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INTERNATIONAL TRADE AND BEPS

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ABSTRACT

International trade is the exchange of goods and services between countries. They create jobs and boost economic growth. They give domestic companies more experience in providing for foreign markets. International trade results in bilateral taxation treaties. But these treaties have certain loopholes which results in strategic tax planning which in turn results in base erosion and profit shifting. International investment law which regulates the conduct of the host state, not investors has a little chance to address BEPS. GATT also has a little scope to tackle BEPS as it does not deal with the measures that does not affect the taxation on income of multinational enterprises. Therefore international soft law with its non-binding nature, which aims at the harmonization of regulation of taxation treaties as well as the domestic legislations, needs to be explored.

Filling gaps in current bilateral taxation treaties would be the most effective way to address BEPS as these treaties primarily and directly affects taxation. Also the cooperation between the states should be there to avoid sophisticated tax planning leading to profit shifting. Thus this paper looks at the loopholes of the international trade laws governing the taxation treaties that are contributing to the issue of BEPS. It will also discuss the problem of non-cooperation between the states in respect of tax planning. Further the paper also provides suggestion to overcome the loopholes both in the domestic laws and international law with respect to the current market trends.

Introduction

The preamble to most bilateral tax conventions provides that the objective of the tax treaty is to avoid or eliminate double taxation as well as to prevent tax evasion. A few tax conventions also make reference to the aim of combating tax avoidance. Double taxation bas always been considered a major barrier to international trade and investment, as well as unfair and contrary to the principle of horizontal equity, requiring the equitable tax treatment of both foreign and domestic income sources. To avoid double taxation, bilateral tax treaties provide a mechanism for assigning taxing rights over income and capital, accruing to residents of one or both contracting states, between the treaty partners in cases where both jurisdictions have a legitimate claim to taxation. The bilateral tax treaty regime, however, is not necessary to deal with this problem. Countries can administer unilateral measures to prevent double taxation, such as foreign tax credits recognizing the taxes paid in foreignjurisdictions, and need not resort to a bilateral tax treaty system. Academics have applied game theory to analyze the tax policies that countries would administer in the absence of a tax treaty regime, concluding that states would unilaterally adopt optimal policies for avoiding double taxation.[1]

As a complement to domestically administered double tax relief policies, tax treaties introduce a measure of uniformity in the tax treatment of income generated in one jurisdiction by residents in another treaty state, and establish a set of miles that lead to predictable results and are simple to apply.[2]It is through the assignment oftaxing rights that the tax treaty regime coordinates the interaction of domestic tax regimes to avoid the overlap between divergent or conflicting domestic tax miles.

Despite the lack of uniformity in treaty practices, the treaty rules and principles governing the allocation and exercise of taxing rights has greatly simplified international taxation, and has introduced some measure of c1arity and certainty with respect to the tax treatment accorded to residents of one treaty jurisdiction, in another treaty state. At the same time, tax treaties play a significant role in circumscribing the scope of each jurisdiction's taxing powers, and function to

[1] See Dagan Tsilly, " The Tax Treaties Myth," (2002) 32 N.Y.U.J. & Pol. 939
[2] Ibid

limit the tax burden levied in the host state, reducing the source jurisdiction's share of the international income base. As a result, the bilateral treaty model functions primarily to reduce the administrative and compliance burden faced by tax subjects with residency or economic ties in more than one treaty country. The treaty regime also has a limited scope and cannot address all the tax related complications that arise when the laws of two jurisdictions overlap or converge.[3]

Treaty shopping

In the report based on the United states- Malta income tax treaty[4], the senate committee on Foreign relations described the term treaty shopping as a situation which is developed when a resident of the country which is not a party of the income tax treaty seeks some benefit from the provisions under the treaty. There can be circumstances such as, establishment of a corporation by the non-resident in one of the countries party to the tax treaty, which would give tax benefits under the tax treaty. It is possible for the resident of the third country to repatriate funds to his home country through the relaxed tax provisions of the tax treaty or by passing funds through another country where the terms are much more favourable.

The inclusion of provisions which usually help in reducing treaty shopping is beneficial ownership clause, specific anti conduit clause, and limitation of benefits clause.

Beneficial ownership

The third company involved in treaty shopping which interpose itself as the company of the country which is the party to the tax treaty is known as the conduit company.

Sometimes, residents of a non-contracting state try to obtain the benefits of a tax treaty by interposing a company in a contracting state, a company that subsequently forwards passive income to the residents of the non-contracting state. This scheme subverts the intention of the contracting states to confine benefits to their own residents. Companies interposed in this manner are sometimes called “conduit companies”. Conduit company cases usually turn on whether the company in question should be characterised as the beneficial owner of passive income that it

[3]LuizaBrindusaCruceru,treaty shopping and the abuse of income tax conventions, Institute of Comparative Law, Faculty of Law, McGill University, Montreal; July, 2005;
[4]senate comm. On foreign relations, report on the tax convention with the republic of malta, S. ExEc. REP. No. 30, 97th Cong., 1st Sess. 20 (1981), reprinted in 2 TAx TREATIES (CCH) 5435 at 5484.

receives, or as a conduit that merely forwards passive income to persons who are not residents of one of the states that are parties to the treaty in question.[5]

Importance of lack of beneficial ownership was tested in the case of A Holding ApS v Federal Tax , here the court relied on the OECD Commentary on Article 1 (that is the 'scope of treaty'); the state do not have to give the benefits of a double taxation convention where provisions of the convention have been abused to entered into an arrangement.

Beneficial ownership might be regarded as one of the most important concepts used in tax treaties. In general terms, it limits the benefit of treaty-reduced withholding taxes on dividends, interest and royalties to recipients who are beneficial owners of such income.

Paragraph 10 of the OECD model commentary on Art 1 suggests the use of a 'beneficial ownership' clause as one of the anti-abuse provisions that can be used to deal with source taxation of specific types of income set out in articles 10, 11 and 12 of the OECD model. The concept of 'beneficial ownership' determines the eligibility of residents of contracting states for the reduction or elimination of source country withholding taxes on interest, royalties and dividends. These words are generally understood to exclude intermediaries, such as nominees and agents who might be interposed between the payer and the ultimate beneficiary.

According to the OECD model commentary to Art 11 where an item of income is received by a resident of a contracting state acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the OECD model for the state of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other contracting state.

Because the term has no specific meaning in the domestic tax law of most countries, the way in which domestic courts should interpret this treaty-originated concept has been the subject of much scholarly debate.

Limitation on Benefits clause

[5] SAURABH JAIN, JOHN PREBBLE, ALLEGRA CRAWFORD, Conduit Companies, Beneficial Ownership, and the Test of Dominion in Claims for Relief under Double Tax Treaties

With the introduction of DTAAs, many companies, in order to minimize tax liability or many a times evade tax liability completely, started exploiting treaty laws. For example, a resident in Mauritius could avoid tax on capital gains in India (the source state) as it was not a resident in India as well as avoid tax on capital gains in Mauritius (residence state) because in Mauritius, residents were not taxed on capital gains. Therefore, in order to prevent abuse of treaty benefits and treaty shopping, countries have revised their tax treaties to include an anti-abuse provision called the limitation of benefit clause, herein after referred to as LOB clause. As the name suggests, this provision limits the benefits of favorable tax treaties.

Under LoB, foreign investors who seek tax exemptions in India should produce documents that he is a resident of the said foreign country (eg Mauritius). LoB refers to procedural requirements that the concerned beneficiary is a resident of the treaty country. The Limitation of Benefit (LoB) Clause is attached by the treaty parties in their bilateral DTAAs. The benefit of tax concession will be limited to such entities that produce the document (for example, the company proving that its residence is in Mauritius).

Mauritius treaty, tax on gains from alienation of shares arising between 1st April 2017 and 31st March 2019 cannot exceed 50% of the tax rates applicable on such gains in the state of residence of the company whose shares are being alienated. As a result of this, numerous companies were incorporated to exploit loopholes provided in tax laws of the DTAA. To counter misutilization of this benefit, the DTAA was renegotiated to include a LOB clause, which states that the benefit will not extend to residents of the contracting State if it's affairs are primarily set up for taking advantage of the benefit of this treaty.

Treaty shopping in India

India has over the time, has very well adapted to the global standards treaty shopping. In its treaties with other countries it is clearly reflected. The typical approach includes a general anti-abuse rule, under which treaty benefits may be denied to a resident of the treaty country if the main purpose, or one of the main purposes, of an arrangement is to obtain tax treaty benefits. The

term used for such a provision typically is "limitation of benefits," but, in essence, the provision is more akin to the PPT rule in the proposals under BEPS action 6 than an LOB rule.[6]

- A completely different approach is taken in India's tax treaty with the US, which includes a detailed anti-abuse rule based on the US model treaty; this is akin to the LOB rule envisaged in the proposals under BEPS action 6.
- A combination of specific and general anti-abuse rules relating to the capital gains exemption is found in India's tax treaty with Singapore. The capital gains exemption may be denied if a company's affairs were arranged with the primary purpose of taking advantage of the exemption. The treaty defines a shell/conduit company and sets forth an objective test for determining whether such a company exists, on the basis of total annual expenditure incurred relating to operations in the country of residence.
- In some of India's recent tax treaties (including the treaties with Luxembourg and Malaysia), the LOB clause includes a provision that permits the application of domestic provisions to prevent tax evasion to prevail over the tax treaty in a case of treaty abuse.

Not only the legislators but also the courts are keen on helping in the issue of treaty shopping.In a landmark Supreme Court ruling in *AzadiBachaoAndolan*, the tax authorities attempted to read an anti-abuse rule into the India-Mauritius tax treaty. They argued that certain offshore companies incorporated in Mauritius were shell companies that carried on no business in Mauritius and were incorporated with the sole motive of taking undue advantage of the capital gains tax exemption available in the India-Mauritius tax treaty. However, the Supreme Court observed that there is no inherent anti-abuse rule (i.e. no rule similar to the LOB rule) in the India-Mauritius tax treaty. The court opined that treaty shopping *"*is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations. This Court cannot judge the legality of treaty shopping merely because one section of thought considers it improper. A holistic view has to be taken to adjudge what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy.*"* The Supreme Court decision generally has been followed by the Indian courts.

The Indian tax authorities' attempts to apply domestic anti-avoidance rules that are not currently part of the Indian tax law were discredited by the Supreme Court in the *Vodafone* case. The court

[6] Treaty Shopping and BEPS- An Indian Perspective, Deloittee, October 2015

noted that taxpayers need certainty as to tax policy if they are to operate efficiently and make rational economic choices, and that certainty also helps the tax authorities enforce the law. The court concluded that it is the government's responsibility to incorporate the relevant anti-abuse rules into the domestic tax law and India's tax treaties, "to avoid conflicting views."

In a recent decision in the *Baker Hughes* case, the Delhi Tribunal considered the relevance of BEPS considerations that the tax authorities argued provided a reason to apply anti-abuse rules. The tribunal explained that BEPS is a tax policy consideration that is relevant for the legislative process, but it cannot have a role in the judicial decision-making process because the judicial process would infringe neutrality if it were swayed by such a policy consideration. The courts must not only be neutral *vis-à-vis* the parties, they also must be value-neutral *vis-à-vis* competing ideologies. The court must interpret the law as it exists, and not as it ought to be in the light of certain underlying value notions.

Transfer pricing

In the globalised economy, developing countries are increasingly opening their borders to international trade and investment. Much of this trade is conducted by multinational enterprises (MNEs), and it is estimated that as much as 2/3 of all cross-border business transactions take place between companies belonging to the same group. Such cross-border trade and investment is vital to economic development. But it is essential, also, that developing countries are able to collect tax on the profits that multinational enterprises earn in their countries and do so in a way that does not discourage or distort international trade and investment.

It should be stressed that transfer pricing is a legitimate and necessary feature of the commercial activities of multinational enterprises, and far from all transfer pricing involves artificial profit shifting. However, multinational enterprises can use their transfer pricing as a means of reducing their global tax bill by shifting profit from normal tax-rate counties to low tax-rate countries. This is an issue faced by developing and developed countries alike. When transfer pricing is used by multinational enterprises to artificially shift profit out of a country, it, first and foremost, denies the country of essential tax revenues. But it can also have much wider implications: tax avoidance by high profile corporate taxpayers will be perceived as "unfair" by citizens, and may undermine the legitimacy and credibility of the tax system, thus discouraging compliance among

all taxpayers. Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike and the G20 has asked the OECD to take forward work on BEPS and advice on how the international tax system can evolve so as to address the challenges. Therefore, the lessons learned through working intensively on transfer pricing and BEPS issues in developing countries are constantly being fed back into the OECD's standard-setting process, to ensure that the developing country perspective is consistently considered in the development of standards and guidance on these fields. This has provided opportunities for developing countries to have a voice in the OECD's work on BEPS.

Most OECD and many non-OECD countries have introduced and are introducing transfer pricing and BEPS rules into their tax legislation. They have done this in order to ensure that the profits reported by MNEs in their jurisdictions are computed in line with internationally accepted principles, to counter any inappropriate or abusive transfer pricing by MNEs, and to avoid BEPS practices done by taxpayers. In most countries that have transfer pricing rules, the benchmark adopted is the "arm's length principle". The arm's length principle requires that transfer pricing between associated enterprises should be the same as if the two companies involved in the transaction were two unrelated parties negotiating in the market, rather than part of the same corporate structure. Relatively few developing countries have fully effective transfer pricing and BEPS regimes in place. Many developing countries that have legislation in place often lack the administrative, technical and auditing capacity to enforce the law and conduct effective and efficient audits.

The three important ways to prevent transfer pricing given by the OECD in its BEPS report are as follows

- In its action 8 the report suggests elimination of BEPS by moving intangibles.[7] It majorly aims at clearly defining intangibles so that the profit related to them is properly allocated. For hard to value intangibles(intangibles having highly uncertain value at the time of transfer) specific transfer pricing rules will be developed. As these intangibles are created in the early in the process of development of new commodities and require research and funding for determination of its true value, this approach would prove beneficial as it

[7] See OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING 20 (2013), https:// www.oecd.org/ctp/BEPSActionPlan.pdf [https://perma.cc/BM2X-P78Q] [hereinafter OECD,ACTION PLAN

would ensure that the taxpayer has appropriately accounted for reasonably foreseeable developments.

- In action 9 of the report it is suggested that the multinational corporations should report returns that are aligned with proper value creations. It will ensure that the risk and capital are allocated to entities according to their contributions.
- Action 10 aims to prevent multinational corporations from engaging in high-risk transactions that other third parties would be unlikely to engage in. The action seeks to apply the arm's length transaction principal to transfers between different entities within a multinational corporation. To do this, the circumstances surrounding transactions must be examined so that reports of profits are aligned with value creation. Further, the application of transfer pricing methods within the context of global value chains of multinational corporations must be clarified. Action 10 requires strong correlations between profit allocation factors and the actual creation of value, to ensure that transactions within a multinational corporation are consistent with the arm's length principle.[8]

Transfer Pricing In India

A recent study by Deloitte and TaxSutra for FY 14-15 [3] reveal some interesting statistics around the trends of TP disputes:

- 50% of the cases selected for TP audit went through adjustments by tax officer
- 500+ court rulings with a distribution of:
  - 4 by Supreme Court,
  - 41 by High court,
  - 486 by tribunals

[8]DELOITTE, BEPS ACTION 10: USE OF PROFIT SPLITS IN THE CONTEXT OF GLOBAL VALUE CHAINS 2 (2015), http://www2.deloitte.com/content/dam/Deloitte/ie/Documents/Tax/BEPS%20 Action%2010%20-%20Scope%20of%20Further%20Work%20on%20Profit%20Splits%20-%20 October%202015.pdf [https://perma.cc/UCY9-6XKH].

- 45% of the cases relate to IT and ITES sector
- Delhi, Mumbai and Bangalore have the highest number of cases contributing to 69% of all cases in a year.

In order to curb this problem, the Indian Government has responded with several measures in the recent years to address the increasing volume of TP litigation. Some of these measures so introduced are as follows [3]:

- Issuance of internal guidance notes to Transfer Pricing Officers (TPOs) for consistent application of Tax Department's views across India;
- Issuance of clarificatory circulars on critical TP matters;
- Introduction of safe-harbor guidelines;
- Introduction of range concept and allowing use of multiple years data;
- Dedicated DRP charge for commissioners;
- Introduction of APA (along with rollback provisions);
- Introduction of risk based approach for manual selection of TP cases instead of compulsory audit of cases selected based on criteria of threshold limit

Problems

Like some developed countries, India has now codified GAAR provisions to safeguard its tax base against impermissible taxpayer behaviour. However, uncertainty persists in relation to the operational scope of these provisions, their interaction with SAAR and their application in the context of tax treaties. Moreover, with GAAR still being at its nascent stage, there may be a number of challenges and issues that may arise on account of different interpretations of the provisions. Aggressive application of Transfer Pricing provisions by the revenue authorities has resulted in increased litigation. In this scenario, the possibility of application of GAAR provisions to augment revenue collection cannot be ruled out, and any indiscriminate application of the provisions is likely to result in increased litigation and adversely affect investors' sentiments. In the backdrop of the Government's policy to ease their doing business in India, investors look forward to tax certainty and facilitated resolution of disputes. This could be a

challenge with the introduction of GAAR. Based on the experience of other countries in implementing GAAR, it is clear that it is the most complex and controversial tax legislation for all stakeholders. Its operation requires entities to pay close attention to the commercial purpose, substance and documentation of transactions to make a representation in a GAAR proceeding.

Under GAAR, the onus lies on the taxpayers to establish that transactions are not undertaken with the main objective of tax avoidance but are backed by commercial and economic substance. Therefore, defence documentation that spells out the commercial reasons for a transaction is crucial in this scenario. Taxpayers may however choose to obtain tax certainty through private rulings. GAAR is set to play a significant role in future enforcement of compliance. Multinational companies seeking to operate an effective global tax governance regime should appreciate and understand current developments in this area and be ready to address application of GAAR.

When we talk about GAAR and Mulilateral Instruments, their co-existence is quite uncertain. In case of GAAR the tax payer can be assured that the principal purpose test is fulfilled while in the case of MLI there is no separate authority to decide that the PPT test has been passed. In this case the Income tax officer can refuse to provide benefits under the tax treaty which can lead to increased litigations. [9]

With the introduction of the long term capital gain tax there could be a return of treaty shopping in India.[10]This is mainly because if an FPI enters through Singapore or Mauritius they will be liable for the 10% LTCG as against nil tax if they come through countries like Netherlands and France. The difference between tax treaties like Mauritius and Singapore compared to Netherlands and France is that the latter have not been amended. India in last two years have amended tax treaties with Singapore, Mauritius and Cyprus where domestic taxes would be

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[9] PWC GAAR decoded, Nov 2017 www.pwc.in

[10]By *Sachin Dave*Tax treaty shopping to restart as FPIs could move base to France or Netherlands , feb 1 2017, economic times

applicable. Many FPIs could now look at setting up a pooling or investment vehicle in Netherlands or France to take the tax advantage.

Suggestions and Conclusions

In order to keep the balance between the need for jurisdictions to enforce their tax rules and the taxpayer's right to have certainty in the tax rules applicable to their business activities, transparency in aggressive tax planning should be evaluated on the basis of the availability, clarity, simplicity and reliability of the anti-avoidance rules. Fiscal transparency requires the drafting of tax rules to be clear for the tax administration to enforce them and for the taxpayer to rely on them. In this framework the notion of transparency has a broader meaning than the one provided by the OECD regarding exchange of information.

The broader approach to transparency has also been addressed by several scholars. For Owens, the notion of transparency should include clarity, simplicity and reliability.[11] Furthermore, Owens rightly states that "greater transparency between the taxpayer and the tax authorities is a good thing as it will lead to fewer disputes, greater mutual understanding and a relationship based on cooperative compliance". [12]

Countries have until now tackled aggressive tax planning by means of enhancing administrative cooperation i.e. concluding agreements to exchange information and administrative assistance to ensure tax compliance. In addition, countries have introduced anti-abuse rules in tax treaties and in national rules. Examples of these rules in tax treaties are the beneficial ownership, the limitation on benefits test, the main purpose test, the subject to tax clause and the switch over clause amongst others. At national level, countries have introduced general anti-avoidance rules such as substance over form, business purpose, and abuse of law. Summarizing aggressive tax planning may result in tax base erosion and therefore measures to counteract aggressive tax planning have been introduced by countries at domestic and at international level.[13]

[11] J. Owens, Moving Towards Better Transparency and Exchange of Information on Tax Matters, 11 Bulletin for International Taxation, 557 (2009)
[12] J. Owens, International Tax Transparency: The "Full Monty", 9 Bulletin for International Taxation, (2014), 384.
[13]Dr. Irma Johanna Mosquera Valderrama1 , Festus Akunobera2 , Addy Mazz3 , Natalia Quiñones Cruz4 , Luís Eduardo Schoueri5 , Jennifer Roeleveld6 , Craig West7 , Pasquale Pistone8 , Frederik Zimmer. Tools Used by Developing Countries to Counteract Aggressive Tax Planning in the Light of Transparency

In response to heightened calls from activists and collection agencies, tax rules are being designed and implemented in a more comprehensive manner the world over – a shift in which the Organisation for Economic Co-operation and Development's base erosion and profit shifting (BEPS) initiative plays an integral role. The shift is forcing companies to share significantly more details regarding their operating data and tax strategies, both publicly and in materials available to tax authorities.

The major requirement of Limitations of benefits clause is to see that the company that has been set up in not a conduit company. For this there need to be a strict scrutiny on the documentation process and the audit of the companies so as to assure that there is no fraud through the way of documents.

Also as it is seen in the case of France and Netherlands, that the non-updation of treaties acting as a major loophole, it should be the aim of the legislators to amend the treaties with the progress of time as to align them with the global standards.

Tax treaties are a very important part of International trade. They should kept in alignment with the changing global standards because the international trade is mostly governed by bilateral tax treaties which do not depend on a country's domestic aw but on the international standards. If the country's domestic laws are not aligned with the international laws then there could be inconsistency in both the law leading to difficulty in the conduct of international trade.