Effect of BEPS project on common tax structures used by MNEs in digital economy

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This article explains the potential effect of the ongoing BEPS project on the tax planning structures adopted by MNEs in their digital businesses.

A. Characteristics of the tax planning structures:

The legal structures adopted by MNEs for tax planning purposes in the traditional businesses are often applied even in the digital businesses. These structures can essentially be broken down into four elements as elaborated in the February 2013 OECD Report on *'Addressing Base Erosion and Profit Shifting'*:

1. Eliminating or reducing tax in the source country:

- The taxable presence in the source country could be avoided by artificially fragmenting operations among multiple group entities in order to qualify for the exemptions to PE status for preparatory and auxiliary activities, or by limiting the time presence of conducting business through that PE to avoid being caught within the threshold period.
- Another way of reducing income accrual in the source country would be to contractually strip down the functions, assets and risks of the group entity in the source country.
- Deductions for payments made to group companies in the form of interest, royalties, service fees, etc. could be increased to reduce the income of the group entity in the source country.

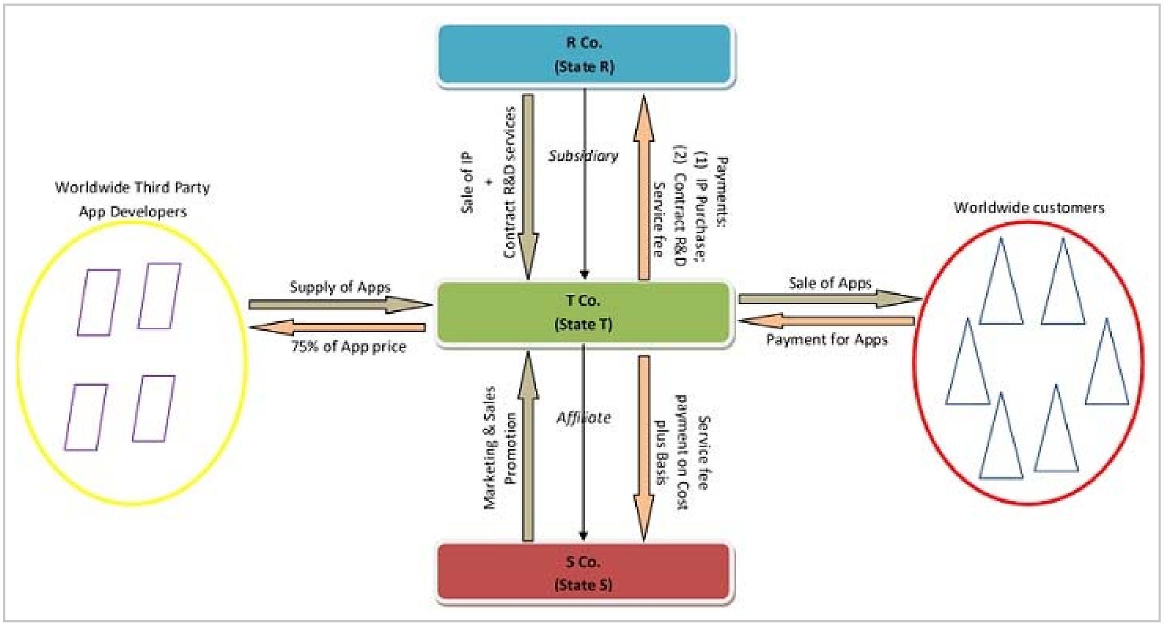
2. Avoiding withholding tax at source: This could be achieved by adopting treaty shopping involving use of shell companies with favourable treaty networks.

3. Eliminating or reducing tax in the intermediate country: Establishing an intermediate entity in a country with preferential tax regime combined with attribution of maximum functions, assets and risks within the group to that entity would enable reduction in tax substantially in the intermediate country.

4. Eliminating or reducing tax in the country of residence of the ultimate parent: This could be achieved by contractually transferring functions, assets and risks from the parent company to the intermediate company. In the digital businesses, this would be done after it would have developed significant intangibles by itself. The result could be enhanced by the absence of CFC regime in the country of residence of the ultimate parent.

B. Example adopted from BEPS Action Plan 1[1]:

The above four elements can be explained in detail with the help of an example of MNE owning and operating an Internet App Store:



The above group structure can be explained summarily as follows:

(a) Introduction: R Co. Group is the creator of an operating system for mobile phones and other portable devices. The operating system, Internet app store as well as own applications sold through the app store were developed by employees of R Co previously. Revenue from sale of third party apps is agreed to be shared between R Co. and third party developers in 25:75 ratio. The ownership of operating system, Internet app store and applications alongwith development tools were sold by R Co. to T Co.

(b) Current FAR analysis of the group entities shows the following:

Entity	FAR
R Co.	Contract R&D service to T Co. (R&D service includes upgradation and development of new technology to run the app store.)
T Co.	· Worldwide Owner of IP purchased from R Co.;· All risks related to R&D performed by R Co. is contractually allocated to T Co.;· The app stores are hosted on servers located in State T & owned by T Co.;· T Co. handles all transaction processing with customers and third party developers around the world (including State R);· T Co. concludes all contracts electronically for purchase of apps, on the basis of standardised terms set by it.
S Co.	S Co. employees promote R Co. operating system and the Internet app store to third party developers, sellers and

	prospective purchasers of mobile devices.

C. **Achievement of tax planning in the example and potential impact of BEPS project on the same:**

The four elements of tax planning structures achieved by R Co. Group in its legal structure can be explained as follows:

Sr. No.	**Element of tax planning structure involved**	**How is it achieved in the legal structure?**	**Potential impact of BEPS project**
1	Eliminating or reducing tax in the source country	S Co. is contractually allocated the functions of only marketing and promotion to be compensated on Cost Plus Basis, without the authority to conclude contracts on behalf of T Co.	*Action 7* – Artificial avoidance of PE by placing reliance on fact of conclusion of contracts in State T could be reviewed in view of reality of electronic conclusion of standardized contracts through automated processes in State T.
2	Avoiding withholding tax at source	Favourable tax treaty between T Co. & S Co. for payment of marketing service fees and between T Co. & R Co. for payment of R&D services.	*Action 6* – Inclusion of 'Principal Purpose Test' in treaties as a measure of GAAR could limit avoidance of withholding tax currently enjoyed by T Co.
3	Eliminating or reducing tax in the intermediate country	T Co. has been incorporated in country with favourable tax regime.	*Action 5* – Introduction of 'Substantial Activity Test' may lead to classification of favourable tax regime of State T as harmful which could eventually lead to its abolition by State T.
		· Undervaluing	*Action 8* – By considering the post-transfer profitability of

4	Eliminating or reducing tax in the country of residence of the ultimate parent	sale of intangibles to T Co.;· R&D development tax credits to offset capital gains on sale of intangibles to T Co.;· Working as Contract R&D service provider whereas in no supervision by T Co. over its work (Contractually less FAR);· No CFC rules in State R.	intangibles, the previous sale value of intangibles could be challenged.*Action 9 & 10* – Contractual risk of R&D allocated to T Co. solely could be challenged by applying concepts of control of risk, financial capacity to bear risk & management of risk.*Action 3* – CFC rules could strengthened by State R to restore taxation in its state.

After reading the above article, I hope you would be in a better position to appreciate the importance of the ongoing BEPS project especially w.r.t. the tax planning structures that are being targeted by the various countries concerned.

Suggestions are always welcome. For any clarification, you can contact me at the co-ordinates given below:

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[1] OECD (2014), *Addressing the Tax Challenges of the Digital Economy,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing at pp 194 – 198.