

Answer-to-Question-_7_

Base Erosion and Profit Shifting refers to tax planning strategies that MNEs use to exploit gaps and mismatches in tax rules, shifting profits to low tax jurisdictions where they have little or no economic activity. This results in erosion of tax base in high tax jurisdictions reducing revenues for governments.

The OECD's BEPS Action Plan consists of 15 measures that aim to eliminate double taxation, align profits with real economic activity, and enhance exchange of tax information among governments. The principle actions that aim at making profits taxable in jurisdiction where they are generated are:

1) BEPS Actions 8-10 on aligning Transfer Pricing Outcomes with Value Creation - This Action focus in ensuring that profits allocated with MNE Groups reflect actual economic activity. The measures include

- Allocating profits based on functions performed, assets used and risks assumed and Preventing entities with little or no economic substance from earning excessive profits
- Ensuring returns from intangibles are attributed to entities that perform DEMPE (Develop, Enhance, Maintain, Protect and Exploit) functions on those intangibles

2) BEPS Action 7 - revised the Permanent Establishment (PE) definition to prevent MNE's from artificially avoiding taxable presence. MNE's operating through local agents / commissionaire arrangements, digital presence may now trigger a PE if they have dependent agents concluding contracts on their behalf in a jurisdiction or conduct significant economic activity in a country even without a physical presence.

3) BEPS Action 5 - Countering Harmful Tax Practices requires preferential tax regimes to be linked to substantial economic activity. The tax arrangement may be disregarded by tax authorities if the principal purpose of the arrangement is to avoid tax and gain an undue tax benefit and the tax benefit may be denied

4) BEPS Action 2 - Neutralising Hybrid Mismatch Arrangements - addresses situations where difference in tax treatment between countries create double deductions or Deduction without corresponding income

inclusion. In such cases, tax authorities either deny the deduction or require the receipt to be taxed

5) BEPS Action 6 - Preventing Treaty Abuse and PPT - the Principal Purpose Test (PPT) denies treaty benefits where a principal purpose of the arrangement is to obtaining a treaty advantage. The treaty benefit may be denied by tax authorities if the principal purpose of the arrangement is to avoid tax and gain an undue tax benefit.

6) BEPS Action 4 addresses the risk of MNE's using excessive interest deductions to reduce taxable profits artificially. By allocating high levels of debts to subsidiaries in high tax countries, MNE's can shift taxable income to low tax jurisdictions, thereby reducing the overall tax burden. To address the challenges posed by base erosion through excessive interest deductions, the BEPS Action 4 provides a comprehensive framework of recommendations aimed at limiting such practices. The core of these recommendation evolves around establishing rules that align interest deduction with genuine economic activity and value creation.

In addition to the above BEPS Actions, OECD has also introduced 2 comprehensive reforms BEPS Pillar 1 and BEPS Pillar 2 to address challenges of globalisation and digital economy.

Pillar 1 is designed to ensure that MNE's with a global turnover exceeding 20Bn EURs pay taxes in jurisdictions where they generate revenues, even if they lack a physical presence, by reallocating a portion of profits to market jurisdictions. This reform is particularly significant for digital service providers who often derive substantial revenue from customers in multiple jurisdictions, without having a taxable presence in all those jurisdictions. By reallocating some of their profits to market jurisdictions, Pillar 1 aims to align profit taxability to revenue jurisdictions.

Pillar 2 aims to establish a Global Minimum Taxation that ensures MNE Group pays a fair share of tax in jurisdictions they are operating in i.e. 15% minimum Tax rate. This initiative aims to avoid aggressive tax planning, such as profit shifting to low tax jurisdictions and prevent

harmful tax competition.

Answer-to-Question- _8__

Answer to 8(1) and 8(2)

BEPS Action 4 addresses the risk of MNE's using excessive interest deductions to reduce taxable profits artificially. By allocating high levels of debts to subsidiaries in high tax countries, MNE's can shift taxable income to low tax jurisdictions, thereby reducing the overall tax burden.

OECD identified excessive interest deductions as a significant factor in base erosion. A common technique is earnings stripping where an entity in a high tax jurisdiction incurs excessive debt from a related party in low tax jurisdiction. The interest payments on these high debts are deductible expense in high tax jurisdiction thereby shifting profits from low tax to high tax jurisdiction.

To address the challenges posed by base erosion through excessive interest deductions, the BEPS Action 4 provides a comprehensive framework of recommendations aimed at limiting such practices. The core of these recommendations revolves around establishing rules that align interest deduction with genuine economic activity and value creation.

It is implemented introduction of

- Fixed Ratio Rule - This rule restricts entities net interest deduction to a fixed percentage of its EBITDA, benchmark ratio with in range of 10% to 30% of EBITDA.

- Group Ratio Rule - The Group Ratio rule allows flexibility to entities that are part of a consolidated group to deduct higher amount of net interest expenses, proportionate to Group's overall external gearing. An entity can deduct net interest expense upto level of the Group's net third party Expense to EBITDA ratio.

Answer to 8(3)

The Interest limitation rule was introduced primarily because ALP based thin capitalisation was perceived as inadequate. The interest limitation rule produces a larger restriction in practice. However the transfer pricing rules take precedence over the interest restriction. If TP produces a similar or greater disallowance, the BEPS Action 4 has no additional application. Transfer Pricing adjusts the Rate of Interest while BEPS Action 4 adjusts the total quantum, they address different aspects. Also Transfer price applies to all Group transactions including guarantee fee, service charges, financial instruments pricing while BEPS Action 4 only restricts only interest. For individual entities, transfer price remains necessary to compute correct ALP interest expense.

Hence, transfer price has not become redundant by introduction of interest limitation. Interest limitation only further supports the Transfer Price outcomes.

Answer to 8(4)

While the OECD's recommendations are not legally binding, they need to be adopted by member and non member countries in their Domestic tax Laws to make them applicable to their tax payers.e.g. UK implemented interest restriction rules in 2017, capping interest deductions at 30% of EBITDA while allowing business to apply worldwide group ratio rule.

Answer to 8(5)

BEPS Action 4 is intended to achieve both objectives but primary purpose is to influence corporate behaviour with increased tax revenue being a consequential outcome.

Action 4 seeks to discourage MNE Groups from

- Using excessive debt financing in high tax jurisdictions
- Shifting profits through inflated interest deductions
- Structuring intra-group loans primarily for tax advantages rather than commercial reasons
- Exploiting difference in tax treatment of financing arrangements across jurisdictions

Action 4 encourages businesses to aligning financing structures with genuine commercial needs rather than tax planning opportunities.

However, as countries implement Action 4, excessive interest deductions are denied or deferred and thereby increasing the taxable profits and governments collect additional income taxes too.

Answer-to-Question-__4__

Answer to 4(1)

In the realm of international banking, capital attribution refers to the process of allocating financial institutions capital to its various branches AND Permanent Establishments (PE) across different jurisdictions. This allocation is crucial for determining the taxable profits of each branch ensuring that profits are taxed where economic activity and value creation occurs. Proper capital attribution aligns with the Arm's length principle, treating each branch as if it operates independently, dealing with rest of the enterprise on an arm's length basis.

The attribution of capital to banking branches is governed by a combination of international guidelines including OECD Guidelines on Profit Attribution, the Basel Accords and National Regulatory Policies.

OECD Guidelines on Profit Attribution provides the primary framework for allocating profits and capital to banking branches. The guidelines developed under Article 7 adopt the Authorised OECD Approach (AOA) which ensures that capital and profits are attributed to PE in a manner consistent with ALP principle.

The AOA applies a two step approach to capital attribution

- Functional and Risk Analysis - Identifies the functions performed, assets used and risks assumed by the PE, ensuring profits and capital align with economic substance rather than mere accounting classification;

- Application of the Arm's Length Principle to ensure that internal dealings between the Branch and HO are priced as if they were conducted between independent parties.

A crucial aspect of OECD guideline is the attribution of capital to support the branch's risk taking activities. Banks operate in a highly leveraged environment where capital plays a central role in ensuring financial stability and risk mitigation. The OECD's framework requires that each branch be allocated sufficient free capital to support its functions, particularly in areas such as:

- Loan origination and credit risk management
- Trading and Market-Making activities
- Treasury and liquidity management

the OECD's approach ensures that banks cannot artificially shift profits by booking them in low tax jurisdictions where minimal capital is actually deployed. This is particularly relevant for global trading and derivative transactions, where multiple branches may contribute to a transaction's profitability.

Answer to 4(2)

The Basel Capital Framework directly influences profit attribution as a banking PE must be allocated sufficient capital to support risk weighted assets. Key Basel III Capital Requirements affecting Banking PEs:

- Common Equity Tier 1 (CET1) Ratio - Ensures that banks hold high quality capital to absorb losses
- Risk Weighted Assets (RWA) Allocation - Requires branches to maintain capital based on their specific risk profile

Total Group RWA = 100 MN

Capital Adequacy = 15%

Capital Adequacy = (Tier 1 + Tier 2 Capital) / RWA

15% = (Tier 1 Capital + Tier 2 Capital) / 100Mn

Tier 1 Capital + Tier 2 Capital = 15mn

Branch Ratios

Branch RWA = $100 \times 25\% = 25$

Branch Profits = 10 MN

Branch Tier 1 Capital = 10 Mn

Capital Adequacy Ratio of Branch = $10/25 = 40\%$

Answer to 4(3)

UK Profits be adjusted for tax purposes due to interest expense deductions regarding interest deductibility, intra group funding. If the Bank receives Over Capitalization (excessive capital allocation), it may have lower interest bearing liabilities leading to reduced tax deductible expenses. Some jurisdictions may require adjustment to ALP principle

If the branch is allocated little capital, it may rely in intra group loans, increasing interest expense triggering thin capitalization or limiting interest deductions to prevent tax base erosion.

Answer-to-Question-2__

Answer to Question 2(1)

For banks and financial institutions, the accounting of crypto is often aligned with regulatory and accounting classification

- They are considered as trading book when they are held for market making, dealing or short term resale - Trading Asset
- They are considered as part of banking book / investment portfolio when they are held for strategic investment or treasury purpose - Non Trading Asset

In the current case, Finance Guard Corp has no plans to sell or trade in these holdings. Clearly, the intention of Finance Guard Corp purchasing crypto is to acquire them as a long term investment with expectation of appreciation in value over time rather than short term trading profits and the holder is not carrying on a crypto trading business.

Under FRS 102, cryptocurrency such as Ethereum and Bitcoin typically meets the definition of Intangible Asset because it is identifiable and separable; and has no physical substance; and is a non monetary asset.

Measurement

Initially Such assets shall be recorded in books of Finance Guard at Initial Cost i.e. \$1,000,000 for Bitcoin and \$50,000 for Ethereum.

Subsequently if Cost Model is adopted, no fair value gains / losses will be recognised subsequently. However, if Fair Value Model is adopted where Crypto are measured at Fair Value on each reporting date and FV Gains Losses are recognised in Profit & Loss.

Answer to Question 2(2)

Cryptocurrency acquired as income are typically subject to income tax. However, disposing of crypto assets whether by selling, exchanging or using them to purchase goods or services is calculated basis difference between the disposal proceeds and the acquisition cost.

Since the company is in USA, the US tax provisions shall prevail. The Internal Revenue Service (IRS) classifies crypto assets as property, meaning general tax principles applicable to property transaction apply to crypto. Therefore, gains on crypto are usually subject to capital gains tax. The crypto will become taxable in hands of company when they are sold / disposed off or transferred or used to purchase goods or services.

Simply buying and holding crypto currency is not taxable.

Answer to Question 2(3)

Whether cryptocurrenct holdings constitute trading or non trading depends on the facts, circumstances and purpose for which they are held, rather than on the nature of crypto itself.

Finance Guard Corp has no plans to sell or trade in these holdings. It can be construed that the intention of purshcaing crpto is to acquire them as a long term investment with expectaion of appreciation in value over time rather than short term trading profits and the holder is not carrying on a crypto trading business. In such a case the investments made by Finance Guard in Cryptocurrency could be considered as a Non Trading asset.

Answer to Question 2(4)

Cryptocurrency holdings are accounted for by applying principles of FRS 102. The disclosures include

Accounting Policy Diclosure - Entity holding cryptocurrency should disclose

- Accounting Policy adopted
- How crypto currencies have been classified
- The measurement basis used (Cost Model, revaluation model, fair value through profit or loss, depending on classification)

Intangible Asset Disclosure - If Cryptocurrency are classified as intangible, disclose carrying amount, amortsatation, impairment losses

Fair Value disclosures - Methodology used ti determine FV, valuation assumptions, Quoted market prices, volatility in pricing

Financil Risk Disclosures including Market Price Risk, Liquidity Risk, Concentartion Risk, Cybersecurity risk

Answer-to-Question-_1__

Prairies Inc - USA - Agricultural Fertilisers

Prairies UK Ltd - Profits GBP 20Mn (CYE2025)

Estimated Profits - GBP 30Mn (CYE 2026)

Prairies UK Ltd - Purchase Indian Business India Growth for USD 1.15 Billion

Delaware LC ==> Loan USD 1.15bn ==> Delaware LC @5% Fixed Interest ==5 Years

Prairies Inc ==> Loan USD 1.15bn ==> Delaware LC @4.5% Fixed Interest ==5 Years

Prairies UK Ltd

Answer to Question 1(1)

Interest paid by a UK Company on a loan relationship is deductible under CTA 2009 Part 5, provided the borrowing has a commercial purpose.

UK Corporation

PBT = GBP 30 Mn

Less/ - Interest on Loan from Delaware Inc = $\$1.15\text{Bn} \times 5\% / 1.15 = \text{GBP } 50 \text{ Mn}$

Add /- Preference Dividend from India Growth = $\$1.15\text{Bn} \times 5\% / 1.15 = \text{GBP } 50 \text{ Mn}$

Taxable Income = GBP 30 Mn Profit

Tax Liability = GBP 30 Mn * Corporate Tax Rate

Answer to Question 1(2)

UK Tax Authority may dispute this calculation since the lender is a connected party, the interest rate must be at Arm's length. The Arm's length principle, related party transaction must be compared to an unrelated party transaction. In the current case, basis market CUP, a commercial lender would have charged 7% rate instead of favourable 5% rate charged by related party to Prairies UK, making interest rate not

at arm's length.

Additionally, any unrelated commercial lender would not have lent more than USD 575 million to Prairies UK. However, the related party extended a loan of USD 1.15 Bn to Prairies UK not complying to Arm's Length Principles.

In this case, the Tax Authority can make following adjustments

- 1) disallowing the total interest charged on Loan principal of USD 575 Mn deviating from the Arm's Length Principle.
- 2) Disallowing the excessive interest of 2% on balance USD 575 Mn aligning to the market non controlled rate of 7%

Answer to Question 1(3)

Under the check the box election, US Parent may treat the UK Entity as a disregarded entity where Entity is ignored for US Tax purposes

Answer to Question 1(4)

The US\$ liability of Prairies UK can be hedged

- Natural Hedge - The company matches the USD liabilities with USD cash inflows
- Forward Foreign Exchange Contracts - The Company enters into a forward contract to buy USD and sell GBP at a fixed future exchange rate
- Cross Currency Swap - The Company borrows USD but enters into a cross currency swap with a bank that swaps USD principal and interest payments for GBP obligations