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BASE EROSION AND PROFIT SHIFTING TECHNIQUE ADOPTED BY MULTINATIONAL CORPORATIONS FOR TAX AVOIDANCE: A LEGAL ANALYSIS

ABSTRACT

This Paper would seek to Appraise the Readers on Various Strategies that are adopted by the multinational corporations for the tax avoidance purposes. The paper would majorly look at three basic such as Treaties, Tax Heavens and Interest Deductions and Financial Payments as the methods adopted for Tax Planning purposes with the recommendations of OCED and Analyses on the 15 Action plan to curb the problem. Fundamental changes are required to effectively prevent Double non -taxation, as well as cases of low Taxation Associated with practices that artificially Segregate taxable income from the activities that generate it. Some of the Basic issues identified by the OCED are: -Establishing international coherence of corporate income tax , Restoring the full effects and benefits of international standards, Ensuring transparency while Promoting increased certainty and predictability , swift Implementation of Measures. The intention behind a government entering into a treaty such as the Double taxation avoidance agreement is that it wants to avoid Double taxation of the corporations, but through several strategies such as these it generally leads to double non taxation or very low taxation of these corporations. BEPS Strategies are not illegal; rather they take advantage of different tax rules operating in different Jurisdictions, which may not be suited to the current global business environment.

KEYWORD

Base Erosion , Profit Shifting , Tax Avoidance , Tax Heavens, Double Non – Taxation ,OCED, Commissionaire agents, BEPS , Principle of Residence , Model Tax Treaty , Tax Regimes, Fundamental Strategies of Taxation, Transfer Pricing. Financial Payments.

INTRODUCTION

The Globalization of Economics has increased International Tax Planning by both individuals and companies. Although tax planning per se is legal and legitimate as tax planning is well within the frame work of the law, there are several weaknesses in the current international tax system along with lack of co-operation among the governments .BEPS(Base Erosion and profit shifting) is the term used to describe tax planning strategies that rely on mismatches and gaps that exist between the Tax rules of different jurisdictions, to minimize the corporation tax that is payable overall by either making tax profits disappear or shift profits to low tax operations.

This Chapter will outline the background of the base erosion and profit shafting and how the prevailing rules are exploited by the multinational corporations for the planning purposes. In this chapter, the basic issues identified by the organization of the Economic co-operation and development (OCED) are also discussed.

DOUBLE TAXATION AVOIDANCE AGREEMENT

Double Taxation Avoidance Agreement (DTAA) also referred as Tax Treaty is a bilateral economic agreement between two nations that aims to avoid or eliminate double taxation of the same income in two countries. The first double taxation avoidance bilateral treaty can be traced between Prussia and Austria-Hungary in 1899. The first structured study of economic consequences of double taxation was presented to the Financial Committee of the League of Nations in 1923[1]. Treaties are generally the instrument which improves the domestic tax legislation and eliminate international juridical double taxation. In other words, treaties assist in the process and integrate with the corresponding treaty law in a better manner.[2] Tax treaties

[1] Charles R. Irish, *International Taxation and Income Taxation at Source*, 23 Brit Inst Int'l & Comp L 293 (1974)

[2] Eusebio Gonzalez & Christoph Trzaskalik, *International Tax Law* 156 (1st Ed.2008)

eliminate the double taxation by restricting the contracting state's claim, where can be an overlapping of these claims. Several definitions are employed so as to assign the right to tax to one state or another or to both of them partly and by providing the mechanism for exemption or credit so as to eliminate double taxation. The relationship between the tax treaty and the domestic law can be seen in the "three step approach" by M.Edwards-Ker, *Tax Treaty Interpretations*. Step one is to determine whether the State's domestic law impose tax, as treaty provisions do not impose tax. Step Two would be to see how the treaty allocates the right to tax the income or capital. Step three is to determine whether state's actual right to tax is within the defined limits of the treaty. If it is, then the state would have the authority to tax the income or capital except when such income is not permitted to be taxed by the treaty.[3] The principle on which the jurisdiction to tax income is based upon is either the principle of residence or the principle of source.[4] Both are used by almost all the countries to determine the tax to be paid by any person. Persons domiciled or who are a resident of a particular country are subject to the country's income tax under the principle of residence.

Article 23 A of the OECD Model Treaty provides for Exemption Method for relief from double taxation whereas Article 23 B provides for the Credit Method.[5] Article 1 of the OECD Model provides for application of the treaty provisions to the persons who are "residents on one or both of the Contracting States". Article 3, paragraph 1 defines the term "Person" and includes "an individual, a company and any other body of persons". Article 4, paragraph 2, contains "tie-breaker rule" which relates to the case where a person is a resident of both the Contracting States. Article 7, paragraph 1 of the OECD Model prescribes for taxation of profits of business enterprise. It precisely mentions that the profits of the enterprise shall be taxable by the resident of the Contracting State and shall be taxable only by that state unless the business enterprise carries on its business through permanent establishment. Artificial avoidance of Permanent establishment states can take place through *commissionaire* arrangements. A *commissionaire* is an arrangement wherein a person would sell products by his name for the foreign enterprise. This way the foreign enterprise is able to sell their products and the taxable income in also not attributed to it. Since the person does not own the product, the person cannot be taxed on the profits derived from such sales and can also be taxed on the remuneration that is usually a commission. A foreign enterprise does not have a permanent establishment which uses a

[3] Id at 24

[4] Hadari, *Tax Treaties and Their role in the financial Planning of the Multinational Enterprises*, 20 Amer J. of Comp.L. 111 (1972)

[5] Eusebio Gonzalez & Christoph Trzaskalik, *International Tax Law* 163-164 (1st ed.2008)

commissionaire arrangement because it is able to avoid the application of Article 5(5) of the OECD Model Tax Convention[6].

The Base Erosion and Profit Shifting (BEPS) can also be through "Fragmentation of Activities". A multinational enterprise may alter its structure to obtain tax advantages. The cohesive business is structured into several operating units and is given a character of preparatory and auxiliary operation. The exception provided under Article 5(3) for the construction sites has also become one of the strategies of the multinational enterprises for Base Erosion and Profit Shifting (BEPS). Through the practice of splitting-up contracts between closely related enterprises, the enterprises are able to avoid the permanent establishment status, thereby avoiding the taxes to be paid. [7]

International tax issues have never been as high on the political agenda as it is today. Integration of the economies and the market has created huge strain on international tax rules which compels the policymakers to reduce the strain. The weaknesses in the international tax rules creates opportunities for base erosion and profit shifting (BEPS), restricting such opportunities which leads to a loss to the exchequer, the policy makers are required to restore the confidence in the system and ensure that profits are taxed where economic activities take place and value is created. Following the report Addressing Base Erosion and Profit Shifting in February, 2013, OECD and G20 countries adopted a 15-point Action Plan to address BEPS in September 2013. The action plan identified was along the three pillars i.e. introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency.

TAX HAVENS

[6] Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph

[7] OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241220-en

Tax havens are generally those countries which offer foreign entities little or no tax liability in a politically and economically stable environment. These tax havens also are known for their secrecy, as they provide limited or no information to the foreign tax authority, which makes it difficult for the tax authorities to track the shift of profits. Tax havens do not require that an individual reside in or a business operate out of the country in order to benefit from the tax policies. Tax havens are merely about giving companies tax or other breaks and get these entities to invest there. Several countries have double tax avoidance treaties with other countries so that the companies have to pay lower taxes in one country and high taxes in a high tax jurisdiction is avoided. A tax haven is a place that tries to attract non-resident investors by offering low or zero taxation and secrecy, then the world has around 50-60 of such tax havens. [8] The money stashed away in all these tax havens is unaccounted for and estimates are that as much as $21 trillion may be stashed abroad for tax avoidance purposes.[9] Some of the countries which serve as a tax haven are Bahamas, Belize, Bermuda, the British Virgin Islands, the Cayman Islands, the Channel Islands, the Cook Islands, Hong Kong, the Isle of Man, Mauritius, Lichtenstein, Monaco, Panama, Switzerland and St. Kitts and Nevis etc. A formal list of tax havens was created by the OECD in the year 2000.[10] Tax havens typically have laws or administrative practices under which businesses and individuals can benefit from the secrecy rules and other protections against investigations by tax authorities thereby preventing the effective exchange of information on taxpayers benefiting from the low tax jurisdiction.

Tax havens in several ways are hampering the economic development of a country. Let us look at several ways in which tax havens can hamper the economic development:

1) Tax havens encroach heavily on the sovereignty of other countries

2) Tax havens harm the efficiency of financial markets

3) Tax havens undermine national tax systems and increase costs of taxation

4) Tax havens reduce the efficiency of resource allocation

[8] Hadari, *Tax Treaties and Their role in the financial Planning of the Multinational Enterprises*, 20 Amer J. of Comp.L. 111 (1972)
[9] J.S.Henry, *The Price Of Offshore Revised* 2012 (Last visited- 05 March,2016) http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_Revisited_120722.pdf, 2012.
[10] "OECD progress report" 18 May 2012

5) Tax havens make it more profitable and less risky to engage in economic and other crimes

6) Tax havens in several cases can hurt private income[11]

INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

Each country designs its income tax system as it wishes. Tax bases and tax rates are determined autonomously from country to country. Accordingly, effective tax rates are different depending on where one conducts business. Locational mismatch between income and deductions leads to income being taxed in a low taxed jurisdiction and deductions are made in a high taxed jurisdiction. This is possible as states make a distinction between debt and equity for their corporate income tax purposes, the deduction of interest expense is determined on a separate entity basis and not on a consolidated group basis and tax treaty between the states prevents state from imposing a high withholding tax on outgoing dividends.

The Multi-national groups may achieve favorable tax results by adjusting the debt in a group entity. It is well known that the groups can easily multiply the level of debt at the level of individual group entities via intra-group financing. Financial instruments can also be used to make payments which are economically equivalent to interest but have different legal form, therefore escaping restrictions on the deductibility of interest. Several approaches have been recommended by OECD which may avoid double taxation of multi-national companies such as Group-wide rule, fixed ratio rule and a combination of both.[12]

CONCLUSION

Base Erosion and Profit shifting is one of the major problems faced by the governments. It leads to major loss of revenue to the exchequer. Base Erosion and Profit Shifting leads to a series of problems such as encroaching sovereignty of a state, reducing the efficiency of financial

[11] Aamir Aijaz, Tax Haven: A Global Scenario, 3 (3) Int. J. Adv. Eng. 125-127 (2013)

[12] OECD *(2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/*G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264241176-en*

markets, undermining the national tax system and increase cost of taxation, reduction in in the efficiency of resource allocation and reduction in the institutional quality and thereby growth in the long run. All this affects the civil society at large. I analysed the various ways through which multinational corporations avoid taxes.

The problem starts with tax avoidance which has a ripple effect on the economy of the states and ultimately the civil society. The tax evasion increases the burden on the salaried class and the honest taxpayers who feel frustrated as they have to pay more taxes since the revenue does not grow fast enough to match the developmental and non-developmental expenditures and the governments have to resort to deficit financing[13] . The Action Plan by the OECD calls for fundamental developments to the current mechanisms and embracing a consensus-based approach, including anti-abuse provisions to stop Base Erosion and Profit Shifting.

For the BEPS package to be a success a consensus based approach is necessary which includes supporting the implementation of the recommended changes in a coherent and consistent manner, monitoring the impact on double taxation and double non-taxation and designing an inclusive framework to support implementation of the recommendations and carry out monitoring on a consistent basis.[14]

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