Base Erosion and Profit Shifting: The New Framework of International Taxation

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Abstract. Base Erosion and Profit Shifting (BEPS) refers to a set of tax avoidance practices that deny the tax revenues to a nation by eroding the tax base of the nation where economic activities generating the profits are performed and where value is created, by shifting the tax incidence to locations where no or low taxes are payable (tax havens). BEPS can be achieved through the use of transfer pricing tactics, treaty shopping, digital economy maneuverings and other dubious means. The term BEPS has been used in a project headed by the OECD which produced final reports in October 2015 in response to fifteen action points agreed previously (July 2013). The BEPS project is an attempt by the world's major economies to rewrite the rules on corporate international taxation so as to address the widespread perception that the corporations, especially MNCs, don't pay their fair share of taxes. It seeks to ensure that MNCs report profits where economic activities are carried out and value is created.

Keywords: Base Erosion and Profit Shifting (BEPS), International Taxation, Tax-treaties, Tax Avoidance, Double non-taxation, Treaty shopping.

1 Introduction

In an increasingly interconnected world, national tax laws in various countries across the world have often failed to keep pace with tactics of global corporations, seamlessly fast movement of capital, and the rise of the digital economy. These complexities create gaps and mismatches that can be exploited to generate double non-taxation. This undermines the fairness and integrity of tax systems.

Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies that exploit these gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. This includes the use of legal arrangements that make profits disappear for tax purposes or allow profits to be artificially shifted to low or no-tax locations.

Base Erosion and Profit Shifting (BEPS) is a broad term referring to the negative effect of multinational companies' tax avoidance strategies on national tax bases. Such practices erode

the tax base of the nation where economic activities generating the profits are performed and where value is created, by shifting the tax incidence to locations where no or low taxes are payable (tax havens). BEPS can be achieved through the use of transfer pricing ("transfer mispricing" actually), treaty shopping, digital economy maneuverings and other dubious means. BEPS is used in a project headed by the OECD which produced final reports in October 2015 in response to fifteen action points agreed previously (July 2013). BEPS project is said to be an "attempt by the world's major economies to try to rewrite the rules on corporate international taxation to address the widespread perception that the corporations, especially MNCs, don't pay their fair share of taxes".

2. The Problem

Research undertaken by the Organisation for Economic Cooperation and Development (OECD) since 2013 confirms the potential magnitude of the BEPS problem. Estimates conservatively indicate annual losses of anywhere from 4 to 10% of global corporate income tax revenues, i.e. USD 100 to 240 billion annually. The reliance of developing countries on corporate tax revenues, especially from MNCs, is very high and therefore the impact as a percentage of GDP is even higher in these countries. Thus, BEPS is of major significance for developing countries. Taxation plays a central role in promoting sustainable development, and developing countries face significant challenges in developing their tax capacities and mobilizing domestic resources.

While Globalisation has opened up opportunities for multinational corporations/enterprises (MNCs/MNEs) to greatly reduce the taxes they pay, it has also increased the need for countries to cooperate to protect their sovereignty on tax matters. The OECD/G20 BEPS Project began when OECD and G20 countries agreed on the need for multilateral efforts to improve tax rules, with the aim of **ensuring that MNCs report profits where economic activities are carried out and value is created.** OECD tax work has always sought to eliminate double taxation. An international tax system that aims to prevent double taxation is not sustainable if the same system generates double non-taxation. This is the driving principle that led OECD and G20 countries to embark on the ambitious BEPS Project. BEPS is a global problem which requires global solutions. BEPS affects everyone. It harms governments because it reduces their tax revenues and raises the cost of ensuring compliance. It harms people

because, when some MNCs pay low or no tax, individual taxpayers must shoulder a greater share of the tax burden. And finally it harms businesses themselves: MNCs face significant reputational risk from the public focus on their tax affairs while domestic companies face an uneven playing field when competing with multinationals. BEPS undermines the tax system's integrity and the trust of citizens. The goal of the BEPS Project is therefore to restore trust and ensure fair competition among all actors, while maintaining the ability to eliminate double taxation. 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.

Multinational corporations are known to employ a wide range of aggressive tax planning techniques covering multiple jurisdictions that result in little or no tax liability and these techniques are referred to as BEPS. Indian tax authorities had received wide criticism for attempting to counter these practices in the country. But, the OECD package will change the landscape of global tax policy.

3. The Solution

The Base Erosion and Profit Shifting (BEPS) project, a joint initiative between G20 countries and the OECD, works towards the development of a coherent global taxation system which addresses BEPS concerns. The main purpose of such initiative is to address the gaps in the current international tax rules relating to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating profits takes place.

The Organisation for Economic Co-operation and Development (OECD) recently unveiled the final plan for a comprehensive, coherent and coordinated reform of the international tax rules, called the Base Erosion and Profit Shifting project. As part of this project, 34 key world economies have announced a new world standard aimed at preventing abuse of double taxation avoidance agreements by incorporating anti-abuse provisions in their tax treaties. Fifteen actions equip governments with the domestic and international instruments needed to tackle BEPS. The final BEPS package 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.

The OECD has released its final reports for the 15 Actions on 05 October 2015. India has actively participated and contributed in this process. The Government of India, in its response to the UN questionnaire on country experience regarding BEPS issues, had identified the following as common practices of BEPS in India: i) Shifting of profits by aggressive transfer pricing by way of payments to foreign affiliated companies ii) Non Taxation of digital economy in country of source iii) Treaty Shopping and iv) Artificial avoidance of PE status. The OECD reports largely address these practices through the following actions.

While accepting that the **digital economy** (action point-1) is largely evolving into the economy itself, the OECD report has acknowledged that working on rules designed exclusively for the digital economy may be detrimental as it is not feasible to ring-fence the digital economy from the rest of the economy for tax purposes. The report notices that certain digital economy features or models worsen the risks of BEPS. Therefore, towards addressing the concerns of the developing countries, modifications have been proposed to the definition of a Permanent Establishment and its list of exemptions, which may lead to formation of PE and taxation of allocable profits in the source countries. The report also emphasizes enabling provisions for efficient collection of VAT in the country of the consumer in case of cross-border digital business to consumer (B2C) transactions.

In the area of **treaty abuse**, i.e. action point-6, a minimum standard has been agreed to ensure that treaty benefits are only granted to those that deserve them. Finally, the definition of “permanent establishment” (which sets the threshold for taxation of non-residents) has been modified to better reflect business realities and avoid widespread circumvention. This report reciprocates the thoughts of the Government of India with regard to addressing **treaty shopping**. The report proposes a "minimum standard" commitment from the Countries, with a goal to address "Treaty shopping" and other conduit arrangements aimed towards the abuse of treaty provisions. To prevent treaty shopping and countering 'letter-box' companies, OECD has suggested a 3-pronged approach by introducing anti-abuse provisions in tax treaties such as the limitation of benefit clause and a more general anti-abuse rule based on the "principal purposes of transactions". Limitation of benefit clause is usually incorporated in treaties to ensure that

only genuine investors avail benefits of a tax pact and include conditions such as a minimum level of investment, listing on the local stock exchange, ceiling on turnover and minimum expenditure, local residents on company board, and number of board meetings for carrying out operations in one of the contracting states. This commitment requires all countries to introduce an express statement in its treaties and adopt a variation of either or both, a LOB Rule (objective rules allowing benefits of a treaty to only qualifying persons) or/and a PPT rule (subjective rule based on a principal purpose test denying benefits of a treaty to an arrangement); What this spells, would be increased focus of the Government of India to renegotiate its tax treaties to avoid double non taxation and deny/curtail treaty benefits to situation of treaty shopping and conduit arrangements.

In the action areas 8-10 & 13, pertaining to transfer pricing, it proposes to tackle the **aggressive transfer pricing methods** adopted by taxpayers by transferring risks among, or allocating excessive capital to group members. The amended guidance on applying the arm's length principle notably provides guidance on: i) the identification of the actual transaction, ii) what is meant by control of a risk, and iii) circumstances in which the actual transaction undertaken may be disregarded for transfer pricing purposes. Transfer pricing rules have been upgraded to ensure that outcomes are driven by economic reality. Recognising the difficulty in valuing intellectual property, an approach to pricing hard-to-value intangibles, such as patents and trademarks, has been designed. Simplification mechanisms have been developed for commodity transactions and low value-adding services, two areas of particular relevance for developing countries. The requirements for transfer pricing documentation have been substantially revised, with a groundbreaking template agreed for country-by-country reporting of indicators of economic activity. With these reforms the Indian Tax Authorities now would have a larger pool of Information at hand, to help them in addressing BEPS concerns.

Even before implementation gets fully underway, the BEPS measures are having an impact. Some large MNEs have announced important changes to their tax structuring, indicating that taxpayers are already changing their behaviour. Once implemented, the measures will improve the coherence of tax rules across borders, tighten substance requirements and ensure increased transparency. Effective dispute resolution mechanisms have been reinforced, including the use of arbitration for interested countries. Minimum standards have been agreed to level the

playing field in four areas, namely treaty shopping, country-by-country reporting, dispute resolution and harmful tax practices. These are areas where countries have committed to consistent implementation to tackle cases where no action by some countries would have created negative spillovers (including adverse impacts of competitiveness) on other countries.

For improving coherence the model rules have been developed with an aim to eliminate Hybrid Mismatch Arrangements that allow income to go untaxed by exploiting differences in domestic tax laws. Further, the building blocks for effective Controlled Foreign Corporation (CFC) rules have been identified; a common approach has been developed in the area of interest deductibility; and best practices have been established for mandatory disclosure regimes. Finally, the work ensures that both companies and governments will play fair, eliminating or modifying preferential regimes that are potentially harmful.

4. Conclusion

According to the OECD (2014), Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD, the current rules have revealed weaknesses that create opportunities for Base Erosion and Profit Shifting, thus requiring a bold move from policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created. The BEPS Project delivered its 15 final outputs in October 2015, two years after its launch in 2013, representing the most fundamental changes to international tax rules in a century, including new or reinforced international standards as well as concrete measures to help countries tackle BEPS.

Among the highlights of the OECD Final Reports are the new transfer pricing approach and reinforced international standards on tax treaties, the setting of minimum standards on harmful tax practices, treaty abuse, country-by-country reporting and dispute resolution, action items requiring national legislation particularly in hybrid mismatches and interest restriction, and analytical reports with recommendations concerning digital economy and multilateral instruments.

The overall aim of the BEPS measures is to close gaps in international tax rules that allow multinational enterprises to legally but artificially shift profits to low or no-tax jurisdictions. OECD and G20 countries developed the measures on an equal footing, with

extensive engagement by developing countries and regional tax organisations. The focus now shifts to designing an inclusive framework for monitoring and supporting implementation, with all interested countries and jurisdictions invited to participate on an equal footing. Monitoring the implementation of the BEPS measures includes targeted monitoring of the minimum standards on treaty shopping and on dispute resolution, the application of the criteria on harmful tax practices, as well as the implementation of the country-by-country reporting requirements. Monitoring will also focus on what countries have done to implement the BEPS recommendations and the measurement of the impact of BEPS and BEPS countermeasures. The OECD will in 2016 come out with a multilateral convention aimed at preventing treaty abuse.

As far as India is concerned, the Government should welcome the proposed checks on BEPS because it stands to augment its tax revenues by improving its abilities at prevention of international tax avoidance. The Government of India, as a member of the G20 group that has sponsored the OECD project, may adopt coherence measures and propose legislative measures to address aggressive transfer pricing strategies and tax treaty abuse. The Government of India should undertake to further deliberate the recommendations and proposed changes in tax laws, treaties and policy with stakeholders, to ensure their amicable integration into the Indian tax and economic scenario.

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