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Tax Haven: Analysing Tax Avoidance in respect of Panama and Pandora Papers

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ABSTRACT

The idea of taxation is not a new one but rather an age-old concept that forms the basic component of governing and administrating a State. Based on the Constitution of India, the central government has to power to impose a tax on both natural and legal persons. It is with the imposition of tax on the legal person that several complications arise. The imposition of tax on corporates is decided based on two principles; source principle and resident principle.

The problem arises when corporates evade tax obligations and undertake different tax evasion techniques which make the imposition of tax difficult irrespective of the principle the home country follows. The prime vehicle used for such evasion is through setting up a shell company in a tax haven country and routing all the income from the home country to a tax haven country, thus, masquerading national income into international income. In such a scenario, since the source of the income becomes difficult to track, it becomes difficult to prove that income has been generated from a corporation based in the home country.

So, to address the issue, the paper shall first analyse the fundamentals of the international taxation regime, and what are the different methods of corporate tax avoidance. Thereafter, the paper shall examine the concept of a tax haven with the help of the OECD rules and corporate tax avoidance principles. Lastly, the paper shall contemplate two recent tax haven controversies and their international implications.

INTRODUCTION

The idea that every person has to pay a certain amount of tax on every earning to the State is a very ancient concept and can be found mentioned in Arthashastra as well. Chanakya in his book "Arthashastra" stated that taxation is the backbone of administration. It states that "*just as one plucks fruits from a garden as they ripen, so shall a king have the revenue collected as it becomes due. Just as one does not collect unripe fruits, he shall avoid taking tax that is not due because that will make the people angry and spoil the very sources of revenue.*"[1635] According to the book, tax should be collected once a year and the rate of taxation should be determined based on the number of people paying the tax. In essence, he was focusing on increasing the wide range of the tax net. Based on this principle, art 265 read with art 246 of the Constitution along with the 7th schedule[1636] provides the government shall have the authority to tax different subject matters to ensure the developmental, social and welfare work of the State remains unaffected.

To that effect, people of the country have to pay both direct tax based on their income level and indirect tax based on the manufacturing of goods and services. The same goes for the corporate as well, they also have to pay tax based on the income of the company and a further surcharge has to be paid if the income of the company exceeds one crore.[1637] The problem arises when a company tries to evade their fiscal responsibility by establishing shell companies or incorporating its business in tax haven countries to escape its tax liability. In this paper, the focus shall be on understanding how an international tax haven works, what are the characteristics of a tax haven, what happened

[1635] Dr. Ramesh Kumar, *Chanakya's taxation*, THE NEWS (Jul. 12, 2019), https://www.thenews.com.pk/print/497114-chanakya-s-taxation.
[1636] INDIA CONST. 1950.
[1637] Income Tax Act, 1961, No. 43, Acts of Parliament, 1961, § 115BA.

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in the Panama and Pandora papers controversy and how different countries have tried to address the issue.

BRIEF OVERVIEW OF INTERNATIONAL TAX

Before understanding the concept of tax haven and its impact on Panama and Pandora papers, it is necessary to have a brief idea as to how international taxation works.

International taxation usually works based on the domestic laws of the targeted country and the bilateral agreement that the country has signed with any of its counterparts. The framework relies largely on separate accounting, which means that the taxation of a corporate entity is at the level of individual subsidiaries that operate in different countries. Each country has a right to tax the income assigned, based on its domestic law and tax treaty obligations.[1638]

The fundamental question that arises is; when can a country have the power to levy tax on a Multinational Corporation (MNCs)? Once that is determined then the subsequent issue of whether MNCs have violated the tax law of that country can be determined. But if the country does not have the power to tax in the first place, then the question of violation of tax laws does not even arise. Thus, determining whether a country can tax MNCs is done based on two principles; the source principle and the resident principle.

a) Source Principle: as per this principle the country in which the source of the income arises that country will have the power to tax MNCs. That is, if the country considers that any income generated within its jurisdiction shall be liable to tax, then such income is taxed regardless of the residential status of the MNCs (place of incorporation of the MNCs).[1639] For example: if an MNC is incorporated in the USA and has its office in India. Then any income generated by the office in India will be taxed in India since the source of the income is in India.
b) Resident Principle: as per this principle the country in which the company is incorporated that country will have the power to tax the MNCs irrespective of the fact whether the income is being generated in that country. That is, the power to tax the entity would reside with the country in which the taxpayer resides.[1640] For example: if the MNC is incorporated in the United States of America (USA) and has its office in India and income is earned from the office in India, then as per this principle tax has to be paid in the USA on income arising in India.

The problem arises when two countries have two different taxation systems based on two different principles, in such cases MNCs have to pay tax twice on a single income, thus increasing the liability of the entity. In the last example, the MNCs have to pay tax in the USA based on the resident principle and pay tax on the same income in India based on the source principle. So, to avoid double taxation on single-income counties usually enter into a bilateral agreement called "Double Taxation Voidance Agreement" to reduce the burden on such companies.[1641]

METHODS OF CORPORATE TAX AVOIDANCE

Several methods are employed by MNCs to avoid taxes and ensure profitability. Each tax avoidance method is based on which principle of taxation that particular country is following:

a) Avoidance of taxation based on source principle: within the international tax framework, MNCs use different techniques to shift profits between entities in the group to minimize their overall corporate tax liability.[1642] Certain

[1638] Sebastian Beer, *International Corporate Tax Avoidance: A Review of the Channels, Magnitudes, and Blind Spots*, IMF WORKING PAPER (2018).
[1639] *Double Taxation Relief*, ICAI, https://resource.cdn.icai.org/62363bos50456-cp3.pdf (last visited Dec. 10, 2022).
[1640] *Id.*
[1641] Sebastian Beer, *supra* note 4.
[1642] *Id.*

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techniques are used which can either be legal which then is termed as "tax avoidance" or can be illegal which is then termed as "tax evasion". The taxation in the source country can be minimized in flowing ways:

1) Transfer pricing

The basic concept of transfer pricing is based on the idea of having transactions between related entities. Usually, entities have an inherent advantage to undertake transactions between related entities rather than an unrelated entity. The Organisation for Economic Co-operation and Development (OECD) model tax convention defines transfer pricing as "*transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises*".[1643] The two enterprises are regarded as associate enterprises if one of the entities is directly or indirectly participates in the management or control of the other or both the enterprise is under some common control.[1644]

For example: in the table below, company X undertakes two transactions of the same commodity; one between related entity Y, and another between unrelated entity Z. In the first transaction, goods are purchased at the cost of 8 lakhs and sold for 10 lakhs and company X makes a profit of 2 lakhs. Now, the same good is purchased at 5 lakhs and sold for 10 lakhs and the company made a profit of 5 lakhs. So, here, in the first transaction company, X artificially increased the cost of the product by 3 lakhs so that profit gets reduced by 3 lakhs. Thus, the taxable profit would be reduced by 3 lakhs.

Thus, by lowering the price of goods sold by the parent company in high-tax countries and raising the prices of their purchases, companies can successfully shift their income from the high-tax jurisdiction.

Particulars	Price Between Related Parties	Price Between Unrelated Parties
Purchase	Rs.8,00,000	Rs. 5,00,000
Sales	Rs. 10,00,000	Rs. 10,00,000
Profits	Rs. 2,00,000	Rs. 5,00,000

So, to determine whether any transaction that has been entered between any company has the element of transfer pricing in it, the principle of arm's length is used. The arm's length principle of a transaction between two associated enterprises is defined in sec 92A of the Income Tax Act, 1961 as the "*price that would be paid if the transaction had taken place between two comparable independent and unrelated parties. The principle seeks to adjust the profits between two associated enterprises by comparing the same as if the transaction is carried out between two independent enterprises.*"[1645]

One aspect of the arm's length principle that MNCs take advantage of is the transfer of intellectual property and intangibles. Suppose, if a patent is developed in the United Kingdom (UK) and it is licensed to an affiliate in a low-tax country, then income will be shifted if the royalty is lower than the true value of the license. The problem that arises in using the arm's length principle in this aspect is that intangibles like the invention of new medicine, tend not to have any similar comparables so, it would become difficult to determine what price would have been paid according to the arm's length principle.[1646] This problem is further complicated when corporates have different cost-sharing agreements. That is, if a corporate is partially developing medicine and an associated enterprise contributes a buy-in, then it becomes

[1643] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL: CONDENSED VERSION 2017 (2017).

[1644] ICAI, *supra* note 5, at 4.

[1645] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING LEGISLATION – A SUGGESTED APPROACH (2011).

[1646] Jane G Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CONGRESSIONAL RESEARCH SERVICE (2015).

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difficult in determining arm's length price in that scenario.[1647]

2) Earnings Stripping Method

Another method to evade tax is by borrowing more from the high-tax jurisdiction and less from the low-tax jurisdiction. In the earnings stripping method, the corporate reduces its tax liability by paying interest to another corporation.[1648] That is, a company is liable to claim tax exemption on the amount of interest paid on the debt of the company. This incentivizes people to increase their debt in the debt-equity ratio and take loans from associated enterprises located in a low-tax jurisdiction and claim higher tax reductions.[1649] Hence, to ensure the source country does not lose out on taxes different countries have formulated the "Earnings Stripping rule" or "Thin Capitalization rule". In India also, the Income-tax Act, 1961 has been amended and sec 94B[1650] has been inserted which deals with the Thin Capitalization rule. The provision restricts the interest amount on which tax deduction can be claimed by an Indian company [i.e., 30% of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)]. The provision further mentions that this clause would be applicable if the interest amount exceeds one crore. Following is the example to understand how the provision works:

i. Suppose company X is incorporated in India and establishes company Z in Panama. The debt-equity ratio of the company is 10 equity and 90 loans from Company X which carries a 10% interest charge. So, the interest amount is 9 (90x10%).
ii. Now, let's assume that company Z generates an EBITDA of 15. This means the taxable profit of the company is 15-9=6 before the implementation of the thin capitalization rule.
iii. And assume that the legislation of Panama restricts the deduction of interest to 30% EBITDA. This means the deductible interest would be limited to 30%x15= 4.5. The rest of the remaining interest, i.e., 1.5 (9-4.5) will not be taken into consideration in the computation of taxable profit. So, the taxable profit of company X would be 15-4.5= 10.5.

3) Contract Manufacturing:

The concept of contract manufacturing works on the idea of outsourcing. In this case, firm A is in the need to develop a product. So, it approaches firm B to produce the product. Then, firm B based on the complexity of the product quote their budget to firm A and thereby the contract is executed. Now, usually, to evade taxes, a subsidiary is established in a low-tax jurisdiction and a shifting of profit occurs. But it may happen that such jurisdiction is not capable enough to manufacture and sell the product that the subsidiary is dealing with. For example, a US-based subsidiary's ideal market would be India since India has the required technical capabilities to manufacture its product.[1651] But because India is a high-tax jurisdiction, the subsidiary would lose out on profits. So, the company instead established its subsidiary in a low-tax jurisdiction and contract a firm in India that will manufacture the product for a fixed price.[1652] The result is that the subsidiary would get the product from the best of places without paying the tax in that jurisdiction and is able to sell the product from a low-tax jurisdiction thus saving in taxes.

In the recent Taxation Laws (Amendment) Act 2019,[1653] sec 115 BAB provided for preferential corporate tax of 15% for companies incorporated in India post 1st October 2019 or establishes their manufacturing in India on or

[1647] *Id.*
[1648] Sebastian Beer, *supra* note 4.
[1649] Stella Joseph, *Introduction of Thin Capitalization Rule in India*, THE DOLLAR BUSINESS (Feb. 16, 2017), https://www.thedollarbusiness.com/news/introduction-of-thin-capitalization-rule-in-india/49459 (last visited Dec. 10, 2022).
[1650] Income Tax Act, 1961, No. 43, Acts of Parliament, 1961, § 94B.
[1651] Jane G Gravelle, *supra* note 12.
[1652] Ashish Karundia, *Permanent Establishment: The Continuing Conundrum*, ITAT ONLINE, (Dec. 31, 2015), https://itatonline.org/articles_new/permanent-establishment-the-continuing-conundrum/ (last visited Dec. 10, 2022).
[1653] Taxation Laws (Amendment) Act, 2019, § 115BAB.

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before 31st March 2023.[1654] So, the question arises whether the contract manufacturing facility is covered under the recent tax relief. In India, though there is no separate provision dealing with contract manufacturing, sec 2 (29BA) of the Income Tax Act,[1655] defines "manufacture". And based on the definition, it could be said that the contract manufacturer is included in the term manufacturing and should be able to benefit from the reduced corporation tax rate of 15%.

4) Check-the-Box provisions

This technique of tax evasion is restricted to US incorporated firms only. This provision allows the US firms to incorporate a subsidiary company in low-tax jurisdiction as a limited liability company which would be treated as a corporation under foreign limited liability and can be also treated as a partnership or disregarded entity under US tax laws. The consequence of this provision is that an entity that can be treated as a limited liability partnership under foreign law could be treated as a corporation under US laws, such a dual character is often regarded as a "hybrid entity".[1656]

The effect of such a provision is that the parent company reduce their global tax liability by having the hybrid entity pay deductible interests to its parent company in the US. And since these payments would be deductible for foreign tax purposes this would reduce the amount of foreign tax imposed on the hybrid companies. This reduction can be particularly helpful when the hybrid entity is operating in a high-tax country by reducing excess foreign tax credits.[1657]

b) Avoidance of residence country taxation: residence principle of taxation can also be avoided by undertaking artificial use of tax deferrals.

1) Tax deferral

The residence principle of taxation as stated earlier taxes the profit earned by the company incorporated in the resident country irrespective of the fact whether the profit is earned from a domestic source or global source. So, MNCs can avoid the implementation of this principle by avoiding repatriation (i.e., the ability of the firm to send foreign-earned profit back to the firm's home country) of the profit and retaining the profit abroad only. This provision is mainly applicable to US companies since US tax laws have provisions for deferring the payment of tax on the profit earned overseas provided such profits are kept offshore.[1658] In India General Anti-Avoidance Rules (GAAR) would apply in relation to the tax deferral evasion method provided the tax benefit of the relevant assessment year is not exceeding INR 30,000,000.[1659]

UNDERSTANDING THE CONCEPT OF TAX HAVEN

Before analysing how Panama papers worked and what effect they had in a different jurisdiction, it becomes important to understand what exactly is a tax haven and how to identify whether any jurisdiction is a tax haven.

TAX HAVEN AND SHELL COMPANY

There is as such no universal legal instrument which defines a common understanding of the term "tax haven". But in general parlance, tax haven countries are the countries where low or no corporate taxes are levied on the companies incorporated in such jurisdiction.[1660] The European parliament in its 2012 resolution has defined tax haven as, "*foreign non-cooperative jurisdictions characterized in particular by no or nominal taxes, a lack of effective exchange of information with foreign tax authorities*."[1661] The success of tax haven countries is entirely

[1654] *Id.*

[1655] Income Tax Act, 1961, No. 43, Acts of Parliament, 1961, § 29BA.

[1656] *Check the Box Regulation Planning*, SF TAX COUNSEL, https://sftaxcounsel.com/practice-areas/international-tax-attorneys/check-the-box-regulation-planning/ (last visited Dec. 10, 2022).

[1657] *Id.*

[1658] *India Tax*, DLA PIPER, https://www.dlapiperintelligence.com/goingglobal/tax/index.html?t=13-anti-deferral-rules (last visited Dec. 10, 2022).

[1659] Income Tax Act, 1961, No. 43, Acts of Parliament, 1961, chapter X-A.

[1660] Will Fitzgibbon, *What Is a Tax Haven? Offshore Finance, Explained*, ICIJ (Apr. 6, 2020), https://www.icij.org/investigations/panama-papers/what-is-a-tax-haven-offshore-finance-explained/ (last visited Dec. 10, 2022).

[1661] EUROPEAN PARLIAMENT, ON THE CALL FOR CONCRETE WAYS TO COMBAT TAX FRAUD AND TAX EVASION (2012).

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dependent on the tax rate they levy supported by a trustworthy local institutional structure that shields financial activity from the eyes of foreign authorities and allows the untaxed funds to be redeployed in the global economy.[1662] It is important to understand that there are different levels a country can be regarded as a tax haven. There are "*absolute tax havens*" which include all the features which are listed below. And then there are "*mixed tax havens*" which have almost all the elements of a tax haven but tax rates are substantially higher than an absolute tax haven.[1663]

Tax haven jurisdiction limits public access to information by not mandating the disclosure of crucial information regarding the company. Since information is hard to extract, such places are also referred to as "secrecy jurisdictions".[1664] Such places do not require the business to be operated in their country or that the individuals have to mandatorily reside in the country to receive such tax benefits.[1665] The main characteristics of any tax haven country are as follows:[1666]

a) There would be no or very low taxes which are imposed on the body corporates and offers a place to non-residents to escape tax in their country of residence. It is important to note there is a distinction between low tax jurisdiction and tax haven. The former just levies tax at a low rate but is not engaged in harmful tax competition, whereas the latter not only offers low tax but is also engaged in harmful tax competition.[1667] Harmful tax competition is a tax policy that offers a variety of tax benefits (like lack of transparency and no exchange of information) to attract investment.[1668]
b) There is a lack of transparency, i.e., corporates are not required by law to disclose any information to the public;
c) Since information is hard to get by, there is no effective exchange of information with other governments and secrecy is maintained in two aspects; *bank secrecy*, where no information can be obtained from banks for any official purpose, and *legal entity secrecy*, where information relating to beneficial owners, types and value of assets are not available.[1669] The only way any country can get access to any information is through a "request-upon" basis as provided by the OECD. That is, the authorized authority of one country requests any specific information about a shell company incorporated in the tax haven country under the authority of any prior bilateral agreement.[1670]
d) The laws of the country are such that it allows for the incorporation of several shell companies for tax evasion purposes;

Shell companies are those companies that are incorporated in tax haven countries for tax evasion purposes. The company exists on paper but there are no employees or physical location of the office in such countries. Since no documentation is required for establishing shell companies it becomes difficult to determine the actual owner of such companies.[1671] Shell companies are often incorporated to hold money, luxury homes, intellectual property, businesses and other assets. They are often used to transfer illicit money around the world. For example: suppose company A incorporated

[1662] Robert Kudrle, *Tax Havens And The Transparency Wave Of International Tax Legalization*, 37 UPILJ (2016).
[1663] *Id.*
[1664] Will Fitzgibbon, *supra* note 26.
[1665] *What is a Tax Haven?*, CORPORATE FINANCE INSTITUTE, https://corporatefinanceinstitute.com/resources/knowledge/other/what-is-tax-haven/ (last visited Dec. 10, 2022).
[1666] Shashank Manish, *Tax Havens And Money Laundering In India*, INDIRA GANDHI INSTITUTE OF DEVELOPMENT RESEARCH, http://www.igidr.ac.in/conf/money/mfc-11/Manish_Shashank.pdf (last visited Dec. 10, 2022).
[1667] Girjesh Shukla, *Regulating Tax Havens: An Imperative Under International Law*, 2 HPNLU (2019), https://www.hpnlu.ac.in/journal-level-3.aspx?ref-id=11 (last visited Dec. 10, 2022).
[1668] Patricia Lampreave, *Fair Tax Competition vs. Harmful Tax Competition*, GLOBAL TAX GOV (Oct. 1, 2018), https://globtaxgov.weblog.leidenuniv.nl/2018/10/01/fair-tax-competition-vs-harmful-tax-competition/ (last visited Dec. 10, 2022).
[1669] *Identifying Tax Havens and Offshore Finance Centres*, TAX JUSTICE NETWORK, https://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf (last visited Dec. 10, 2022).
[1670] Shashank Manish, *supra* note 32.
[1671] Will Fitzgibbon, *supra* note 26.

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in the US establishes a new subsidiary, Company B on Cayman Island. Now, company A sells company B, a patent for their new drug and thus pays a big licensing fee to the offshore company, which in turn would allow it to record lower profits at home and in the end pay low taxes. Thus, company A on paper paid low tax because of low income, but in reality, hardly paid any tax with respect to the revenue the company generated.

THE LEGALITY OF TAX HAVEN UNDER INTERNATIONAL LAW

The country most affected by the issue of tax havens are the developing countries since they are high tax jurisdictions and corporates evades tax by employing different methods of tax avoidance.[1672] Because of the presence of such tax haven countries, developing countries often lose out on their revenue which negatively affects their economic growth and developmental work. So, the question arises regarding the legitimacy and legality of tax haven in the context of international law which shall be determined based on State sovereignty and normative obligation.

a) State Sovereignty

State sovereignty is the defining characteristic of international law. The term state sovereignty means the authority of the country to govern its municipal affairs without interference from any external source. A country has sole power and authority to determine legal, socio-political and regulatory affairs within the territorial jurisdiction of the State.

One of the international documents which legitimize State sovereignty is art 2(7) of the United Nations (UN) charter which provides for limits in the traditional understanding of sovereignty.[1673] Art 2(7)[1674] states that the UN will not have the power to interfere in matters related to the domestic affairs of the member country. But at the same time, the member countries must respect and follow the obligation of charter values in a good faith. This indicates that sovereignty was never to be taken as a rigid understanding of enforcing universal values. And UN Charter is not the only document that deals with this understanding of sovereignty. Art 2 of the Universal Declaration of Human Rights,[1675] states that States should provide the rights mentioned in the document "*without distinction of a kind, such as race, colour, sex, language, religion, political or other opinion, national or social origin, property, birth or other status*." Thus, a universal standard is set that every State has to follow, giving it the face of universal applicability. The document further states that State's municipal laws should mirror the values, and goals outlined in the document. This also restricts a country's sovereign power which proves that the traditional understanding of State sovereignty has evolved.

Based on the above understating, it can be said that the presence of tax haven jurisdiction poses threat to other countries. With the presence of such jurisdiction, developing countries would lose out on the revenue needed for their development. The sovereignty of any State cannot be used in such a manner that it causes harm or is liable to cause harm to any other member country. The power to decide municipal affairs should be restricted within the internal values and global cooperation a harmony depicted in UN Charter. Hence, member countries can pass a resolution against such countries which aid in the incorporation of shell companies to evade tax in their home country.

b) Normative Obligation

The bone of contention is whether tax haven States have a normative obligation towards other States. In other words, if a State has a harmful tax regime equivalent to a tax haven, then can it be said that the existence of such a tax regime is harmful to other States if it causes any legal damage?

[1672] Sec I.II of the paper.

[1673] Charter of Uniter Nation (adopted on 20 December 1971, entered into force 24 September 1973) 1 U.N.T.S. XVI art. 2(7) (UN Charter).

[1674] *Id.*

[1675] Universal Declaration of Human Rights (adopted 10 December 1948 U.N.G.A. Res. 217 A(III) (UDHR) art 2.

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The question arises how to establish a connection between two contradictory international provisions; on one hand, each State has the right to sovereignty as per which they are free to design their own tax regime and on the other hand; such State must ensure their act does not cause any legal injury to other states. In that regard, the OECD committee has tried to resolve this dilemma by stating that each State is free to design its own tax regime as long as such regime follows the internationally accepted standards of taxation.[1676] In that regard, as per the Responsibility of States for Internationally Wrongful Acts, as adopted by the International Law Commission provides certain provisions relating to the harmful tax regime of any State.[1677] As per art 1 of the Act, any State which intentionally commits any wrongful act entails international responsibility. Such liability may arise either by way of the act which could be termed international crime,[1678] international delicts,[1679] or liability arising out of an internationally permissible act.[1680]

Though the question of whether an international tax haven could be termed an "international crime" is yet to be settled, it cannot be denied that such transnational act undertaken with the help of certain tax haven nations results in huge damage to other states. In that regard, it can be stated that if such acts result in financial and economic damage to other States, then such tax haven countries have an obligation not to undertake such wrongful acts intentionally.

REGULATING TAX HAVENS HAS PER OECD RULES

No country can be a mute spectator when its tax bases are being eroded due to the harmful tax regime of some other country. In such a scenario, countries often undertake bilateral or multilateral approaches to address the issue. Still, there is a certain limitation in adopting different approaches because of three reasons;[1681] *firstly*, with the presence of jurisdictional limits, the tax authorities of the concerned country cannot successfully counter harmful tax competition. *Secondly*, if the concerned country wants to monitor all forms of harmful tax practice, then it would impose a huge administrative cost on such a country and the benefit gained from such exercise would be far less than the cost incurred. And *lastly*, the uncoordinated unilateral measures would increase the compliance, cost, and burden on the taxpayers.

In that regard, even though the country has the power to undertake unilateral measures to address the issue of a tax haven, still it would be in the best interest of the country if they undertake bilateral coordinated efforts to address this menace. Keeping that in mind, the OECD has provided certain bilateral and unilateral guidelines to tackle the problem of tax havens;

GUIDELINES CONCERNING DOMESTIC LEGISLATION

- Regarding Controlled Foreign Corporations (CFCs) rules of the OECD which is the same as action 3 of Base Erosion and Profit Shifting (BEPS)[1682]

One of the ways in which tax can be avoided is by routing the revenues earned to low tax jurisdiction. To do that, companies often incorporate CFCs which though established in low-tax jurisdictions but are governed by high-tax jurisdictions. So, when revenue is earned in CFCs they are often taxed in the resident country, and the source country would lose out on the tax revenue. To avoid that the OECD has provided the CFCs rule which aimed to address the issue and the same has been incorporated in India in the form of the Place of Effective Management (POEM) provision under the Income Tax Act, 1961.

[1676] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, REPORT ON HARMFUL TAX COMPETITION 1998 (1998).
[1677] United Nation, Responsibility of States for Internationally Wrongful Acts (adopted November 2001) Supplement No. 10 A/56/10.
[1678] *Id.* at art. 19.
[1679] *Id.* at art. 19(4).
[1680] M Akehurst, *International Liability for Injurious Consequences Arising Out of Acts Not Prohibited by International Law*, 2 NETHERLANDS YEARBOOK OF INTERNATIONAL LAW (1997).
[1681] OECD, *supra* note 46.
[1682] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, BASE EROSION AND PROFIT SHIFTING (2016).

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But the problem arises as not all countries apply this rule and the counties which have such provisions do not cover all the situations of harmful tax practices. While the guidelines only apply in the context of curbing harmful tax practices, CFC rules may also apply in situations that do not involve harmful tax practices as defined in the OECD report. According to the OECD, to deal with the problem of CFCs, it has laid down two guidelines: *firstly*, countries that do not have any provisions similar to that of CFCs rules are suggested to incorporate the same and *secondly*, countries that have such provisions in their domestic tax legislation are suggested to ensure that such provision is in the same lines as the OECD rules.

- Regarding foreign information reporting rules which are the same as action 5 of BEPS

The issue of tax haven arises when the resident of the country has a certain transaction in foreign countries and the tax authorities of the home countries are unaware of that information. So, to resolve this issue, it was given in the OECD guidelines that countries should incorporate rules that will help other countries in obtaining information about the foreign activities of its resident which can be useful in counteracting harmful tax practices like transactions with related foreign players. Obtaining such information from the tax authorities of the home country is often difficult as such information is located in the jurisdiction of such foreign countries and requires a long diplomatic procedure to retrieve it. But if all the countries have a certain domestic rule regarding the same, then obtaining such information and identifying foreign transactions of its resident would become feasible.

- Accessing banking information for tax purposes

Though it is undeniable that any banking transaction between a person and the bank is private and confidential in nature, in the context of harmful tax practices such restriction on the access of information acts as a barrier to the function of tax authorities. If tax authorities are unable to access banking information it will unduly restrict the authorities to perform tax assessments and would be a serious impediment to the fair and effective implementation of tax rules. Furthermore, as discussed, the above guidelines complement this guideline. In the sense that, when countries incorporate rules relating to foreign reporting rules, then such rules by default need to have a provision dealing with the access of banking information between such residents and the bank concerned or else such provision though will comply with the suggestion of the OECD in letter but not in essence.

- Regarding transfer pricing rules which is the same as action 13 of BEPS

Transfer pricing rules are incorporated by the country so that it would earn more tax revenue, but a country can deviate from the same and relax or remove such provision to attract more Foreign Direct Investment (FDI) in their country as removal of such provision would mean the country would be deemed as tax-friendly jurisdiction. The OECD suggests that such action could encourage offshore transactions and tax deferrals. So, the OECD provides the guideline that countries should eliminate such practices and incorporate such provision of transfer pricing incongruence to the OECD standards.

GUIDELINES CONCERNING TAX TREATISES

- Regarding efficient use of the exchange of information

Domestic tax authorities need information on foreign transactions of its resident so that they can counteract harmful tax measures but with the advent of tax havens, it becomes very difficult to obtain the same. So, countries should undertake bilateral agreements with tax haven countries to ensure the exchange of relevant information concerning transactions in the tax haven countries so that countries do not lose out on tax revenue.

- Regarding entitlement to treaty benefits which is the same as action 6 of BEPS

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Countries often enter into bilateral tax treaties with other countries with the motive of providing relief to their residents from double taxation. But to restrain people from undertaking transactions in tax haven countries, the OECD has suggested that such companies or people who undertakes offshore transaction should not be allowed to claim any benefit under the tax treaties. Home countries should aim at denying the tax treaty benefits to entities and income covered by practices constituting harmful tax competition.

- Regarding treaty with tax haven countries which is the same as action 15 of BEPS

Countries should terminate their tax treatises with tax haven countries even if it raises several political and diplomatic difficulties. It may also raise broader economic considerations. Experience has shown that it is usually very difficult to take such action alone, despite the fact that most tax treaties explicitly provide for the possibility of termination. The OECD in its harmful tax competition report stated that "while termination of a treaty is a matter to be decided by each party to that treaty, the possibility that many countries could adopt the same position vis-à-vis treaties entered into by a tax haven would increase the credibility of such action."[1683] But the decision as to whether the country should terminate such a treaty with a tax haven country must be decided based on cost-benefit analysis. If the country is certain that there is no other way of accessing relevant banking and other financial information of its residents other than the mechanism provided in the tax treaty then terminating the same would be against its interest. It is only then alternative ways are available then only the termination of the treaty can be decided by the country.

- Regarding coordinated enforcement regime

Since the early 1970s countries have often undertaken joint audit programmes under which the tax authorities of both countries audit the tax returns of affiliated corporations for the same taxation year. Such coordination between the tax authorities will also improve international tax compliance. The OECD in its report stated that *"joint training activities on topics such as audit strategies, transfer pricing, could improve compliance by disseminating successful audit practices and by promoting closer contacts between tax inspectors dealing with international transactions."*[1684]

INTERNATIONAL TAX HAVEN CONTROVERSY

In recent times there have been several tax haven controversies which when leaked created havoc in the international forum. In this segment focus shall be given to 2 tax haven controversies; the infamous Panama Papers and the recent Pandora Papers.

a) PANAMA PAPERS

The Republic of Panama is a country situated on the isthmus linking Central and South America. Panama is also known for its laid-back approach toward taxation. It is a low-tax country that acts as a tax haven for different MNCs. Because of its low tax companies often incorporate a shell company in Panama to prove that the company is a resident of Panama, but in reality, the main operation of the business is happening someplace else. That is, the effective control of the management lies in some high-tax jurisdictions but the main office and headquarters of the company are incorporated in Panama. And since Panama levies very low to negligible tax, it provides a breeding ground for several shell companies.

Around 2018, the International Consortium of Investigative Journalists (ICIJ) launched a covert mission that led to the famous leak of the Panama Papers. The leak was unprecedented as the leaked database contained 11.5 million files from the 4th biggest offshore law firm Mossack Fonseca.[1685] The records were obtained

[1683] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998).

[1684] OECD, *supra* note 49.

[1685] Luke Harding, *What are the Panama Papers? A Guide to History's Biggest Data Leak*, THE GUARDIAN (Apr. 5, 2016),

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by a German newspaper which was later shared with ICIJ which in turn was shared with British Broadcasting Corporation (BBC) and other international media houses.[1686]

The firm Mossack Fonseca acted as the registered agent of some 2,00,00 shell companies incorporated in Panama, the British Virgin Islands, the Bahamas and Seychelles to hold property and bank accounts.[1687] Most such companies do not exist in reality but only on paper with no real offices. The clients become the owner of one of such companies and nominate people known as nominees to act as the shareholder and directors of such companies. And since neither the owner of the money cannot be traced nor the existence of the company, this provided a good opportunity to launder money. So, when such companies undertake huge transactions from one country to another, the money cannot be traced back as it does not have a definite origin. Diverting the money through different sources makes it difficult to identify the real owner of the money. The firm did not directly deal with the owner of such companies, but rather the firm took instruction from lawyers and accountants of such companies. And since the anonymity of the clients is maintained, it makes it even more difficult to trace such monies.[1688] The shell companies are an excellent vehicle to move a large sum of money across borders and since the origin of the money could not be identified, the monies remain untraced. And if any one of the tax haven jurisdictions becomes compliant with international standards of taxation, the firm simply incorporates a different shell company in other tax haven jurisdictions.

The leak revealed that high-profile people including 140 politicians, film stars and even Russian President Vladimir Putin have been using offshore tax havens.[1689] Renowned public figures like Nawaz Sharif, Peter Poroshenko (President of Ukraine), 6 members of the House of Lords, and authorities from the International Federation of Association Football (FIFA) were involved in having undertaken offshore transactions.

After the leak, several countries initiated an investigation into such offshore transactions. Belgium formed a panel to look into the offshore transaction,[1690] and the Australian government created a new police task force to undertake raids and ensure action against all the individuals named in the scandal.[1691] In Denmark,[1692] the tax authorities started hiring new employees to increase their human resources so that high-level investigations can be initiated.

Not only that, the aftermath of the data leak was followed by several arrests and detention. In Malta,[1693] law enforcement authorities charged Keith Schembri, former Prime Minister's Chief of Staff with money laundering which was started as a result of the Panama Papers. In Peru,[1694] presidential candidate Rafael Lopez was being investigated by the court regarding his role in the Panama papers scandal.

Another effect of the scandal was that politicians from different countries started to resign from their posts. Iceland's Prime Minister resigned after a nationwide protest took place because of the controversy and Pakistan Supreme Court removed its longest-serving Prime Minister Nawaz Sharif from his post and sentenced him to 10 years in prison.[1695]

To tackle the menace of tax evasion, several countries have enacted stringent tax evasion laws. Like the UK passed legislation that

https://www.theguardian.com/news/2016/apr/03/what-you-need-to-know-about-the-panama-papers (last visited Dec. 10, 2022).

[1686] *Id.*

[1687] *Id.*

[1688] *Panama Leak: How Does Mossack Fonseca Work?*, RNZ NEWS (Apr. 1, 2016), https://www.rnz.co.nz/news/world/300605/panama-leak-how-does-mossack-fonseca-work (last visited Dec. 10, 2022).

[1689] *Id.*

[1690] Juliette Garside, *Panama Papers: European Parliament Opens Inquiry*, THE GUARDIAN (Sept. 27, 2016), https://www.theguardian.com/world/2016/sep/27/panama-papers-inquiry-opens-at-european-parliament (last visited Dec. 10, 2022).

[1691] Paul Karp, *Coalition says Panama Papers Sparked Action Against More Than 100 Australian Taxpayers*, THE GUARDIAN (Sept. 6, 2016), https://www.theguardian.com/australia-news/2016/sep/06/coalition-says-panama-papers-sparked-action-against-more-than-100-australian-taxpayers (last visited Dec. 10, 2022).

[1692] *Id.*

[1693] Will Fitzgibbon, *supra* note 26.

[1694] *Id.*

[1695] *Id.*

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imposed criminal punishment on lawyers who do not report the client's tax evasion mechanism. Similarly, Ghana passed legislation that mandates companies incorporated in the country to identify their owners thus ensuring only legitimate companies are incorporated in Ghana and not any shell companies.[1696] Likewise, the US has taken an extra effort to enact two new legislations to control offshore transactions; Stop Tax Haven Abuse Act and For the People Act.[1697] The US has also enacted the Corporate Transparency Act which requires US companies to disclose their identities to Treasury Department.

And lastly, in France, the tax authorities are pursuing hundreds of tax fraud cases that could have criminal punishment.[1698] The cross-border joint investigation started in the aftermath of the incident. Algeria sought the help of Switzerland in obtaining information about the milk mogul so that they can order a probe into his money laundering activity.[1699] Banks are also being raided in Germany (Deutsche Bank) as a part of a money-laundering investigation.[1700]

But what is more concerning is that such a tax haven has been used by terrorist organisations, hardcore criminals and smugglers to divert their income sources so that their funding could not be traced.[1701]

But countries did not stop their effort to address the issue by only sentencing its citizen. As many as 10 countries have been able to successfully recover $185 million in new money as a result of the Panama Papers investigation with Norway being able to recover $35 million from the offshore transaction.[1702] The United Kingdom has recovered $252.8 million; Germany has reclaimed $195.7 million ($12.5 million new since 2019); Spain has recovered $166.5 million, and France has recouped $142.3 million.[1703] And globally the amount reached the staggering figure of $1.36 billion.[1704]

And interestingly, Panama has signed a multilateral tax convention with other countries for sharing of foreign taxpayer's information.[1705]

Like any other nation, India also had its share of tax evaders. Among the notable names who had offshore companies in Panama were; Soli Sorabjee's Son, DLF group's KP Singh and Amitabh Bachchan (who was the director of 3 shell companies; Lady Shipping, Treasure Shipping and Sea Bulk Shipping Company) and other politicians.[1706]

But this is not the end of the story, it is just the halftime. In 2018 another set of leaks happened again from Panama which again leaked the names of the people who have shell companies in the country. It was termed Panama Paper 2.0 or Panama Papers: The Aftermath.[1707] In this leak, more than 1.2 million fresh documents were published out of which 12,000 were related to Indians. New Indian names emerged like PVR owner Ajay Bijli, son of Airtel's Sunil Mittal and son of Asian Paints promoter Ashwini Dani. Outside India also, famous names cropped up; like Lionel Messi, Argentina's President's family members and French jeweller Pierre Cartier.[1708]

In connection with these scandals, the Central Board of Direct Taxes (CBDT) launched an investigation investigating 426 Indians connected to Panama Papers. Out of which CBDT claimed only 74 cases were actionable cases.[1709] Till 2018, INR 1,088 crores of undisclosed

[1696] *Id.*
[1697] *Id.*
[1698] *Id.*
[1699] Will Fitzgibbon, *supra* note 26.
[1700] *Id.*
[1701] David Pegg *Panama Papers: Europol links 3,500 Names to Suspected Criminals*, THE GUARDIAN (Dec. 1, 2016), https://www.theguardian.com/news/2016/dec/01/panama-papers-europol-links-3500-names-to-suspected-criminals (last visited Dec. 10, 2022).
[1702] Will Fitzgibbon, *supra* note 26.

[1703] Sean McGoey, *Panama Papers Revenue Recovery Reaches $1.36 Billion As Investigations Continue*, ICIJ (Apr. 6, 2021), https://www.icij.org/investigations/panama-papers/panama-papers-revenue-recovery-reaches-1-36-billion-as-investigations-continue/ (last visited Dec. 10, 2022).
[1704] *Id.*
[1705] *Id.*
[1706] Gogona Saikia, *Panama Papers: The Aftermath' Reveals 1.2mn Fresh Documents, including 12,000 Indians,* NEWS BYTES (Jun. 21, 2018), https://www.newsbytesapp.com/news/india/how-panama-papers-accused-implicated-themselves-in-the-aftermath/story (last visited Dec. 10, 2022).
[1707] *Panama Papers 2.0: New Leak Reveals Fresh 12,000 Documents Linked to Indians*, BUSINESS TODAY (Jun. 21, 2018), https://www.businesstoday.in/latest/economy-politics/story/panama-papers-leak-kavin-bharti-mittal-airtel-mossack-fonseca-148516-2018-06-21 (last visited Dec. 10, 2022).
[1708] *Id.*
[1709] *Id.*

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wealth has been detected by the authorities.[1710] To investigate the offshore transactions CBDT has created 8 dedicated specialised units whose sole focus shall be to investigate claims regarding money laundering and Panama Papers.[1711] The units will initiate action under the Prohibition of Benami Property Transaction Act, 1988 and Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015.[1712] The authorities are currently investigating cases under Foreign Exchange Management Act, but once they decide to prosecute the same, the charges have to be converted under the Prevention of Money Laundering Act.[1713]

The dedicated units so created, will be working under the Multi-Agency Group (MAG) headed by the chairman of CBDT, comprised of representatives from ED, RBI, Income Tax department and Foreign Intelligence Unit instituted for speedy investigation of Panama Papers. Since the leak by the ICIJ did not contain any financial data, the same has to be sought from foreign jurisdictions under different tax treatises. Afterwards, the same shall be reviewed in the backdrop of Income Tax Returns (ITRs) made under foreign assets' schedule residential status, annual income and foreign remittance details. Out of the 74 cases, searches were conducted for 50 cases out of which, in 12 cases the authorities were able to detect INR 1140 crores of undisclosed foreign income. And in 16 cases criminal action is pending and in the remaining 32 cases, notices have been issued under sec 10 of the Black Money Act.[1714]

PANDORA PAPERS

One of the most recent leaks by ICIJ, Pandora papers leaks which took place on 3rd Oct 2021 created havoc in several countries.[1715] The leak is being termed as one of the largest leaks in the history of the offshore transaction, as it resulted in the leak of 11.9 million documents or in other words 2.95 TB of data has been leaked which contain information about the offshore transaction in tax haven countries.[1716] This leak is different from Panama or Paradise papers since in both these cases leaks happened from the database of one law firm; in Panama it was Mossack and in Paradise, it was Asiaciti Trust. But in Pandora, the leak is not from one service provider but from 14 service providers that offer such service in 38 jurisdictions. The leak revealed the details of 27,000 shell companies and 29,000 beneficial owners which are more than twice the number of beneficial owners in Panama papers.[1717]

The leak provided valuable information on how tax has been avoided through various means. Notable people like the Qatari ruling family avoided an 18.5-million-pound tax on the purchase of a mansion in London,[1718] and the ruler of Jordan King Abdullah II has $100 million property in Malibu, London and Washington owned via offshore companies.[1719] Not only that, Azerbaijan's ruling Aliyev family purchased around 400 million pounds of UK property through shell companies.[1720] This leak has already started to cause political upsets in the Czech Republic where the Prime Minister of the country used a shell company to acquire $22 million chateaus in France and, in Cyprus, where a law firm founded by the country's Prime Minister was accused of hiding assets of

[1710] *Id.*

[1711] Divyesh Singh, *CBDT Creates 8 Dedicated Units to Fasten Probe in Panama Papers Scam*, INDIA TODAY (Dec. 15, 2020), https://www.indiatoday.in/india/story/cbdt-creates-8-dedicated-units-to-fasten-probe-in-panama-papers-scam-1749558-2020-12-15 (last visited Dec. 10, 2022).

[1712] CENTRAL BOARD OF DIRECT TAXES, PROMPT INVESTIGATION IN FRESH SERIES OF CASES PERTAINING TO PANAMA PAPERS (2018).

[1713] Prevention of Money Laundering Act, 2002, No. 15, Acts of Parliament, 2002.

[1714] The Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015, No. 20, Acts of Parliament, 2015.

[1715] *Pandora Papers: A Simple Guide to the Pandora Papers Leak*, BBC NEWS (Oct. 5, 2021), https://www.bbc.com/news/world-58780561 (last visited Dec. 10, 2022).

[1716] *Id.*

[1717] Emilia Díaz-Struck, *Pandora Papers: An Offshore Data Tsunami*, ICIJ (Oct. 3, 2021), https://www.icij.org/investigations/pandora-papers/about-pandora-papers-leak-dataset/ (last visited Dec. 10, 2022).

[1718] BBC NEWS, *supra* note 82.

[1719] *Pandora Papers: Biggest Ever Leak of Offshore Data Exposes Financial Secrets of Rich and Powerful*, THE GUARDIAN (Oct. 3, 2021), ttps://www.theguardian.com/news/2021/oct/03/pandora-papers-biggest-ever-leak-of-offshore-data-exposes-financial-secrets-of-rich-and-powerful (last visited Dec. 10, 2022).

[1720] *Id.*

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Russian billionaire under the veil of fake company owners. Even the president of Ukraine Volodymyr Zelensky has been accused of transferring a 25% stake in an offshore company to his close friend who now works as the president's advisor.[1721] And lastly, Kenyan president Uhuru Kenyatta has been named in the leak since he purchased a property in London from his offshore wealth of $30 million. In India, 300 people have been named in the leak, notable among them are Sachin Tendulkar, Anil Ambani, Jackie Shroff and Vinod Adani.[1722]

The leak consists of confidential records of 14 offshore service providers that provide professional service to wealthy individuals and companies seeing to incorporate shell companies in tax haven countries. The entities enable owners to conceal their identities from the public.[1723] The leak contains the details of beneficial owners of entities registered in different tax havens countries like Seychelles, Panama and British Virgin Islands and South Dakota. It also contains information on the shareholders, directors and officers. Furthermore, such entities are often used to purchase assets like real estate, jets and make investments. The Pandora Papers investigation also reveals how banks and law firms work closely with offshore service providers to design complex corporate structures even when they are prohibited by law not to do business engaged in questionable dealings.[1724]

The working of Pandora papers is as follows; let's suppose Mr. A has a huge amount of undisclosed income which if disclosed then he has to pay high taxes in his home country. So, Mr. A incorporates a shell company in Panama or the British Virgin Islands i.e., in a tax haven country. Thereafter, Mr. A transfers his wealth into that shell company through a service provider and appoints a nominee or beneficial owner to act as director or shareholder of the company. Now, since the amount of money cannot be traced back to Mr. A, he has successfully been able to hide his income. Now, to legitimize their wealth Mr. A buys a property in London through a shell company. Thus, Mr. A has been able to divert the money into a legitimate tax jurisdiction and money can no longer be traced back to Mr. A.

One way to avoid the sale to such shell companies is to maintain a public register of owners of every property in that city. With this transparency, if any shell companies try to purchase any property, then authorities can use the information to trace the money back to its original owner and can avoid selling the property to any individual or company undertaking shady business.

The Indian government has also decided to launch an investigation regarding the Pandora leak. The government released a press release[1725] in which they stated that they will undertake their own investigation with the help of relevant information obtained from foreign jurisdictions about relevant entities. The government will initiate criminal action under Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 to retrieve the undisclosed income and penalize the guilty. Furthermore, the government has been able to detect INR 20,352 crore of undisclosed income from both the Panama and Paradise papers leak and has assured due importance shall be given to Pandora papers as well. The investigation will be headed by the MAG formed at the time of the Panama papers which will actively monitor any further development in this area.

CONCLUSION

The tax avoidance methods and the OECD rules show that tax haven has been regarded as an illegal act undertaken by corporates to

[1721] *Id.*

[1722] Shrimi Choudhary, *Centre Orders Multi-Agency Investigation into Pandora Papers Leak*, BUSINESS STANDARD (Oct. 5, 2021), https://www.business-standard.com/article/current-affairs/centre-orders-multi-agency-investigation-into-pandora-papers-leak-121100500043_1.html (last visited Dec. 10, 2022).

[1723] Emilia Díaz-Struck, *supra* note 85.

[1724] *Id.*

[1725] CENTRAL BOARD OF DIRECT TAXES, CASES PERTAINING TO 'PANDORA PAPERS' TO BE INVESTIGATED (2021).

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safeguard their profit. Even by the measures of international law, any country providing the service of a tax haven would directly affect the sovereignty and revenue-earning capacity of such a country. The incorporation of shell companies has not only become the vehicle to evade tax by corporates but rather it is being used to route such profits to different illegal activities which are detrimental to all countries. Often there are reports that funds from shell companies are being used to fund terrorism, drug operation, funding of cartels and other illegal activities which have repercussions not only for the home state but also to tax haven countries as well.

Allowing the corporates to have an untraced and unaccounted sum of money which have an untracked source of origin could have a disastrous result. It will not only affect the corporate governance principle of the home country since shareholders will not get their due return, but the home country would suffer since the government would lose out on huge revenue sources which could have been used for the developmental and welfare work of the people. The only remedy to address this menace is to promote the idea that every country has the sovereign power to tax income based on source or resident principles, and no country should have any policy which undermines the taxing power of any country. At the same time, multilateral agreements should be formed with different tax haven countries so that there are uniform standards of tax laws and a smooth exchange of information.

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