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Website: www.aarf.asia Email : editor@aarf.asia , editoraarf@gmail.com

BASE EROSION AND PROFIT SHIFTING

Author: Daliya Singh, Maryanka

INTRODUCTION

"BEPS is a 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 where there is little or no genuine activity. In general, 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 and digital business environment.

OECD as a response to the 2008 economic crisis to create sustainable economic growth, and step up the momentum of global recovery initiated the BEPS project. The idea is to strengthen "the foundations for long-term growth" and avoid policies that "promote growth at other countries' expense" Multinational businesses have over the years through a complex structuring process artificially reduced their corporate tax outgo by shifting to lower tax jurisdictions. OECD estimates that tax avoidance through base erosion and profit shifting has resulted in loss of tax revenue to the tune of $100-240 billion every year - that is around 4-10% of global corporate income tax revenue. The BEPS plan aims to improve transparency - for business and governments - by introducing commonly agreed minimum standards for tax administration across countries. This includes alignment of taxation with the location of economic activity and value creation, reinforcing substance requirements in tax rules globally"[1]

RESEARCH QUESTION

[1] Sudipto Dey, *The Beps Effect: Is India Ready*,2015.

1 Whether Base Erosion and Profit Shifting is a serious problem and its standards have affected Indian Companies and Indian multinationals

2 Whether the countries around the world are successful in implementing properly the anti-avoidance measures that are aimed at addressing tax avoidance by Multinational Companies.

<u>Whether Base Erosion and Profit Shifting is a serious problem and its standards have affected Indian Companies and Indian multinationals</u>.

"BEPS is a 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 where there is little or no genuine activity. In general, 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 and digital business environment. The BEPS (base erosion and profit shifting) initiative is an OECD initiative, approved by the G20, to identify over a period to December 2015, ways of providing more standardized tax rules globally. Phase two now involves implementation and monitoring (together with some remaining standard setting and clarification)."[2]

"Research Undertaken since 2013 confirms the potential magnitude of the BEPS problem. Estimates conservatively indicate annual losses of anywhere from 4 - 10% of global corporate income tax (CIT) revenues, i.e. USD 100 to 240 billion annually .BEPS is a global problem which requires global solutions. For the first time ever in tax matters, OECD and G20 countries worked together on an equal footing. More than a dozen developing countries have participated directly in the work and more than 80 non-OECD, non-G20 jurisdictions have provided input.

Fifteen actions equip governments with the domestic and international instruments needed to tackle BEPS. The final BEPS Report gives countries the tools they need to ensure that profits are taxed where economic activities generating the profits are performed and where value is created, while at the same time give business greater certainty by reducing disputes over the application of international tax rules, and standardizing compliance requirements.

[2] http://lexicon.ft.com.

In an increasingly interconnected world, national tax laws have not always kept pace with global corporations, fluid movement of capital, and the rise of the digital economy, leaving gaps and mismatches that can be exploited to generate double non-taxation. This undermines the fairness and integrity of tax systems"[3].

SERIOUS PROBLEMS

"In today's global environment, there are a number of major forces now influencing wide range of the activities, processes and perceptions of stakeholders- tax authorities, legislative bodies, non- governmental entities, taxpayers, and civil society around the globe. These key forces are creating megatrends in global tax controversy. The number and size of audit, exams, and inquiries are dramatically increasing worldwide. Despite the OECD'S call for co-ordinated action by nations in addressing base erosion and profit shifting, individual countries are not waiting for consensus to be reached and are acting unilaterally by engaging in range of activities- from the use of aggressive audit tactics to the promulgation of new legislation or policies and procedures, as well as the implementation of other measures intended to protect their respective tax bases. Developing and emerging countries are also taking divergent position on the interpretation of the international tax standards. The arm's length standard is under pressure, with some nations adopting positions openly inconsistent with the decades old principle. Now the debate continues whether the tax administrations should have the authority to re-characterize bonafide arrangements and disregard legal entities. In this situation, the use of ADR is gaining popularity. But with the nations acting aggressively, and taking diverse positions on the basic fundamentals, fewer disputes are being resolved, and the treat of double taxation is becoming pervasive than ever. So the use of litigation in certain territories is unfortunately viewed as a necessary option in the key area tax controversy esp. where the risk of double taxation is prominent."[4]

"Their greatest fear is that if the proposals prompt some countries to take unilateral action, it could lead to the return of double taxation—multiple countries claiming tax on the same dollop of profit. This was a risk firms often ran before double taxation was abolished under various treaties. They can, however, take comfort from the way that governments are increasingly aiming their punches at each other. As Richard Hay, a tax lawyer with Stikeman Elliott, puts it: "BEPS

[3] Organization for Economic Co-operation and Development (OECD)
[4] Swenson, David, *Global-Emerging-megatrends-in-global-tax-controversy*,3rd September 2014

started out as a plan to squeeze more tax out of big companies, but it has morphed into a competition between countries over revenue allocation"[5].

"As part of G20, India has been very active in the (BEPS) project, working closely with the Organization for Economic Cooperation and Development (OECD) officials in preparing rules and participating in deliberations. "BEPS is a reality. The report presents a consensus among G20 nations," says Akhilesh Ranjan, joint secretary, ministry of finance, who represented India. "We will now start examining the report, and see when and how we can start bringing in the measures," says Ranjan. According to OECD estimates, BEPS measures will affect around 9,000 companies globally. "Not all companies in India will be affected by these measures, only the very large ones," says Grace Perez-Navarro, deputy director, Centre for Tax Policy and Administration, OECD.

Arun Giri, group editor, Taxsutra.com, estimates that 155 Indian companies would qualify for country-by-country reporting that is likely to be the first visible BEPS measure to hit corporates. Besides, this would also apply to subsidiaries of multinational companies operating in India. Companies with global turnover in excess of 750 million (approximately Rs 6,000 crore) have to report details of revenues, profits and taxes paid on a country-by-country basis to their respective tax administrators. The concern among tax experts is the low level of awareness among Indian companies on how the BEPS measures will impact their business operations and the need for increased compliance. "Companies would have to start preparing now to comply with the regulations if they become mandatory from FY17," says Neeru Ahuja, partner, Deloitte Haskins & Sells. "They should accept the fact this is something that will change the way they do business.

They have to look at what changes are required in their own set up - in their accounting systems, in their compliance mechanisms, and the way they report data" - Ranjan's advice to corporate India. As BEPS recommendations come into force, tax experts say companies are going to see greater need for sharing information, leading to increased transparency in their business operations globally. Companies will have to think of what resources they need to meet country-by-country reporting requirements, and comply with enhanced transfer price rules. "Companies are going to see more controversy. There will be a lot more arguments among countries over

[5] Taxing multinationals patently problematic, 2015

who gets the tax dollars," says Kate Barton, vice-chair for Tax Services, EY Americas. Most tax experts expect a spurt in transfer price-related issues, as governments start questioning companies based on information on their tax outgo and margins in other jurisdictions. Measures to bring the digital economy under the tax net are of concern for the burgeoning start-up and e-commerce industry in India. "Start-ups would have to think about taxation from day one. They can optimize their opportunities if they think about how they want to be structured from the very beginning," says Barton.

“Tax experts say the success of measures against BEPS will depend on the manner in which they are implemented. "There has to be a balance between competitiveness and compliance. Driving that balance is the challenge for tax administration," says Ranjan. "If we implement it properly, it should not affect the investment climate," he adds. For that, the tax administration would need to ramp up its work force to implement different aspects of the BEPS project, point out experts”[6]

Large multinational enterprises (MNEs) may be required post-Budget to furnish to Indian tax authorities information on their global incomes and taxes. This move — a fallout of India agreeing to OECD’s Action Plan on Base Erosion and Profit Shifting (BEPS) project — will enable the Indian tax administration to secure adequate information to conduct transfer pricing risk assessments effectively. It seeks to tackle the problem of companies exploiting mismatches in tax rules to shift profits to low tax or no-tax jurisdictions. Finance Ministry official Akhilesh Ranjan, who represented India at the BEPS deliberations, said on Thursday that India was committed to implementing the “minimum standards” of the Action Plan, including country-by-country (CbyC) reporting. Changes will be brought to the domestic tax law in the upcoming Budget to stipulate CbyC reporting, Ranjan said at an interactive session on ‘Changing tax and regulatory landscape: A global and India perspective’, organized by professional services firm KPMG.

“India has always supported BEPS since inception. It has played a leading and intensive role in the formulation of its proposals. We will be implementing all the minimum standards, including some in the upcoming Budget,” he said. The OECD’s objective of mandating CbyC is to ensure that all relevant tax authorities have access to the same information about an MNE group’s value

[6] Sudipto Dey, *The Beps Effect: Is India Ready?*, 2015.

chain and the resulting tax consequences. CbyC reporting will require MNEs to provide aggregate information annually, in each jurisdiction where where they do business, relating to the global allocation of income and taxes paid, together with other indicators of the location of economic activity within the MNE group. They will also be required to furnish information about which entities do business in a particular jurisdiction and the business activities each entity engages in.

Ranjan said that India will most likely adopt the same threshold as specified in the OECD's action plan on BEPS. "We will specify the equivalent of €750 million as the threshold," he said"[7]. "India is committed to implementing the minimum standards prescribed under Action 14 in total. India wishes to ensure that every taxpayer has full access to MAP. If implementation of such standards requires India to amend domestic law or tax treaty provisions, it would be inclined to proceed with the necessary amendments so as to be able to fully meet the "ask" of the minimum standards requirement. India is also considering the way forward in providing for corresponding adjustment where Article 9(2) is not present in the concerned tax treaty, as well as providing access to TP-MAP/bilateral Advance Pricing Agreements under such tax treaties. This may be achieved by renegotiating existing tax treaties. India is presently evaluating the possible approach on this. Additionally, India may also consider implementing best practices that facilitate effective MAP implementation, such as suspension of collection of taxes during pendency of MAP proceedings. Presently, only tax treaties with the US, the UK and Denmark provide for suspension of collection of taxes"[8]

CORPORATE TAXATION IN GLOBALISED ECONOMY

"The taxation of companies and business activities is a difficult task for states. The difficulties of taxation are multiplied by any transnational business activity. If there is a company that is active in two different countries, it is not easy to determine which country has the right to tax the profits: Whether the country where the parent company is located or where the affiliate is doing

[7]K. R. Srivats, Multinationals may have to provide global income, tax details to taxman, 2016

[8] EY Tax Alert ,*India looks to implement anti-BEPS measures*,2015

the actual business. Tax avoidance is sometimes used to refer to a legal reduction in taxes, whereas evasion refers to tax reductions that are illegal."[9]

BACKGROUND

MNCs account for a large part of the world's GDP, with intra-firm trade a growing proportion. They have global operating models with integrated supply chains and functions centralized at regional or world levels. The digital economy (products and processes) means more of their activities being located distant from customers. The problem in case of an MNC operating within a country is that the country for purposes of taxation, considers only the part operating in its jurisdiction and not as a whole.

"In order to avoid this leading to the double taxation of profits of growing global MNCs, from the 1920s an international tax regime came into operation. Based on model OECD/ United Nations treaties, with shared principles and common standards, over 2 500 worldwide tax agreements now exist between countries to eliminate double taxation. But the outcome led to under taxation or no taxation and such taxation policies become a matter of concern where:

- the use of different tax rules leads to double non-taxation or taxation lower than the level of either jurisdiction
- profits are shifted away from the jurisdictions where the economic activities creating them take place, known as "base erosion and profit shifting" (BEPS)"[10]

METHODS OF TAX REDUCTIONS/ TAX AVOIDANCE

PROFIT SHIFTING STRATERGY- When operational activities are shifted to a lower taxed state.

TRANSFER PRICING- setting of prices for transactions between companies that are part of the same MN

[9] Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, 2015

[10] Corporate Tax Avoidance by Multinational Firms, Nidham Christoper, library of the European Parliament

CORPORATE DEBT EQUITY- Inter-company loans given from entities in lower-tax states to subsidiary companies in higher-tax countries pass interest income to the lower-tax state, reducing the taxable profit in the higher-tax country.

- PAYMENT OF INTANGIBLES

COMPANY EXAMPLES

"Adobe had a recent average tax rate on its overseas profits of below 7%. Adobe's local units around the world have a tax residence in their markets, but not as sellers of software, rather as "service providers", i.e. a support function. This is known for tax purposes as the "Service PE" model. On the other hand, Amazon paid little or no UK corporate tax between 2009 and 2011, on sales of over £7.6 billion."[11]

BEPS: AN INDIAN PERSPECTIVE

"As part of G20, India has been very active in the Base Erosion and Profit Shifting (BEPS) project, working closely with the Organization for Economic Cooperation and Development (OECD) officials in preparing rules and participating in deliberations. According to OECD estimates, BEPS measures will affect around 9,000 companies globally. "Not all companies in India will be affected by these measures, only the very large ones," The concern among tax experts is the low level of awareness among Indian companies on how the BEPS measures will impact their business operations and the need for increased compliance. The BEPS action plans will impact both outbound as well as inbound investment holding structures, financing and operating arrangements put in place by MNEs."[12]

"In the backdrop of concerns raised by Governments, revenue authorities and social organizations that multinational enterprises (MNEs) are not paying their 'fair share' of taxes and are shifting profits to low tax jurisdiction, the G20 nations requested the Organization for Economic Co-operation and Development (OECD) to develop action plans to tackle Base Erosion and Profit Shifting (BEPS) in a comprehensive manner. The BEPS refers to tax planning

[11] Tax Havens and the Taxation of Transnational Corporations, M Henn, Friedrich-Ebert-Stiftung, 2013.

[12] http://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/BEPS/in-tax-beps-consumer-business-noexp.pdf

strategies that exploit gaps and mismatches in tax rules to make profit ‘disappear’ for tax purpose or to shift profits to locations where there is little or no real activity but taxes are low, resulting in little or no overall corporate tax being paid.

The OECD commenced work on the BEPS project to address concerns that existing principles of domestic and international taxation were failing to keep pace with the development of modern business models.”[13] Countries are committed to the comprehensive package and to its consistent implementation. These measures range from new minimum standards to revision of existing standards, common approaches which will facilitate the convergence of national practices and guidance drawing on best practices. “As has been shown, the problem underlying almost any tax evasion problem associated with TNCs is that relationships that normally occur between separate entities from different owners occur between entities belonging to the same owner. Therefore, the core solution to this problem has thus far been to compare intra-firm transactions with comparable transactions between unrelated entities or enterprises – and then require the intra-firm trade to be the same as the extra-firm one. This approach became known as the Arm’s Length Principle (ALP).”[14]

Transparency is key to many problems around tax evasion. Accordingly, information on transnational companies is required that reveals the geographical distribution of their corporate figures – assets, staff, sales, etc.

INTERNATIONAL ACTIONS

“In its May 2013 plenary, the EP voted two non-legislative resolutions (Fight against tax fraud, tax evasion and tax havens and the 2013 Annual Tax Report), which included calls for MS governments to close avoidance loopholes, combat aggressive tax planning, aforesaid coordinate their tax systems better including tax information exchange. Communiqués in 2013 from the G8 leaders' and G20 Finance Ministers included similar considerations on reducing taxation loss.”[15]

Therefore, the BEPS Project entailed a revamp of the work on harmful tax practices, with a priority and renewed focus on requiring substantial activity for any preferential regime and on

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[13] Analyzing BEPS impact: consumer business, deloitte

[14] Markus Henn, *Tax Havens and the Taxations of Transnational Corporation*, 2013

[15]http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2013/130574/LDM_BRI%282013%29130574_REV1_EN.pdf

improving transparency, including compulsory spontaneous exchange of information on certain tax rulings.

EFFECTIVENESS OF ANTI-AVOIDANCE MEASURES

“Tax experts say the success of measures against BEPS will depend on the manner in which they are implemented. "There has to be a balance between competitiveness and compliance. Driving that balance is the challenge for tax administration,"[16] “The BEPS outputs are soft law legal instruments. They are not legally binding but there is an expectation that they will be implemented accordingly by countries that are part of the consensus. The past track record in the tax area is rather positive. Minimum standards were agreed in particular to tackle issues in cases where no action by some countries would have created negative spill overs (including adverse impacts of competitiveness) on other countries. Recognizing the need to level the playing field, all OECD and G20 countries have committed to consistent implementation in the areas of preventing treaty shopping, Country-by-Country Reporting, fighting harmful tax practices and improving dispute resolution.”[17]

CONCLUSION

“The BEPS project reflects the view that current international tax standards have not kept pace with changes in global business practices. It also sets out that the gaps in the interaction of domestic tax rules of various countries, the application of bilateral tax treaties to multi-jurisdictional arrangements and the rise of the digital economy have led to weaknesses in the international tax system. The BEPS Final Reports include recommendations for significant changes in key elements of the international tax architecture. International tax changes stemming from the OECD BEPS project will transform the global tax environment in which MNEs operate. India is fully committed to implementing a number of BEPS recommendations. Enterprises that are part of a multinational group (both Indian-headquartered and subsidiaries/affiliates of overseas-headquartered group) must evaluate the implications of the likely anticipated changes for their holding/funding patterns, business models and operating

[16] www.business-standard.com/article/opinion/the-beps-effect-is-india-ready-115101800760_1.html

[17] http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm

structures. Enterprises also need to closely monitor legislative and tax administrative developments in India and in jurisdictions where they operate"[18].

LITERATURE REVIEW

1. James R. Hines Jr, *How Serious Is the Problem of Base Erosion and Profit Shifting*, 2014.

   This article identifies the nature of Base Erosion and profit shifting, considers empirical evidence of its magnitude, and evaluates proposed policy responses. There is clearly scope for beps to reduce tax liabilities, and ample evidence that multinational firms arrange their affairs in a tax-sensitive manner. The empirical puzzle is why there is not more tax avoidance than appears to be the case and this particular issue I have used in the paper.
2. OECD, *Addressing Base Erosion and Profit Shifting*, 2013

   This report aims to present the issues related to BEPS in an objective and comprehensive manner. The core of the report, which I have used in the paper, sets out an overview of the key principles that underlie the taxation of cross-border activities, as well as the BEPS opportunities these principles may create. This report also shows that current international tax standards may not have kept pace with changes in global business practices

3. Rajendra Nayak**,** Shweta Pai ,*OECD Beps reports: An Indian perspective*, by *CNBC - The firm*

   This article deals from an Indian Perspective and talks about measures, which addresses with treaty shopping and other forms of treaty abuse, transfer pricing rules in the key area of intangibles and country-by-country reporting. The Action Plan explained in this article is used in my Paper.

4. Deepshikha Sikarwar, *OECD unveils BEPS Plans to curb tax evasion by MNC'S,* 2015

   The article deals with final plan for "comprehensive, coordinated and coherent" reform of the International tax rules called Base Erosion and Profit Shifting. The approaches to check tax evasion given in this Article is dealt in the paper.

[18] EY Tax Alert, *India looks to implement anti-BEPS measures*, 2015- Tax Alerts cover significant tax news,developments and changes in legislation that affect Indian businesses

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Whether Base Erosion and Profit Shifting is a serious problem and its standards have affected Indian Companies and Indian multinationals**.**

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4 Taxing multinationals patently problematic, 2015- Proposals for consistent global rules on company tax cause worries all round

5 Sudipto Dey, *The Beps Effect: Is India Ready?*,2015-This paper deals with the plans adopted by BEPS in improving transparency. I have researched on how tax avoidance through base erosion and profit shifting has resulted in loss of tax revenue. The useful information related to is utilized in my paper.

6 K. R. Srivats, Multinationals may have to provide global income, tax details to taxman, 2016 http://www.thehindubusinessline.com/economy/budget-to-implement-certain-beps-project-standards-says-finmin-official/article8135677.ece

7 EY Tax Alert, *India looks to implement anti-BEPS measures*, 2015- Tax Alerts cover significant tax news,developments and changes in legislation that affect Indian businesses.

Whether the countries around the world are successful in implementing properly the anti-avoidance measures that are aimed at addressing tax avoidance by Multinational Companies

1. Library of the European Parliament, *Corporate Tax Avoidance by Multinational Firms*, 2013. This article highlights the increasingly aggressive use of tax-avoidance schemes by MNC and

the various methods of tax reductions existing within the system and their impact on the global economy. The MNSs have global operating models with integrated supply chains and functions centralized at regional or world levels. http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2013/130574/LDM_BRI%282013%29130574_REV1_EN.pdf

2. Markus Henn, *Tax Havens and the Taxations of Transnational Corporation,* 2013

   This paper deals with issues relating to tax avoidance and tax evasion by international companies and highlights the case study of how prominent companies pay virtually no income tax on their massive international profits and its effect of developing countries. The paper discusses the role of tax havens and preferential tax schemes, the abuse of intra-firm transfer pricing, and describes how different treatment of companies can result in double taxation. http://library.fes.de/pdf-files/iez/global/10082.pdf

3. Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, 2015

   This paper details the actions taken up by Organization for Economic Cooperation and Development (OCED) and the G-20 industrialized nations addressing issues of tax evasion and avoidance. Further, this article lays down numerous legislative proposals that have been drawn to address both individual tax evasion and corporate tax avoidance. Additionally, the paper points ways in which the Multinational firms artificially shift profits from high-tax to low-tax jurisdictions using a variety of techniques.
4. Amit Kumar, *Issues and Challenges relating to Base Erosion and Profit Shifting: An International Tax Perspective, 2013*

   This article identifies the issues relating to BEPS exhaustively and deals with the possible actions that can be taken by the countries in relation to the problem with a special focus on India in relations to actions taken by it to curb the problem. http://www.fitindia.org/downloads%5CAmit_Kumar_