Need and Impact of Base Erosion and Profit Shifting (BEPS) Project: An Indian Perspective

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Abstract

With the introduction of globalization although borders seem to be vanishing, a major challenge faced by the economy all over the world is the challenge of difference in policy around the world. The MNCs take benefits of these mismatches in policies to save themselves from paying taxes. There are many tax havens on globe which do levy no or low taxes on Corporates, Multinational Enterprises (MNEs) by eroding their bases to tax havens and shifting the profits there to avoid paying taxes. These type of arrangements are called BEPS (Base erosion and profit Shifting). This preferential tax competition results in low tax revenues to the developing countries that are mostly desperate for foreign investments. It also results in profits not being taxed anywhere on the globe making the countries, the resources of which are being exploited by these MNCs, more poor and vulnerable due to their increased dependence on foreign aids. Tax Justice Network[1] estimated that losses arising as a result of the global system of taxation through tax havens up to 255 billion dollars per year. Oxfam[2] Africa too has multiple times showed concern over this cycle of tax revenue loss and foreign aid in which developing African countries are trapped in. To address these challenges OECD (Organization for Economic Cooperation and Development) a group of G-20 nations along with other developed and developing countries came up with Base Erosion and Profit Sharing Programme (BEPS) which formulated a 15 point action plan with the main goal of making profit taxable in the territories the resources of which are exploited to make such profit. The action plans aims at bringing transparency in the international taxation regime. These action plans are on the verge of being implemented worldwide and India is no exception. Such implementation will have multiple impacts on various industries, economy and society at large. The compliance burden is expected to increase but the registration of remote sellers is going to be simpler and mandatory as well. The effective tax rate of the MNCs, especially the outbound ones is forecasted to rise as they will no longer be able to avoid taxes using shell companies in tax havens. Some impact will be there on the indirect taxes like customs also with the change disclosure as well as valuation policies of mutual agreements and transfer pricing etc. However it is difficult to predict if this increase in effective tax rate will result in decrease in tax rates for individual assesse or will it result in better infrastructure.

Keyword: Base Erosion and Profit Shifting; Tax Heaven; OECD's BEPS Action Plan; Tax Evasion; International Taxation.

Introduction

Globalization is generally seen as an advantageous advancement in the timeline of global economy. It has virtually resulted in removal of the borders. However, in reality these borders do exist. This fact when clubbed with the another fact that the trade and tax policies of all the economies in world differ for each other poses a challenge collectively in front of the globe. The Multinational Companies (MNCs) take benefits of these mismatches in policies to save themselves from paying taxes. The tax avoidance usually is done through using a nation with low or no tax regime for setting up a base, and then funnelling the profits through that base. This aggressive tax planning for tax avoidance is known as Base Erosion and Profit Shifting (BEPS) activity.

Organisation for Economic Co-operation and Development (OECD) defines Base Erosion and Profit Shifting (BEPS) as "tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations". Such countries are popularly known as tax havens. These activities are so widespread around the globe that they impact the entire economy of many developing nations. Even huge business conglomerations like Google, Apple, Microsoft, SABMiller etc. have been caught in such tax avoidance activities by the national governments of these countries, judicial systems, Pressure Groups like Tax Justice Network, or NGOs like ActionAid. Most commonly used structures by such Multinational Enterprises (MNEs) include the Double Irish and Dutch Sandwich Scheme, Debt Loading, Capital Thinning, Treaty Abuse (like The Mauritius Route), and taking undue advantage of regional Incentives (Like Patent Box of UK).

Using this aggressive tax planning Apple avoided majority of its taxes from profit outside US for 30 years and didn't even file the tax return of AOI for last 5 years before they went to court. Similarly Microsoft paid only $17mn as taxes with Effective tax rates going as low as 17.53%, in spite of corporate tax rate of US being 35%.

To cease these tax avoidance policies by MNEs, OECD, a unique forum where the governments of 34 member countries work with each other, as well as with more than 70 non-member economies to promote economic growth, prosperity, and sustainable development, started a BEPS Project which Stands for Base Erosion and Profit Sharing (instead of shifting). The BEPS project came with a 15 point action plan to tackle the situation.

Tax Havens and the Need for BEPS Project:

A cursory glance at the BEPS techniques will easily reveal that the primary reason for such aggressive tax planning is the very presence of preferential tax regimes. This fact raises important questions; Are tax havens or preferential tax regimes of any kind a boon or a bane? What impact do they have on the global economy? Why do such havens exist at all?

As per Investopedia "A tax haven is a country that offers foreign individuals and businesses a minimal tax liability in a politically and economically stable environment, with little or no financial information shared with foreign tax authorities." Many tax havens do not even mandatorily require individuals or businesses or any other assesses to reside in, or operate out of their countries. Many corporations, including Alphabet (parent company of Google), Microsoft, and Apple are keeping cash in offshore tax havens to minimize corporate taxes, hiding behind the veil of globalisation of business operations.

About 15% of the countries on the globe are tax havens; in absolute terms roughly there are 40 big tax havens. A close look at the existing tax havens reveals that those countries where the quality of governance is very stable and good are more likely to become tax havens. This happens because it gives a favourable location to put money at, to the foreign investors. It also helps the governments to provide the investors with data confidentiality. It is a common trend that countries with less population are easy to govern and hence have effective governance; research says that for a country with population less than one million, the chances of being a tax haven increase by 26% to 61%.

This data pretty much answers the question why tax havens exist at all. There can be many reasons for a nation to become a tax haven. Some nations may find that they earn sufficient amounts from other sources (like indirect taxes) and do not need to charge as much as some industrialized countries in order for them to earn sufficiently for their annual budgets. Some may offer a lower tax rate to larger corporations, in exchange for the companies investing in their nation through setting up subsidiaries etc. and employing some of the local population. Other domiciles find that this is a way to encourage conglomerates from industrialized nations to transfer needed skills and upgraded technology to the local population. If we ignore Switzerland as an exception, it can be observed that most of the tax havens are tiny and very vulnerable states. Pressure from large and powerful countries could have forced them to become more transparent , given that most MNCs are based in countries like US and it results in tax revenue loss to such large and powerful countries as well. But clearly this is not the case. It can be observed that there is an actual demand of tax havens not only because they save taxes but also for giving niche economic players the privacy that they need. It can also be concluded that there are many powerful and influential people for whom keeping their financial information private is of utmost importance.

Tax Havens or other countries with very low tax rates lead to activities like mobility of funds and tax competition among the countries. Both the processes if practiced in a healthy manner are beneficial for the society at large but there are two sides of the story. Some Economists believe that tax competition is a favourable practice, on the contrary many other economists thinks that tax havens actually do not serve any economic purpose and is solely responsible for tax revenue losses by the governments. We may praise these nations for providing a space to the niche class of people with privacy of information and low tax burden which ultimately results in a tax competition among the economies and hence impacts the society in a positive way, but the fact that large corporations use these areas for exploiting resources of other developing countries without compensating them with taxes cannot be ignored. MNEs shift their operations or create a shell company in the tax favourable countries, hence most of the time there's no new activity or actual value addition that takes place. It is generally noticed that level of activity in the host country is not necessarily proportionate to the amount of investment or profit, increasing the wealth gap between rich and poor countries.

The UN estimated that countries across the developing world lose roughly $100 billion in potential tax revenue annually to corporations that seek tax havens in an effort to maximize profits. One IMF estimate cited by the Independent Commission for the Reform of International Corporate Taxation (ICRICT) put the total even higher, at nearly $213 billion in the long run. Since tax havens provide Concealment Services to the investors and assure them that financial information relating to their transactions will not be shared with their government or any other institution or individual, it motivates many people to hide their money offshore, which not only results in tax evasion (not avoidance) but also gives a way to hide illicit money in the tax havens. The most recent example of this is the recent Panama Papers leak in which over 11.5 million documents were released by a Panama based law firm Mossack Fonseca. It was about 2.6 terabyte of data which pointed fingers at many world leaders and celebrities. It resulted in Iceland's Prime Minister stepping down from office and many other leaders around the globe admitting to being involved in avoiding taxes. Britain's Prime Minister, David Cameron, admitted that he had profited from his father's offshore account.

Tax evasion disproportionately affects the poor. OECD once estimated that developing countries lose three times as much to tax evasion as they receive in foreign aid. The Tax Justice Network estimates put it closer to 10 times. There's a vicious cycle at work here. Tax revenue is one of the strongest indicators of an economy's health. In many developing countries, with poor and/or rural populations, collecting tax is expensive for the government just as much as paying it is unaffordable for the majority of citizens, who may work in the 'informal economy' anyway. Therefore, much of the tax revenue is expected to come from commercial transactions and foreign investment. A report by ActionAid, released in 2013, shows how almost half of all investment in developing countries is funnelled through tax havens. The United Nations Economic Commission for Africa estimates in a recent report that African governments lose between $30 billion and $60 billion per year to tax evasion, or other forms of what they call "illicit financial flows." According to information provided to Canadian Broadcasting Corp. by Matt Salomon, chief economist at the Global Financial Integrity the amount of flow, from developing economies into tax havens is around $1 trillion.

In a paper titled "Harmful Tax Competition: A special reference to Mauritius", Danish Halal enlists a number of ways in which tax competition and tax havens affect other economies:-

- Undermining the integrity and fairness of tax structures;
- Distorting financial and, indirectly, real investment flows;
- Discouraging compliance by all taxpayers;
- Re-shaping the desired level and mix of taxes and public spending;
- Causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption, increasing the administrative costs and compliance burdens on tax authorities and taxpayers

India's stand on BEPS:

India just like other developing countries faces the challenge of tax revenue loss due to BEPS activities by the big global corporations. India has recognized the challenge and has started to take actions to tackle the situation on its own level, apart from OECD's directive a few years ago. India has revised its Mauritius Treaty to save the tax loss that it used to incur due to residents using the Mauritius route of tax avoidance. Similar Double Tax Avoidance Agreements are being revised by other countries too. India, on the global platform, has a stance that that the root causes of the problem is the residence based taxation instead of source based taxation. Hence, India strongly advocates the 'Source based taxation'. In reply to one of the questionnaires sent by UN to the developing countries in relation with the Base erosion and Profit Shifting practices and the BEPS project by OECD, dated August 8, 2014, India replied to one the question with the words "to ensure that income sourced in India is taxed under the domestic laws, the domestic "source laws" have been strengthened both for taxation of assets located in India transferred "indirectly" and "taxation of royalty". Through Finance Act, 2012 the General Anti-Avoidance Rules (GAAR) have been introduced in the Income-tax Act, 1961 and the "Rules" have been notified on 23rd September, 2013."

Just like GAAR, India is also working on several other solutions to tackle the issue. The equalization Levy on online payments to non-residents for specific services has also been recently implemented by Finance Minister Arun Jaitley to bring giants like Google and Facebook under the purview of tax through indirect taxation, especially for their revenues from advertisement services.

Impact of BEPS Project on India:

India due to its enormous population and strong demographic dividend is a sweet spot for outbound companies to invest in. This is the reason why Tax authorities in India are mainly targeting these MNCs through implementation of BEPS. The first major impact that these MNCs will experience is the drastic change in their Documentation process due to introduction of stricter laws in line with the Action Plan 13 of the BEPS which talks about Transfer Pricing (TP) Documentation. After several revisions the final Action Plan 13 provides for a very strict three tier TP documentation. First tier is the Master File, second tier is the Local documentation and the third one is Country by country reporting (CbC). Legal contracts may no longer be the sole basis for determining transfer prices. After implementation of action plans (8-10) it will not be possible for companies to make huge TP adjustments to avoid taxation in India, which will in turn result in increase in the tax revenues. Apart from the Tax avoidance through transfer pricing adjustments, one of the biggest tax revenue losses that Indian authorities face is the tax evasion through treaty abuse (mostly through Mauritius Route) and tax havens. With the introduction of BEPS action plans, two crucial tests are introduced namely LOB (Limitation of

Benefit) and PPT (Principle Purpose Test) which will choke the amount of tax avoided by the MNCs all at once.

With the increased effectiveness of rules regarding Permanent Establishment (PE) status which were already pretty strong in India along with measures aimed at regulating the digital economy, like the Equalisation levy, there will be a broadening of the tax base of the nation, and service sector companies who works online from outside the domestic borders will not be able to escape their tax liabilities. Since the BEPS action Plan aims at eliminating both Double-Taxation as well as double Non-Taxation, it is expected that although the compliance burden will increase on the companies, for example the creation of master file by all the companies involved in TP, however in the long run it will reduce the effective tax rate the benefit of which will first be reflected on individual tax rates.

However it is not the case that only corporations will be affected by these Action Plans, and all the benefits will be showered upon the society. It is expected that just like in the other countries there will be a lot of change in the indirect taxation policy, the burden of which will ultimately fall on the consumers, especially for the Business to Business (B2B) transactions. Action Plan 1 of the BEPS talks about the digital economy, and is focused on the aim that the tax should be collected by the country where service is being provided irrespective of the location of the service providers. The Action Plans provides for ease of registrations for the remote sellers and digital service providers. This will not only increase the indirect tax base in form of increase in the number of companies but also in the form of increase in the number of products. Many items are expected to fall under purview of customs like 3D prints, Software embedded with hardware etc. It won't be a surprise if some MNEs bring in their "intangibles ownership" to their counterparts in India due to exemption/lower tax rates provided under certain product categories, salt for instance is exempt from taxes in India.

Finance Minister, Arun Jaitley signed the multilateral convention to implement tax treaty related measures to prevent BEPS at Paris on 7th June, 2017.

Conclusion:

There were a number of methods which many companies employed to avoid their tax liability, most popular among them were the use of tax havens for shifting profits, methods like double Irish scheme and Dutch sandwich. Base Erosion and Profit Shifting is a real concern from the global taxation and economy perspective and needs to be addressed urgently. The Action Plans given by the BEPS Project of OECD are well formulated, thoroughly researched, and take into account the opinions of the member as well as non-member countries. There may not be a consensus on all the matters but at least the minimum standards are accepted by all the countries which are part of the project. India is not a member of OECD, but it is a part of the BEPS project and has actively participated in formulating and amending the terms in the action plans. The agreement to give assurance that the countries will comply with the action plans is historic as it is expected to bring changes to about 3000 treaties among various nations using one document. This will prevent the use of widespread tax avoidance techniques which used the loopholes in the tax laws or variations among tax laws of different countries to avoid paying taxes, or paying minimal taxes.

Most of the policies suggested in the BEPS Action Plan are the ones which India has been advocating on various international platforms. Even before the execution of BEPS Action Plan, India has been changing its tax laws on domestic level to address the changes in the modern economy and to address the problem of tax avoidance using BEPS activities.

It is expected that the transparency in the system will increase due to the strict three tier Transfer Pricing Disclosure laws, which will increase the trust of the civil society in the taxation system. It is also expected that the tax collection which was lost due to the use of shell companies by MNCs in the tax havens will hereafter be restored as per their actual liability. However it is a concern that due to inappropriate interpretation of the Action Plan, the avoidance of treaty abuse may result in the double taxation of some profits. Apart from that, since the transfer pricing policies are becoming stricter, disclosure compliance burden will rise; it may so happen that the aspiring Indian companies who are willing to expand beyond borders may rethink about their expansion plans. Similarly those businesses having B2B transactions with remote digital service providers may be discouraged from importing services due to equalisation levy. However the opposite is the case with businesses struck between the treaty disputes on government levels, as with the introduction of Mutual Agreement Procedures (MAP) dispute resolution is going to be faster and simpler. This will encourage businesses to make use of the crucial resources made available to them by the government i.e. the trade treaties.

Overall it is anticipated that the tax base will broaden, helping society in the long run either in form of more liberal tax policies or better infrastructure. However Indirect taxes are expected to increase not only in the form of increase in the number of companies but also in form of increase in product lines. The sharing of information between custom authorities and income tax authorities is already very good in the country but after the implementation of action plans it is expected to become even stronger so that no company can manipulate prices of imported inventory lower to the customs authority and higher to the income tax authority.

Although these actions have been approved in good faith with the expectation that the whole global society will benefit from them in more ways than one, but it is difficult to ascertain the actual increase in the revenue or reduction/increase in effective tax rates, as the Indian economy is at a crucial turning point especially with the recent demonetization bid and the upcoming GST. It will be interesting to observe how the Indian economy and the world at large will react to these changes.

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Endnotes:

[1]The Tax Justice Network is an independent international network, dedicated to high-level research, analysis and advocacy in the area of international tax and the international aspects of financial regulation.

[2]Oxfam is an international confederation of 20 NGOs working with partners in over 90 countries to end