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THE GLOBAL TAX REVOLUTION

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Public Finance, Taxation & Black Money incl. Government Budgeting

International tax jurisprudence received a shot in the arm when 130 countries agreed to introduce a new global tax regime for taxing multinational corporations (MNCs) operating the globe over. For over a century now, the corporate tax system was based on the application of the twin principles of the source rule and the residence rule. All that a MNC had to do to avoid high tax in a country where they did business was to get registered in a tax haven. Globalisation allowed MNCs to replace fears of double taxation with the joys of double non-taxation by exploiting mismatches between the tax laws of various countries and by cutting taxable profits. A digitalised world made their task easier.

Tax havens came in handy for the MNCs. It became easier with the rise of intangible assets, which could easily be shifted from one country to another. But shifting of profits to low tax havens deprived poor countries of revenue by as much as 5% as compared to an alternative system where profits are taxed based on the current location of companies, revenues, their employees and their wage codes. Small countries wanted investments on a grand scale. That could be achieved with low direct taxes. Countries like Belgium, Britain, India and Indonesia brought in Digital Services Taxes on the local sales of foreign firms with online platforms. The U.S. objected and threatened retaliatory tariffs.

Hence, realisation dawned on all the countries that the time had come for a radical change in the tax system. U.S. Treasury Secretary Janet Yellen announced that it was time to end the “race to the bottom” on corporate tax. Egged on by the Organisation for Economic Co-operation and Development (OECD), 130 countries achieved a historic agreement in June on a more stable and fairer international tax architecture. As per the agreement, MNCs would no longer pay taxes in the country where they register their headquarters for tax purposes, but would pay in the country where they generate their sales. A minimum global tax of 15% on profits would be introduced in all countries.

Google, Alphabet, Amazon, Facebook, Apple, and various other Chinese corporations and German companies like Volkswagen, Daimler and Siemens would henceforth pay more taxes in countries where their markets flourished.

How did this happen? The Global Financial Crisis of 2008 forced all countries to change the international tax rules to prevent base erosion and profit shifting. Anti-abuse provisions, new transfer pricing documentation provisions, countering harmful tax practices more effectively taking into account transparency and economic substance and the introduction of an effective dispute resolution mechanism were the objectives that were agreed upon.

The OECD estimates that the proposal to levy 15% minimum tax on global corporations that do business in each country would fetch additional $150 billion per year and move taxing rights of over $100 billion in profits to different countries. Taxing rights would be reallocated so that a slice of the profits could be levied according to the location of a company’s sales. A minimum rate of 15% would be levied on such a slice of profits. As per the agreement, countries where MNCs operate would get the right to tax at least 20% of the profits exceeding a 10% margin.

India, China, Russia, Germany and other countries have signed the agreement, which has to be implemented from 2023. But there are hurdles to cross. India would have to reconsider the equalisation levy. Revenue from the equalisation levy should be compared with the 15% global minimum tax. The Ministry of Finance said significant issues, including the share of profit allocation and the scope of subject-to-tax rules, would have to be addressed and a consensus agreement had been reached on October 8. The draft rules would reset the system for international taxation and subject MNCs to new nexus and profit allocation rules.

Simultaneous implementation of the law by all the signatories to the agreement would be a stupendous job. If achieved, it may herald the dawn of the 'Golden Era' of direct taxes. Revamping India's Direct Tax Code to sail with the concept of global minimum tax requires effort, which is easier said than done.

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