Country by Country Reporting (BEPS Action Plan 13) in India

By

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1. **Introduction:**

In recent years, there has been a number of controversies relating to MNC's, such as Google, Apple, Amazon, Netflix, and as to whether they pay their "fair share" of taxes given how they seem to shift their margins to tax-favourable jurisdictions and operate through complex organizational structures in order to reduce their tax liabilities. This has led to Government's around the world clamouring for ways protect their precious tax base which they felt was getting eroded.

In response to this global clarion call, the Organization for Economic Co-operation and Development (OECD), which is the world's premier forum for Governments on tax policy related matters, started in 2012 an ambitious program called "BEPS" - short for **Base Erosion and Profit Sharing.**

At a macro-level, OECD BEPS project aims to establish a **global consensus to redraw international tax rules** and **encourage a global consistency in the way these tax rules are applied.**

The BEPS project aims to achieve these goals by focusing on certain actionable areas and address specific methods through which tax bases of countries were being eroded and the profits being shifted by corporate entities so as to reduce or eliminate their taxes.

The OECD BEPS initiatives are crystallized through **15 "Action Plans**" with each Action Plan dealing with a specific focus area.

Final Action Plan Reports on many of the Action Plans have already been released with global consensus by Governments – no mean task! The effect of OECD BEPS Action Plans will reverberate across the world as various countries adopt in their local laws the recommendations brought out in these Action Plans.

India is a key stakeholder in the G20/OECD BEPS summit and has subscribed to many Action Plans and is committed to implementing the same.

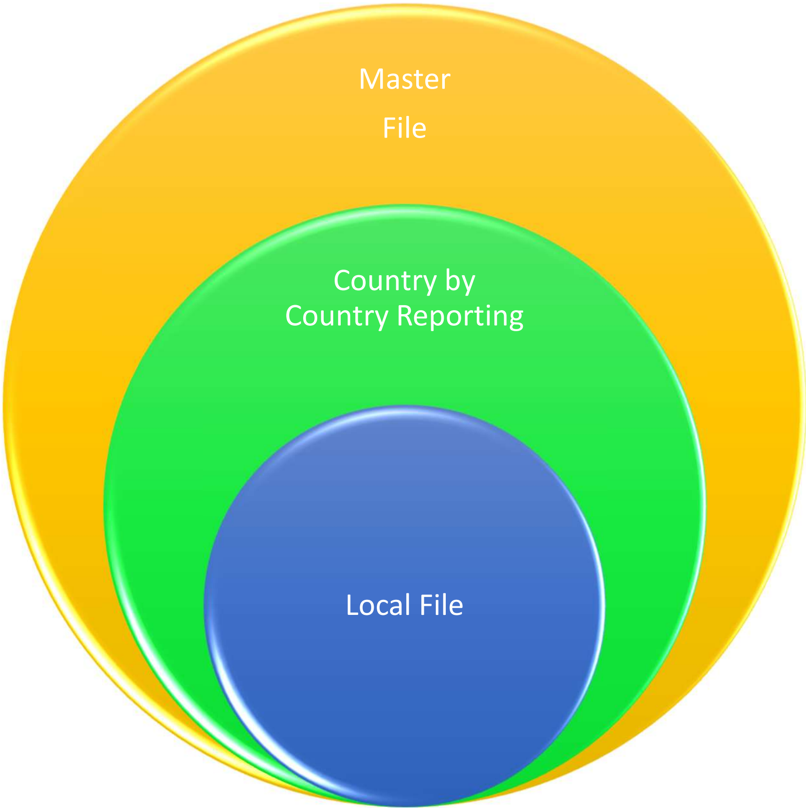
One of the most significant action plans and most relevant to transfer pricing in India, on an immediate basis, is **BEPS Action Plan 13 related to "Transfer Pricing Documentation"** which is the focus of this article

2. **Action Plan 13 : New Documentation Requirements for Transfer Pricing**

Action Plan 13 prescribes revised standards for Transfer Pricing documentation and has completely overhauled the way International Transactions, Associated Enterprises and Nature of activities will be disclosed.

To understand Action Plan 13, we must understand the purpose of the action plan and its objective.

The Objective of the Action Plan is to establish rules regarding TP Documentation that enhance the transparency and availability of information to tax authorities; and are also not burdensome or cumbersome to MNEs (it may not necessarily have achieved the 2nd objective).



BEPS recommends a 3-Tiered documentation approach. The MNEs will have to provide their respective Governments the following information:

a) **A Master File:**
The Master File would be a 'blue print' of the organisation, providing high level information regarding worldwide operations and transfer pricing policies. This would be a common file available to all relevant tax authorities. Some of the information it would contain is Legal Ownership Chart, descriptions of business and drivers of the business, location of intangibles including principal R&D facilities and agreements.

b) **A Local File**
The Local file specific to the relevant country of filing where the related party transactions are identified and necessary documentation is maintained regarding the same. In India, this is already in existence in the form of 3CEB and the Transfer Pricing Study prepared.

c) **Country by Country Report (CbCR)**
The CbCR will be the most revolutionary change brought in through BEPS 13. MNEs will provide annually, to the respective tax authorities, details about the turnover, margins, capital employed, no. of employees, reserves and retained earnings, fixed assets and income tax paid

in each jurisdiction the MNE operates in. The MNE will also have to provide information on the business activities and the nature of business done in each jurisdiction.

By providing the **Master File, Local File and CbCR**, a Tax Administration would now be equipped with enough information to assess the position of the local entity in the global MNE business. It allows a bigger picture to assess the risks and functions; and gives enough information to target enquiries during Transfer Pricing Audits.

In layman's terms, what this gives the tax administration is not only a narrow view of the MNE's local operations but also a birds-eye view of the MNE globally as a whole. A holistic picture is thus now available for the tax administration to feast upon!

It is expected that by the MNE articulating the information in the TP documentation, in the 3 tier approach, the instances of artificially shifting profits to low tax jurisdictions will be reduced, as tax authorities will have more information to make upward adjustments in instances of profit shifting. This is also thought to make businesses take decisions of establishing entities in jurisdictions purely on commercial/business terms, rather than for tax purposes additionally. Further, the 3 tier documentation will integrate with the bolstered Mutual Administrative Assistance provisions and the Tax information Exchange Agreement.

In typical OECD fashion, the objectives of Action Plan 13 were detailed as one to increase the transparency to revenue authorities and steps to not make documentation burdensome on the MNE. But what the Action Plan actually does is make it more burdensome for the assessee by prescribing additional requirements for the MNE to comply with and thereby **increasing the level of documentation to be prepared, maintained and submitted to Revenue Authorities.**

The Countries that are signatories or subscribers to the BEPS Action Plan 13 have undertaken to review and implement the same, after assessing the relevance to their local jurisdiction, by 2020.

<u>3. India jumps the gun on CbCR</u>:

The erstwhile Indian Transfer Pricing Regulations required every person who has entered into an international transaction to maintain prescribed information /documents for substantiating the arm's length price (ALP) of its transactions with the related parties. **These contemporaneous documentation requirements which were prescribed under Section 92D of the Income Tax Act and Rule 10D of the Income Tax Rules were onerous enough for the Indian taxpayer**

But the Indian Government, as is usually the case, jumped the gun and implemented the CbCR requirements in its local laws through Finance Act 2016. **The Indian Income Tax Act CbCR requirements are largely in line with BEPS Action Plan 13 with a few additional measures and significant penalties in case of violation of the CbCR provisions.**

The saving grace, if one could call it that, is that the Indian CbCR requirements applies only to large taxpayers ie taxpayers having an annual consolidated group turnover of over 750 Million Euros (~Rs.5,000 crores) in the immediately preceding financial year will be required to file CbCR Report.

The CbCR Report will include the following information for each entity in the group:

- Revenue, profit/loss before tax, tax paid, tax accrued, stated capital, accumulated earnings
- Number of employees
- Tangible assets, not being cash or equivalents

- Details of each group entity, including residential status and main business activity
- Any other prescribed information

Though the Indian provisions broadly covered the requirements to maintain a local file, the requirements to maintain the information demanded by the Master File and Country by Country reporting are not comprehensive. In fact, the format for CbCR is yet to be prescribed but it is expected to broadly align with BEPS Action 13.

The CbCR Report covers not just legal entities or subsidiaries of the MNE group but also branches/ permanent establishments located in other countries through which it carries on business.

The timeline for filing the same is established at within 12 months from the end of the financial year (i.e. if the financial year ends at 31st March, 2017 – the 3 Tier Documentation should be filed before 31st March, 2018).

While the responsibility to file the CbCR is that of the Parent Entity (the ultimate holding company), **the Indian entity will have to take up the responsibility of filing the CbCR in the following circumstances:**

a) Where Ultimate Parent Entity is established in a jurisdiction where there is no CbCR rules
b) The jurisdiction of the Ultimate Parent Entity does not have a robust enough information sharing mechanism with India

And in both cases above, the CbCR will have to be filed by the due date of filing of the return of income.

Penalties: What is a good Indian taxation provision with a corresponding penalty provision? It is no surprise thus that the Govt. introduced **penalties for non-compliance** with the CbCR provisions:

a) Penalty for failure to furnish file Master File: Rs.500,000
b) Penalty for providing incorrect information: Rs.500,000
c) TP Adjustment Penalties: 50% of tax on TP adjustment where no documentation maintained and 200% of tax on TP adjustment where transaction not declared or facts undisclosed

Establishing reasonable cause for the above could mitigate levy of penalty.

<u>4. What does CbCR mean to the Indian taxpayer?</u>

CbCR combined with automatic information exchange standards, will greatly improve the availability of information for tax authorities across the world.

However, in our opinion, **this is not good news for the Indian assesse**. Too much information is not always a good thing especially given the information is apt to be misinterpreted, misunderstood and misconstrued by Revenue authorities who maybe resource-constrained and thereby ill-equipped to analyse all the data available.

The Indian Revenue Authorities will now have a treasure trove of information at their disposal and so the interpretation (or mis-interpretation, as the case maybe) of the global data will definitely lead to new additions and maybe *new kinds of* additions in transfer pricing in the years to come. **In short, we expect high-pitched assessments based on CbCR reports filed by large taxpayers.**

It is humbly submitted that this CbCR just gives more ammunition for the Revenue to levy transfer pricing adjustments which may not be justified at all given the local facts and circumstances of the assessee's case. It could lead to the import of foreign practices and methods which are ill-suited for the market here.

The recent Bright-line test application to “brand” value by the Revenue is a simple example of how foreign analysis and jurisprudence can be erroneously brought into play causing widespread adjustment and litigation finally settled after many years in the Courts.

Consequently, CbCR is very likely to increase litigation over TP which will only continue to clog the judiciary and further strain the system.

To summarize; it is our considered opinion that **in theory** CbCR should shine a light on the dealings of the taxpayer across the world and should lead to lesser tax evasion manoeuvres but **in practice** it may very well lead to high-pitched TP adjustments and more litigation in India.

5. CbCR and Global Formulatory Apportionment (GFA)

Under the current global system, MNEs fix the transfer price based on Arm’s Length Pricing(ALP). ALP aims to look at the open market (arm’s-length) price for given transactions; it is a price arrived at after evaluating the Functions, Assets and Risks (FAR) of the transacting entities. ALP seems intuitive but is hard to implement as finding open market equivalents is hard in practice. However, ALP is by de-facto the cornerstone and undisputed king of global TP.

Global Formulatory Apportionment (GFA) has been long touted, mainly in academic circles, as the alternative to ALP but has failed to take off due to lack of reliable information available to implement it correctly.

Under GFA, a multinational corporation would allocate its profits across countries based on its sales, payroll, and capital base in each jurisdiction. It would pay domestic corporate taxes on the share of its worldwide income that is allocated to each jurisdiction. An alternative would base a corporation’s taxes only on the fraction of its worldwide sales destined for domestic consumers, a so-called “destination-based” corporate profits tax.

The biggest challenge with GFA however is that it would require an agreement among the major economies to scrap the current separate-entity system and to agree on how to allocate corporate income among jurisdictions. It would also require agreement on common accounting methods for measuring corporate profits.

At the heart of GFA is a formulaic apportionment of taxes rather than a transaction-based, bottom-up approach of ALP

What does CbCR change in this ALP vs GFA turf war? CbCR would make information available necessary to arrive at GFA. That is a big step indeed. However it can’t help address the fundamental downside with GFA which is that it fails to consider the challenge of unilateral changes made by any jurisdiction. A unilateral move by India to formulary apportionment would result in double taxation of some income of multinationals and exemption of other income. That’s because different countries would use radically different methods of allocating income among jurisdictions.

Therefore, while CbCR may equip revenue authorities with enough information to implement GFA; it suffers from the *pack of cards syndrome*. The rigidity of the pricing method, the cumbersome process of drafting anti-abuse rules and the gaps in valuing important aspects of Transfer Pricing(intangibles), will eventually lead to the unilateral changes – driving the entire model to collapse.

So ALP continues to reign and will do so for the foreseeable future but CbCR can be considered as a nod by the OECD towards allowing GFA-like formulaes within the ambit of ALP framework ie for example using CbCR data to arrive at an profit-split ALP method based on a formulaic allocation across jursidictions.

6. Bottom Line – CbCR is great for the Revenue; not so much for the Assessee

While the Master File demands requirements are usually demanded by the Transfer Pricing Officer in the course of TP Scrutiny or Assessment Proceedings, the requirements of the CbCR are completely new. **CbCR is introducing a slew of new compliance requirements to MNEs operating in India.**

While globally, a comprehensive TP study needs to be undertaken only once in 3-5 years; in India, Action Plan 13 adds to the cumbersome requirements of preparing a detailed Transfer Pricing study annually, coupled with maintaining the contemporaneous documentation. Where the ultimate holding company is based in India, the companies will have to consolidate information across jurisdictions for Action Plan 13 purposes.

While CbCR is a responsibility of the management of the company (and in most cases the Parent Company itself), given the challenges of various GAAPs across multiple jurisdictions, it would advisable if both the management and auditors work in tandem to keep the necessary documentation ready.

It is evident that the OECD objectives for Action Plan 13 will only be partially met. The plan will yield little benefit to the Assessee/MNE in India. As discussed above, the Indian assesse can be apprehensive of high-pitched assessments based on this global data due to possible misinterpretation and misapplication of the same.

A transcendental shift in Transfer Pricing will only happen in India when the norms required for scrutiny of transfer pricing are reduced and the ease of litigation is improved.

With the increased annual compliance, non-specification of benchmarking norms in TP regulations and constant litigation with poor safe-harbour rules in place, we are of the opinion that **Action Plan 13's CbCR implementation in India doesn't promise a rosy future for the Indian assessee. Hopefully, going forward, the Govt. and CBDT will consider the practical challenges faced by Assessee's and ease the reporting requirements.**