“Recently more and more enterprises organized abroad by American firms have arranged their corporate structures aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices [...] in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.”

President John F. Kennedy

INTRODUCTION

In this globalized world with growing cross border investment, border between countries have limited impact. Post liberalisation phase has seen tremendous investment in those countries which have liberal tax regime from companies based in most developed nations of the world. As per Global Investment Report, 2013\(^1\) it has been found that countries like British Virgin Island, Hong Kong, Belgium, Luxembourg etc. are considered as favourite investment destinations, as these countries are known as tax havens from companies point of view. With growing investment, grew the problem of tax evasion and tax planning.

Establishment of Special Purpose Entity in tax jurisdiction with low tax rates, inter- company debts or financial transaction, hybrid mismatch arrangements by Multi-national enterprises, aggressive tax planning, transaction of intangibles between companies and transfer pricing issues related to them etc. are some of the issues which are in limelight now a days amongst different economies of the world. These acts amounts benefit erosion and profit shifting from jurisdiction with high tax rates to jurisdiction with low tax rates under tax treaty, causing huge revenue loss to countries and sometimes these transactions also fall under double non taxation due to some

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loop holes in the taxing provision of the country where the company is registered or due to loopholes in tax treaty.

The seriousness of the issues can be gained from statement given by American President, Mr. Barak Obama, when he said, “the empirical events suggests that income shifting by multinational enterprises is a significant concern that should be addressed through tax reforms”.

In G-20 summit held at St. Petersburg in 2012, leaders from different economies of the world, discussed about these issues and directed Organization for Economic Co-operation and Development (OECD) to frame guidelines in relation to this growing issue of benefit erosion and profit shifting. OECD has most recently come up with draft proposals for combatting this hot issue.

Author in the present paper will discuss the issues relating to benefit erosion and profit shifting exhaustively. Chapter I of the paper will be dealing with the meaning and significance of the phrase benefit erosion and profit shifting. Chapter II of the paper will be dealing with the issues which are responsible for benefit erosion and profit shifting. Chapter III of the paper will be dealing with the possible actions which can be taken by the countries in relation to the problem. Chapter IV of the paper will focus India in relation to actions which can be taken by it to curb the problem.

**CHAPTER I**

**MEANING AND IMPLICATION OF PROBLEM OF BASE EROSION AND PROFIT SHIFTING**

The term “base erosion and profit shifting” means, tax planning strategies that exploit gaps and mismatches in tax rules to make profits ‘disappear’ for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid. The most astonishing fact is that these activities are not considered as illegal, as it arises mainly due to anomaly in the prevailing taxation policy of the

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state concerned. Multinational Enterprises (MNE) just take advantage of the taxation regime of countries as they still are based on bricks and mortar economic environment and are not able to compete with today’s market practices of e-Commerce and dealing of intangibles between companies. A common example can be of Company like Amazon, which is considered as king of online market. Its business strategy shows that, it does not indulge in trade in any country rather than it do business by establishing a delivery company there. By this, the internet retail company runs bulk of its European operation out of Luxembourg, allowing it to minimize the amount of tax it has to pay on revenue generated in other European countries. Same is the case with other MNEs like Apple Inc., Vodafone Group Plc., Google Inc., Starbucks Corp. etc. Their strategies are really smart. In case of MNEs like these they have various options available with them to manage their tax liabilities. They follow the mechanisms like double deduction i.e. pay the tax in one country and then deduct that sum in two or more countries. They also decrease their tax liability by showing their income as deduction in one country, which is not included in calculation anywhere else. The effect of these tax avoidance schemes is so dreadful for countries that they are calling for stricter rules to deal with this menace as it is not illegal. The effect of this problem can be shown through some empirical data’s relating to flow of investment and tax collection rate by countries, collected by OECD.

In 2010, Barbados, Bermuda and the British Virgin Islands received more FDIs (combined 5.11% of global FDIs) than Germany (4.77%) or Japan (3.76%). During the same year, these three jurisdictions made more investments into the world (combined 4.54%) than Germany (4.28%). On a country-by-country position, in 2010, the British Virgin Islands were the second largest investor into China (14%) after Hong Kong (45%) and before the United States (4%). For the same year, Bermuda appears as the third largest investor in Chile (10%). Similar data exists in relation to other countries, for example Mauritius is the top investor country into India (24%), while Cyprus (28%), the British Virgin Islands (12%), Bermuda (7%) and the Bahamas (6%) are among the top five investors into Russia.³ This shows how tax haven countries are considered as favorite destination for investment. MNEs by incorporating their parent or subsidiary companies in these destinations befool the world in relation to taxation by their effective tax planning and tax avoidance.

Corporate income tax receipts constitute an important component of government revenues. While the scale of revenue losses through BEPS may not be extremely large in relation to tax revenues as a whole, the issue is still relevant in monetary terms and may also be of wider relevance because of its effects on the perceived integrity of the tax system. In terms of trends, the unweighted average of taxes on corporate income as a percentage of total taxation in OECD countries was 8.8% in 1965, dropped to 7.6% in 1975, and then consistently increased over the years until 2007, when the reported average ratio was 10.6%. Starting from 2008, likely due to the economic downturn, the ratio declined to 10% in 2008 and 8.4% in 2009; subsequently it increased to 8.6% in 2010. Then also, problem relating to base erosion and profit shifting is emerging as biggest problem for countries as they are losing millions of dollars due to it.

The 2012 G20 leaders’ summit in Mexico, on 18-19 June, explicitly referred to ‘the need to prevent base erosion and profit shifting’ in its final declaration. This message was reiterated at the G20 finance ministers’ meeting of 5-6 November 2012, the final communiqué of which stated: ‘We welcome the work that the OECD is undertaking into the problem of base erosion and profit shifting and look forward to a report about progress of the work at our next meeting.’

In the same month, the UK’s Chancellor of the Exchequer George Osborne and Germany’s Minister of Finance Wolfgang Schäuble issued a joint statement, also backed by France’s Economy and Finance Minister Pierre Moscovici, calling for coordinated action to strengthen international tax standards and for states to back the OECD’s efforts to identify loopholes in tax laws.

It is delighted to hear the political leaders of some of the world’s most powerful countries calling for a reform of the current international tax system. However, the problems that political leaders are now mentioning, problems that enable MNCs to avoid paying their fair share of tax and undermine efforts to tackle poverty and inequality, are not new. For decades, developing countries have been the main victims of an unfair and ineffective tax system. Only when the

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4 Id., p. 15.
6 http://www.taxjustice.net/cms/upload/pdf/OECD_Beps_130327_No_more_shifty_business.pdf
damaging consequences have been felt in the richest economies, there is hue and cry for solutions.

Base erosion and profit shifting has created a chain of interlinked problems which have a detrimental effect on all stakeholders of the nation. Firstly, it harms the common man on the street, when tax rules allow business houses to shift their income away from where it was produced; it erodes that country’s tax base and shifts the burden onto individual taxpayers. Secondly, it harms government’s reputation, when multinationals are not perceived as paying their ‘fair share’; it undermines the integrity of the entire tax system in the eyes of the public. Moreover, in some countries the resulting lack of tax revenue leads to reduced public investment thereby causing hindrance to developmental activities launched by the State. Thirdly, it harms other’s businesses. Domestic firms face the economic burden of higher taxes, while the multinational next door easily reduces its tax liability by shifting its profits to a low tax jurisdiction. These issues make it harder for small and family-owned businesses to compete fairly with MNEs.

Taxation remains at the core of countries’ sovereignty. But without international consensus any unilateral action taken by a country to protect their tax bases, could easily lead to tax chaos for the global business community. So, there is a need to take some holistic action by developed and developing economies of the world in order to check this ever-growing issue of benefit erosion and profit shifting.
CHAPTER II

ISSUES RESPONSIBLE FOR THE PROBLEM OF BASE EROSION AND PROFIT SHIFTING

Before moving with the topic in relation to issues which are responsible for the problem of ‘Base Erosion and Profit Shifting’ (BEPS), it is necessary to understand the business model under which MNCs work in this globalized world.

Globalization is not a new phenomenon now a day, but the pace of integration of national economies and markets has increased substantially in recent years. The free movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers, technological and telecommunication developments, and the ever-increasing importance of managing risks and of developing, protecting and exploiting intellectual property, have had an important impact on the way MNEs are structured and managed. This has resulted in a shift from country-specific operating models to global models based on matrix management organisation and integrated supply chains that centralize several functions at a regional or global level. Moreover, the growing importance of the service component of the economy, and of digital products that often can be delivered over the Internet, has made it possible for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers.\(^8\) Moreover, Global Value Chains (GVCs), characterized by the fragmentation of production across borders, have become a dominant feature of today’s global economy, encompassing developing as well as developed economies.

Globalization has in effect caused products and operational models to evolve, creating the conditions for the development of global strategies aimed at maximizing profits and minimizing expenses and costs, including tax expenses. At the same time, the rules on the taxation of profits from cross-border activities have remained fairly unchanged, with the principles developed in the past still finding application in domestic and international tax rules. In other words, the changes in business practices brought about by globalisation and digitalisation of the economy have

\(^8\) Addressing Base Erosion and Profit Shifting, OECD, 2013, p.27.
raised questions among governments relating to, whether the domestic and international rules on the taxation of cross-border profits and transaction have kept pace with those changes.9

Other than the cases of illegal abuses of tax laws, which are the exception rather than the rule, MNEs indulged in BEPS comply with the legal requirements of the countries in which they operate in relation to taxation. Governments recognise this and also recognise that a change in this legal framework can only be achieved through international co-operation and transparency in tax regime.

Liberalisation of trade, the abolition of currency controls and technological advances have all contributed to a dramatic increase in the flows of capital and investments among countries. This has created unprecedented interconnectedness at all levels: individuals, businesses and governments. In striving to improve their competitive positions, businesses bring about the changes in investment, technological improvements and higher productivity that enable improvements in living standards. For a corporation, being competitive means to be able to sell the best products at the best price, so as to increase its profits and shareholder value. In this respect, it is just natural that investments will be made where profitability is the highest and that tax is one of the factors of profitability, and as such tax affects decisions on where and how to invest.10

From a government perspective, globalisation means that domestic policies, including tax policy, cannot be designed in isolation, i.e. without taking into account the effects of it on other countries’ policies and the effects of other countries’ policies on its own ones. In today’s world, the interaction of countries’ domestic policies becomes fundamental. Tax policy is not only the expression of national sovereignty but it is at the core of this sovereignty, and each county is free to devise its tax system in the way it considers most appropriate. Tax policy and administration influence many of the drivers of increased productivity, ranging from investment in skills, capital equipment and technical know-how to the amount of resources required to administer and comply with the tax regime. Governments work to ensure the highest level of growth for the highest level of well-being. Growth depends on investments, which includes foreign investments. As investments take into account, together with several other factors, taxation, governments are

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9 Id., 29.
10 Id.,30.
often under pressure to offer a competitive tax environment to MNEs. Taking this factor into consideration, MNCs manage their activities in order to have least tax liability.\(^{11}\)

Now a day determinations of countries regarding the availability of any relevant information in tax matters (ownership, accounting or bank information), the appropriate power of the administration to access the information and the administration’s capacity to deliver this information to any partner which requests it, is somehow helping the countries to fight with the menace of BEPS. Moreover, since the 2012 update of article 26 of the OECD Model Tax Convention, the standard on exchange of information clearly includes group requests. Needless to say, these developments provide opportunities to obtain better and more accurate information on BEPS instances that in the past were often not available.

**CORE ISSUES RELATING TO BASE EROSION AND PROFIT SHIFTING**

The most report recent prepared by OECD\(^ {12}\) in relation to combatting BEPS and in addition to requirement of having increased transparency on effective tax rates of MNEs, have found the below mentioned grounds which needs to be checked for effective control of BEPS. Those grounds are:

1) International mismatches in entity and instrument characterization including, hybrid mismatch arrangements and arbitrage;
2) Application of treaty concepts to profits derived from the delivery of digital goods and services;
3) The tax treatment of related party debt-financing, captive insurance and other intra-group financial transactions;
4) Transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents;
5) The effectiveness of anti-avoidance measures, in particular GAARs, CFC regimes, thin capitalization rules and rules to prevent tax treaty abuse; and
6) The availability of harmful preferential regimes.

\(^{11}\) Id.

\(^{12}\) Addressing Base Erosion and Profit Shifting, OECD, 2013, p. 8.
1. **Hybrid Mismatch Arrangements**

Hybrid mismatch arrangements can be described as practices where differences in countries’ legislations are exploited and same expense is deducted in multiple countries or multiple tax deductions are applied for single tax paid.

As per the guidelines of the OECD in its report titled, “*Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*”13 following can be deduced about the issue:

**Elements of Hybrid mismatch arrangement:**

Hybrid mismatch arrangements generally use one or more of the following underlying elements:

A. **Hybrid entities**: Entities that are treated as transparent for tax purposes in one country and as non-transparent in another country.

B. **Dual residence entities**: Entities those are resident in two different countries for tax purposes.

C. **Hybrid instruments**: Instruments which are treated differently for tax purposes in the countries involved, most prominently as debt in one country and as equity in another country.

D. **Hybrid transfers**: Arrangements that are treated as transfer of ownership of an asset for one country’s tax purposes but not for tax purposes of another country, which generally sees a collateralized loan.

**Effects of Hybrid Mismatch Arrangements**

Hybrid mismatch arrangements are generally made by MNCs keeping in mind following benefits:

A. **Double deduction schemes**: Arrangements where a deduction related to the same contractual obligation is claimed for income tax purposes in two different countries.

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B. **Deduction/ no inclusion schemes**: Arrangements that create a deduction in one country, typically a deduction for interest expenses, but avoid a corresponding inclusion in the taxable income in another country.

C. **Foreign tax credit generators**: Arrangements that generate foreign tax credits that arguably would otherwise not be available, at least not to the same extent, or not without more corresponding taxable foreign income.

**Implication of Hybrid Mismatch Arrangement on Taxation of Countries involved:**

International hybrid mismatch arrangements typically lead to a reduction of the overall tax paid by all parties involved as a whole. Although it is often difficult to determine which of the countries involved in the transaction has lost tax revenue, it is clear that collectively the countries concerned lose tax revenue. Further, the taxpayer incurs certain costs for devising and implementing these arrangements, such as costs for advice or for the formation of special purpose entities, which will generally be deductible in one of the countries involved and further reduce tax revenue.

So, the issue of hybrid mismatch arrangement needs to be looked upon seriously and some mechanism is to be drawn in the taxation system in order to avoid its effect on revenue of the country.

2. **APPLICATION OF TREATY CONCEPTS TO PROFITS DERIVED FROM THE DELIVERY OF DIGITAL GOODS AND SERVICES**

The development of digital economy is characterized by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterization of income for tax purposes. At the same time, the fact that new ways of doing business may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may
lead to low taxation is not per se an indicator of defects in the existing system. It is important to examine closely how enterprises of the digital economy add value and makes their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent BEPS.\textsuperscript{14}

The digital market has revolutionized traditional ways of conducting business around the globe, while international tax rules have been slow to adapt to this new business environment and could not come up with the possible solution for taxation even though OECD has conducted a study in relation to the same in 2005. Some countries are looking at unilateral approaches to deal with the evolving issue as it is causing huge revenue loss to them. On 24 July 2012, the French Government commissioned a report on the taxation of the E-Commerce. The report was released on 18 January 2013 in relation to taxation of digital products, accelerated legislative discussions towards a proposal to tax the digital economy in the best possible manner it can. Moreover, The US Congress has introduced recent changes in its taxing statutes and has pending proposals which significantly impact taxation of US technology companies that primarily drive the digital economy. The US House Committee conducted a hearing on 13 June 2013 on use of tax havens by MNEs to avoid tax by shifting profits from the US and eroding the US tax base and causing significant loss to it.

The dominant players in the digital economy are large “ecosystems” who base their business model on radically new paradigms – for example, privileged relationship with customers/users, exploit existing relationships by entering into new sectors, extensive use of digital technologies and constant innovation, optimize exploitation of data collected from their users, capability to generate “traction”, i.e. fast development of the user base. They are often structured from inception in a way that allows them to optimize the tax treatment of their income. From this starting point, the structure may remain optimized because most of their activity is “intangible” and therefore normally does not require significant business restructuring actions to adapt their models as they evolve.\textsuperscript{15}

\textsuperscript{15} Rajendra Nayak, Will BEPS on Digital Economy achieve tax Neutrality, http://www.taxisutra.com/experts/column?sid=117, (last accessed on 30\textsuperscript{th} October, 2013).
The traditional tax optimization models that are used in other sectors produce exponential effects in the case of the digital economy. This could lead to tax base erosion in the country where the customers/ users of the digital products and services are based. While this could impact developed as well as developing countries equally, the effect on emerging economies, such as India, which constitute a large customer/ user base could be quite significant. Additionally, it could result in asymmetry in favor of countries where the digital companies have located their “headquarters” and/ or ownership of intangible property.16

Any consideration of the applicable tax policy, and tax administration and compliance issues which arise in this area must be guided by basic tax policy principles prevailing in the contemporary taxation regime and must also take into account the technical and scientific characteristics of the digital economy, which makes it difficult to find the identity of parent company which is indulged in the transaction. A fundamental guiding principle should be based on neutrality. Neutrality principle requires that the tax system should treat economically similar income equally, regardless of whether they are earned through digital means or through more conventional networks of commerce. Preferably, tax rules should not affect economic choices about the structure of markets and commercial activities. This will ensure that market forces will alone determine the success or failure of the digital economy. The best way by which neutrality can be achieved is through an approach which adopts and adapts to existing principles, in lieu of imposing new or supplementary taxes. Latest technological developments in the digital economy may appear to be drastic innovations primarily because they have grown within a relatively short period of time.

The prevailing OECD Model Tax Convention, 2010 is silent on the issue relating to taxation of digital products and services traded on internet. Looking at the seriousness of the issue, OECD in its Action Plan relating to Benefit Erosion and Profit Shifting, 2013 has highlighted the loss e-commerce is causing to the economies of the world in relation to taxation and is planning to come up with possible solution by September, 2014.

3. **The Tax Treatment of Related Party Debt-Financing, Captive Insurance and Other Inter-Group Financial Transactions**

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16 Id.
Over the last few years, MNEs have faced increased scrutiny from regulators and the media for their aggressive tax avoidance practices. One common practice is the use of related-party debt to achieve base erosion and profit shifting—in particular, using hybrid mismatch arrangements between related companies to exploit how different countries characterize a transaction or an instrument for tax purposes. With the slow-down of economy worldwide, the practice of related party-debt financing, captive insurance and inter-group financial transactions have increased with tremendous rate. Establishment of a conduit company in low tax-jurisdiction like Luxembourg, British Virgin Islands etc. merely for the purpose of financing the group companies or subsidiary companies in High Tax-Jurisdiction is witnessed by tax authorities of different countries. Related Party debt financing help countries to reduce their tax burdens and thereby caused huge loss to taxing states. Even OECD Transfer pricing Guidelines for Multinational Enterprises and Tax Administration, 2010 is silent over the issue of related-party debt financing and inter-group financing. Looking on to the seriousness of the issue OECD in its report titled “Addressing Base Erosion and Profit Shifting”, 2013, highlighted the issue and call for the need to have comprehensive guidelines in relation to these transactions which avail the MNEs to get high deductions on interest paid for these transactions in high tax jurisdictions. Such was the seriousness of the issue that Indian Government amended Income Tax Act, 1961 in 2012 and amended the definition of “International Transaction” under Section 92B\(^\text{17}\) of the Act in order to include any type of “capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business” between Indian Company with its foreign parent/subsidiary company or group companies. Similar steps were taken by Jurisdictions like Australia, Norway etc. Similar steps need to be taken by other jurisdictions of the world.

In the present circumstances, it is necessary to understand the characteristics of different strategies undertaken by companies to deal with these types of situations.

1) **Captive Insurance:**

In recent years, the use of captives, both domestic and foreign, has increased dramatically. This is due to advancement of the global economy. It is also due to corporations structuring transactions to utilize more favorable tax rates and capitalization requirements.

\(^{17}\) Income Tax Act, 1961, Section 92B.
A captive insurance company is generally defined as a wholly owned insurance subsidiary. The purpose of a captive insurance company is to insure the risks of the parent and affiliated entities. Captives can either be formed as a domestic captive within the country, or as a foreign captive in another country. When 100% of the insurance risk accepted by the captive is the risk of the parent entity, the captive is called a ‘pure’ captive. Pure captives may not be treated as true insurance companies for purposes of income and excise taxes under domestic tax laws.\(^\text{18}\)

A captive can insure the risks of other entities within the affiliated group (i.e. brother/sister risks) and the risks of unrelated outside third parties. Once brother/sister risks and especially unrelated third party risks are accepted by the insurance subsidiary, there becomes a point where the insurance subsidiary can no longer be called a pure captive. At that point, depending upon the facts and circumstances of the case, namely the percentage of premiums received by the captive from affiliated entities and third party entities, the captive may not be treated as a true insurance company.\(^\text{19}\)

**Reasons for establishment of Captive insurance Companies:**

a) The parent Company may wish to reduce the amount of money paid for insurance premiums. By establishing a captive, the parent has control over the amount of premiums paid as the captive will establish its own premium rates.

b) The parent Company retains the profits made on insuring within its corporate structure instead of paying the premiums and the underlying profits to an unrelated third party.

c) The parent may want to reduce the amount of risk retained in the affiliated group. By establishing a captive insurance company and acquiring its insurance through the captive, the parent company can control the number of outside third party insured’s and thereby control the amount of risk involved with its insurance needs.

d) Establishment of a foreign captive can be used to funnel income to a country with no or a lower income tax rate than the tax rate in the domestic country. This offers a substantial savings on income tax expense.


\(^\text{19}\) Id.
e) A domestic captive can be established to reduce the percentage of foreign insurance excise tax paid on premiums paid to foreign insurers or reinsurers. With these implications of taxation aspect of captive insurance in relation to the jurisdiction in which parent company is situated, there is a need to have an international consensus over the issue relating to taxing these kinds of transactions, so that these kinds of tax avoidance can be avoided and countries do not lose their revenue base.

2) Related Party Debt- Financing and Inter-Group Financial Transaction:
Under international taxation regime, profits could be shifted through the transaction of borrowing and lending. This is done when enterprises charges no interest or charges at a lower rate than the market rate on loan and advances made to, or otherwise becoming a creditor of an associated enterprise either being parent company or subsidiary company. Indebtedness may be *bona fide* in that loan and advances have been actually made under a contract or otherwise or that it has arisen in the ordinary course of business on sales made or services provided. There are number of factors to be taken into consideration in the case of related party debt:-

a) The rate of interest on the loan;
b) The capital amount of the loan.

These factors will come into consideration when debt is made or taken with bona fide intention, and in this situation entities involved can be taxed easily under the transfer pricing regime of the country. But in situation when MNEs enter into these kinds of transaction in order to avoid their tax liability by taking loan from their own Parent/ subsidiary company situated in low tax jurisdiction or through establishment of Conduit company or Controlled Foreign Company in Low tax jurisdiction, it requires special provision under tax statutes and international tax regime to deal with these situations.

4. **TRANSFER PRICING, IN PARTICULAR IN RELATION TO THE SHIFTING OF RISKS AND INTANGIBLES, THE ARTIFICIAL SPLITTING OF OWNERSHIP OF ASSETS BETWEEN LEGAL ENTITIES WITHIN A GROUP, AND TRANSACTIONS BETWEEN SUCH ENTITIES THAT WOULD RARELY TAKE PLACE BETWEEN INDEPENDENTS**

20 D. P. MITTAL, TAXMANN’S LAW OF TRANSFER PRICING IN INDIA, 162, (3rd Ed., 2009).
21 Id.
The issue of jurisdiction to tax is closely linked with the one of measurement of profits. Once it has been established that a share of an enterprise’s profits can be considered to originate from a country and that the country should be allowed to tax it, it is necessary to have rules for the determination of the relevant share of the profits which will be subjected to taxation. Transfer pricing rules perform this function. The internationally accepted principle underlying transfer pricing determinations is the arm’s length principle, which requires that for tax purposes, related parties must allocate income as it would be allocated between independent entities in the same or similar circumstances.

When independent enterprises transact with each other, the conditions of the transaction are generally determined by market forces. When associated enterprises transact with each other, their relations may not be directly affected by market forces in the same way. The objective of the arm’s length principle is for the price and other conditions of transactions between associated enterprises to be consistent with those that would occur between unrelated enterprises for comparable transactions under comparable circumstances. In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs, taking into account assets used and risks assumed. Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, a comparability analysis is needed to ensure that the economically relevant characteristics of the situations being compared are sufficiently comparable. One of the key factors in that comparability analysis is a functional analysis to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions.

One of the underlying assumptions of the arm’s length principle is that the more extensive the functions/assets/risks of one party to the transaction, the greater its expected remuneration will be and vice versa. This therefore creates an incentive to shift functions/assets/risks to where their returns are taxed more favorably. While it may be difficult to shift underlying functions, the risks and ownership of tangible and intangible assets may, by their very nature, be easier to shift. Many corporate tax structures focus on allocating significant risks and hard-to-value intangibles

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23 Id, Glossary.
24 Supra note 26.
25 Transactions between two enterprises that are associated enterprises with respect to each other.
to low-tax jurisdictions, where their returns may benefit from a favorable tax regime. Such arrangements may result in or contribute to BEPS. Shifting income through transfer pricing arrangements related to the contractual allocation of risks and intangibles often involves thorny questions.26

One basic question involves the circumstances under which a taxpayer’s particular allocation of risk should be accepted. Transfer pricing under the arm’s length standard generally respects the risk allocations adopted by related parties. Such risk allocation and the income allocation consequences asserted to follow from them can become a source of controversy. The evaluation of risk often involves discussions regarding whether, in fact, a low-tax transferee of intangibles should be treated as having borne, on behalf of the MNE group, significant risks related to the development and use of the intangibles in commercial operations. Such arguments put stress on the ability of tax administrations to examine the substance of such arrangements, and determine whether the results of such arrangements, viewed in their totality, are consistent with policy norms (i.e. avoidance of inappropriate base erosion). Transfer pricing rules regarding the attribution of risks and assets within a group are applied on an entity-by-entity basis, thus facilitating planning based on the isolation of risks at the level of particular members of the group. There are a number of examples of risk allocations that can be undertaken under the arm’s length principle between members of an affiliated group (e.g. low-risk manufacturing and distribution, contract R&D and captive insurance).27

Under each of these models, the principal/insurer could be located in a low-tax jurisdiction, and the service provider/insured located in a high-tax jurisdiction. A key challenge is determining the circumstances under which such arrangements result in or contribute to base erosion, and the principles under which the base erosion is addressed. Arrangements relating to risk shifting raise a number of difficult transfer pricing issues. At a fundamental level they raise the question of how risk is actually distributed among the members of a MNE group and whether transfer pricing rules should easily accept contractual allocations of risk. They also raise issues related to the level of economic substance required to respect contractual allocations of risk, including

26 Addressing Base Erosion and Profit Shifting, OECD, 2013, p.44.
27 Id.
questions regarding the managerial capacity to control risks and the financial capacity to bear risks.

Finally, the question arises as to whether any indemnification payment should be made when risk is shifted between group members. In summary, the Guidelines are perceived by some as putting too much emphasis on legal structures (as reflected, for example, in contractual risk allocations) rather than on the underlying reality of the economically integrated group, which may contribute to BEPS.

5. **THE EFFECTIVENESS OF ANTI-AVOIDANCE MEASURES, IN PARTICULAR GAARS, CFC REGIMES, THIN CAPITALIZATION RULES AND RULES TO PREVENT TAX TREATY ABUSE**

Intricacy in the world’s tax regime has grown in tandem with the challenges of doing business in an increasingly connected global economy. The globalization of business and the mobility of capital across border, however, continue to challenge tax administrators who worry about the potential abuse of what are perceived to be unintentional tax benefits. Developing markets such as Chile, China and India are making headlines by broadening their tax net and, in some cases, ignoring holding company entities. And some countries that are enacting reforms aimed at increasing their competitiveness are at the same time considering anti-avoidance measures that may actually increase ambiguity.

Several countries of the world have taken steps to modernize their corporate tax systems to align better with rapidly shifting business models. Many countries have reduced their corporate tax rates and have moved to a more territorial approach to taxing business income. The United States, which is home to a large number of the world’s largest MNEs, continues to debate whether a switch to a territorial tax system will be a central part of the tax reform for improving its economy.

The recent focus of the world at large on tackling “tax abuse” can also be attributed to the rising deficits and falling tax revenues that have resulted from the global financial crisis as well as aggressive tax planning and legal tax avoidance measures by MNEs. Governments have been encouraged to act by multilateral organizations, including the G-20, the Organisation for

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28 The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, 2010 have touched upon these issues in the context of work on business restructuring, Chapter IX. These issues are also being addressed in connection with work on intangibles, Chapter VI.
Economic Co-operation and Development (OECD) and the European Commission. Tax activist groups have bowed a focus on tax haven countries, high net-worth individuals and, now, the seemingly low effective tax rates reported by some multinational companies. Countries around the globe have failed to implement properly the anti-avoidance measures which are aimed at addressing tax avoidance by MNEs. Moreover, the rules relating to CFC and Thin Capitalization is still at their nascent stage to curb the problem of benefit erosion and profit shifting.

A. General Anti-Avoidance Rule

Under the GAAR provisions, an arrangement (including a step in or a part) shall be considered to be an impermissible tax avoidance arrangement, if it is undertaken with the main purpose of obtaining a ‘tax benefit’ and it:

a. creates rights or obligations, which would not be created if the transaction was implemented at arm’s length; or
b. results, directly or indirectly, in the misuse of the provisions of the Code; or
c. lacks commercial substance in whole or in part; or
d. is entered into or carried out by means, or manner which would not be normally for *bona fide* purposes.

If an arrangement is regarded as an avoidance arrangement, such an arrangement could be disregarded, combined with any other step in the transaction or re-characterized, or the parties to the transaction could be disregarded as separate persons and treated as one person or any accrual or receipt of a capital or revenue nature or any expenditure, deduction, relief or rebate could be reallocated amongst the parties.29

B. Controlled Foreign Corporations Rule:

This artificial deferral of taxes through the holding structure in low tax or preferred tax regimes has been seen as injurious to revenue collection targets in various countries specially the developed economies. Several Countries have adopted measures aimed at preventing this artificial deferral of passive or investment income through CFC’s. CFC Rule generally deeming in nature and are applied to apportion income of a CFCs to the parent entity and subject it to taxation in the parent entity’s home country. Under CFC any

29 [http://www.pwc.in/assets/pdfs/publications-2012/pwc-white-paper-on-gaar.pdf](http://www.pwc.in/assets/pdfs/publications-2012/pwc-white-paper-on-gaar.pdf), (last accessed on 30th October, 2013).
undistributed income of the CFC is deemed to be distributed to the parent company / shareholders, thus, taxed in their hand in the home country tax jurisdiction.\textsuperscript{30}

C. **Thin Capitalization Rule:**

Thin Capitalization rules can apply in situations where:

i. A security is issued, which would not have been issued without a special relationship between the parties (tax deductions for interest on loans from group entities are stopped where the borrower would not have been able to sustain the debit on its own);

ii. A loan is made because of a guarantee given to the lender by a party related to the borrower.

In view of Transfer Pricing issues, an entity (which may be part of a group) may be said to be thinly capitalized when it has excessive debt in relation to its arm’s length borrowing capacity, leading to the possibility of excessive interest deductions. An important parallel consideration is whether the rate of interest is one which would have been obtained at arm’s length rate while comparing from independent lender as a standalone entity.\textsuperscript{31}

6. **THE AVAILABILITY OF HARMFUL PREFERENTIAL REGIMES**

Governments work to ensure the highest level of growth for the highest level of well-being. Growth depends on investments, which includes foreign investments. As investments take into account, together with several other factors, taxation, governments are often under pressure to offer a competitive tax environment.

Governments have long accepted that there are limits and that they should not engage in harmful tax practices. The process for determining whether a regime is harmful contains three broad stages: (i) consideration of whether a regime is preferential and of preliminary factors, to determine whether the regime needs to be assessed; (ii) consideration of key factors and other factors to determine whether a preferential regime is potentially harmful; and (iii) consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful.

If a regime is considered preferential and within the scope of the work, following factors are used to determine whether a preferential regime is potentially harmful. These factors are: (i) no

\textsuperscript{30} http://www.caclubindia.com/articles/cfc-rules-an-indian-perspective-6012.asp#.Um3Sh_mnoQ0, (last accessed on 30\textsuperscript{th} October, 2013).

\textsuperscript{31} http://www.transferpricing-india.com/Thin_Capitalization.htm, (Last accessed on 30\textsuperscript{th} October, 2013).
or low effective tax rate; (ii) ring-fencing of the regime; (iii) lack of transparency; and (iv) lack of effective exchange of information, (v) an artificial definition of the tax base; (vi) failure to adhere to international transfer pricing principles; (vii) foreign source income exempt from residence country taxation; (viii) negotiable tax rate or tax base; (ix) existence of secrecy provisions; (x) access to a wide network of tax treaties; (xi) the regime is promoted as a tax minimisation vehicle; (xii) the regime encourages purely tax-driven operations or arrangements.

In order for a regime to be considered potentially harmful the first key factor, “no or low effective tax rate”, must apply. This is a gateway criterion. However, an evaluation of whether a regime is potentially harmful should be based on an overall assessment of each of the factors and on its economic effects. Where a preferential regime has been found harmful, the relevant country will be given the opportunity to abolish the regime or remove the features that create the harmful effect. Where this is not done, other countries may then decide to implement defensive measures to counter the effects of the harmful regime, while at the same time continuing to encourage the country applying the regime to modify or remove it.

Now a day determinations of countries regarding the availability of any relevant information in tax matters (ownership, accounting or bank information), the appropriate power of the administration to access the information and the administration’s capacity to deliver this information to any partner which requests it, is somehow helping the countries to fight with the menace of tax evasion. Moreover, since the 2012 update of article 26 of the OECD Model Tax Convention, the standard on exchange of information clearly includes group requests. Needless to say, these developments provide opportunities to obtain better and more accurate information on BEPS instances that in the past were often not available.
CHAPTER- III

ACTION PLAN FOR COMBATTING BASE EROSION AND PROFIT SHIFTING

Organization for Economic Co-operation and Development, in its report\(^\text{32}\) titled “Action Plan on Base Erosion and Profit Shifting” has provided with some 15 point solutions in order to deal with the problem of BEPS. It has highlighted the possible solution and is working to bring possible policy framework latest by 2015 for implementing the solutions for curbing BESP.

**Broad framework on which action plan revolves:**

1. Fundamental changes are needed in anti-abuse provisions as well as model tax treaty to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it.
2. New international standards must be designed to ensure the coherence of corporate income taxation at the international level.
3. Whilst bilateral tax treaties have been effective in preventing double taxation, there is a concern that they often fail to prevent double non-taxation that results from interactions among more than two countries.
4. In the area of transfer pricing, the rules should be improved in order to put more emphasis on value creation in highly integrated groups, tackling the use of intangibles, risks, capital and other high-risk transactions to shift profits.
5. The availability of timely, targeted and comprehensive information is essential to enable governments to quickly identify risk areas.

**Actions to be undertaken to combat BEPS:**

1. **Address the tax challenges of the digital economy:** It includes identifying the main difficulties that the digital economy poses for the application of existing international tax rules and developing detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation.

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2. **Neutralize the effects of hybrid mismatch arrangements:** The incentive behind this scheme is to develop model treaty provisions and provide recommendations regarding the design of domestic rules to neutralize the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure.

3. **Strengthen CFC rules:** To develop recommendations regarding the design of controlled foreign company rules under international taxation regime.

4. **Limit base erosion via interest deductions and other financial payments:** Developing recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. Moreover, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be co-ordinated with the work on hybrids and CFC rules.

5. **Counter harmful tax practices more effectively, taking into account transparency and substance:** Revamping the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime.
6. **Prevent treaty abuse:** Developing model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.

7. **Prevent the artificial avoidance of PE status:** The definition of permanent establishment (PE) needs to be updated to prevent abuses and to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions.

8. **Intangibles:** Developing rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

9. **Risk and Capital:** Developing rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital.

10. **Other high-risk transactions:** Developing rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.

11. **Establish methodologies to collect and analyse data on BEPS and the actions to address it:** Requires taxpayers to disclose their aggressive tax planning arrangements: Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis.

12. **Require taxpayers to disclose their aggressive tax planning arrangements:** Developing recommendations regarding the design of mandatory disclosure rules for
aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules.

13. **Re-examine transfer pricing documentation**: Developing rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business.

14. **Make dispute resolution mechanisms more effective**: Developing solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties.

15. **Develop a multilateral instrument**: Analysing the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.
CHAPTER – IV

INDIA AND ISSUE RELATING TO BASE EROSION AND PROFIT SHIFTING

In the aftermath of the financial crisis around the globe, fiscal consolidation has become a major problem and therefore has attained high priority amongst most governments of the world, including India.

Hence, a political debate surrounding the tax structures adopted by MNEs, where profits are shipped to low tax and perhaps no tax jurisdictions by them, has assumed center stage at the present time, especially when the amounts are expressed as a percentage of the sales/turnover being made by such MNEs.

The debate surrounding Base Erosion and Profit Shifting (‘BEPS’) in the present time have highlighted the issues such as lack of a vibrant tax policy that encourages enterprise to undergo legal tax avoidance schemes and thereby causing huge revenue loss to the exchequer.

Nonetheless, it cannot be denied that the tax regime on an international level has failed to keep pace with the advancement in business structures and planning exercise. Most tax regimes, as the Chair of the OECD Committee on fiscal affairs describes “are still characterized by fixed assets, plant and machinery and a low degree of economic integration across borders, rather than today where most profits lie in risk taking and intangibles”.33

Whilst the world of tax practitioners awaits the final recommendations from the OECD on the issue of Base Erosion and Profit Shifting, it high time to discuss the provisions under Indian Tax regime which try to undermine the problem of Benefit Erosion and Profit Shifting.

Unlike the OECD countries, India’s concerns with BEPS are mainly two fold. First, to ensure that exploitation of Indian markets by MNEs should not escape tax free and each transaction be charged effectively and secondly, the taxation laws should be effective is checking the illicit capital flight from the country.

Broadening the Sphere in relation to Taxation:

In the recent past, Indian government has undertaken various legislative measures to expand the scope of the deeming provision in the Income Tax Act, 1961 (Act) to bring non-resident income directly into the Indian tax fold. Most notable amongst such has been the retrospective amendment brought in the Act to counter the effects of the Supreme Court of India’s decision in

Vodafone case\textsuperscript{34}. The amendment brought changes in Section 9 of the Act, which talks about income which deemed to accrue or arise in India, purports to clarify that any income arising on account of transfer of shares, irrespective of its location, which derive substantial value from assets situated in India shall be taxable in India.

Another interesting illustration in this regard is the treatment of Royalty and Fees for Technical Services paid to non-residents and amendment of same provision by Finance Act, 2012. The law has been amended to emphatically provide that for purposes of taxation under Indian law, the only significant requirement is that the services/rights were utilized in India for purposes of earning income. Other factors like the place of performance and non-resident’s place of business in India or not shall have no bearing for the purpose of taxation.

\textbf{Developments in Transfer Pricing Regime:}

The Transfer Pricing (‘TP’) regime was introduced in India in the year 2001, but the current volume of transfer pricing litigation in India is one of the highest in the world. Total value of adjustments, till seventh round of audits was approximately US$17.51 billion with 52,951 cases under litigation.

Indian Income Tax department is treating Transfer Pricing cases with a specialized set of officers entrusted with the task of Transfer Pricing assessment known as Transfer Pricing Officer.\textsuperscript{35} The Act also incorporates the provision for reference to Transfer Pricing Officer, during the course of regular assessment if the taxpayer has entered into an international transaction.\textsuperscript{36}

In 2009, a new layer of alternate form of adjudication was added to the Transfer Pricing regime in India, enabling the taxpayer to approach the Dispute Resolution Panel (‘DRP’) based on the draft assessment order passed by the Transfer Pricing Officer.\textsuperscript{37} Though the DRP has failed to provide a major breakthrough in relation to transfer pricing disputes in India, nonetheless it offers a time bound attempt for resolution of dispute. Last year, the Government of India also provided for the requisite machinery for Advance Pricing Agreements (‘APAs’)\textsuperscript{38} by bringing on amendment in Income Tax Act, 1961 through Finance Act, 2012 and thereby provided for

\textsuperscript{34} Vodafone International Holdings BV v. Union of India, (2012) 6 SCC 613.
\textsuperscript{35} Income Tax Act, 1961, Section 92CA.
\textsuperscript{36} Income Tax Act, 1961, Section 92.
\textsuperscript{37} Income Tax Act, 1961, Section 144C.
\textsuperscript{38} Income Tax Act, 1961, Section 92 CC.
Advance Pricing Agreement by Indian Company undergoing international transaction on unilateral, bilateral and multilateral level.

The Income Tax Department has also adopted a very proactive approach for dealing with existing and prospective Transfer Pricing issues. For instance in the case of intangibles, an attempt has been made to balance India’s appetite as a capital importer and to ensure profits are not shifted under the guise of Research & Development Centers alleging insignificant risks, by laying down specific rules.\(^{39}\) Further, the rules also provide that in case of intangible, if multiple transactions are closely interlinked then the Profit Split Method\(^ {40}\) should be preferred, since the TPO shall base his assessment on the basis of global positions of the MNE.

Another manifestation of the over-zealous TP regime is the controversy involving Shell.\(^{41}\) Income Tax authorities are keen on expanding the understanding of the term ‘international transaction’ in order to include the share issuances by the Indian subsidiary of the Shell to its Dutch parent company and they argue that the same should be covered by the Arm’s Length Principle provided under Section 92 C of the Income Tax Act, 1961, hence the instant issuance was underpriced by INR 15,000 Crores (nearly USD 3 billion). The rationale is based on the reasoning that, had the full value of shares come to India, the same would have been utilized for income generation and other developmental activities

**Anti-avoidance Regulations:**

After much deliberation, General Anti – Avoidance Rules (‘GAAR’) have been incorporated into the Income Tax Act, 1961 under Section 95 to Section 102 and shall come into force from 1\(^{st}\) April, 2016. Needless to say, it shall provide the Tax Officer with wide powers in relation to re-characterization of commercial substance in any business transaction if it is found to be lacking or the same appears to be an attempt to abuse the provisions of the Act.

The Tax Department has also taken a step forward in relation to the issue of Tax Residency Certificate (‘TRC’), which is required for claiming the benefit of tax treaty provisions (DTAA).

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\(^{39}\) Circular No. 03 /2013, issued by Central Board of Direct Taxes vide F No. 500113912012, dated 26\(^{th}\) day of March 2013.

\(^{40}\) Circular No.0 2/ 2013, issued by Central Board of Direct Taxes vide F No. 500113912012 dated 26\(^{th}\) day of March 2013.

A prescribed set of particulars\textsuperscript{42} should be reflected in the TRC and it shall be required but not sufficient for claiming the treaty benefit.\textsuperscript{43}

The draft of the proposed tax law also seeks to broaden the tax base to include income earned by Controlled Foreign Companies\textsuperscript{44} (‘CFC’) based a particular formula. CFC rules could have a drastic impact on the investments being routed through Mauritius route into India.

In the past, India has generally been quick to adopt and take cue from the OECD perspective. Especially, on the issue of tax base preservation, Indian lawmakers have remained fervent and adopted determined measures.

**CONCLUSION**

Base Erosion and Profit Shifting, which is growing day by day as a global problem and thereby causing huge revenue loss to different economies of the world, need a holistic approach to solve the issue. Though, different economies are coming out with unilateral measures to control the effect of BEPS, but it requires co-operation amongst governments of different nations to develop a holistic approach in relation to sharing information in relation to transaction which has effect like BEPS and moreover develop a common framework to combat it. Actions plans suggested by OECD are comprehensive in nature and will surely help in diminishing the effect of BEPS in coming years. Hence, the deepening effect of BEPS call for earliest possible solution to curb it so that effect of economic slowdown could be diminished and countries can return to the path of development with sufficient funds for it, generated through taxation.

\begin{footnotesize}
\begin{enumerate}
\item The Income Tax Rules 1962, Rule 21AB.
\item Income Tax Act, 1961, Section 90(4).
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