Global Minimum Tax - The Antidote for Race to The Bottom

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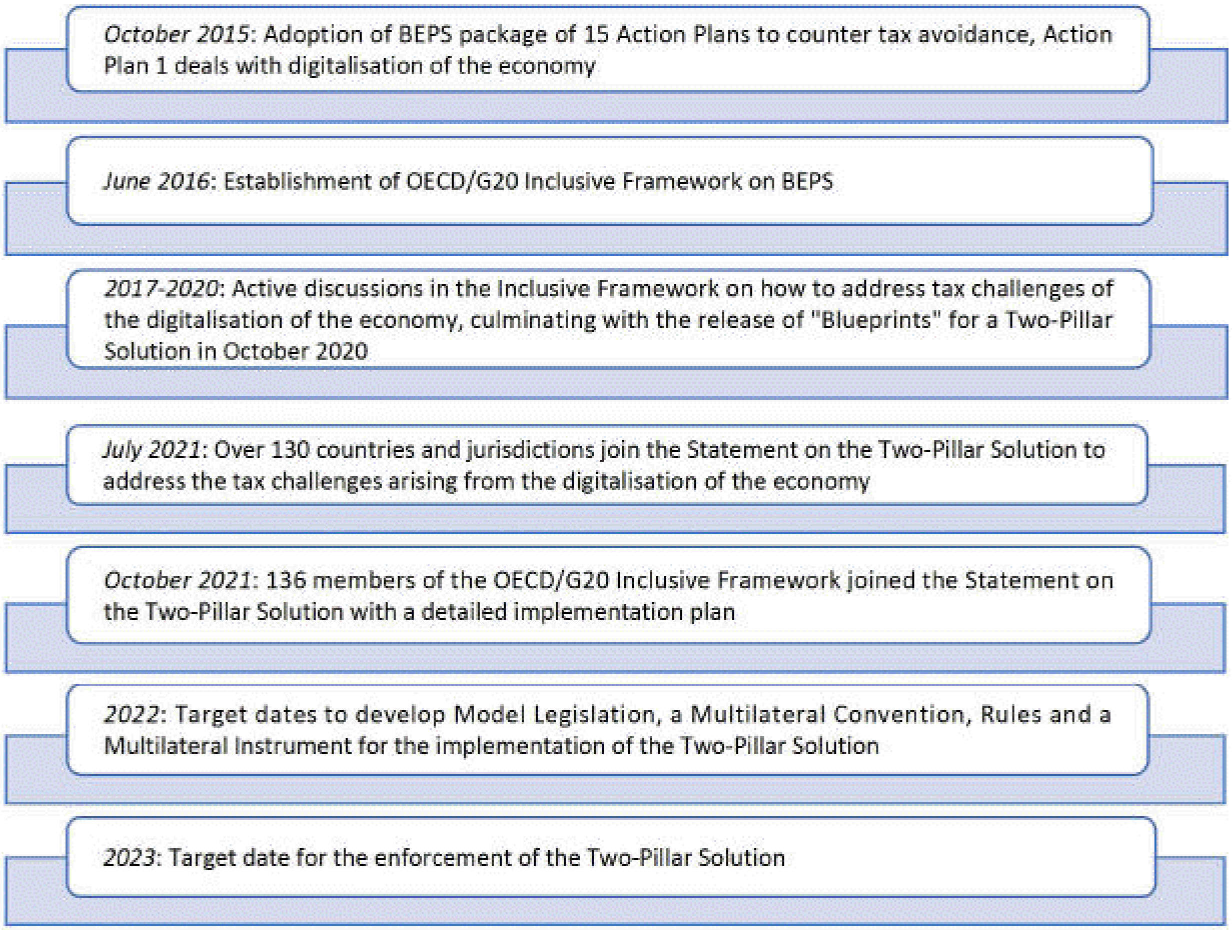
The Journey So Far

The G20/OECD in the recent years have made efforts to discourage MNCs and technology giants from shifting profits and tax revenues to low or no tax jurisdictions regardless of where the sales are made, or physical presence is based. Multinationals with income from intangibles such as royalties from trademark, patent, and software licenses have located or relocated such rights in lower tax jurisdictions to avoid paying higher taxes imposed by their home countries and by the countries where their income is earned.

With a view to preventing base tax erosion, the world leaders have moved to broadly agree on a Global Minimum Tax (GMT) in 2021, based on the "Pillar Two" proposal from the G20/OECD[1] Inclusive Framework on BEPS. The objective has been to curtail the fostering of 30-year old tax competition of 'Racing to the Bottom' (an expression by the US Treasury Secretary) for attracting investments, by flooring the effective tax rates applied to cross-border investment by large MNCs.

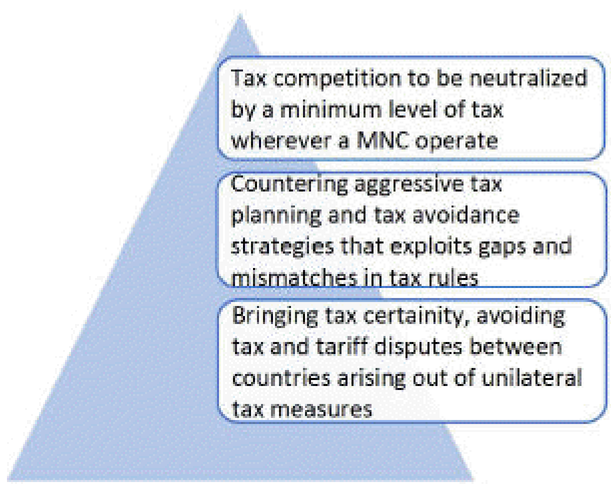
In achieving the aforesaid objectives, most countries (including India) have been pushing for an overhaul of cross-border taxation of MNCs and have expressed harmony for a GMT at 15%. Out of 140 member countries in G20/OECD Inclusive Framework on BEPS, 136 countries have joined and agreed to the landmark deal on GMT to keep MNCs away from dodging taxes. While an agreement on GMT has been reached, time-to time consultations between G20/OECD member jurisdictions will be undertaken to settle the key technical aspects, rules, and specific element.

The journey towards GMT started in 2015 and has maintained a respectable pace since then



The Two Pillar Approach

GMT is an outcome of a consensus-based solution in developing a tax framework for digital businesses viz.



The tax challenges emanating out of digital economy were identified as one of the focal issues in the OECD/G20 BEPS Project. The specific characteristics of digital business viz.,

- establishing nexus without physical presence,
- heavy reliance on intangible assets,
- data assimilation beyond territorial borders, attribution of value to source, and user participation,
- characterization of income – whether business profits or royalty/fee for technical services?

emerged as core challenges to the existing tax framework. To overcome the same, OECD/G20 Inclusive Framework on BEPS agreed to formulate a Programme of Work[2] (PoW) for addressing the tax challenges of the digital economy and arriving on a consensus-based solution. PoW was divided into two pillars - Pillar One and Pillar Two. The key elements of these Pillars are

Pillar One (Unified Approach)

- A set of proposals to revisit tax allocation rules in a changed economy
- Reallocation of taxing rights more closely with local market engagement where customers/ users are located
- Physical presence is not essential
- 25% of residual profits of MNC in excess of 10% of revenue will be allocated to market jurisdictions
- Removal of all unilateral tax actions such as Digital Service Tax, Equalisation Levy, etc.
- Covers MNCs based on global turnover and profitability criteria
- Double taxation of profits allocated to market jurisdictions to be eliminated

Pillar Two [Minimum Tax, and Global Anti-Base Erosion Rules (GloBE Rules)]

- Applies to MNCs that meet the EUR 750 million threshold as determined under BEPS Action Plan 13 (CbCR)
- Two inter-locking domestic rules ('GloBE Rules') - Income Inclusion Rule (IIR)* and Untaxed Payment Rule (UTPR)**
- A Treaty-based rule [Subject to Tax Rule (STTR)] that allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below minimum rate
- Minimum tax rate used for the purposes of IIR and UTPR at 15%
- Countries are free to apply IIR to MNCs headquartered in their jurisdiction even if revenue threshold not met

Reaching a Consensus

With G7 nations reaching a consensus (in June 2021) and committing a GMT rate of at least 15% on a country-by-country basis, on July 9, 2021, the G20/OECD Inclusive Framework member nations accorded a political agreement in Italy on introducing a GMT rate of at least 15% conceived under Pillar Two[3]. Subsequently on October 8, 2021, the G20/OECD Inclusive Framework[4] member nations agreed on certain essential parameters related to Pillar One and Pillar Two, and also fixed GMT at 15%. Certain technical aspects on execution are still being negotiated between G20/OECD's Inclusive Framework members. However, the baseline for the discussions have been set out in Pillar Two. Accordingly, Pillar Two could be brought into law in 2022 and, made effective in 2023.

GMT Regime in Practice

- GMT is a tax regime established by an international agreement where participating countries would impose a specific minimum tax rate on the income of corporations (either as headquarters or subsidiary of an overseas entity) subject to the respective jurisdictional tax laws. Accordingly, each country would be entitled to its share of tax revenue.
- GMT does not require countries to set their home tax rates at the agreed floor rate but give the countries the right to apply a top-up tax to the minimum on income sourced from an offshore country that has a lower rate.
- Broadly, the main mechanism proposed is to ensure the taxation of untaxed profits through IIR, which operates similarly to Controlled Foreign Company Rules, whereby the profits of group companies that are taxed at an effective tax rate below the minimum tax rate, are included in the tax base of the Ultimate Parent Entity (UPE) and consequently subject to a 'top-up' tax in that jurisdiction to make up for the shortfall. The basic illustration (in Annexure) gives the concept of

top-up tax. Again, if the country where UPE is located does not adopt IIR, the next intermediate holding company in the ownership structure would calculate and pay the top-up taxes in respect to their low-taxed subsidiaries.

- GMT would not be self-implementing. Each country choosing to participate, would have to incorporate the rate and rules in its local tax laws. In addition, international and bilateral tax treaties may require amendments or alternations could be done through Multilateral Convention (MLC) and Multilateral Instrument (MLI).
- GMT and GloBE Rules are intended to apply to MNCs with annual consolidated group revenue of EUR 750 million or more in the immediately preceding fiscal year (similar to the CbCR Rules).
- Government entities, international organizations, non-profit organizations, pension funds or investment funds that are UPE of a MNC Group or any holding vehicles used by such entities, organizations or funds, international shipping income are Excluded Entities from GloBE Rules.
- To ensure a simple and smooth administration of GloBE Rules, same are framed as possible to avoid compliance and administrative costs that are disproportionate to the policy objectives, the implementation framework will include safe harbors and/or other mechanisms.

The Indian Narrative

India has always advocated to tax large digital companies that earn a substantial share of their revenues on account of their large user base in the country. Having said that, India has favored a consensus solution which is easier and one that results in allocation of meaningful and sustainable revenue to market jurisdictions. As such, India was the first country to take a unilateral action and introduce Equalisation Levy (EQL), and also formalise Significant Economic Presence (SEP) provisions in its domestic tax laws.

As a matter of fact, India has principally aligned with the Pillar Two proposals and is likely to benefit from the inking of GMT 15% pact, as the existing effective domestic tax rate is above the threshold. In that sense India would continue to attract overseas investment owing to its large consumer market, quality labour at competitive rates, strategic location for exports, and a thriving private sector.

To encourage global investments in India, in September 2019 India dramatically reduced the corporate tax rates for domestic companies to 22% and to 15% for new domestic manufacturing units. GMT at 15% would mean that the concessional Indian tax regime would still work, and India would continue to attract investments. Going forward it would be interesting to see how the profit allocation/sharing transpires between countries for taxation purposes.

The Statement agreed between G20/OECD Inclusive Framework member nations on October 8, 2021, provides that for the implementation of Pillar One proposals, MLC will require member nations to remove all unilateral tax measures such as Digital Services Tax and other similar levies in respect to all companies with a commitment to not introduce such measures in the future. It is further agreed that no newly enacted Digital Services Tax or other similar levies will be imposed on any company from October 8, 2021, and until the earlier of December 31, 2023, or the date MLC comes into force. The modalities for the removal of existing Digital Services Taxes and other relevant similar measures will be appropriately coordinated.

The existing EQL provisions has brought in substantial revenue for India. However, with the aforesaid deadline being set for withdrawing the unilateral digital tax measures by the member nations joining the Statement, India has to roll-back the EQL regime to remain consistent with the Pillar One solution. Having said that, decision to do away with EQL whenever taken in due course, will require Indian Revenue Administration to consider the revenue impact, the modalities of EQL removal, impact on non-resident taxpayers who have already borne the brunt of EQL, and develop the guidelines/rules for transiting into GMT. With the recently notified thresholds to trigger SEP in India for non-residents, based on revenue and user thresholds in India, the Indian Revenue Administration may certainly wish to give the law a fair run prior to repealing the same. Hence, it would be interesting to see how India navigates the implementation of the agreed components under Pillar One.

Impact Assessment

Introduction of GMT is undoubtedly a historic step, but not without its share of challenges and more importantly, the impact on investment decisions.

- At the outset, GMT can act as a backstop to current corporate tax rules, it could also increase the tax burden on business investment across the world. Hence, to mitigate the negative economic effects on account of GMT, policymakers should ensure that both the minimum rate and the tax base to which it applies are designed in a way that does not distort investment decisions.
- The experience of MNCs following the elimination of a tax benefit connected to tax havens shows that policies that increase the taxes owed on offshore operations can have negative blowback effects on domestic markets.
- Foreign Direct Investments are sensitive to tax rates, GMT could directly impact such investment decisions.
- GMT under Pillar Two have the potential to neutralize tax benefits (if not completely eliminating tax-based competition among jurisdictions) and countries may then have to economically compete based on factors other than a tax advantage such as better or stable regulatory regime, ease of doing business, strength of infrastructure, access to global talent or pool of resources, amongst others.
- Issues like determining the income base subject to GMT, rules on coverage/scope, basis of profit allocation/reallocation, deductions, exclusions, and other adjustments remains open for discussion and presents complex, legal, technical, and political challenges.
- International economic leaders consider USA's dedicated agreement and unceasing participation is essential to the success of GMT.
- Tax administration of participating countries have to brainstorm and chalk out how to implement the complicated new tax system, which consists of revenue allocation to market jurisdictions with nexus using a revenue allocation keys.
- Countries that do not currently levy a corporate tax or have effective tax rates below GMT rate of 15%, are likely to face key decision tests. If they do not rationalize their stand, these countries may effectively lose out on taxing rights and face situations where profits generated locally could be subject to tax in another country. The corporate tax rates in countries e.g., UAE, Bahrain and Qatar are below the proposed global minimum tax rate of 15%. Accordingly, profits of businesses in these countries could be subject to top-up tax abroad unless domestic tax law changes are made to tax such profits. The more likely outcome is that such countries may engage in domestic tax policy reforms to protect the local tax base from foreign tax claims.
- Considering that GMT foundation stone has being laid, global corporates should closely monitor the developments around Pillar Two, as its implementation may have a significant impact on the regional tax landscape. While the technical aspects and specifics of GMT rules are yet to be concluded, global MNCs should be taking steps to evaluate the potential impact these rules may have on their group matrix, by running scenario analysis and headline modelling in readiness for its introduction.
- MNCs may look to tweak their existing business structures that helps in splitting their revenues under different umbrellas in response to G20/OECD tax deal to avoid dealing with the regulators in fast emerging economies such as India.

- Phasing out of unilateral tax measures like Digital Service Tax and other similar levies and switching over to GMT have to be deeply examined by countries and MNCs factoring in the transitional impact of the same.
- With GMT being on the cusp of execution, it may happen that large MNCs start exploring new tax havens for designing their aggressive tax planning. Countries in Africa and Northern America with flexible economic environment and brittle tax and regulatory regime could be eyed as the new destinations for business structures.
- Implementing a GMT would require international agreement and astute enactment by each signatory country.

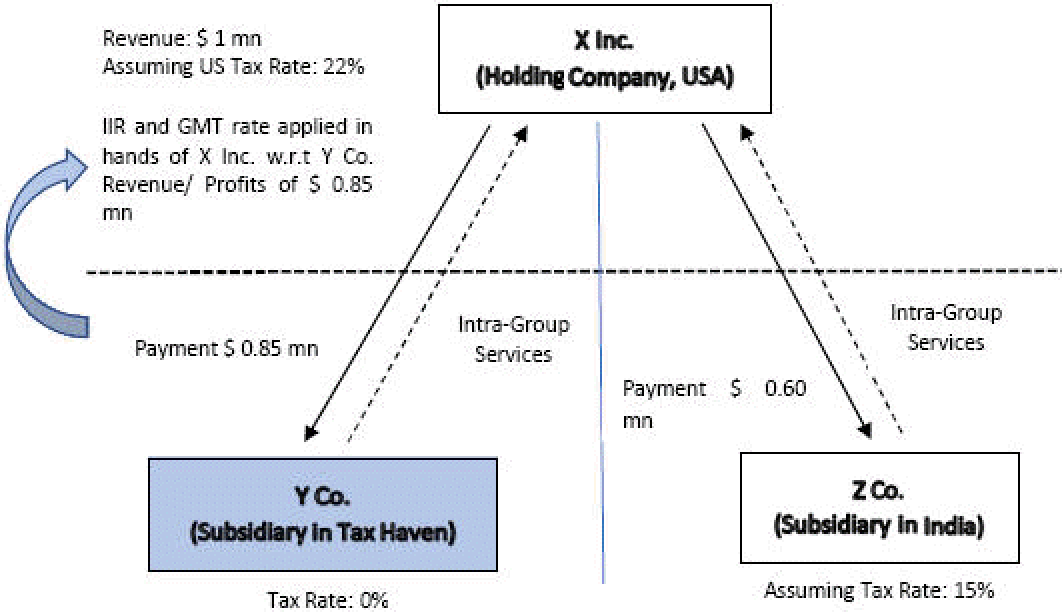
Is GMT 'The' Antidote?

GMT arrives as a vortex to globalization and digital economy. It has the potential to change the phenomenon inside out. If the highly publicized GMT has a high enough floor i.e., the rate at which it will be charged is high enough, then tax competition could be a bygone, and the global tax deal could be the 'New Normal in the Sphere of Taxation.' There may no longer be any incentive for tax haven to offer competitive rates. When there is no longer a question of taxes, then the most attractive location for a MNC will be where the workforce is productive, infrastructure is high quality, and consumers have enough purchasing power to buy their products apart from rule of law and enforceability of rights. Thus, the competition will no longer be about countries slashing tax rates without incurring a loss but will be directed towards organic and constructive business practices. Hereon the countries will now have to compete by boosting infrastructure spending, investing in access to education, and funding research. Instead of focusing solely on the bottom line of shareholders, international competition would contribute to more equality within countries.

Further, the outbreak of pandemic has intensified the need of revenues for the Governments across the world. Unsurprisingly, not only there is a pressing need to bolster tax revenue, but the digital economy also offers an attractive source for deriving such revenue. It is amply clear that taxation of digital economy is in one of the prime concerns within the international tax community. Having said that, during these challenging times and with economies being hit by pandemic, it is hoped or rather it has become a necessity to encourage trade and economic activity is prioritized over a disagreement regarding tax allocations and tariff wars. A tax related trade war or a further entrenchment of unilateral levies is likely to further harm both the global and national economies, including consumers. A less than ideal GMT deal may seem to be a better antidote against Race to the Bottom tax competition, until the next best remedy yet.

Annexure

Illustration [5] *on IIR and GMT at 15%*



- X Inc., a US MNC has two subsidiaries – Y Co., in a Tax Haven and Z Co., in India
- X Inc. avails intra-group services from the two subsidiaries and makes payment for the same respectively
- Total Group Revenue = $ (1 + 0.85 + 0.60) mn = $ 2.45 mn
- Net Profits of X Inc. = $ 1 mn
- With the application of GMT and IIR, the Tax Haven benefit of NO tax is diminished
- Since Y Co. being in Tax Haven the profits/revenue of $ 0.85 mn suffers no tax. However, due to IIR the untaxed profits would be added in tax base of X Inc. and made subject to GMT @ 15%
- Effective Tax Rate due to IIR and GMT, at Group level = 17.85% [((1*22%) + (0.85*15%) + (0.60*15%)) /2.45) * 100]
- Effective Tax Rate prior to IIR and GMT = 12.65%

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1. OECD, Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint, October 14, 2020.
2. OECD (2019), Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Inclusive Framework on BEPS; OECD/G20 Base Erosion and Profit Shifting Project Addressing the tax challenges arising from the digitalisation of the economy, July 2021.
3. OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors, July 2021, Italy.
4. OECD/G20 BEPS - Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021.

* IIR imposes top-up tax on a parent entity in respect of the low taxed income of a group /constituent entity.

** UTPR denies deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR.

5. Assuming all conditions / rules and thresholds for the application of GMT and IIR are met.