

Questionnaire

Countries' experiences regarding base erosion and profit shifting issues

Developing countries are invited to provide feedback by answering the following questions. Feedback (and any questions about the feedback requested) should be sent to taxffdoffice@un.org. The deadline for responses is 8 August 2014.

1. How does base erosion and profit shifting affect your country?

Base Erosion on account of shifting of profits outside the jurisdiction where the economic activities deriving the profits are performed, and where value is created, has been a concern for the developing and emerging economies, such as India, for long and has now been acknowledged and appreciated by the developed countries also as a serious cause of concern. Launch of the G20/OECD Project on Base Erosion and Profit Shifting (BEPS) underscores the point that the international standards on taxation, including on transfer pricing, have not kept pace with larger economic integration across borders and rapid development of information and communication technologies, and have provided opportunities to Multi National Enterprise to minimize their tax burden, which in many cases is not intended by the current rules. This has an adverse effect on (a) Governments as their tax revenues are impacted (b) on individuals as they have to bear a greater share of the tax burden and (c) on domestic companies as they are at a competitive disadvantage by paying disproportionately high taxes.

Base erosion and profit shifting in developing economies and low income countries (LICs), such as India, whose tax revenues are often more reliant on corporate tax, particularly from multinational enterprises in view of their lower per capita GDP, are intricately linked and dependent upon the international taxation rules and procedures adopted by the developed countries, in particular, the OECD member countries. Many of these international taxation rules, which have been drawn to a large extent, on the basis of the

preference of the developed states to allocate greater taxation rights to the state of residence and restrict the ability of the source states to enforce their sovereign right of administering the taxes allocated to them, have to be accepted by the developing countries and LICs, in view of their limited ability to bargain with developed countries. In view of the inherent vulnerability of these countries in their bilateral treaty negotiations with developed countries, the United Nations needs to take a position that protects the sovereign taxation rights of the developing countries and LICs and prevent the international taxation rules from getting unjustly skewed in favour of the developed countries. In particular, the United Nations needs to take the interest of the developing countries and the base erosion and profit shifting faced by them into account while carrying out work on BEPS.

In particular, BEPS has a detrimental effect on the Indian economy because it reduces the tax revenues that could be collected in the absence of BEPS. In a developing economy like India, tax revenues are crucial for reducing poverty and inequality. BEPS slows down the pace of development by lowering the fiscal spend of the country.

2. If you are affected by base erosion and profit shifting, what are the most common practices or structures used in your country or region, and the responses to them?

One of the major ways in base erosion takes place in India is through excessive payments to foreign affiliated companies in respect of interest, service charges, management and technical fees and royalties.

Shifting profits out of India through aggressive transfer pricing by MNEs is also one of the major ways in which BEPS operates in India. These include profit shifting through supply chain restructuring that contractually reallocates risks, and associated profit, to affiliated companies in low tax jurisdictions. The base erosion on account of transfer pricing gets aggravated since significant difficulties are faced in obtaining the information needed to assess and address

BEPS issues, and to apply the transfer pricing rules.

Similarly, in spite of the huge market for the digital economy in emerging economies like India, digital enterprises face zero or no taxation because of the principle of residence-based taxation as against source-based taxation. Since the dominant players in the digital world like Amazon or Google are not tax residents in India, profits sourced from India are not offered for taxation. Thus, significant base erosion is caused by the inadequacy of existing international tax rules to allocate profits to countries from where these profits are sourced, and in particular, the irrelevance of physical presence as a criteria for allocating taxing rights to source countries in case of digital enterprises

Substantial tax base erosion also results from artificial avoidance of PE status and treaty shopping including the use of techniques to obtain treaty benefits in situations where such benefits were not intended.

Tax base erosion also takes place on account of incentives in the tax laws for attracting investment through offering tax incentives,

Further, tax base erosion takes place by MNEs adopting strategies to avoid tax paid when assets situated in India are sold owned by companies located in low tax jurisdictions with no substance.

To curb shifting out of profits from India through transfer pricing, India has developed a robust transfer pricing audit system over the last decade. This system has made significant progress and has resulted in curbing the aggressive transfer pricing approach adopted by MNEs. Though there is criticism that Transfer Pricing Officers (TPOs) in India have gone overboard at times, the fact remains that this aggressive approach by the TPOs has actually resulted in higher profits being declared in India now as compared to a few years ago. Moreover, the Indian judicial system and the alternative dispute resolution mechanisms [APAs, Safe Harbours, etc.] are there to ensure moderation and reasonableness in transfer pricing outcomes.

To ensure that the benefits of the growth of the digital footprint across the country are reaped through higher tax collections from such activities, India has consistently made demands for source-based taxation. It has also suggested withholding of taxes on payments made for digital transactions.

Further, to ensure that income sourced in India is taxed under the domestic laws, the domestic "source laws" have been strengthened both for taxation of assets located in India transferred "indirectly" and "taxation of royalty".

The General Anti-Avoidance Rules (GAAR) have been introduced in the Income-tax Act, 1961 through Finance Act, 2012 and the "Rules" have been notified on 23rd September, 2013. The current legal position is that the GAAR provisions shall apply with effect from 1st April, 2015 in respect of the tax benefit obtained from an arrangement and the said arrangement, subject to certain conditions, may be declared to be an impermissible avoidance arrangement.

3. When you consider an MNE's activity in your country, how do you judge whether the MNE has reported an appropriate amount of profit in your jurisdiction?

So far, there was no scientific method to determine whether an MNE has disclosed correct taxes in India or not at the pre-audit stage. Accordingly, any shifting out of profits through transfer pricing was detected only during a detailed audit. However, from the current financial year, India is moving on to a system of identifying cases of aggressive transfer pricing through a risk-based approach. This would help in identifying those cases where the correct profits have not been reported in India.

Audits are conducted by tax officers of the International Taxation Directorate to determine whether a MNE has paid taxes on "passive income" such as royalty, dividend or interest earned by it, or on the profits attributable to its PE in India. However, on account of techniques adopted by MNEs for tax avoidance and aggressive

tax planning, these audit techniques have either not been successful or have led to litigation.

The withholding rules requiring the “withholding agents”, which may be resident or non-residents, to withhold taxes before making payments to non-resident are quite stringent. However, in practice these also have limited effect on account of wide prevailing tax avoidance and aggressive tax planning techniques adopted by the MNEs.

4. What main obstacles have you encountered in assessing whether the appropriate amount of profit is reported in your jurisdiction and in ensuring that tax is paid on such profit?

Lack of transparency on the part of the MNEs as stated in response to the previous question and the lack of resources, including the need of training the officers dealing with issues relating to international taxation, transfer pricing and exchange of information, are the two biggest obstacles in assessing whether an MNE has disclosed correct profits in India.

The Subcommittee have identified a number of actions in the Action Plan that impact on taxation in the country where the income is earned (the source country), as opposed to taxation in the country in which the MNE is headquartered (the residence country), or seek to improve transparency between MNEs and revenue authorities as being particularly important to many developing countries (while recognising that there will be particular differences between such countries). These are:

Action 4 – Limit base erosion via interest deductions and other financial payments

Action 6 – Prevent Treaty Abuse

Action 8 – Assure that transfer pricing outcomes are in line with value creation: intangibles

Action 9 – Assure that transfer pricing outcomes are in line with value creation: risks and capital

Action 10 – Assure that transfer pricing outcomes are in line with value creation with reference to other high risk transactions (in particular management fees)

Action 11 – Establish methodologies to collect and analyse data on BEPS and the actions to address it

Action 12 – Require taxpayers to disclose their aggressive tax planning arrangements

Action 13 – Re-examine transfer pricing documentation

5. Do you agree that these are particularly important priorities for developing countries?

Yes, they are.

6. Which of these OECD's Action Points do you see as being most important for your country, and do you see that priority changing over time?

While all the Action Points are important, Action Points 1, 4, 6, 7, 8,9,10, 12, 13 and 15 are crucial for India.

7. Are there other Action Points currently in the Action Plan but not listed above that you would include as being most important for developing countries?

Yes. The Action Point 1 on addressing the tax challenges of the digital economy is also very crucial for India. Besides, Action Point 15, i.e., 'Develop a multilateral instrument', is also a high priority action because a multilateral instrument that is binding on all countries is of utmost necessity to combat tax treaty abuse which is one of the primary concerns of Developing countries like India.

8. Having considered the issues outlined in the Action Plan and the proposed approaches to addressing them (including domestic legislation, bilateral treaties and a possible multilateral treaty) do you believe there are other approaches to addressing that practices that might be more effective at the policy or practical levels instead of, or alongside such actions, for your country?

No.

9. Having considered the issues outlined in the Action Plan, are there are *other* base erosion and profit shifting issues in the broad sense that you consider may deserve consideration by international organisations such as the UN and OECD?

Some of the issues stated in response to above questions may be considered by United Nations and OECD. In particular, challenges posed by the digital economy deserve greater consideration.

10. Do you want to be kept informed by email on the Subcommittee's work on base erosion and profit shifting issues for developing countries and related work of the UN Committee of Experts on International Cooperation in Tax Matters?

Yes.

Do you have any other comments you wish to share with the Subcommittee about base erosion and profit shifting, including your experience of obstacles to assessing and then addressing the issues, as well as lessons learned that may be of wider benefit?

India is of the strong belief that the BEPS issues must be addressed in a manner that result in breaking down all such structures or practices that promote or protect base erosion and profit shifting. For example, if the problem is a leaking bucket then steps must be taken to swiftly plug that leak or replace the bucket instead of debating how to calibrate the speed of inflow of water into the leaking bucket.

In many of the discussions and decisions at the OECD, India gathers the impression that the real issues are being swept under the carpet and the superficial ones are sought to be addressed. This approach is not going to significantly impact BEPS.

Besides, the approach of expecting developing countries to implement all the decisions made by the developed countries appears to be somewhat patronising and should be avoided. Steps must be taken to involve the developing countries in all decisions that are made.

Further, the developing countries should be able to benefit from the experience of Government officials of other developing countries as well as developed countries, including their experience in implementing the recommendations to address BEPS concerns and the problems faced by them. This may be done by way of technical assistance through more south-south and triangular cooperation and the United Nations must take necessary steps to facilitate the same.

Last but not the least, effective Exchange of Information amongst jurisdictions may address many BEPS concerns since the tax administrators will have additional information regarding BEPS techniques adopted by the taxpayers and it may be considered whether there is a need for convergence of these two important initiatives taken in recent times to improve the international tax structure.