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BEPS
(Base Erosion and Profit Shifting)

ACTION PLAN 3 AND 4
Basic understanding

OVERVIEW:

In the last knowledge update[1] we discussed on the first two Action Plans recommended by OECD on BEPS. Now we understand that the BEPS Action Plans ensure that profits are taxed where economic activities generating the profits are performed and where value is created thereby addressing the tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations.

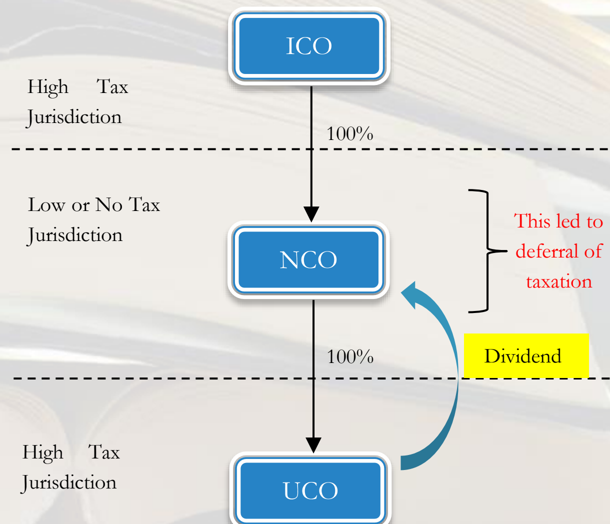
Let us have a look at the next Action Plans.

Action Plan – 3 [Strengthen Controlled Foreign Company (CFC) Rules]

Controlled Foreign Company rules aim to prevent the avoidance of tax through shifting profits to low tax foreign subsidiaries. In certain cases the taxpayer who have controlling interest in Foreign subsidiaries, can use an intermediary company ('CFC') to reduce or defer the tax base of their country of residence by shifting/ retaining income in a CFC jurisdiction. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation.

Let us understand this by an example:

Suppose an Indian Co. (ICO) wants to acquire 100% stake in a UK Co. (UCO). So when UCO will distribute the profit as dividend to ICO, the same will get taxed under the Indian tax laws say at 15%. Now ICO wants to defer such tax on dividend and in order to do so ICO created a 100% subsidiary in a low or no tax jurisdiction say Netherland (NCO) and indirectly acquired the stake in UCO through NCO.



[1] http://www.jainshah.com/resource/Image/Int_Taxupdate1.pdf

Now when the UCO will distribute the dividend to NCO, no tax liability will arise on such dividend income because of No tax in the jurisdiction of NCO. In the above illustration NCO will be treated as CFC, as the entity was created just to defer the tax base.

In order to address such issues the OECD set out six building blocks for effective CFC rules:

a. **Definition of CFC:** It should cover not only corporate entities but also non-corporate entities
b. **CFC exemption:** Recommended that CFC rules only apply to controlled foreign companies that are subject to effective tax rates that are meaningfully lower than those applied in the parent jurisdiction
c. **Definition of income:** Recommended that CFC rules include a definition of CFC income, and it sets out a non-exhaustive list of approaches that CFC rules could use for such a definition
d. **Computation of income:** CFC income to be computed as per parents law jurisdiction
e. Attribution of income: It should be based on Control threshold and proportionate ownership.
f. **Prevention and elimination of double taxation:** Jurisdictions with CFC rules allow a credit for foreign taxes actually paid, including any tax assessed on intermediate parent companies under a CFC regime

Action Plan 3 basically outlines essential "building blocks" for effective CFC legislation that will limit opportunities for tax deferral through blocker entities in low tax countries. It aimed at taxing passive profits which are accumulated in low tax jurisdictions.

Action Plan – 4 (Limiting Base Erosion involving Interest Deductions and other Financial Payments)

The Action 4 recommendations aim to limit base erosion through the use of interest expense to achieve excessive interest deductions. The MNC may achieve favourable tax results by adjusting the amount of debt in a group entity. BEPS risks in this area may arise in three basic scenarios:

- *Groups placing higher levels of third party debt in high tax countries.*
- *Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense.*
- *Groups using third party or intragroup financing to fund the generation of tax exempt income.*

These scenarios can give rise to double non-taxation in both inbound and outbound investment scenarios.

To address these issues, this report established rules that linked an entity's net interest deductions to its level of economic activity within the jurisdiction, measured using taxable earnings before interest income and expense, depreciation and amortisation (EBITDA). This approach includes three elements:

a. Fixed Ratio Rule: An entity's net actual interest expense is capped to percentage of its EBITDA between 10% to 30%.
b. Group Ratio Rule: Under this the interest deduction within the group is limited to overall third party interest expense incurred by group.
c. Targeted Rules: To address specific risks such as interest incurred to earn exempt income or under back-to-back arrangements.

The report also acknowledges that in view of the specific requirements of the banking and insurance sectors, further work will need to be undertaken to address these sectors.

MEASURES TAKEN BY INDIA

Action Plan 3:

- Concept of POEM ('Place Of Effective Management') introduced vide section 6(3)(ii) of the Income-tax Act, 1961. The introduction of the POEM test of corporate residency also suggests that the introduction of the CFC rules may no longer be a policy priority for the Government. This is because, the POEM rules, can to some extent, address the same abuses as a CFC regime by bringing to tax incomes earned by subsidiaries abroad.
- Introduction of section 115BBD of the Act that levies tax on certain dividends received from foreign companies at the rate of 15%

Action Plan 4:

- Introduction of Section 94B (Limitation on interest deduction in certain cases) vide Finance Act 2017: Under this provision the deduction of interest payment in excess of INR 1 crore by an Indian Company or by a PE of foreign company in India towards debt issued by a non resident AE is restricted upto 30% of EBITDA. The excess interest can be carry forward for 8 succeeding assessment years.
- Introduction of GAAR: It provides for recharaterising of any arrangement. It is expected that thin capitalisation norms could be indirectly made applicable through a potential recharacterization of debt into equity

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