits to the extent of Central Sales Tax (CST) levied on inter-state transactions. This has effectively denied the benefit of the reduction in the CST rate from 4% to 2%.

Basically on inter-state sales, 2% tax is collected in the form of CST, and an additional 2% is collected through a denial of input tax credits.

In the case of exports, although exports are zero rated wherein the exporter is entitled to claim a VAT refund on the inputs locally procured by him, these refunds invariably take time, which again adds to the cost of doing business.

Levy of entry tax: litigation galore

The levy of entry tax on goods entering the state has been subject of protracted litigation. The courts have already ruled the levy to be ultra vires of the Constitution as it violates the condition of non-discrimination under Article 304 (a). Yet, the states, keen on garnering revenues from this source, have appealed the matter to a larger bench of the Supreme Court. Entry tax fragments the Indian common market and also acts as a tariff barrier akin to import of goods from outside the country. It impedes the free flow of trade, and gives rise to competitive distortions

and inefficiencies in the supply chain. Hence, subsuming of entry tax within GST is extremely important.

The introduction of VAT and the experience in the last eight years should have given us a simple robust and consistent tax regime with a broad base, low rates, ease of compliance resulting in increased revenues — a virtuous circle.

Unfortunately, the unravelling of VAT system experienced over the past few years, has recreated the vicious circle of narrow tax base, high tax rates, low compliance and reduced revenues.

Without harmonization across the states, VAT in India has become complex.

This further underlines the urgency for GST with a broad base, harmonization and reasonable rates to simplify the tax regime, remove cascading and create a common market leading to increased competitiveness and growth.

India's Free Trade Agreements: trends and challenges

With the breakdown of WTO multi-lateral talks, countries and trading blocs world over have been very active in negotiating Free Trade Agreements (FTA). India's engagement with Free Trade Agreements (FTAs) has also increased considerably.

Several comprehensive FTAs with important markets are already in place. These include the India-Korea, India-ASEAN, India-Malaysia, India-Singapore and India-Japan FTAs.

In addition, India is negotiating FTAs with several significant trading partners such as the EU, Canada, the Gulf Cooperation Council, EFTA (Iceland, Norway, Liechtenstein and Switzerland), New Zealand, and Australia amongst others. India is also engaged in negotiations to expand the scope of certain existing FTAs, which includes the FTA with the ASEAN countries to cover trade-in services and investment.

Most FTAs today take the form of comprehensive economic partnership agreements or CEPAs, covering trade in goods as well as services and investment. Moreover, some of India's more recent FTAs such as India-Japan CEPA include even controversial areas such as government procurement and competition, albeit limited in scope.

Industry in India and those overseas that have trade and investment dealings with India have much to gain from these FTAs. Broadly speaking, the gains lie in legally binding market access for their goods and services. In particular, the agreements set out legal commitments undertaken by the FTA parties to liberalize bilateral trade in goods, services and investment and to provide protection to intellectual property rights. In addition, they include the non-discriminatory treatment of foreign vis-à-vis domestic goods and services.

Although India is currently engaged in FTA negotiations with several trading partners, the India-EU FTA negotiations, in particular, have shown few signs of progress. India and the EU began negotiations on a broad based Bilateral Trade and Investment Agreement (BTIA) in 2007. However, the signing of the BTIA has been held back due to certain unresolved issues between the parties. In particular, the EU has been demanding increased market access to India's automobile, agriculture, and pharmaceuticals sectors, liberalization of India's insurance sector and inclusion of government procurement within the ambit of the agreement. India on the other hand seeks concessions from the EU particularly in services sectors such as information technology and for the movement of Indian professionals. In addition, certain contentious issues relating to India's intellectual property regime have contributed to stalling the negotiations.

Challenges in FTAs

The purpose of an FTA is to facilitate closer economic integration between the economies of the FTA parties. The integration between the parties is increased by elimination of customs duties and other restrictive regulations of commerce across all sectors of trade and is reduced if any major sector of trade is excluded from the ambit of FTA.

In addition to challenges faced by the countries in reaching a consensus in their negotiations on the commitments in an FTA, there also exist certain hurdles for the industry seeking to secure benefits under the FTA, once it is in place.

Engaging with the government in the context of India's current FTA negotiations is crucial for the industry facing barriers in their trade and investment dealings with overseas markets. The onus to raise critical concerns regarding trade and investment restrictions with the negotiators on either side falls upon the industry. Therefore, the industry needs to actively engage in discussions with regard to concessions that prospective FTAs will cover.

In addition, to avail tariff benefits under existing FTAs, companies need to examine potential duty savings under such FTAs and to ensure that their products have been duly classified under the correct tariff code so that concessional

duty rate can be availed of. Moreover, a company looking to secure duty concessions under a particular FTA must comply with the rules of origin requirement.

The Rules of Origin (ROO) help determine the eligibility of goods to receive preferential tariffs under an FTA based on whether or not they are wholly obtained or produced in the territory of the FTA party. In most of India's FTAs, where a product is not wholly obtained or produced in the territory of an FTA party, the primary method of determining the origin of the goods is based on the twin criteria of "value-added content" and "change in tariff classification."

The value-added content rule requires that a certain specified minimum percentage of local content be added to a product in the country where the origin is being claimed. The required value-added content percentage may vary across FTAs. The change of tariff classification rule, on the other hand, is based on a tariff shift, which means that the product at issue must be classified under a different tariff heading than the tariff heading of the components used in the production of that good. While some FTAs require a change of tariff classification at the four-digit level, others do so at the six-digit level.

ROO pertaining to each FTA may therefore be different and therein lies the challenge to an company seeking to avail of FTA concessions. In addition, India may have agreed to grant different levels of duty concession to a particular imported good from the same country under multiple FTAs. For instance India offers duty concessions to imports from Malaysia under the India-Malaysia FTA as well as the India-ASEAN FTA. As a result, companies may have a choice between multiple FTAs for availing preferential benefits when trading with one country.

ROO under these FTAs, however, differ and therefore, though a product may originate from the partner country under one FTA, it may not satisfy the rules of origin under another. The number of overlapping FTAs and the distinct set of rules specific to them pose a problem for companies. Structuring production processes specifically for each FTA raises compliance costs for importers. Furthermore, calculating whether a product satisfies the value-added content requirement of an FTA can be cumbersome and requires sophisticated accounting systems.

Adherence to customs formalities adds to the complexity of complying with the rules of origin. The intricacies of calculating the value added content may result in a difference between the importers determination of origin and the customs authorities' findings with regards to the origin.

A possible solution to this problem is the harmonization of various rules of origin under different FTAs for the same product, which should in turn help companies plan their production and sourcing chains. In addition, capacity building programs that enhance the institutional infrastructure as well as train customs officials in the application of rules of origin could help mitigate such problems.

With several prospective FTAs in the pipeline, tackling the above challenges becomes increasingly important so that businesses can fully take advantage of benefits accorded by India's FTA partners for access to these markets and for sourcing of goods.

Benefits of FTAs have always been a debate, e.g., divergent views expressed by the Ministry of Finance and Ministry of Commerce. However with India's mandate to increase its share of global trade FTAs being a reality and will equally help in managing our foreign exchange pressures.

Annexure A

Extracts from the BEPS Action Plan

Action 1 - Address the tax challenges of the digital economy

Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.

Action 2 —Neutralize the effects of hybrid mismatch arrangements

Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) 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. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.

Action 3 — Strengthen CFC rules

Develop recommendations regarding the design of controlled foreign company rules. This work will be co-ordinated with other work as necessary.

Action 4 — Limit base erosion via interest deductions and other financial payments

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, ansfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be co-ordinated with the work on hybrids and CFC rules.

Action 5 —Counter harmful tax practices more effectively, taking into account transparency and substance

Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

Action 6 — Prevent treaty abuse

Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids.

Action 7 — Prevent the artificial avoidance of PE status

Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the

specific activity exemptions. Work on these issues will also address related profit attribution issues.

Action 8 — Intangibles

Develop rules to prevent BEPS by moving intangibles among group members. This will involve – (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

Action 9 — Risks and capital

Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense deductions and other financial payments.

Action 10 — Other high-risk transactions

Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be re-characterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.

Action 11 — Establish methodologies to collect and analyse data on BEPS and the actions to address it

Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an on-going basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spill over effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses.

Action 12 — Require taxpayers to disclose their aggressive tax planning arrangements

Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of "tax benefit" in order to capture such transactions. The work will be co-ordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations.

Action 13 — Re-examine transfer pricing documentation

Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.

Action 14 — Make dispute resolution mechanisms more effective

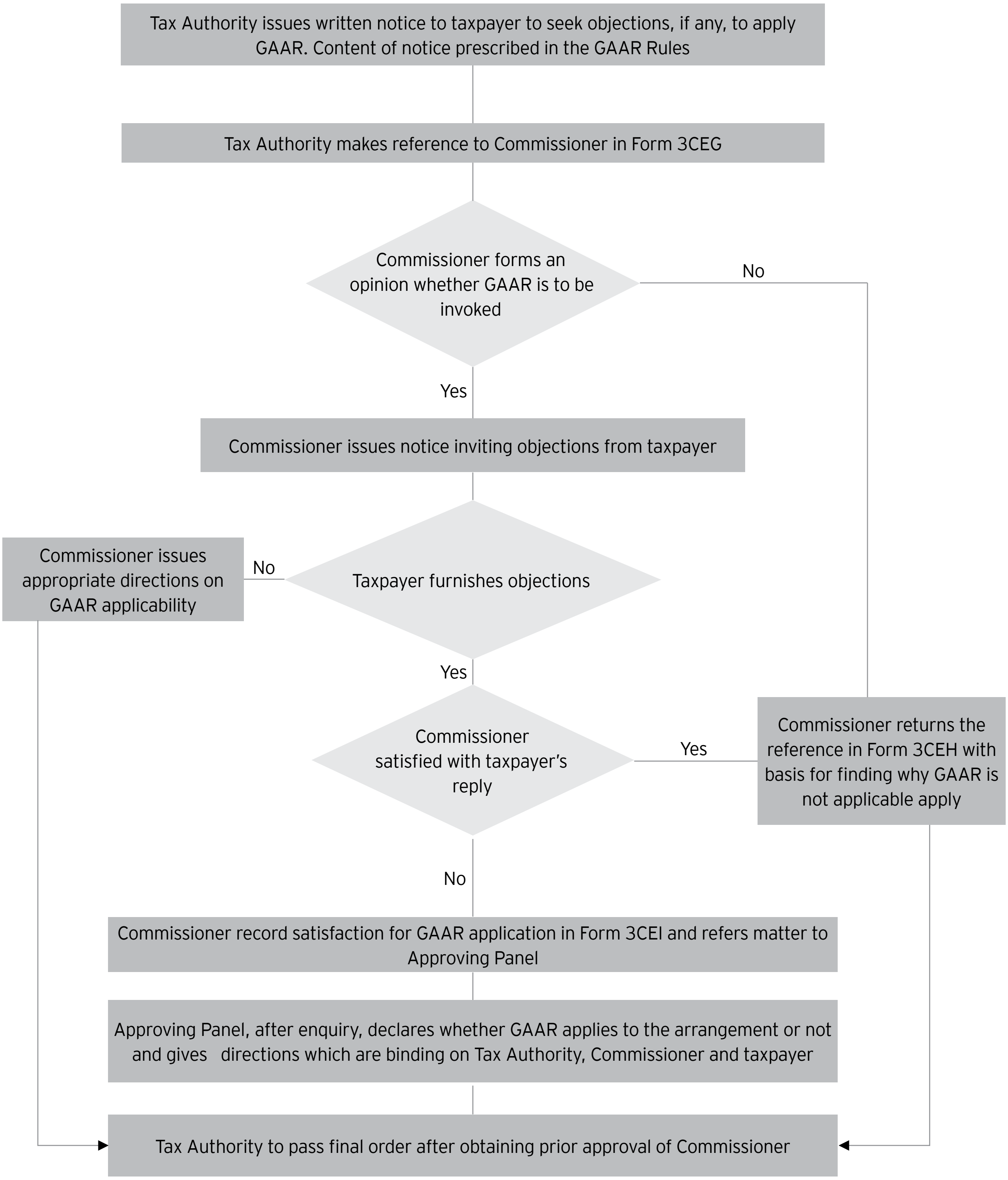
Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.

Action 15 — Develop a multilateral instrument

Analyze the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution.

Annexure B

Pictorial depiction of GAAR procedure as follows



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