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Action Plan on Base Erosion and Profit Shifting:An Indian Perspective

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Distribution of taxation rights across countries are determined by the tax policies of individual countries and the Double Taxation Avoidance Agreements (DTAAs) signed by these countries. In recent years, many countries have realized that as a consequence of the current distribution of taxation rights, there is considerable base erosion and profit shifting with double non-taxation becoming a more important problem than double taxation. In the wake of the financial crisis of 2007-08, with countries facing fiscal crisis, this aspect received a lot of attention. The G-20 has flagged this issue as needing attention and global cooperation. It has tasked the OECD to come up with an Action Plan in this regard.

Rao and Sengupta (2014) – on which this one pager is based -asks whether the issue of base erosion and profit shifting has relevance for India, assesses evidence for base erosion in India and provides a commentary on the OECD Action Plan from India's perspective.

The Background

Ever since the opening up of the Indian economy in the 90s, India has been signing comprehensive Double Tax Avoidance Agreements (DTAA) with different countries. At the last count, India has 86 such agreements. The DTAAs were signed with the avowed objective of increasing mutual trade and investment with the countries concerned. Given the context in which model agreements were developed, the model entailed giving up taxing rights by source countries in favour of residence countries. In the beginning the signatories of such DTAAs were all developed countries having trade and investment flows more or less in balance and hence the model worked reasonably well. However, such a model does not work when the trade and investment flows of the parties are not in balance, when there is disproportionate revenue sacrifice by the source countries.

Moreover, rules were developed at a time when there was far less integration of the world economies and doing business involved setting up brick and mortar establishments in the other jurisdiction. This is no longer true in the current globalised scenario where owing to internet penetration and digital world, substantial economic presence in a market has become possible, leading to serious tension in the global international tax architecture.

The global financial crisis that engulfed the world in 2007-08 has jolted the western governments to the stark reality of the inadequacies of the current international tax system. Realisation has dawned to the fact that the corporate structure enables entities to set up paper companies in any of the multiple tax havens and indulge in treaty shopping. The secrecy offered by such jurisdictions along with the lure of *nil* or very low taxation, has resulted in massive shifting of profits by multinationals to these jurisdictions. The existence of such jurisdictions along with the distribution of taxing rights skewed in favour of the residence countries, has resulted in a situation where, more often than not, some companies end up paying no tax anywhere in the world. The double tax avoidance agreements thus have become instruments of double non-taxation resulting in spectacular public outcry in the west against companies like, Google, Apple, Starbucks, Amazon, and Vodafone.

Revenue starved nations therefore want multinationals to pay their fair share of taxes in jurisdictions that they do business with. This calls for coordinated efforts on the part of all nations, whether developed or developing. The G-20 therefore took the initiative in taking remedial measures and tasked the OECD to come up with an action plan in this regard. Accordingly, the OECD has come up with a 15-point action plan released in February 2013 to address the menace of base erosion and profit shifting.

Present Analysis

Payments of interest, royalties, fees for technical services, head office management service payments, along with transfer pricing are some of the more common ways of eroding the tax base of a country. In the absence of disaggregated data being available in the public domain, the study focuses on royalty and interest payments. Using the company accounts data as available in the Prowess, the study asks the question as to whether interest/ royalty payments are different for purely domestic firms as compared to MNCs. The result in respect of interest is that at a given level of borrowing, non-domestic firms pay more interest thereby reducing the tax payable. In respect of royalty again, it is found that for a given level of sales, non-domestic firms pay more royalty as compared to pure domestic firms.

The specific methods of eroding the Indian tax base are also not available in the public domain. The study, therefore, examines about a dozen reported cases and finds evidence of substantial base erosion through various techniques especially in the context of the digital economy. These cases also examine why because of the existing rule of distribution of taxing rights, the tax department ends up losing even where there is substantial revenue involved.

The study then examines the 15 action points individually and concludes that while most of these are important, the measures suggested by the OECD do not go to the root of the problem, which is the skewed distribution of taxing rights between nations. It also cautions against blindly accepting the suggestion of compulsory arbitration in the context of the mutual agreement procedure in view of the experience of developing countries relating to arbitration in the context of the investment protection treaties. As for the question whether foreign investment will be adversely affected if stringent measures are adopted, the study concludes that in the event of a global consensus, there is no likelihood of such a consequence.

Reference

Rao, R. Kavita, D.P. Sengupta (201:. 'Action Plan on Base Erosion and Profit Shifting: An Indian Perspective', Working Paper no. 133, NIPFP, New Delhi (March).