



Foreign Direct Investment: Inclination Towards Tax Havens

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ABSTRACT

Tax havens all over the world are used by Multinational Corporations and business houses to minimize their tax liability and enjoy tax rebates exercised in other countries while operating business in one country. Countries like Mauritius and Singapore are used very intensively as source of Foreign Direct Investment in India. They are used for tax evasion. Though countries try to avoid misusing these tax havens but because their secrecy regulations Multinational Corporations and businesses take advantage and keep abusing tax havens without the fear of being scrutinized. Several amendments are being made in Double Tax Avoidance Agreement with countries so that scope of misusing or abusing through tax avoidance or evasion can be minimized.

I. Introduction

In today's day and age, Foreign Direct Investment has gained a lot of importance from the countries all over the world, be it developed or developing. But for the capital scarce countries that fall under the category of developing countries, Foreign Direct Investment is all the more necessary. To attract foreign investors who provide foreign direct investment to their country, Governments provide them incentives of various kinds. In general terms, a country is characterized as 'tax haven' when it levies no or little tax liability on foreign individual investors and businesses; these countries are very secretive i.e. they share limited financial information with the authorities; these countries do not even require physical presence of investors or business in their territory to gain benefit from their tax policies.

In the past few decades, Foreign Direct Investment has seen many fold growth all over the globe reason being governments trying to frame persuading policies to attract more and more foreign direct investment because it is one of the main element in the economic development of any country.

A subsidiary established in one or more country that does not perform any actual economic activity will still have cost associated with it. A

general objective of any business is "profit maximization" and to achieve this objective these big business houses choose to set up their subsidiaries in tax haven so that the gains from their 'tax levy' is greater than the associated cost. These business houses further use these subsidiaries for reducing the tax payments in countries other than the tax havens by following two ways:

(1) Double Taxation Avoidance Agreement (DTAA): It is an agreement between two or more countries to avoid taxing the same income twice. Both the signatories of the agreement agree to rates of tax on specified types of income. This means if a tax payer resides in one country and earns in other country, he will be covered under DTAA.

(2) Abusive Transfer Pricing: Transfer price is the price at which affiliated enterprises transact with one another. If transfer price is much more than that of the market price, it is called abusive transfer pricing. These Multinational Corporations shift their income from high tax economy to a low tax one by this abusive transfer intra-corporate via its multiple subsidiaries set up in various countries, thus dodging their tax liability.

However, it is seen that in the past few years, DTAA's are used to route capital fund flows through tax havens. While DTAA's are signed with the motive to promote trade and investment among countries, it is being criticized for provoking treaty shopping and round tripping black money, tax evasion, tax avoidance, etc. which are harming host economies to an extent.

II. Review of Literature

Over the span of generations, Foreign Direct Investment has evolved and is still evolving accordingly with the changes in the world economy. And so has the literature on foreign direct investment evolved with the time. Stephen Hymer and John H. Dunning, both did the early studies and their attempts have a great influence on the subsequent theories made over the years. Both Hymer and Dunning noted that movement of portfolio capital is different from the movement of Foreign Direct Investment across countries. While portfolio capital is influenced by interest rate,



Foreign Direct Investment is more likely to be influenced by other factors.

Graham and Krugman (1989) and Sodersten and Reed (1994) studied and came to the point that Foreign Direct Investment by Multinational Corporations bring in with it transfer of superior technology and skills. John Dunning (1958), applying theories of other academics like product cycle theory (by Vernon 1966), role of technological differences between countries and internationalism theory (by Buckley and Casson 1976), came up with a theory stating four motivations that lead an Multinational Corporation to expand abroad viz. Market Seeking, Resource Seeking, Efficiency Seeking and Strategic Asset Seeking.

All over the world, Governments have treated Foreign Direct Investment differently. During 1990's foreign direct investment was treated positive as a vehicle of economic growth but during 1970's and 1980's Governments were too negative about foreign direct investment and were not ready to open up their economies.

Many studies and researchers have pointed out that the theory that suggests using tax havens for tax evasion etc. due to which tax revenue is lost by the home country, is exaggerated. Dharmapala (2008) has given example of United States of America and United Kingdom and stated that even by using tax havens, corporate tax collection in these countries has not reduced but rather its increased.

Desai et al (2004, 2006) in his study reveals that tax planning by corporate using tax havens lowers the investment cost and thus encourages more investments which is beneficial in the long run. Hong and Smart (2007) support this theory and further add their research to it stating that effective international tax planning using tax havens results in increased investments which further nullify the Revenue Erosion Effect.

India and the Tax Havens

The intensity of a country towards using tax cuts, loopholes and secrecy regulations to falsely attract multinational activity, and its cross-border activity, all these sum up to provide a corporate tax haven score based on which ranks are given to 64 countries under the Corporate Tax Haven Index. Top 10 most corrosive tax haven in the world are :

1. British Virgin Island
2. Bermuda
3. Cayman Island
4. The Netherlands
5. Switzerland

6. Luxembourg
7. Jersey (British Dependency)
8. Singapore
9. Bahamas
10. Hong Kong

Multinational Corporations and other big business houses across the globe make investments through these nations to avoid scrutiny. These top ten tax havens have dodged 52% of world's tax revenue. Mauritius, Singapore, Netherlands, Japan and the United States are the top countries investing in India. United Kingdom alone is responsible for major part of the breakdown of the world corporate tax system, all because of its strong corporate tax haven network.

Statistics of Foreign Direct Investment inflows and outflows country-wise and sector-wise is published in Secretariat for Industrial Assistance (SIA) Newsletter, by the Department of Industrial Policy and Promotion (DIPP) under the Ministry of Commerce and Industry. It provides details of each and every foreign direct investment inflow and outflow (including investors and his company's details). There has been huge growth of foreign direct investment inflows in India from the year 2000 onwards due to multiple factors. One of the reasons for this tremendous growth in Foreign Direct Investment was noted to be the role played by Mauritius, Singapore and Cyprus as sources of Foreign Direct Investment inflows. Mauritius in particular, holds 40 percent of the total Foreign Direct Investment share. The total Foreign Direct Investment from both Mauritius and Singapore sum up to be more than the rest of the world. Mauritius and Singapore's economies are small, such huge amounts of Foreign Direct Investment coming from them raises serious questions. Not just India, Mauritius invests in many other Asian and African countries, which means foreign direct investment outflow from Mauritius is more than its own Gross Domestic Product (GDP). All these points connect to one dot and that is that Singapore, Mauritius and Cyprus etc. are used for tax avoidance, tax evasion and round tripping black money to India.

The Multinational Corporation's establish shell companies in tax havens specially to exploit the taxation framework of the Double Tax Avoidance Agreement (DTAA) network. The tax havens have 0 percent effective short term capital gains tax rate. In simple words, tax is exempted on these gains either in India or in their home country. Recent study points out that countries where capital gains taxes are exempted under specific conditions, like Netherlands, Spain and France, are the new



sources of Foreign Direct Investment inflows to India. Abusive Transfer Pricing through tax havens provides two fold benefits to Multinational Corporations. First, low tax rates to dodge the tax liabilities and second, the secrecy and confidentiality provisions help them to hide information from authorities and dodge anti-abuse regulations.

III. Conclusion

All over the world, countries want Foreign Direct Investment to flow in their economies to make it strong specially developing countries. Foreign Direct Investment, along with capital, opens door for new technology and skills, increased production capacity, innovations and promotes job creation as well. So, in the race to gain more Foreign Direct Investment, countries provide many incentives and perks to the investors. Double Tax Avoidance Agreement (DTAA) were introduced with the intention that they would promote cross border trade and investments but instead DTAA's with tax havens is being misused for treaty shopping, tax avoidance/evasion and round tripping. India has signed Double Tax Avoidance Agreements with both Mauritius and Singapore where they have agreed upon Zero Effective Tax Rates for capital gains and because of this agreement, Multinational Corporations and big business houses, have used these two small countries to fraudulently route investments to India. Today, Mauritius and Singapore are two major sources of Foreign Direct Investment inflow into India. Though the Government of India is trying to overcome the loopholes in the DTAA's and make transactions with these countries transparent but their secrecy regulations are another hindrance. Major amendments at different levels will have to be made so that these countries that are categorized as 'tax havens' are not abused and misused by the Multinational Corporations and Business houses and make whole of the world economy suffer.