IMPACT OF OFFSHORE BANKING AND TAX HAVENS ON THE INDIAN ECONOMY

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ABSTRACT

Tax havens are countries, states, or jurisdictions that offer low or no taxation to individuals or corporations. They are attractive to businesses and individuals seeking to reduce their tax burden, as well as to those looking to avoid taxes altogether. Tax havens often provide favorable tax treatment and low levels of regulation, making them attractive to businesses, individuals, and even criminals. The problems faced due to these havens are Loss of Tax Revenue; Unfair Competition; Money Laundering; Reputational Damage; Regulatory Issues. Similarly, Offshore banking in India is largely unregulated. This means that there is no official governmental oversight or regulation of offshore banking activities in the country. As a result, it can be difficult for individuals or businesses to ensure that their funds are secure and that their transactions are compliant with Indian law. Additionally, there is a lack of consumer protection for those engaging in offshore banking in India. Problems with offshore banking in India are Lack of Transparency; Lack of Government Oversight; Weak Anti-Money Laundering Regulations; Limited Taxation; Use of Shell Companies. Such problems led to the formation of the Organization for Economic Co-operation and Development (OECD) to regulate tax practices around the globe. In this paper, I attempt to highlight the adverse effects of tax evasion practices on the Indian Economy. I aim to discuss the areas where offshore accounts become unregularized and lean toward tax evasion tactics. This article also analyses the current framework regulating offshore banking in India along with probable solutions.

Keywords: Tax Havens, Offshore Banking, Money Laundering, Indian Economy

Introduction:

The so-called "tax havens" are places with extremely low tax rates and other tax benefits intended to attract foreign investment. Large amounts of foreign capital are invested in tax haven nations[1], and as a result, these nations' economies have grown incredibly quickly during the past 25 years. Over the past 20 years, startling technological advancements and the telecommunications revolution have made it simpler to access offshore facilities. As a result, the offshore industry has grown into a significant global industry that spans all continents and accounts for roughly half of the world's financial transactions by value. Each year, more than 150,000 offshore corporations are established[2].

However, due to their role in reducing foreign tax revenues by providing noticeably low tax rates and encouraging domestic tax fraud and money laundering through stringent financial secrecy regulations, these offshore havens have recently come under harsh international criticism. There is a lot of discussion about tax havens in the area of international taxation, including how to handle the problem of tax competition that the havens are posing, policy formulation, and diplomatic efforts to find a solution, but there is also a view that the developed countries' taxation rates, which have improved significantly over the years, owe a great deal to the existence of the havens.

Impact of Tax Havens on India's Economy:

Such jurisdictions reduce tax obligations and revenue bases for taxing nations, which results in a lack of cash needed for economic growth.

The government's attempts to gather resources to recover the black money are hampered by it[3].

It impedes the execution of the government's numerous economic policies.

Because of the increase in tax rates levied by the government as a result of some people's reduced tax obligations, the tax burden is unfairly distributed and falls on honest taxpayers.

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[1] The Rise of Phantom FDI in Global Tax Havens

[2] Hines, J. R., Jr. and E. M. Rice (1994) "Fiscal Paradise: Foreign Tax Havens and American Business" Quarterly Journal of Economics.

[3] Press Release: Government's White Paper on Black Money, Dated 16-5-2012

It hinders wealth transfer, widens income gaps[4], and leads to the concentration of economic power in the hands of a select few.

Base erosion and profit shifting are encouraged by tax havens, which wastes time, effort, and resources on the part of the Indian tax authority.

It weakens the social and moral fabric of society and promotes unethical behaviour like bribery, intimidation, falsifying documents, altering official records, etc.

Mechanisms Adopted by Government to Counter Tax Evasion:

Strengthening of legislation governing controlled foreign companies on a national and international level (CFCs)[5].

Resolve any difficulties with resident corporations evading taxes by using a non-resident affiliate.

Suggesting different adjustments to the domestic tax laws and regulations as well as the model tax convention.

introducing several payment methods will help stop base erosion and profit shifting.

Determine the system's negative tax practises and fix them. Base reduction via the transfer pricing mechanism.

Tax Havens in Theory and Practice

Tax havens are in a good position to profit from the substantial international corporate investment mobility and the resulting tax base. There are several reasons to believe that their low tax rates will affect foreign investors' investment and tax avoidance decisions, and a wealth of literature outlines the impacts of low tax rates in detail.

Given that higher tax rates lower after-tax returns, which lessens incentives to commit investment funds, tax policies are certainly capable of influencing the volume and location of

[4] Causes and Consequences of Income Inequality: A Global Perspective (June 2015) by Era Dabla-Norris, Kalpana Kochhar, Frantisek Ricka, Nujin Suphaphiphat, and Evridiki Tsounta

[5] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, available at http://www.oecd.org/ctp/BEPSActionPlan.pdf

FDI[6] when it comes to investments. Foreign investment is drawn to tax havens not just because domestic income is taxed favourably, but also because tax haven operations make it easier to evade taxes that would otherwise have to be paid to other nations. Tax havens let taxpayers avoid paying taxes by allowing them to transfer their taxable income from high-tax to low-tax jurisdictions[7].

Pricing reductions by affiliates in high-tax countries for goods and services provided to affiliates in low-tax countries are often advantageous to multinational corporations. OECD governments compel businesses to use transfer prices that a third party would pay, but enforcement is challenging, especially where pricing concerns distinctive or private goods like patent rights.

A range of transactions, including intra-firm debt, royalties, dividend repatriations, and intra-firm commerce, can be structured by multinational corporations in a way that facilitates tax avoidance. Last but not least, tax haven operations can be used to avoid making home-country taxes on repatriated money due. There are chances to redistribute money across foreign jurisdictions without having the income received in the firm's home country and resulting in a home country tax requirement when a tax haven company is at the top of the ownership chain of the firm's international operations. The consequent tax savings can be significant and raise the value of activities in tax havens.

Many governments are considering international cooperative measures geared to protect their capacity to tax mobile business income due to concern over the potential effects of international tax competition. Despite the enthusiasm of certain parties, it is notoriously difficult to reach an agreement on international tax accords involving more than two nations because of varying interests and points of view. The Organization for Economic Cooperation and Development has undertaken the most comprehensive and successful global tax agreement to date (OECD). The OECD started its Harmful Tax Practices effort[8], currently known as its Harmful Tax Competition programme[9], in 1998. The initiative's goal was to deter OECD members and

[6] External Debt and Capital Flight in the Indian Economy, Oxford Development Studies, vol. 29, no. 1, 2001
[7] Director General of Income Tax (Administration), Director General of Income Tax (Systems), Director General of Income Tax (Vigilance), Director General of Income Tax (Training), Director General of Income Tax (Legal & Research), Director General of Income Tax (Business Process Re-engineering), Director General of Income Tax (Intelligence), Director General of Income Tax (HRD).
[8] Harmful Tax Competition - An Emerging Global Issue 1998, available at https://www.oecd.org/tax/harmful/1904176.pdf
[9] OECD (1998) Harmful Tax Competition: An Emerging Global Issue Paris: OECD.

specific non-OECD tax havens from implementing practises that were believed to hurt other nations by unjustly eroding their tax bases. The OECD also highlighted the use of preferential tax regimes that had extremely low tax rates, the lack of effective information exchange with other nations, and ringfencing, which gave foreign investors access to tax benefits that domestic people were barred from receiving.

Money Laundering: The Indian Scenario

Banks in India need to be on high alert in order to prevent money laundering given the sophistication of the technology used to move cash, as well as the significant liberalisation and progressive removal of constraints in the regulatory environment in India. It's crucial to keep in mind that banks and other financial institutions both transport money and control the flow of money. India has certain responsible banking policies that limit the growth of money laundering.

• Prior to creating a bank account, identification of potential customers is accomplished by requesting a proper introduction. This process partially satisfies the KYC requirement.

• Banking transactions in India are subject to criminal scrutiny. The Income Tax Department, for instance, has the authority to request details on customer accounts and transactions.

Accounts with errors may be frozen. The Basle Principle on Compliance with Laws and Law Enforcement Agencies is addressed here.

• Several laws, like "The Bankers Books Evidence Act, 1891" and "Banking Companies (Preservation of Records) Rules, 1985," address the Basle Principle on Record Keeping and Systems by requiring the availability or retention of records to investigating bodies.

Existing Legal Framework to Curb Money Laundering in India

The primary piece of legislation India used to fight money laundering is the Prevention of Money Laundering Act, 2002 (PMLA 2002)[10]. On July 1, 2005, PMLA 2002 and the Rules made thereunder became operative. Banking businesses, financial institutions, and intermediaries are required by the PMLA of 2002 and the rules thereunder to confirm the

[10] Prevention of Money Laundering Act, 2002, available at https://dea.gov.in/sites/default/files/moneylaunderingact.pdf

identification of their clients, keep records, and provide information to the financial intelligence unit of India.

The proceeds of crime can be frozen, seized, and confiscated under the PMLA 2002, which also defines money laundering as an offence. 49 Other laws, besides the PMLA, have the same goal of reducing money laundering. These are what they are:

The Conservation of Foreign Exchange and Prevention of Smuggling Activities Act, 1974

The Income Tax Act, 1961

The Benami Transactions (Prohibition) Act, 1988

The Indian Penal Code and Code of Criminal Procedure, 1973

The Narcotic Drugs and Psychotropic Substances Act, 1985

The Prevention of Illicit Traffic in Narcotic Drugs and Psychotropic Substances Act, 1988

Tax Evasion:

When tax obligations are minimised and the resulting tax payment is also minimised, this is known as tax evasion. The matching of a specific circumstance to the circumstances that directly affect the tax payer is the basis for the minimization of tax liability[11]. For instance, the actions that a tax payer makes can affect and shape the background circumstances that influence his or her attitudes. For instance, in the case of a farming firm, dividing up property among family members might reduce the level of tax liability (in terms of taxation rates). Additionally, actions that are "legally-based" and aimed at lowering the level tax rates can include decreasing manufacturing, services, or relocating a specific organisation.

Differentiating between legally-based and unlawful businesses intended to evade taxes is a difficult challenge in practise. As a result, in order to establish a sharper perspective in this regard, the following criteria have been developed:

[11] Machogu, C. G. (2013). The Effect of Taxpayer Education on Voluntary Tax Compliance, Among Smesin Mwanza City-Tanzania.

- the purpose of operations (intended actions).
- fake moves and actions that have been made, as well as the traits that indicate they have actually been done.
- the amount of any potential benefits from tax fraud.
- the assessment of the circumstance by a qualified body (e.g. authorities).

The tax evasion offence in Poland involves[12], first of all, illegal trade of cigarettes and alcohol. This very case involves two strategies employed. The first method is trafficking, which impoverishes the state budget due to the lack of duty fees and taxation involved. Those who introduce the goods into the market fabricate receipts of payment, as well as produce false evidence regarding the trademark or name of the firm or business. The second method involves fictitious exportation. The party that purchases alcohol produces false evidence of exporting goods. The price of spirits exported is ostensibly lower by a few dozens. The same practice involves tobacco products.

In Poland, the primary element of the tax evasion offence is the illicit sale of alcohol and cigarettes[13]. There are actually two tactics being used in this example. Trafficking is the first technique, and because there are no duty fees or taxes involved, it depletes the state budget. Those that release the products onto the market create payment receipts and present fraudulent documentation regarding the firm's or business's name or trademark. The second technique entails false exports. The person who purchases alcohol presents fictitious exportation documentation. Evidently, the cost of spirits exported is a few dollars less. The use of tobacco products is the same practise.

Effects of Tax Heaven on India:

In 1983, the Indo-Mauritius DTAA[14] was initially agreed upon. The key clause stated that no Mauritius resident would be subject to Indian taxation on capital gains from the selling of securities in India. The agreement exempts investments from capital gains taxes if they go

[12] Poland Tax avoidance is understood as a legal act.
[13] Joossens, L., & Raw, M. (2012). From cigarette smuggling to illicit tobacco trade. Tobacco Control, 21(2), 230-234.
[14] Agreement for avoidance of double taxation and prevention of fiscal evasion with Mauritius

through Mauritius. It has been a really contentious agreement. It has received media attention over the past six years, in part due to a public interest lawsuit against certain of its provisions in India's Supreme Court. 51 Officials want the Treaty to include the same clauses as are included in the treaty with Singapore to prevent its misuse. Similar clauses are found in the India-Singapore Double Tax Avoidance Treaty, although only legitimate enterprises are free from paying taxes.

Since Mauritius eliminated its capital gains tax, foreign institutional investors (FIIs) with Mauritius addresses can invest in India without paying any taxes. Mauritius has been India's largest foreign investor in recent years, proving that the country has turned into a tax haven for international investors. This reveals the path investors are taking entering India to avoid paying taxes that would otherwise be owed. Despite the controversy it has sparked, a number of Indian finance ministers have firmly backed it in its current form.They argued that altering its provisions would cause capital to leave the nation, restrict foreign investment inflows, and possibly trigger a large stock market meltdown. However, in an unexpected turn of events, the Indian Finance Ministry has now acknowledged that DTAA[15] is being abused in front of the Indian Parliament. Therefore, it has decided to reconsider some of its provisions, especially those that encourage what is known as "treaty shopping."

Before going into more depth, it's critical to clarify the guiding principles and philosophy of double taxation agreements as well as the ways in which some of them are exploited globally. Nations typically sign these types of agreements to prevent corporate firms and individuals who operate enterprises in multiple nations from having to pay taxes on the same revenue in both their home country and the country where they are doing business. The issue occurs when such bilateral agreements are made with offshore finance centres, or what are popularly known as tax havens, and, more precisely, when tax authorities fail to read their contents effectively. There are chances for corporate entities to avoid paying any taxes at all or to pay very little tax in tax havens like Mauritius, which does not impose any appreciable income tax on local offshore enterprises.

According to Mauritius law, India permits businesses with offices in Mauritius[16] to pay taxes on their income from India. The Mauritius businesses consequently wind up paying almost no

[15] Department of Financial Services, Ministry of Finance, Government of India.
[16] Mauritius tweaks rules for global business licensees

tax on earnings from Indian operations. The potential for exploitation is enormous due to the regulations of Mauritius, which let corporations to become residents simply by registering their firms locally. Indians reportedly used Mauritius-registered businesses and offshore trusts to hold assets beyond the country's tax jurisdiction. This practise of Indians rerouting their money stored abroad through the Mauritius route is known as "round-tripping”. The Comptroller and Auditor General of India (CAG)[17] recommended that the money received by FIIs from stock market activities be regarded as corporate profit and taxed accordingly in a report to Parliament in May 2005. Unfortunately, the Parliament rejected this plan.

According to the DTAA that Mauritius and India signed in 1983, capital gains obtained by investors who reside in Mauritius on the sale of shares of Indian firms will only be taxed in Mauritius and not in India. The treaty was only in effect on paper for ten years because FIIs were not permitted to invest in Indian stock markets. The entry of FIIs into India in 1992 brought about a change in that[18]. The Offshore Business Activities Act, which permitted foreign businesses to register in the island nation for international investments, was passed by Mauritius in the same year. The obvious benefits of setting up a business in Mauritius include complete exemption from capital gains tax, rapid incorporation, complete business secrecy, and a fully convertible currency.

Tax havens are nations that provide low or no tax rates, loose rules, and stringent secrecy laws to people and companies looking to evade or pay less in taxes. Tax havens may have both positive and negative effects on India. Tax havens can attract foreign investment[19], as enterprises and investors seek to take advantage of the low tax rates and relaxed regulation. This might result in a flow of foreign capital into India, which would accelerate economic expansion. Tax havens are advantageous for Indian firms as well since they allow them to lower their tax obligations and put the money saved back into their operations. Increased investment in Indian businesses and the development of new jobs may result from this[20].

As people and businesses can evade or lower their tax obligations, the use of tax havens may result in income loss for India. This may result in less tax income being collected by the Indian

[17] Comptroller and Auditor General of India
[18] FII Investment Trends 1992-2014
[19] Janský, P., & Prats, A. (2015). International profit-shifting out of developing countries and the role of tax havens. Development policy review, 33(3), 271-292.
[20] Aspray, W., Mayadas, F., & Vardi, M. Y. (2009). Globalization and offshoring of software. In The Innovation Imperative. Edward Elgar Publishing.

government, which may have an effect on the delivery of public goods and services. Tax havens are frequently linked to a rise in financial crimes[21] such money laundering, tax evasion, and terrorism financing. India may suffer as a result of this, as it might be more challenging for law enforcement to find and bring to justice financial criminals operating in tax havens. As businesses who can use tax havens to lower their tax obligations may have an unfair advantage over those that cannot, the usage of tax havens can also distort competition within India. This may result in a market that is less competitive, which would ultimately be bad for consumers.

Conclusion:

Small, wealthy, and with excellent governance systems, tax havens are these characteristics. While all of these traits are somewhat related to one another, it is interesting to observe that tax havens almost never exist in poorly governed nations, of which there are many in the world. Since these nations are not generally recognised for their conformity and since international tax norms are in any event not particularly well established, it is difficult to assume that their absence is due to a lack of desire on the part of poorly governed nations to adhere to international tax norms. The more plausible answer is that tax havens fail in the absence of effective governance, thus bad countries don't even try to become tax havens[22] because they know that they will fail. From the perspective of individual nations, the inability to tailor tax policies to maximum national advantage just adds to the many horrendous costs of poor governance. Whether the absence of more tax havens is good or bad for the world as a whole is an interesting question that lies beyond the scope of this paper.

A similar multilateral effort to address international money laundering would be more effective and fiscally equitable to countries of all economic conditions, notwithstanding the obvious shortcomings of the OECD's battle against detrimental tax competition[23]. The regulations required to detect illicit funds, like modest KYC laws[24], are less intrusive than those in the fight against damaging tax competition, which call for an endless exchange of financial data with tax authorities. Therefore, by adopting the less intrusive KYC rules, offshore tax havens risk

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[21] Otusanya, O. J., & Adeyeye, G. B. (2022). The dark side of tax havens in money laundering, capital flight and corruption in developing countries: some evidence from Nigeria. Journal of Financial Crime, 29(1), 62-100.

[22] Akiko Hishikawa, The Death Of Tax Havens?, 25 B.C. Int'l & Comp. L. Rev. 389

[23] Wolfgang Schön, Tax Competition in Europe--General Report, ed., 2003 It has been noted how high-tax OECD countries have taken steps, such as lowering taxes, to compete in the European tax setting

[24] Johnson, R. A. (2006). Why Harmful Tax Practices Will Continue After Developing Nations Pay: A Critique of the OECD's Initiatives Against Harmful Tax Competition. Boston College Third World Law Journal, 26(2), 351-375.

deterring illegal investments exclusively, while protecting the revenues from legitimate deposits upon which their economic sustainability depends. In addition, these offshore financial centres actually stand to gain from the suppression of money laundering as it would entice a larger volume of legitimate investors, thus stimulating the economic growth necessary to remove these offshore tax havens from "developing nation" status[25]. Most compelling, however, is that such a campaign would prove effective given the common global interest in eradicating the concealment of illegal funds offshore. Specifically, the ubiquity of offenses and the rising interest in uncovering terrorist finances around the world ensures the pervasive support needed for an effective and globally-unified movement against money launTherefore, by implementing the less onerous KYC procedures, offshore tax havens run the risk of just discouraging illicit investments while preserving the income from legal deposits that is essential to their economic sustainability. Additionally, these offshore financial centres actually stand to benefit from the eradication of money laundering as it would draw more genuine investors, spurring the required economic expansion to remove these offshore tax havens from the category of "developing nations." The strongest argument, however, is that an effort of this nature would succeed given the widespread desire to stop the offshore hiding of criminal funds. Particularly, the prevalence of crimes and the growing worldwide interest in locating terrorist financing assure the widespread support required for an efficient and coordinated global action against money laundering.

[25] Salehi, M., Tarighi, H., & Shahri, T. A. (2020). The effect of auditor characteristics on tax avoidance of Iranian companies. Journal of Asian Business and Economic Studies, 27(2), 119-134.

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11. Otusanya, O. J., & Adeyeye, G. B. (2022). The dark side of tax havens in money laundering, capital flight and corruption in developing countries: some evidence from Nigeria. *Journal of Financial Crime*, *29*(1), 62-100.

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