

WHAT THE OTHERS SAY

“It is no secret that ties between Pakistan and the United States are going through a difficult phase.” —DAWN

Fixing the tax leak

The Pandora papers reveal inequality of taxation, limits to legislative measures, and call for reform that makes tax avoidance illegal



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THE UNCOVERING OF roughly 12 million records of companies in tax havens by the International Consortium of Investigative Journalists (ICIJ) has only served to underline the endemic use of tax havens. The Pandora papers, as detailed in this newspaper, reveal the extent to which incomes and assets are being stashed away by the who's who through artful skulduggery. Five years after the Panama papers, the latest exposé only reveals the legislative limits of preventing tax dodging across the world.

The Panama papers and Paradise papers had marked a significant shift in the public perception over notions of the rich paying their fair share of taxes. The resulting public pressure encouraged governments to take on a more proactive role in clamping down on shell corporations, improving tax transparency and introducing anti-avoidance measures. Reportedly, 16 out of 88 countries identified in the Panama papers undertook at least one substantive reform by 2019. India recovered Rs 20,352 crore from the investigations following the leaks. Yet, change has been slow and limited.

Over the years international initiatives have been undertaken to uncover the trail of untaxed or under-taxed funds. The OECD introduced the common reporting standard, using which countries could partner better to exchange the financial information of their residents. Today, 110 jurisdictions are signatories to the standard and, through 4,200 bilateral exchange relationships, have exchanged 84 million pieces of information uncovering \$107 billion in tax revenue.

However, there are countries that even today have not signed up to this framework. The conspicuous absentees are the United States (it employs the Foreign Account Tax Compliance Act or FATCA to receive information unilaterally on US residents), the Philippines, Thailand and Vietnam. This essentially means that tax authorities looking to probe the siphoning of money from one country to another may not be able to procure substantive evidence if a country is not obligated to exchange such information.

In spite of the measures taken, financial secrecy thrives not just on pristine islands, but also in countries like the US. The Tax Justice Network reports that the US ranked second in the world, before Switzerland and after the Cayman Islands in financial secrecy. This is not surprising since states such as Delaware and South Dakota, as identified by ICIJ, are hotbeds for offshoring. The ICIJ claims that between 2000 and 2019, US-based trusts held assets worth more than \$1 billion (the amount mentioned for select trusts set up in the US) that include real estate and bank accounts in Panama, Switzerland, Luxembourg and the Bahamas.

Evidently, the days for offshoring are far from over. Individuals and corporations seek complex structures such as companies and trusts to hold assets in or operate via low-tax jurisdictions. In fact, as per the latest information reported by the OECD on coun-

try-by-country operations by select multinational companies, more than 40 per cent of the entities located in the British Virgin Islands, the Isle of Man, Bermuda and Mauritius, essentially performed the passive function of holding shares or equity instruments, indicating profit booking without real activity. Many of these countries have adopted a lax regulatory framework to remain economically relevant.

An important debate that emerges from these leaks, which is more relevant for India, is the distinction between tax avoidance and tax evasion. While from a moral standpoint both may be socially unacceptable, legally, parties to the former can only be reprimanded where it is established that the intent is to undermine tax law. In the past, as has been observed in landmark judgements such as that of Vodafone, a higher threshold for tolerance is applied to avoidance, especially in the name of economic benefits such as investment inflows.

Unfortunately, India's FDI statistics hint at oblique investments through jurisdictions such as Mauritius and Singapore. In 2019, the stock of inward direct investment from these two jurisdictions reported by India exceeded what these countries reported as outstanding outward investments, thus indicating that investors, including India entities, were using them as conduits.

It is often challenging to unveil transactions, especially since corporate entities are treated as an entity separate from the shareholders. This places the burden of proof on tax administrators if the structure so adopted is solely to avoid taxes. Moreover, often the company/trust facilitating tax avoidance or evasion and the individuals associated with it are disassociated using layers of entities across countries. For this purpose, the concept of beneficial ownership gained prominence. Countries, including India, under the Companies Act maintain a register of beneficial owners that is accessible to regulators so that they can construct the true ownership pattern. However, there are limits to traceability due to non-cooperative jurisdictions.

As a result, while one may think that celebrities associated with entities operating in tax havens are indulging in scandalous behaviour, this may not be illegal. The ICIJ itself places a caveat — that there are “legitimate uses” of trusts and companies. And that the data does not suggest that “companies or other entities included in the ICIJ Offshore Leaks Database have broken the law or otherwise acted improperly.”

Despite initiatives to improve tax transparency, these leaks point to the continuing existence of these opaque structures. These range from golden passports that allow economic fugitives to flee, to the use of financial structures, legally designed to avoid tax and regulatory oversight. Over the years, to discourage countries from offering such deals to taxpayers, half-hearted attempts have been made at greylisting countries, often not resulting in any sanctions.

The scale of the offshore leaks reaffirms the sense of inequality in taxation. In response, the CBDT has, like in the past, ordered an inter-agency inquiry. While such inquiries can assuage public resentment, to truly reform the existing tax system socially unacceptable tax avoidance must be made impermissible in law.

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