Base erosion and profit shifting

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Manifest pedagogy

BEPS and other measures such as money laundering, prevention of corruption, fugitive economics offenders etc are paramount to curb tax evasion. these issues are of importance with respect to their provisions, impact and implementing authorities for both prelims as well as mains

Our other relevant articles on the same topic:

G20 MINISTERIAL MEETING

G – 20 SUMMIT

TAX TREATY

In news

- India has ratified the Multilateral Convention to Implement Tax Treaty (MLI) Related Measures to prevent BEPS.

Placing in syllabus

- Economic policies (not explicitly mentioned)

Static dimensions

- What is tax evasion and tax avoidance
- What is a tax haven
- Round tipping

Current dimensions

- G20, OECD and BEPS
- Convention on BEPS
- GAAR

Content

Tax evasion and tax avoidance

Tax evasion is the use of illegal means to avoid paying taxes. Tax evasion occurs when the taxpayer either evades assessment or evades payment. For example, if someone transfers assets to prevent the tax authorities from determining their actual tax liability, there is an attempt to evade assessment. However, if the assets are hidden after a tax liability has become due and owing, this is an attempt to evade payment. Under reporting of income, taking unearned deductions, not filing tax returns are examples of Tax Evasion.

Tax avoidance is the legitimate minimizing of taxes, using methods included in the tax code. Businesses avoid taxes by taking all legitimate deductions and by sheltering income from taxes by setting up employee retirement plans and other means, all legal and under the state tax codes. "Tax shields" are used for protection against higher taxes and they are the strategies of tax avoidance. A **tax loophole is tax avoidance** which is "technicality that allows a person or business to avoid the scope of a law or restriction without directly violating the law."(E.g accelerated depreciation)

Tax haven

The Organization of Economic Cooperation and Development (OECD) uses **three key attributes** for identifying whether a jurisdiction is a tax haven

- **No or Only Nominal Taxes**

Tax havens impose no or only nominal taxes. The tax structure varies from country to country, but all tax havens offer themselves as a place where non-residents can escape high taxes by putting their assets or businesses in that jurisdiction.

- **Protecting Personal Information**

Tax havens protect personal financial information. Most tax havens have formal law or administrative practices that prevent scrutiny by foreign tax authorities. There is no or minimal sharing of information with foreign tax authorities.

- **Lack of Transparency**

The legislative, legal, and administrative machinery of a tax haven are opaque. There are always chances of behind-closed-doors secret rulings or negotiated tax rates that fail the test of transparency.

Apart from these three attributes, the United States Government Accountability Office has listed two additional attributes of a tax haven.

- Local Presence Not Required Tax havens typically do not require outside entities to have a substantial local presence. For example, one building in the Cayman Island is said to house supposedly 12,000 U.S.-based corporations. This suggests that you can claim tax benefits by merely hanging your nameplate in a tax haven. There is no need for actually producing goods or services or conducting trade or commerce within the boundaries of the country.
- Marketing Tax Havens They promote themselves as offshore financial centres.

Many tax havens like Mauritius have become popular due to loopholes in multiple tax avoidance treaties signed with different jurisdictions. Some are becoming less popular due to various information-sharing treaties signed with different governments. Destinations like Switzerland and Austria, although not strictly tax havens, are nevertheless popular for offshore banking services and a safe destination for assets. The Bahamas has been a popular offshore destination for U.S. corporations due to its proximity to Florida.

Round tripping

Round-tripping, also known as round-trip transactions is a form of barter that involves a company selling “an unused asset to another company, while at the same time agreeing to buy back the same or similar assets at about the same price.” Swapping assets on a round-trip produces no net economic substance, but may be fraudulently reported as a series of productive sales and beneficial purchases on the books of the companies involved, violating the substance over form accounting principle. The companies appear to be growing and very busy, but the round-tripping business does not generate profits. In international scenarios, round tripping is used for tax evasion and money laundering. So far many companies have used round-tripping to distort the market by establishing false revenue benchmarks.

G20, OECD and BEPS

What is BEPS?

Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity or to erode tax bases through deductible payments such as interest or royalties. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. Moreover, when taxpayers see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers.

BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises. Engaging developing countries in the international tax agenda is important to ensure that they receive support to address their specific needs and can effectively participate in the process of standard-setting on international tax.

The **OECD/G20 Inclusive Framework on BEPS** brings together over 125 countries and jurisdictions to collaborate on the implementation of the BEPS Package. The BEPS Package provides 15 Actions that equip governments with the domestic and international instruments needed to tackle tax avoidance. Countries now have the tools to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. These tools also give businesses greater certainty by reducing disputes over the application of international tax rules and standardising compliance requirements.

The OECD/G20 Inclusive Framework on BEPS actively monitors the implementation of all the BEPS Actions and reports annually to the G20 on this progress.

Key figures

- 125+ countries and jurisdictions collaborate on the implementation of the BEPS package
- $ 240 billion are lost annually due to tax avoidance by multinational companies
- 85+ countries and jurisdictions have signed the Multilateral Instrument on BEPS

Convention on BEPS

India has ratified the **Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI)**, which was signed by the Honourable Finance Minister at Paris in June, 2017. In June, 2019 India has deposited the Instrument of Ratification to OECD and **MLI will**

enter into force for India on 01st October, 2019 and its provisions will have effect on India's Double Taxation Avoidance agreements (DTAAs) from FY 2020-21 onwards.

The Multilateral Convention/MLI is an outcome of the OECD / G20 Project to tackle BEPS. The MLI will modify India's tax treaties to curb revenue loss through treaty abuse and BEPS strategies by ensuring that profits are taxed where substantive economic activities generating the profits are carried out. The MLI will be applied alongside existing tax treaties, modifying their application in order to implement the BEPS measures.

The Convention enables countries to implement the tax treaty related changes to achieve anti-abuse BEPS outcomes through the multilateral route without the need to bilaterally re-negotiate each such agreement which is burdensome and time consuming. It ensures consistency and certainty in the implementation of the BEPS Project in a multilateral context. It enables all signatories to meet treaty-related minimum standards that were agreed as part of the Final BEPS package, including the minimum standard for the prevention of treaty abuse under Action

GAAR

- **General Anti-avoidance rule (GAAR)** was first introduced in the Direct Taxes Code Bill 2010.
- It is an anti-tax avoidance law under Chapter X-A of the Income Tax Act, 1961 of India.
- It is framed by the Department of Revenue under the Ministry of Finance.
- The original proposal gave the Commissioner of Income Tax the authority to declare any arrangement or transaction by a taxpayer as 'impermissible' if he believed the main purpose of the arrangement was to obtain a tax benefit.
- The 2012-13 Finance Bill, defined '**impermissible**

avoidance arrangements' as an arrangement that satisfies one of four tests if agreement

1. creates rights and obligations not normally created between parties dealing at arm's length,
2. results in misuse or abuse of provisions of tax laws,
3. Is carried out in a way not normally employed for bona fide purpose **or**
4. lacks commercial substance.

As per the Bill, arrangements which lack commercial substance could involve round trip financing. A transaction that disguises the value, location, source, ownership or control of funds would also be deemed to lack commercial substance.

GAAR was introduced to address tax avoidance and ensure that those in different tax brackets are taxed the correct amount. In many instances of tax avoidance, arrangements may take place with the sole intention of gaining a tax advantage while complying with the law. This is when the doctrine of 'substance over form' may apply. 'Substance over form' is where real intention of parties and the purpose of an arrangement is taken into account rather than just the nomenclature of the arrangement. Many countries, like Canada and South Africa, have codified the doctrine of 'substance over form' through a GAAR – type ruling.

A common criticism of GAAR is that it provides discretion and authority to the tax administration which can be misused. In May, 2012 following the Standing Committee's recommendations, the Finance Minister amended the GAAR provisions. The main change was to delay the implementation of GAAR by a year to "provide more time to both taxpayers and the tax administration to address all related issues". In addition, the Finance Minister removed the burden upon the taxpayer to prove that the main purpose of an alleged impermissible arrangement was not to obtain tax benefit. These amendments were approved with the passing of the Bill.

GAAR was considered controversial because it had provisions to seek taxes from past overseas deals involving local assets retrospectively. GAAR came into effect in April,2017. It is applicable to every resident taxpayers, including individuals, Indian companies or foreign investors. GAAR sets in only when the amount of tax benefit availed in a relevant tax year arising in aggregate to all the parties to the arrangement is **more than Rs 3 crore**