"AN ANALYTICAL STUDY OF BASE EROSION AND PROFIT SHIFTING (BEPS) BY MULTINATIONALS"

VIVEK SHUKLA[1]

UNIVERSITY OF LUCKNOW

DR. SOMESH KUMAR SHUKLA[2]

UNIVERSITY OF LUCKNOW

Abstract:

Base erosion and profit shifting has become a popular tool of evading tax by MNCs now a days and is posing a threat to honest entities all over the world, other than depriving the revenue authorities of the countries from deriving their fair share. The microscopic area of study is the OECD report on *Addressing Base Erosion and Profit Shifting* launched in *February 2013.* Action Plan 1 of BEPS, i.e., addressing the challenges of a digital economy has been studied in detail in a broader perspective. This report has been studied in light of the key pressure areas of the *Addressing Base Erosion and Profit Shifting, 2013.* This paper studies the investing trends of Indian MNCs wherein it is seen that the low tax jurisdictions attract Indian MNCs to invest. This paper also seeks to find out whether the Indian MNCs use low tax jurisdictions to channelize their investments into India.

Key words: Digital economy, Base erosion and profit shifting, Organization for economic cooperation and development, Multinational companies, Low tax jurisdictions.

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[1] Research scholar, University of Lucknow, R/O Ashiana colony, Lucknow, vivekshuklahs@gmail.com, +918765922837, ORCID 0000-0003-4624-2702.
[2] Professor and Head of Commerce Department, University of Lucknow, R/O Jankipuram Lucknow, prof.someshshukla@gmail.com, +919450378945.

LIST OF ABBREVIATIONS

BEPS	Base Erosion and Profit Shifting
B2B	Business To Business
B2C	Business To Consumer
CFC	Controlled Foreign Company
C2C	Consumer To Consumer
CUP	Comparable Uncontrolled Price
DTAA	Double Taxation Avoidance Agreements
DTC	Direct Tax Code
DTTs	Double Tax Treaties
ICT	Information and Communication Technology
IIAs	International Investment Agreements
IMF	International Monetary Fund
IP	Internet Protocol
IRS	Indian Revenue Service
ISP	Internet Service Provider
IT	Income Tax
MLE	Multi Location Enterprises
MNC	Multi-National Companies
MNEs	Multi National Enterprises
NGOs	Non-Governmental Organizations
OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
SAAR	Specific Anti-Avoidance Rules
SDTs	Specified Domestic Transactions
SEZ	Special Economic Zone
TFDE	Task Force on the Digital Economy
TNMM	Transactional Net Margin Method
TP	Transfer Pricing
TPR	Transfer Pricing Regulations
UK	United Kingdom
UN	United Nations
US	United States
USA	United States of America
UTIN	Universal Tax Identification Number
VAT	Value Added Tax
GAAR	General Anti Avoidance Rules

1.1 Introduction

Base Erosion and Profit Shifting (BEPS), is used to describe tax planning methods that depend on mismatches and gaps that exist between the tax rules of different jurisdictions. These strategies are designed to minimize the corporation tax that is payable overall by either making tax profits ‘disappear’ or by shifting profits to low tax operations where there is little or no genuine activity.[3] Base Erosion and Profit Shifting mainly has two dimensions. It can occur when multinationals make aggressive use of the tax planning opportunities opened up by a mischaracterization of different vehicles and income sources and where tax treaties and transfer pricing are misused to shifts profits into low tax jurisdictions. *Secondly*, base erosion and profit shifting can also occur when governments compete aggressively for the tax base especially when they design regimes which are targeted at highly mobile activities.

In most cases, Base Erosion and Profit Shifting strategies are not illegal. Largely they just take advantage of current rules that are still grounded in a bricks and mortar economic environment rather than today’s surroundings of multinational players which is described by the increasing importance of intangibles and risk management. Some of the schemes used for this purpose are illegal and tax administrations are fighting them. It is relevant for a number of reasons.

First, because it distorts competition, businesses that operate cross-border may profit from Base erosion and profit shifting opportunities, giving them a competitive advantage over enterprises that operate at the domestic level.

Second, it may lead to inefficient allocation of resources by distorting investment in such a way that return on investment higher after tax.

Finally, it is an issue of unfairness, when other taxpayers, see that multinational corporations are used to avoiding income tax; it undermines voluntary compliance by all taxpayers.

1.2 Research Objectives

[3] Available at < http: // lexicon. ft .com / term ? term = base-erosion-and-profit-shifting-Beps >

a. This paper seeks to review the aforementioned report in the context of the first Action Plan given by the OECD for addressing the issue of Base Erosion and Profit Shifting, which deals with the specific issue of 'Addressing the Tax Challenges of the Digital Economy'.
b. Another factor that is dealt with in the paper relates with the issue of Indian MNCs investing in low tax jurisdictions. The trend of investment by the Indian MNCs is studied in the light of aggressive tax planning strategies adopted by them.

1.3 Organisation for Economic Co-operation and Development Report Views

The OECD's Report on "*Addressing Base Erosion and Profit Shifting"* describes *jurisdiction to tax* as one of the key principles that underlie the taxation of profits from cross- border activities and it creates an opportunity for base erosion and profit shifting among MNE's by moving their profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates.

Every country is free to choose its tax system. States have the sovereignty to implement tax measures that raise revenues to use for nation. An essential issue which relates to the need to ensure that tax does not produce unintended and distortive effects on cross-border trade and investment or that it distorts competition and investment within each country by disadvantaging domestic players. In a globalized world where economies are increasingly integrated, local tax laws framed in isolation are often not at the same platform, thus creating space for taxation.

As already discussed, these gapes may result in double taxation or may the income untaxed in any jurisdiction or these gapes make income disappear for tax purposes. Although it is also very difficult to determine which of the jurisdiction involved has lost tax revenue, it is clear that collectively the countries concerned lose tax revenue. This also undermines competition, as those entities which operate cross -border and have access to sophisticated tax expertise, may profit from these opportunities and have competitive advantages over small and medium size entities that operate mostly at the country level.

Considering how tax systems interact with each other is therefore relevant not only to eliminate obstacles to cross-border trade and investment, but also to limit the scope for unintended non-taxation.[4] Although the most efficient way to reduce or evade

[4] Organisation for Economic Co-operation Development, "*Addressing Base Erosion and Profit*

taxation is to shift income in that jurisdiction where low rate of tax applicable, the same results may be achieved in a number of other ways.

Following are the different ways in which the current rules can be applied to achieve low or no-taxation, mostly in relation to financing:

a. *Low-taxed branch of a foreign company*
b. *Hybrid entities*
c. *Hybrid financial instruments*
d. *Conduit companies*
e. *Derivatives*

1.3.1 Digital Economy

The digital economy is the consequence of the far reaching and transformative process brought on by Information and Communication Technology (ICT). All sectors whether retail, education, broadcasting, financial services, media or others are not untouched by digitization. Digital economy is a worldwide network of all those economic activities which are performed through information and communication technologies. It is an electronic market in which like a traditional market buyer and seller meet each other, but without physical presence and place, all other formalities like product description, legal issues and payments are make electronically. Nowadays digital economy is spreading all over the world rapidly and now has become an economy in itself.

Today approximately half of the countries globally have become digital with 3.2 billion web clients and 4.4 billion cell phone or smart phone clients on the planet. India has become the second largest country in the world of web users with 350 million users in 2015 which were 120 million in 2011, after china. With the help of various government schemes and 'Digital India Scheme' smartphone users are expected to increase to 651 million till 2019 with comparison to 140 million in 2014, which is 4.65 times[5].

The political fraternity around the world has been making a fuss about the aggressive tax planning by the MNEs that has been taking place around the world of late because it makes use of the gaps crept in the bilateral or multilateral provisions, which ultimately reduces or altogether eliminates tax liability of corporations.

Shifting", February, 2013, p. 39

[5] http://fortune.com/2015/11/18/india-internet-population/

The digital economy is a transformative process developed by information and communication technology (ICT), which has made technologies cheaper, more powerful and widely standardized, improving business processes and bolstering innovation across all sectors of the economy.

Digital economy has become the norm of the hour, so digitized economy and the rest of the economy have become inseparable, thus leading to the issue of aggressive tax planning.

With the spread of digital economy new challenges are being posed in the arena of international taxation. The digital economy is characterized by an unparalleled dependence on intangibles, the gigantic use of information (personal data), and far reaching adoption of multi-sided business models capturing value from externalities created by free products and the trouble of determining the nation in which value creation happens. This brings up major issues with reference to how undertakings make revenue and add value in the digital economy, and how the concept of source and residence or the portrayal of income will be suited in digital economy.

1.4 BEPS in the context of Direct Taxation

On one hand India has launched schemes like 'Digital India' and 'Start up India' whereas on the other hand successful Indian startups like Grofers, Flipkart, Knowlarity, Freshdesk, AdNear, Mobicon and Druva have a leg in Singapore or in other low tax jurisdictions. It is an estimate that more than 5000 Indian companies, mostly digital companies have their headquarters in Singapore[6].

The February 2013 Report *Addressing Base Erosion and Profit Shifting* (OECD, 2013) identifies a number of coordinated strategies associated with BEPS in the context of direct taxation, which can often be broken down into four elements:

Minimization of taxation in the market country by avoiding a taxable presence, or in the case of a taxable presence, either by shifting income or by reducing profit by maximizing deductions at the level of the payer. The most popular methods are:

1.4.1 Avoiding a taxable presence

1.4.2 Minimizing the income in market jurisdictions

1.4.3 Maximizing tax expenses in market jurisdictions

[6] Retrieved from https://www.saddahaq.com/dear-pm-ensure-that-bureaucracy-doesnt-make-life-difficult-for-us-to-operate-from-our-own-country

1.4.4 Avoiding withholding tax

1.4.5 Elimination or reduction of tax in the intermediate country

1.4.6 Eliminating or reducing tax in the country of residence of the ultimate Parent

1.5 Challenges raised by Digital economy in the area of direct taxation

"New Opportunities come with new threats". The main challenges which are raised by new business models, i.e., digital economy in the context of direct taxation can be broadly categorized in the following three manners.

1.5.1 Nexus: It is the general rule of the taxation that the income must have nexus with jurisdiction but with the birth of digital economy, rules have changed. Nowadays MNEs can enter in the economy of another jurisdiction without having a permanent establishment or dependent agent therein.

1.5.2 Data: The growth of Information technology also raises the threat of transfer of value created through digital products and services. Information technology makes it possible to transfer valuable data, information, innovations, digital products, services and other intangible assets from one jurisdiction to another without imposing tax.

1.5.3 Characterization: Digital economy also creates a problem in the context of proper characterization of income/payments especially in relation to cloud computing.

1.6 Opportunities for BEPS with respect to VAT/Service tax

Under certain circumstances, opportunities for tax planning by MNEs and corresponding BEPS concerns for governments with respect to VAT/ Service Tax may arise in relation with the following issues

(i) Remote digital supplies to exempt businesses.

(ii) Remote digital supplies acquired by enterprises that have establishments (branches) in more than one jurisdiction (MLE) that are engaged in exempt activities.

Explanations

1. Such a disadvantage may likewise emerge when competing undertakings are liable to various different levels of taxation in their domestic jurisdictions, even though that is far beyond the worries raised by BEPS.

2. notwithstanding the fact that the country from which the Internet Protocol (IP) is transferred requires that such transfers be made at arm's length, taxpayers may take aggressive positions that in reality result in less than an arm's length sum being recorded for tax purposes regarding the transfer.

1.7 Measures that will address BEPS concerns in the market jurisdictions

A number of measures of the BEPS Action Plans will have the primary effect of restoring source taxation, in particular with respect to treaty abuse (Action 6) and artificial avoidance of PE status (Action 7).

Prevent treaty abuse (Action 6)

The Report *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*[7] (OECD, 2015a) demonstrates model guidelines to handle the menace of abuse of tax treaties. These tenets accommodate a minimum standard to address treaty shopping arrangements through which organizations are set up in a nation in order to exploit the treaty network of that nation as opposed to carrying on actual business activities in that country. They additionally prevent the use of principles involving the use of dual resident organizations that claim to be resident of a particular treaty country to accomplish double non-taxation. Moreover, the rules address unintended instances of non-taxation that arise out of tax treaties, in particular where countries wipe out double taxation through the exemption method. The report mirrors the further work that has been done with respect to the exact contents of the model provisions.

The denial of treaty benefits in cases that could otherwise improperly result in double non-taxation will guarantee that the market nation will have the capacity to apply its local law unconstrained by treaty rules aimed at avoiding double taxation. This is of significance both in situations where the seaward company has asserted not to have a taxable presence in that nation as a PE or when there is for sure a taxable presence in either the form of a PE or as a group company, but the pertinent taxable income is almost halved by application of deductible payments. In situations where such deductible payments would be liable to a withholding charge under local law, the market nation will have the capacity to apply such a withholding tax without any treaty limitation or restriction.

[7] Retrieved from oecdactionplan1.pdf, page number 87

1.7.1 Prevention of the artificial avoidance of Permanent Establishment status to reduce tax liability (Action 7)

The definition of PE as given by the treaty, may constrain the application of local law rules applicable to the tax collection of the business profits of non-resident organizations derived from sources located in the market country. The rules framed with respect to Action 7 were aimed at eliminating the artificial avoidance of the treaty threshold underneath which the market country may not charge. This work was distinguished by the Task Force on the Digital Economy (TFDE) as a key territory of focus keeping in mind the end goal to guarantee that BEPS hazards in the digital economy could be tended to. The work in this manner considered the key elements of the digital economy in creating changes to the definition of PE to guarantee that artificial arrangements or simulated courses of action cannot be utilized to circumvent the threshold for practicing taxing rights.

The work likewise guarantees that where basic and essential business activities of an enterprise are carried on at a given location in a particular nation, the endeavour cannot profit from the rundown list of exceptions normally found in the meaning attached with PE. It was therefore consented to modify Article 5(4) of the OECD Model Tax Convention to ascertain that all exceptions included therein are restricted to activities that are generally of a preliminary or incidental character. In addition to broader arena of dealing with cases of aggressive tax planning to avoid and evade tax, BEPS issues are raised when the absence of tax collection in the market nation is combined with techniques that lessen or dispose of tax in the country of the beneficiary or of the ultimate parent. Likewise, a new rule was introduced related to anti fragmentation to make sure that it is not feasible to benefit from these exceptions through the fragmentation of business activities among firmly related enterprises.

1.7.2 Measures that will address BEPS issues in both market and domestic (ultimate parent) jurisdictions

Various measures mentioned in the BEPS Action Plans will enhance the address BEPS issues both at the level of the market jurisdiction and at the level of the jurisdiction of the parent company. These incorporate the measures created in the span of the work on Action 2 (i.e., neutralize the effects of hybrid mismatch arrangements), Action 4 (i.e., limit base erosion via interest deductions and other financial payments), Action 5 (i.e., counter harmful tax practices more effectively), and Actions 8-10 (i.e., assure that transfer pricing outcomes are in line with value creation).

1.7.3 Neutralize the effects of hybrid mismatch arrangements (Action 2)

The BEPS Action Plan takes notice of the fact that hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral by, for example, creating two deductions for a single expense, generating deductions in one jurisdiction without corresponding income inclusions in another, or misusing foreign tax credit or participation exemption regimes. In common with other MNEs, digital economy businesses take advantage of hybrid mismatch arrangements to achieve BEPS by stripping income from a market or intermediate jurisdiction or by avoiding application of CFC rules or other anti-abuse regimes.

1.7.4 Limit base erosion via interest deductions and other financial payments (Action 4)

The innovation that is essential to success in the digital economy must be financed. Many large and well-established digital economy players are cash rich and they often finance new ventures, the acquisition of start-ups, or other assets with intra-group debt. It is often the case that taxpayers will establish and capitalise entities in low-tax environments that are then able to engage in transactions with associated enterprises that have the effect of eroding the tax base. For example, an affiliate in a low-tax environment might be established to lend to high-tax operating entities. Interest deductions on loans from such low-tax entities can present BEPS concerns in countries where business operations actually take place. Where the capital contributed to the low-tax entity to fund these activities is borrowed from third-party lenders, the base erosion effect of these arrangements may be exacerbated. In other words, existing rules may allow affiliate entities in a low-tax environment to fund the profit-generating activities of the group with intercompany debt, even though the MNE group as a whole may be much less heavily leveraged. This ultimately reduces tax at the level of the market jurisdiction and at the level of the parent company jurisdiction, with the interest often going untaxed anywhere for a number of reasons (such as the availability of preferential regimes, the use of hybrid instruments, and the availability of generous deductions). The work done with respect to Action 4 provides an agreed framework for best practices in the design of domestic rules, in order to reduce opportunities for BEPS via interest and other deductible financial payments. This work addresses BEPS in respect of interest paid to both related parties and third parties and addresses both inbound and outbound investment scenarios.

1.7.5 Counter harmful tax practices more effectively (Action 5)

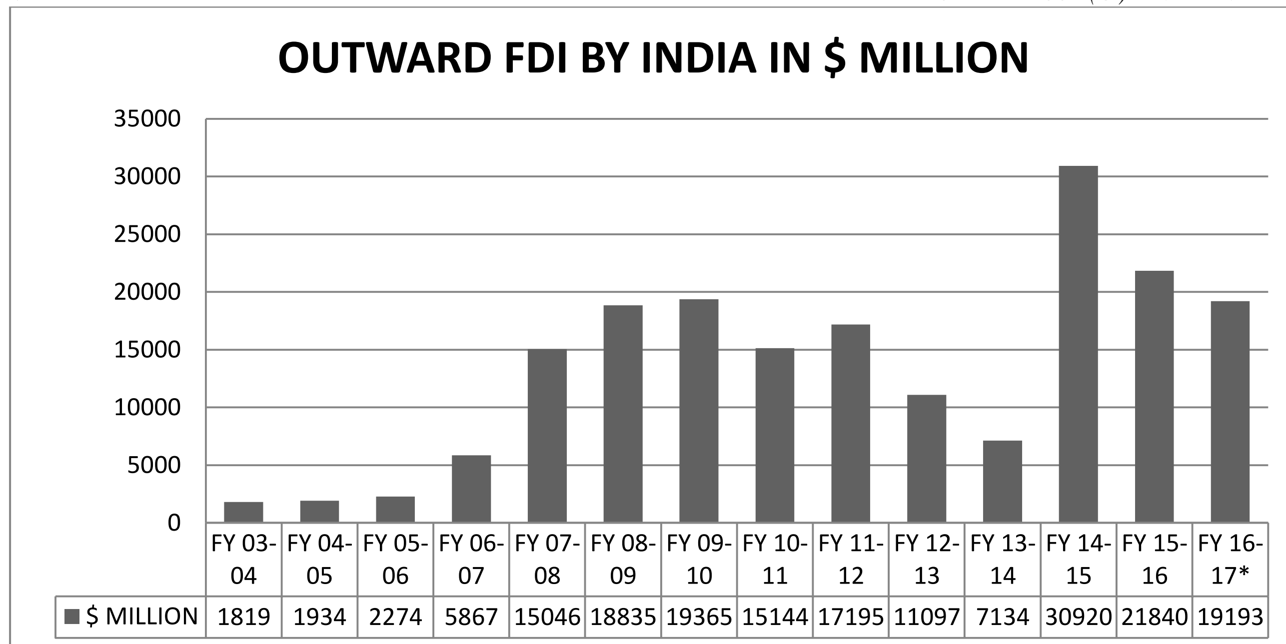
Digital economy companies heavily rely on intangibles to create value and produce income. Intangibles, and income arising from the exploitation of intangibles, are by definition geographically mobile. Over the last decade, a number of OECD and non-OECD countries have introduced regimes which provide for a preferential tax treatment for certain income arising from the exploitation of intellectual property (IP), generally through a 50% to 80 % deduction or exemption of qualified IP income. The work undertaken under Action 5 has therefore included an examination of intangible regimes of the type described to determine whether they constitute harmful preferential tax regimes within the meaning of the OECD's 1998 Report "Harmful Tax Competition: An Emerging Global Issue". Action 5 of the BEPS Action Plan requires there to be considerable activity for any preferential regime and as a result the existing substance factor has been elaborated and elevated in importance.

1.7.6 Assure that transfer pricing outcomes are in line with value creation (Actions 8-10)

The BEPS work on transfer pricing addresses BEPS issues that commonly arise among companies active in the digital economy as well as other taxpayers. Taken together, the overall objective of the transfer pricing actions is to bring the allocation of income within a multinational group of companies more directly in line with the location of the economic activity that gives rise to that income (*Aligning Transfer Pricing Outcomes with Value Creation*, OECD, 2015c). This objective is pursued by focusing on key transfer pricing.

1.8 BEPS and India (FDI data analysis)

1.8.1 Outward FDI by in $ Million

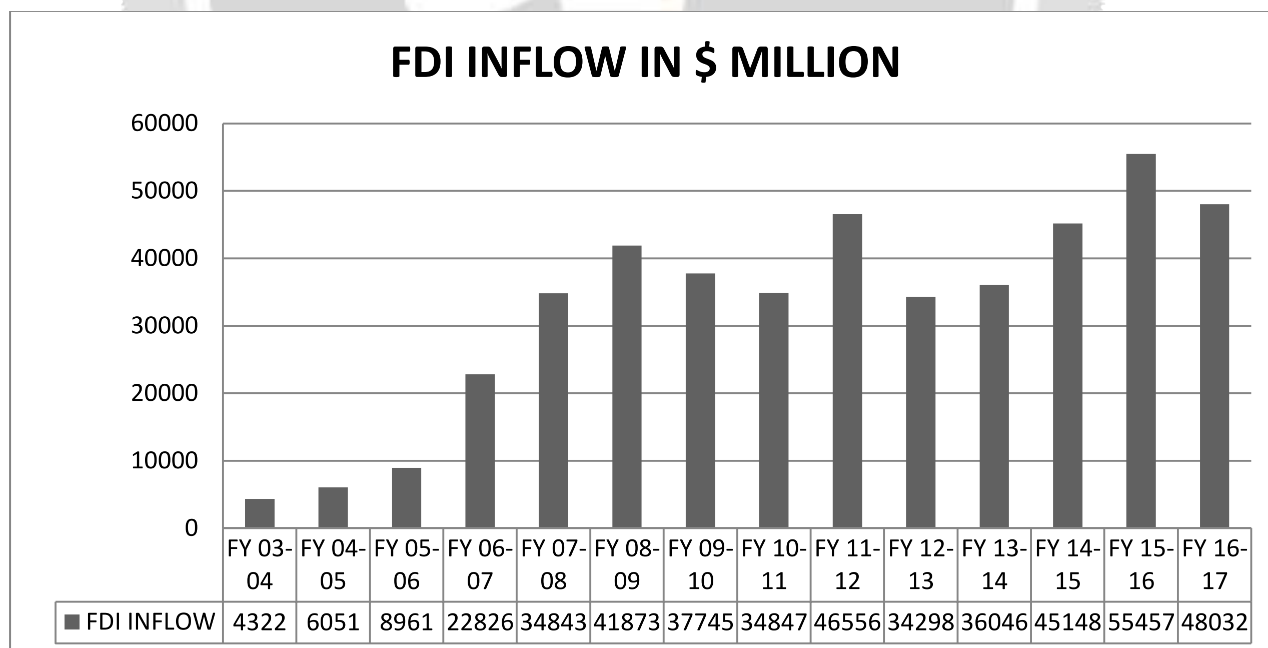


Graph I

*Data till 31 December 2016

Source: https://www.rbi.org.in/Scripts/Data_Overseas_Investment.aspx

1.8.2 FDI inflow in $ Million



Graph II

Source:http://dipp.nic.in/English/Publications/FDI_Statistics/2016/FDI_FactSheet_OctoberNovemberDecember2016.pdf

1.8.3 Country wise list of FDI by India (In $ million)

Country Name	**Tax Rate**[8]	**Equity**	**Loan**	**Guarantee**	**Total**	**% of Total**
SINGAPORE	17	1568	667	2949	5184	23.61
MAURITIUS	15	2861	459	1068	4388	19.99
SWITZERLAND	17.9	138	492	3480	4110	18.72
USA	38.9	842	216	805	1863	8.49
UNITED KINGDOM	20	425	84	898	1407	6.41
NETHERLANDS	25	366	354	339	1059	4.83
UNITED ARAB EMIRATES	55	104	146	619	869	3.96
CAYMAN ISLAND	0	0	82	625	707	3.22
BERMUDA	0	437	0	0	437	1.99
IRELAND	12.5	5	42	112	159	0.73
BRITISH VIRGIN ISLANDS		16	28	105	149	0.68
SAUDI ARABIA	20	0	10	137	147	0.67
INDONESIA	25	92	50	2	144	0.65
OMAN	12	10	6	120	136	0.62
RUSSIA	20	79	0	12	91	0.41
HONGKONG	16.5	7	8	74	89	0.4
MALAYSIA	24	0	0	72	72	0.33
JERSEY	0	31	33	0	64	0.29
LUXEMBOURG	29.2	45	0	14	59	0.27
PANAMA	25	0	4	51	55	0.25
GERMANY	29.7	35	3	10	48	0.22
OTHERS	_	426	146	144	716	3.26
TOTAL		**7487**	**2830**	**11636**	**21953**	**100**

Source: RBI Table I

[8] Retrieved from https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html

1.8.4 Top Countries investing directly in India (FDI equity inflows) (In $ million)

Country Name	Tax Rate	2014-15	2015-16	2016-17*	% of Total
MAURITIUS	15	9030	8355	12819	35.76
SINGAPORE	17	6742	13692	7115	19.85
JAPAN	30.86	2084	2614	4249	11.85
UK	20	1447	898	1266	3.53
USA	38.9	1824	4192	1940	5.41
NETHERLANDS	25	3436	2643	2500	6.97
GERMANY	29.7	1125	986	907	2.53
CYPRUS	12.5	598	508	559	1.56
FRANCE	33.33	635	598	419	1.17
UAE	55	367	985	613	1.71
OTHERS	_	3643	4530	3457	9.64
TOTAL FDI		**30931**	**40001**	**35844**	**100**

Table II

Source:http://dipp.nic.in/English/Publications/FDI_Statistics/2016/FDI_FactSheet_OctoberNovemberDecember2016.pdf

1.9 *Conclusion*

The above tables show that FDI by Indian MNEs has increased rapidly in the last few years. In Financial Year 2003-04 it was $1819 million whereas it increased to $19193 million in Financial Year 2016-17 (till December 2016) which was more than 10 times. The outward FDI by Indian MNEs was highest in F.Y 2014-15 amounting to $30920 million. It can be clearly observed that the maximum outward FDI by India is in low tax jurisdictions. Approximately 85% of Indian outward FDI is in low tax jurisdiction in which Singapore stands at the top position with 23.61% of the total amount invested. On the other hand more than 60% of total FDI inflow in India is also

from low tax jurisdictions in which Mauritius and Singapore are the ones that put in maximum investment.

After the analysis of FDI (inflow and outflow) data of India it can be asserted that low tax jurisdictions are the top investing destinations of Indian MNCs and through low tax jurisdictions MNCs channelize their investment into India to evade tax.

One more trend to be observed is that the maximum inflow of investment into India is through those countries with which India maintains a Double Taxation Avoidance Agreement (DTAA). Among these countries, Mauritius is a well-known destination through which investment is channelized into India. Although, now India is in talks with the nation for certain amendments in its bilateral agreement (DTAA) regarding capital gains.

Therefore, it can be summed up that digitalization is working like a double sided sword. On one side it is being used to accelerate economic growth, to curb corruption and to provide better facilities and services to countrymen whereas on the other side it is being used for evading revenue by multinational players.

2.0 Suggestions

Thus the following suggestions can be given in this regard:

I. Taxing B2C supplies of both digital services and low value e-commerce in the country of residence of the consumer will place a greater compliance burden on vendors in the global digital economy and potentially increase the cost to consumers.
II. Universal taxpayer identification number (UTIN) should be issued by governments instead of separate identification numbers like PAN, TAN, TIN, ST number etc. This will ensure efficient compliance by the tax payer as well as transparency at the level of administration.
III. A worldwide minimum tax could potentially allow for some balance to be struck between multinational corporations' concerns over tax burdens and governments' concerns over profit shifting.[9]

[9] See, for example, Rosanne Altshuler and Harry Grubert, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," *National Tax Journal*, vol. 66, no. 3 (September 2013), pp. 671-712.

IV. Implementation is key; some countries that have restrictions on interest deductions may be reluctant or slow to change these if they believe they are already effective.

V. Taxpayers should be made aware that information will be exchanged spontaneously in relation to certain rulings including on preferential regimes, unilateral transfer pricing and PEs. The countries must follow the laid down norms on that behalf.

VI. It is difficult to assess the success of the proposed tools in monitoring BEPS until Actions are implemented more widely in a variety of jurisdictions. Thus countries must adopt the rules as soon as possible in the larger interest of the world.

VII. Multinationals need to have a transfer pricing documentation strategy to coordinate the content and preparation of transactions. Many tax authorities are asking for transfer pricing documentation to be submitted alongside tax returns. Transfer pricing documentation will become part of the annual tax compliance cycle.

VIII. Another suggestion can be made in the context of the rates of taxes imposed in different jurisdictions. To ensure full compliance by the tax payers, a certain amount should be charged by both the jurisdictions, the total of which should amount to that rate which the taxpayer ought to pay in his home country. For example, resident of country A is supposed to pay 10% tax in the country B where he is carrying on his business by virtue of a DTAA between the two nations. Ultimately, provisions should be made in such a way that the difference between the tax payable in the home country and the tax actually paid should be made chargeable in the resident country, or whichever jurisdiction is charging less. This will act as a deterrent factor for the assessees to shift their base because ultimately, the burden will remain the same for him.

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