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BEPS
(Base Erosion and Profit Shifting)

ACTION PLAN 5

OVERVIEW:

BEPS Action 5 is one of the four BEPS minimum standards applicable to all members of the Inclusive Framework on BEPS and any jurisdictions of relevance. The OECD Forum on Harmful Tax Practices (FHTP) has been conducting **reviews of preferential regimes** since its creation in 1998 in order to determine if the regimes could be harmful to the tax base of other jurisdictions

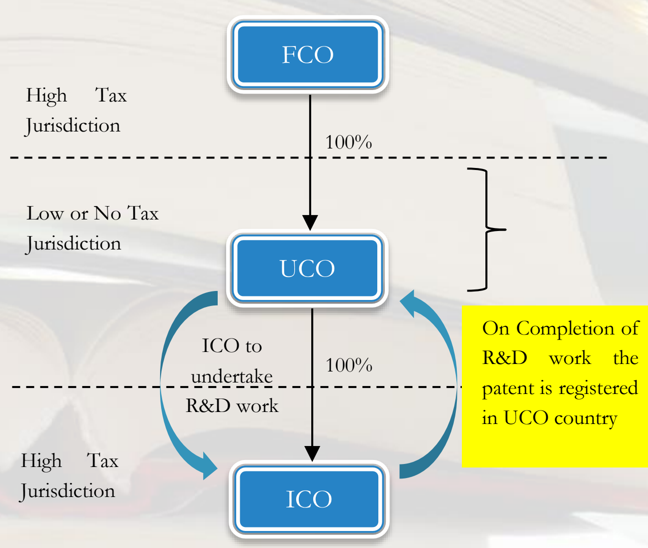
Let us understand this Action plan in brief:

Action Plan – 5 [Counter Harmful Tax Practices]

What are Preferential tax regimes?

Such regime that provide no or low tax rate; weighted deductions; tax holidays etc. Such regime that offers tax preference in comparison with general principles of taxation. These are generally offered by countries to develop their economy; to encourage development etc. These regimes are not actually harmful but some companies might use such regime to shift profit from high tax jurisdictions to low tax jurisdiction without generating any economic activity in low tax jurisdiction.

Suppose a Foreign Co. (FCO) wants to undertake Research and Development activity on a particular project. In order to avoid any tax liability, FCO created a 100% subsidiary company (UCO) in a country with no tax or very low tax. UCO created a 100% subsidiary company in India (ICO) to undertake research and development activity. All the research on the project is undertaken in India and when the activity got completed the Patent to that got registered in UCO Country. By doing so all the income through use of patent escaped the tax liability.



The above illustration is an example of misutilization of preferential regime.

That's why the FHTP reviews preferential regimes to ensure that they do not contain features which can negatively impact the tax base of other jurisdictions, and cause a race to the bottom. This process includes a detailed review of applicable legislation and an open dialogue between FHTP members including the jurisdiction providing the relevant regime. The focus of the work is on preferential regimes that provide benefits to geographically mobile business income (such as income from the provision of intangibles, and financial services), which present a risk of BEPS activity. The review does not include regimes that relate to non-geographically mobile activities such as manufacturing, given that these present an inherently lower risk of BEPS activity.

Potentially harmful tax practices – are defined based on the following factors:

- ✓ Where no or low effective tax rates (or negotiable tax rates or bases) are imposed on income from highly mobile assets and activities
- ✓ Where the low tax regime is ring-fenced (separated) from the domestic economy
- ✓ Where there is no transparancy and no exchange of information with other jurisdictions, eg. secrecy provisions
- ✓ Where regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities.

To counter such practice BEPS set out framework covering **six categories of taxpayer-specific rulings** which in the absence of compulsory spontaneous exchange of information could give rise to BEPS concerns. These six categories are

i. rulings relating to preferential regimes;

ii. unilateral advance pricing agreements (APAs) or other cross-border unilateral rulings in respect of transfer pricing;

iii. cross-border rulings providing for a downward adjustment of taxable profits;

iv. permanent establishment (PE) rulings;

v. related party conduit rulings; and

vi. any other type of ruling agreed by the FHTP that in the absence of spontaneous information exchange gives rise to BEPS concerns.

This does not mean that such rulings or the legal or administrative procedures under which they are given represent preferential regimes. Instead, it reflects jurisdictions' concerns that a lack of transparency can lead to BEPS, if jurisdictions have no knowledge or information on the tax treatment of a taxpayer in a specific country and that tax treatment affects the transactions or arrangements undertaken with a related taxpayer resident in their country. The availability of timely and targeted information, which was agreed and included in Action 5 Report, is essential to enable tax administrations to quickly identify risk areas.

What action is taken if regime is found to be harmful?

Firstly, it is important to identify whether the regime is potentially harmful or actually harmful.

Potentially Harmful:

When the FHTP concludes that a regime is potentially harmful, the next step is to assess whether the regime has harmful economic effects. For this assessment, economic data is used (such as number of taxpayers and amount of income benefiting from the regime). When the economic effects shows that the regime is not harmful in practice, the regime is found be potentially harmful but not actually harmful. This means that the jurisdiction does not have to take steps to amend the regime, but the regime is subject to a yearly monitoring process by the FHTP and where changes in economic effects are identified, the conclusion can be revisited.

Actually Harmful:

Where a regime is found to be actually harmful, the jurisdiction is expected to amend or abolish the regime in accordance with the FHTP timelines. This includes ensuring that such regimes are quickly closed-off to new applicants and new expansions of business activities, and that any grandfathering is provided for a limited transition period only

MEASURES TAKEN BY INDIA

Action Plan 5:

- Patent box regime (w.e.f. 01 April 2016):
  India has a concessional regime for taxation of royalty income from patents to incentivize companies to retain and commercialize existing patents and to develop new innovative patented products
  The tax rate is 10% on grosss royalty income from patents 'developed' and 'registered' in India by a person resident in India. By linking the reduced tax rate on IP income to the expenditure incurred on development, the regime appears to be in line with the 'nexus approach' recommended by the Action Plan 5

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