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Redistributing Gains from Digitalisation:

Why a Multilateral Tax Solution is the Best Option for India

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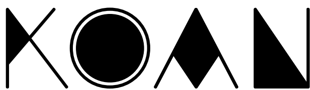

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Executive summary

In the last three decades, economies worldwide have seen tremendous growth in digitalisation, which has led to intensive integration with transnational markets. This development has an important effect on taxation rules that do not account for transnational economic activity. As countries search for the optimal rates for tax competitiveness, transnational corporations cash in on the opportunity for base erosion and profit shifting (BEPS) created by taxation differentials. As a result, countries have slashed their tax rates approximately by half since 1980, while transnational corporations avoid a sizable tax burden, estimated at USD 275 billion annually if all countries charged 15 percent corporate tax.

Recognising the challenges arising from digitalisation and globalisation, countries have reinvigorated efforts to update legacy tax rules. The OECD/G20 Inclusive Framework on BEPS, established in 2016 brings together nearly 140 countries. In 2019, member states agreed to examine proposals under two pillars that form the basis of a multilateral solution. Pillar One seeks to amend profit allocation and nexus rules, to expand the taxation rights of countries where businesses operate. Pillar Two proposes a global minimum tax rate of 15 percent to mitigate tax arbitrage opportunities.

Finance ministers and central bank governors of the G7 countries reached a political agreement in June 2021 on both pillar proposals, followed by a statement from the OECD/Inclusive Framework on July 1 accepted by 134 countries. In a meeting shortly after, the G20 accepted the Two Pillar solution.

Despite demonstrated willingness to engage at the OECD level, recent communications from the Indian government indicate that its support is conditional on several factors such as allocating a greater share of profits to market jurisdictions. India's decision to impose an equalisation levy (EL) of 2 percent on foreign e-commerce operators and 6 percent on digital advertising platforms reflects this sentiment.

Unilateral actions such as the EL are inadvisable in the long run. In its design and effect, the equalisation levy resembles the consumption-based taxes that seem to have increased the cost of availing services for Indian firms. The levy also seems to be inconsistent with the World Trade Organisation's Work Programme on E-Commerce and the General Agreement on Trade in Services, as we discuss. Further, if other jurisdictions adopt similar levies it would adversely affect India's exports in IT/ITES and professional services, damaging an Indian startup ecosystem on the path to significant global expansion.

The OECD-led multilateral solution offers a more systematic and coordinated approach. The Pillar One and Two proposals will likely create a stable international framework that can survive the business model transformations driven by technology, preventing tax uncertainty to the benefit of trade and investment.

Pillar One provides taxing rights to market jurisdictions on part of the residual profits earned by a TNC with an annual global turnover exceeding EUR 20 billion and 10 percent profitability. With increasing digitalization of all business models, this is more likely to create a stable international tax framework that can survive for the long term even as business models undergo greater digital change. The Pillar One aims to significantly enhance tax certainty. In this regard, it provides for a mandatory and binding dispute prevention and resolution mechanism. The Pillar One proposal is also in line with the principles agreed in the Ottawa Electronic Commerce: Taxation Framework, being neutrality, efficiency, certainty and simplicity.

India's gains from a 15 percent global minimum tax (Pillar Two) are estimated at USD 4 billion per year, while 12 other countries (the US, China, Japan, Germany, France, the UK, Cayman Islands, South Korea, Canada, Italy, Belgium and Australia) will likely gain a higher amount. The US which leads the chart would gain approximately USD 84 billion annually in additional revenues.

India's likely gain should be viewed in light of its developmental landscape. To illustrate, India is on the 'growth' part of the S-shaped technology adoption curve, while the countries appropriating most of the revenue gains have already reached the 'saturation' part. Therefore the amount of tax revenue appropriated, and the proportion of total additional tax gains under the OECD proposal, will likely grow at a faster rate for India.

And within the global innovation landscape, India is rapidly transforming from an imitator to an innovator. Both foreign and domestic firms see India as a key constituent of the global production-consumption nexus. The level of economic activity within the country is likely to increase in the next few years, which will increase revenue appropriation in the new tax regime. These revenue gains may accrue purely because of India's movement along the 'growth' part of the technology adoption curve. Thus its alignment with the OECD proposal presents a win-win scenario.

Context

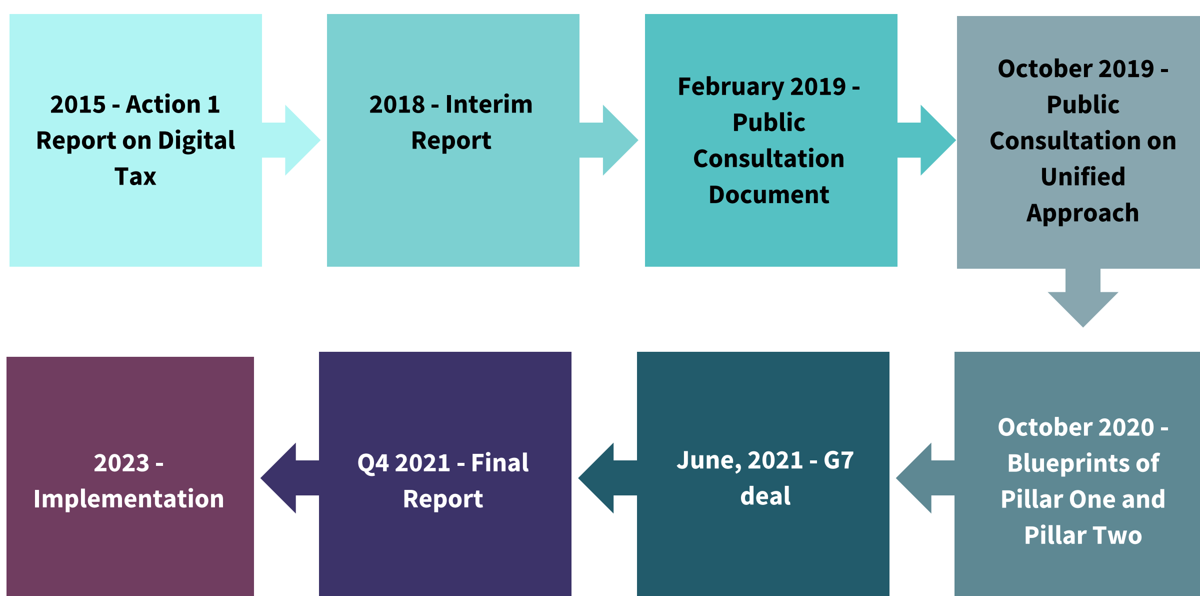
Political leaders around the world have voiced concerns over tax planning by transnational corporations (TNCs) to artificially reduce their taxable profits by using low-tax jurisdictions *in which little or no economic activity is performed.* This report details the efforts of multilateral organisations including the OECD and the UN to tackle this problem. Regional and national measures adopted by jurisdictions such as the EU and India are also discussed.

It is recognised that international taxation rules, formulated in the 1920s, are becoming obsolete. They fail to account for the evolving nature of economic activity, especially the rise in digital trade and commerce. To tackle this, the OECD and the G20 proposed to focus on base erosion and profit shifting (BEPS) measures to rationalise costs by TNCs.

In 2013 at the G20's behest, the OECD published an Action Plan identifying 15 specific actionable strategies to address BEPS concerns. Tax challenges arising from digitalisation were one of the focus areas, and are comprehensively discussed in the BEPS Action 1 Report on addressing the tax challenges of the digital economy published in 2015.

The Action 1 Report recognises that ring-fencing the all-pervasive digital economy from other segments will be difficult for international taxation. It also acknowledges that digitalisation raises a series of broader direct-tax challenges over and above BEPS. Identified as "data, nexus and characterisation", they pose the question of how taxation rights, on income generated from cross-border digital trade, should be allocated amongst countries.

Figure 1 Timeline for Developments in 'Inclusive Framework' on International Taxation



In 2017, G20 finance ministers mandated the OECD to deliver an interim report on the tax implications of digitalisation by April 2018, and a final report by 2020. The Interim Report (Tax Challenges Arising from Digitalisation – Interim Report 2018) was accepted by all members of the Inclusive Framework and delivered to the G20 that March. At present 140 countries including India are members of the Inclusive Framework to collaborate on the implementation of BEPS updates to international taxation.

The Interim Report provides in-depth analysis of new and changing business models in the digital economy that are relevant to allocating taxation rights. Its basic premise is that under existing taxation rules (enforced through Double Tax Avoidance Agreements or/and tax treaties between countries) a non-resident company can be taxed on business profits only if it has a permanent establishment in a particular jurisdiction. In other words, a non-resident transnational corporation must have a physical presence in a country for the state to exercise its taxation rights.

Three key points from the Interim Report are noteworthy in this regard:

- Digitalisation allows firms in many sectors to locate various stages of their production process in different countries, and access more customers around the globe, it has also allowed certain highly digitalised enterprises heavy involvement in the economic life of a jurisdiction where they have no significant physical presence, or none at all, giving them operational local scale without local mass ('scale without mass').
- Heavy reliance on intangible assets such as intellectual property, software and algorithms strains the rules for allocating income from these assets across different organs of a global enterprise (parent, subsidiary or lessee) creating uncertainties and opportunities for shifting income to a low or zero tax jurisdiction.
- Data, user participation, network effects and the supply of user-generated content pose considerable challenges to profit-allocation rules in situations where digitalised businesses exploit data and user-generated content, but have little or no taxable presence in the jurisdiction where their users are located.

The Interim Report also notes that "there is general agreement that cross-jurisdictional scale without mass and the increased reliance on intangible assets can be highly relevant to the value creation of digitalised businesses, however, there is also agreement that these factors are not exclusive or unique to digitalised businesses."

Recently, the OECD set an ambitious October 2021 deadline to finalise technical work on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, as well as a plan for effective implementation in 2023. An effective and binding solution to these challenges will require a coordinated multilateral response, including from India.

Resolving the ‘prisoners’ dilemma’ in international corporate taxation

Public policy on corporate taxes has long wrangled to find the optimal mix of tax rates and a taxable base. Lowering tax rates has two effects – an ‘income effect’ that depresses tax revenue due to the lower rate, and a ‘substitution effect’ that improves competitiveness in attracting capital flows. The taxable base, on the other hand, depends on economic activity accruing within a jurisdiction’s ambit. With growing digitalisation, the integration of economies with transnational markets has increased significantly, putting a strain on tax rules that do not account for transnational economic activity. This is creating friction between sovereign states looking for the optimal mix of tax rates and a taxable base, and transnational corporations seeking opportunities for base erosion and profit shifting (BEPS).

Depressed tax revenue and growing capital inflows are not equally probable outcomes of a tax rate reduction. This presents an additional layer of difficulty in determining the optimal mix of tax rates and the taxable base; meanwhile TNCs ride on BEPS opportunities created by this friction. While tax revenue depression is almost certain due to the ‘income effect’ of a tax rate cut, the ‘substitution effect’ caused by greater capital inflows is uncertain and depends on a host of other factors, such as political regime, state of human capital and locational advantage or disadvantage.

Amidst this “substitution effect”-driven policy ambiguity in synthesizing the optimal tax rate, , countries have optimistically adopted the strategy of slashing their corporate tax rates to improve the prospects of capital inflows. As noted by Harvard economist Dani Rodrik, this strategy has led to a secular fall in the average global statutory tax rate, from nearly 50 percent in 1980 to around 24 percent in 2020 – a worldwide ‘race to the bottom’ in corporate taxation. Several countries also have generous loopholes and exemptions that reduce their effective tax rates to single digits. The Centre for European Economic Research suggests that this race to the bottom has a spiralling effect – a country will reduce its statutory tax rate by 1.5 to 3.2 percentage points in response to every percentage point reduction in its neighbouring countries.

Responding to this secular fall in corporate tax rates around the world in recent decades, eminent economists including Nobel laureate Joseph Stiglitz suggest that the race to the bottom on corporate taxation is starving many countries of the resources they need to resolve economic problems. The larger question looms: Why does this race to the bottom exist, and what does it do to developing economies?

The race to the bottom in corporate taxation exists because of a ‘prisoners’ dilemma’ game across countries (which the *Wall Street Journal* terms ‘a figment of the progressive imagination’). The gameplay is: countries will consider their best response imagining what other countries will do. If all other countries keep their corporate tax rates high, reducing corporate tax rates will ease capital inflows at the cost of other economies. Conversely, if others reduce their corporate tax rates, it is important to slash rates to remain competitive. With every country basing its strategy on this game, a secular and spiralling fall in global corporate tax rate is inevitable.

Table 1 Average Corporate Tax Rates

Tax Measure	Average tax rate in practice, percent	Average tax rate for maximizing tax revenue, percent
Statutory tax rate	25	31
Effective average tax rate	22	27

Note: The estimates are based on a sample of 112 countries. Source: E. Steinmüller, G.U. Thunecke and G. Wamser (2021) "Corporate income taxes around the world: A survey on forward-looking tax measures and two applications", International Tax and Public Finance, vol. 26

The Laffer Curve (which represents the relationship between tax rates and tax revenues) is another important framework to understand how economies perform in such a race to the bottom. A research paper published in 2019 uses estimates for the Laffer Curve based on a sample of 112 countries to show that global corporate tax rates are on average below the revenue-maximizing rates (Table 1). These estimates present a chilling picture for policymakers: corporate taxes account for less than 3 percent of aggregate global GDP and reveal a falling trend, as per estimates from the International Centre for Tax and Development.

Countries seem aware of the limits posed by the race to the bottom in corporate taxation. Their recipe for coordination – a theoretical solution to the prisoners' dilemma – predominantly hinges on bilateral tax treaties intended to create a stable and attractive tax environment. A coordinated approach also encourages capital inflows while ensuring mutual assistance and dispute resolution (for example, avoiding double taxation). There are over 3,000 such bilateral tax treaties of which the G24 alone accounts for over 800.

In trying to solve this coordination problem on a bilateral basis, countries have inadvertently created opportunities for 'treaty shopping' by TNCs. Treaty shopping is a situation when corporations resort to tax avoidance (partial or complete) by routing mobile capital flows from the source country to the destination country through a bilateral agreement partner of the latter.

Thus these bilateral tax treaties do not solve the problem of coordination, but manifest it as a 'negative externality problem', a higher order coordination problem, for which a complete solution is to 'internalize the externality'.

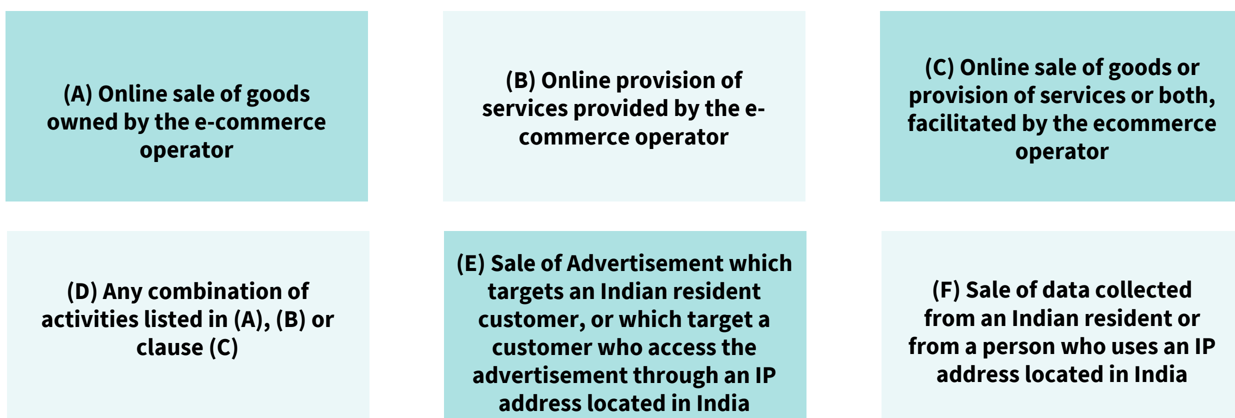
Simply put, given that capital flows can be routed through any country, international cooperation on corporate taxation is a must. Unlike bilateral treaties, such cooperation is Pareto improving – a gold standard in public policy, where some countries gain, and none lose.

The experience with unilateral actions

Despite focused discussions to resolve the tax challenges of digitalisation, consensus was elusive at the OECD. India has therefore taken several unilateral measures, in an effort to tax income accruing to foreign entities that do not have a permanent local establishment. For instance the Finance Act of 2016, on the basis of recommendations made by the Committee on Taxation of e-Commerce introduced an 'Equalisation Levy' of 6 percent on revenue generated from online advertisements. In 2018 the country also adopted the concept of Significant Economic Presence (see Box 1).

Subsequently, the Finance Act of 2020 extended the scope of the equalisation levy (EL 2.0) to foreign e-commerce operators, albeit at a lower rate of 2percent, and also imposed compliance and reporting obligations on these operators. Essentially, EL 2.0 is levied on 'ecommerce supply or services' as defined in Figure 2.

Figure 2 Scope of 'Ecommerce Supply or Services under EL 2.0



The Government of India estimates that the revenue accrued to the exchequer through the EL increased from INR 339 crore (3.4 billion) in FY17 to INR 1,493 crore (14.9 billion) in FY21 (up to January 30).

The EL, which aims to impose tax on income, is intentionally designed as a consumption-based tax and not a corporate income tax. This design empowers India to impose the levy without the need to renegotiate its tax treaties. But to understand whether unilateral measures like the EL are a viable alternative to a multilateral solution, it is important to consider the ways in which they distort economic activity, their economic incidence, and their distributional impacts on the economy. This is discussed in the following section

Box 1 Significant Economic Presence

Having a permanent local establishment plays a vital role in determining the direct tax/corporate tax liability of a TNC. In India, it is determined on the basis of a 'business connection' test provided under Section 9 of the Income Tax Act, 1961. In 2018, the Government of India expanded the scope of the business connection test to include 'Significant Economic Presence (SEP)' as the basis to assess a non-resident entity.
A non-resident entity can be characterised as having 'significant economic presence' in India under two distinct scenarios:

- A threshold based on local revenue: Any transaction in respect of any goods, services, or property carried out by a non-resident in India, including the provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds INR 20 million;
- A threshold based on number of local users: Systematic and continuous soliciting of its business activities or engaging in interaction with at least 3 million users in India, through digital means.

These thresholds create a direct tax/corporate tax liability in India irrespective of the location and/or residence of the taxpayer entity. Notably, the conditions based on 'revenue', and 'users' threshold' are mutually exclusive. That is, a non-resident entity would be liable to pay taxes if it falls under either of the two conditions.

It is worth noting that Double Tax Avoidance Agreements (DTAA) entered into by India, provides that 'business profit' of an enterprise is taxable in the country in which the taxpayer has a permanent establishment which inter alia includes – place of management, branch, and office of the business. Therefore, even if the SEP amendment is effectuated by April, 2022 there might not be any immediate impact on non-resident firms located in countries with whom India has entered into a DTAA by availing the benefit of DTAA provisions.

Concerns raised by the EL

A. Tax burden

The equalisation levy, India's digital service tax, aims to address the issue of neutrality between resident and non-resident entities and hence is in the nature of a tax on income. But as it is levied on turnover or revenue, by design it is an indirect tax. It therefore resembles other consumption-based taxes like the Goods and Services Tax (GST) or the customs tariff. A 2019 study by Deloitte/Taj of a similarly structured French Digital Service Tax found that approximately 55 percent of the total tax burden was borne by consumers, 40 percent by commercial users, and only 5 percent by the targeted large internet companies. Several anecdotal accounts suggest that the EL too is largely passed on to consumers, reducing consumer surplus.

The EL also increases input costs for Indian firms that rely on the support of foreign digital companies. The role of digital companies in increasing downstream competition in sectors such as retail, media and entertainment, and gaming is widely acknowledged and accepted. For instance in 2020, nearly 150,000 new sellers joined the Amazon India platform and over 70,000 of them earned more than USD 2 billion in cumulative exports. A unilateral levy outside of bilateral tax treaties therefore directly impacts Indian businesses and undermines their international competitiveness. It also increases the burden on Indian consumers

B. Wide scope

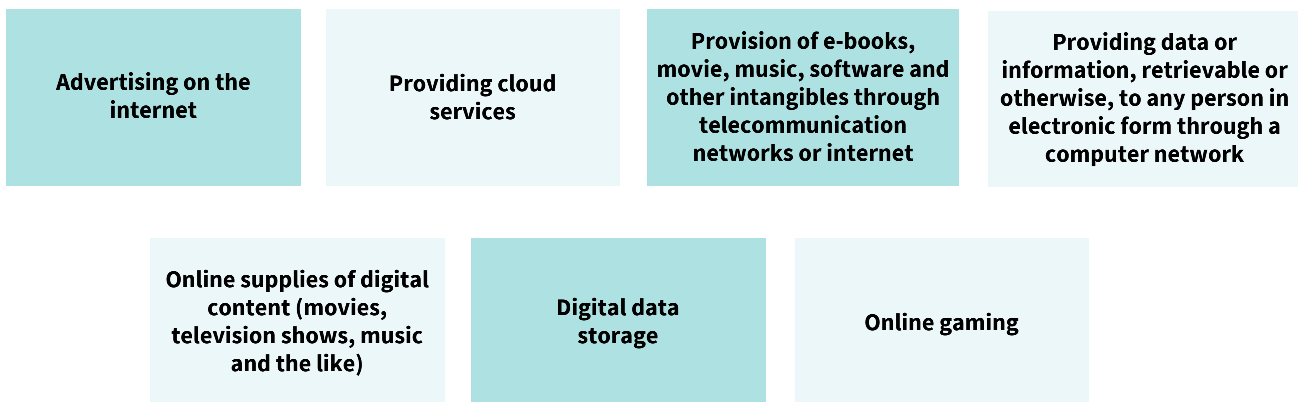
Another major concern with India's EL 2.0 is its wide scope relative to the digital services tax regimes enacted in jurisdictions such as France and the United Kingdom. Figure 3 lists the provisions in which the EL 2.0 is applicable under online sale of goods and services as per the Finance Act of 2021. The broad scope of the levy even includes transactions where a digital platform is used for placing an order, or for communication. This means for instance that the levy would be applicable if an Indian consumer places an online order for a Tesla car, even though the payment and final delivery is made through offline channels.

Figure 3 Provisions in which the EL is Applicable under Online Sale of Goods and Services

C. Double taxation

Domestic double taxation - The EL on digital businesses in India is levied over and above the 18 percent GST on such entities. These digital firms are categorised as Online Information Database Access and Retrieval services (OIDAR) under the GST regime. OIDAR services are those provided over the internet and received by the recipient online, without having any physical interface with the supplier. Figure 4 provides a non-exhaustive list of services included under OIDAR.

Figure 4 Online Information Database Access and Retrieval services in India



The OIDAR regime and the EL leads to a situation where the same amount can be taxed twice. To the detriment of consumers, such double taxation is estimated to increase the cost of consumption by one-fifth the basic cost of digital supplies.

International double taxation. By its design and effect the EL is outside the Income Tax Act of 1961 and therefore outside the scope of tax treaties agreed by India. This results in double taxation, as a transnational corporation paying EL in India will not be able to claim income tax credit for the levy paid in its country of tax domicile. This significantly increases the cost of doing business in India.

D. Legal validity

A number of legal experts have voiced concerns about the constitutional basis of India's EL, more so the expanded EL of 2020. They note that Article 265 of the Constitution provides that no tax shall be levied or collected except by authority of law. With taxation powers divided between the Union and State governments, the Committee on Taxation of e-Commerce while recommending the introduction of an EL said that the Union government was empowered to impose this levy based on entries 92C and 97 of List I of the Seventh Schedule of the Constitution.

Entry 92C allows the Union government to prescribe tax on services, and entry 97 confers residuary powers of taxation, i.e. powers to make law on any matters not enumerated in Lists II or III of the Seventh Schedule. However, entry 92C was omitted by the Constitution (One Hundred and First Amendment) Act of 2016. As for the residuary powers under entry 97, experts point to the presence of Article 246A which empowers the Union to impose GST on OIDAR services. The presence of this specific provision (Article 246A) limits the powers of the Union government to impose an EL under entry 97 of List I.

E. Inconsistency with taxation principles

The Ottawa Taxation Framework Conditions (OTFC) developed by the OECD in 1998 offer the most widely accepted principles for formulating taxation policy on digitalisation. The framework is endorsed by OECD member states and by non-members, as well as the business community. Its principles include neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility, and equity. By contrast India's EL, as discussed above, appears inconsistent with the OTFC for the following reasons.

- The EL introduces new distortions that disturb neutral treatment of digital and non-digital entities in the tax framework. This is because the EL may motivate taxpayers to prefer (or reject) one form of distribution channel over another, i.e. offline over electronic commerce.
- As the EL is a consumption-based tax imposed on the transacted value, it disproportionately harms those with lower profit margins. An entity with a 10 percent profit margin may decide to subsume the levy in order to remain competitive, while an entity with a 2 percent margin will have no choice but to pass on the tax burden to downstream consumers, simply to survive.
- The OTFC states explicitly that taxation in each country should be structured so as to achieve a fair sharing of the tax base from electronic commerce between countries, and to avoid double taxation. As discussed in this paper, however, the EL burdens transnational corporations by subjecting them to double taxation, and in some cases multiple taxation.
- The EL's wide scope has caused confusion among foreign TNCs about how to determine their tax liability. Businesses have been forced to engage in costly and time consuming tax litigation. This is against the stated objective of the EL, which is to provide greater clarity, certainty and predictability in the characterisation of payments for digital services, and consequent tax liabilities.

F. Frictions with trading partners and the impact on India

Increased tensions among trading partners have emerged as a notable offshoot of proliferating taxes on digital services. For instance, following India's decision to expand the EL in 2020, the United States Trade Representative conducted a study to assess whether the EL 2.0 "is discriminatory or unreasonable and burdens or restricts United States commerce" and violates international trade rules. Upon an affirmative finding, it announced retaliatory tariffs on a host of products from India (under Section 301, ad valorem tariffs of 25 percent). Some of the sectors expected to be impacted by the US retaliatory tariffs include gems and jewellery and handicrafts. While implementation of these retaliatory tariffs is suspended for six months, they may come into effect if the OECD fails to reach a consensus in its next meeting scheduled for October 2021.

Importantly, enactment of the EL sets a precedent and other economies may adopt a similar approach, leading to large-scale friction. This may adversely affect global trade, including with India. Trading sectors such as IT/ITES and professional services, which rely largely on the digital medium for distribution, have perhaps the largest stake in this debate. This is because India's comparative advantage in ICT trade stems from IT/ITES and professional services, which account for some 80 percent of total revenues in the domestic ICT industry, and clocked a remarkable growth of 9.1 percent in FY20. Second, countries in North America and Europe together account for over 85 percent of India's exports in IT/ITES and professional services: these markets are apprehensive of the EL as opposed to a multilateral tax framework like the OECD proposes. These country blocks are the largest export destinations for India.

In the IT/ITES sector such digital services taxes may also adversely impact India's own digital startup ecosystem. The growth of this ecosystem is accompanied by a shift in mindset, wherein global expansion is part of the business plan from the early stages of operation. According to estimates, in the first half of 2021 alone, Indian tech startups witnessed investment of at least USD 11 billion. It is important that government actions, of which taxes are a crucial component, do not significantly reduce the international competitiveness of Indian players.

G. Inconsistency with international arrangements

Digital taxes like the EL are based on the premise that local customers or users generate significant value for TNCs. While there is general 'extensive' agreement on the contribution of users or customers in creating value, the 'intensive' extent of their contribution remains in doubt. While India seems to assume that no international arrangements it is part of prohibit the imposition of digital taxes, experts have cautioned against this approach.

Notably, the 2 percent EL applies if an e-commerce operator meets or exceeds the revenue threshold of INR 20 million (approximately USD 267,000) in its India-based digital services revenue in the previous year. The 6 percent EL applies where gross annual receipts equal or exceed INR 100,000. These thresholds are lower than the digital service tax regimes in other jurisdictions. The low threshold implies that most foreign digital businesses fall within the ambit of EL. Therefore, even if the EL was designed as a tax, for foreign TNCs it is effectively a tariff barrier.

It is worth noting that since 1998, WTO Members have agreed to not to impose customs duties on electronic transmissions, a moratorium renewed in every Ministerial Conference including MC11, the last Ministerial held in Buenos Aires in December 2017. This moratorium on customs duty has become one of the foundational pillars of e-commerce regulations in various bilateral and plurilateral trade agreements.

The WTO declaration adopted in 1998 states that

"Without prejudice to the outcome of the Work Programme or the rights and obligations of Members under the WTO Agreements, we also declare that Members will continue their current practice of not imposing customs duties on electronic transmissions".

As part of its commitments under the Work Programme, India does not at present levy customs duty on electronic transmission. The moratorium applies only to digitised delivery of services and to digital products, not to goods traded over the internet and delivered in physical form. However, the EL in effect acts as a tariff because it distinguishes between foreign and domestic e-commerce operators.

Besides being inconsistent with the Work Programme on E-Commerce, several studies emphasise that digital service taxes may also violate country obligations under the General Agreement on Trade in Services. Specifically, Article XVII of GATS, which provides for national treatment obligations on member countries, restricts contracting parties from discriminating between domestic and foreign suppliers.

Solutions through multilateral cooperation

On June 5, 2021 the finance ministers and central bank governors of the G7 nations agreed a deal to update the international taxation framework, reinvigorating multilateral discussions. The G7 communiqué, similar to the OECD proposal, calls for awarding market jurisdictions a taxing right on at least 20 percent of profits that exceed a 10 percent margin for the largest and the most profitable TNC. It also proposes a global minimum tax rate of 15 percent to deter jurisdictional rent seeking.

On July 1 the discussions resulted in a statement by the Inclusive Framework that outlines key components of the Two Pillar Solution, detailed in the sections below. The statement has gained the support of 134 jurisdictions to date.

India's initial reaction to the G7 proposal deemed it as interfering with a country's sovereign right to determine tax policy. Since then, the growing possibility of a global consensus for an Inclusive Framework seems to have prompted greater willingness to engage with the OECD proposal. As recent official statements indicate, India's support remains conditional on several factors, such as allocation of a greater share of profits to market jurisdictions. We discuss how a multilateral arrangement may offer a more viable solution for concerns on profit share allocation, which is a necessary and sufficient incentive for participation. Indeed, not all international solutions may be a viable option – Box 2 provides a case in point.

Box 2 Article 12B (proposed) of the United Nations Model Tax Convention

Besides the OECD's proposal, the UN Committee of Experts on International Cooperation in Tax Matters (UN Committee) has also released alternative suggestion for introducing Article 12B to the United Nations Model Tax Convention (UNMC).

The proposed Article 12B to the UNMC suffers from several drawbacks. It does not recommend a solution based on multilateral consensus, and requires amendments to the bilateral treaty framework. As a result, jurisdictions looking to adopt Article 12B will have to renegotiate their tax treaties – involving a sizable sunk cost. The scope of the Article 12B is restricted to only businesses providing automated digital services (ADS) services, therefore leaving other consumer facing businesses as contemplated under the Pillar One proposal. The scope of Article 12B also appears significantly narrower than India's EL and SEP.
Furthermore, in contrast to the OECD proposal, the proposed Article 12B to the UNMC does not consider a separate dispute settlement process. The Committee, instead, relies on the existing Mutual Agreement Procedure (MAP). The drawbacks of MAP with respect to tax administrations' capacity to negotiate and administer tax treaties are well recognized.

Considering the limited scope, Article 12B allows countries to enact unilateral measures such as the EL, resulting in double taxation and tax uncertainties.

OECD Pillar One Proposal: Nexus and Profit Allocation

The Pillar One proposal is designed to tax the TNCs that are able to participate in a sustained and significant manner in a market jurisdiction, without necessarily having a commensurate level of taxable presence (based on physical-presence based nexus rules). It covers TNCs with a global turnover of EUR 20 billion or more and profitability above 10 percent. It is expected the turnover threshold will be reduced to EUR 10 billion, contingent on successful implementation that includes tax certainty on Amount A (see Box 3) with the relevant review beginning seven years after the agreement comes into force and being completed in no more than a year.

Box 3 OECD Pillar One Proposal

Under its Pillar One proposal, OECD seeks to adapt the international income tax rules to account for increasingly digitalized global economy through changes to the profit allocation and nexus rules applicable to business profits. It recommends expanding the taxing rights of market jurisdictions for TNCs with no/skeletal presence in the such jurisdictions (i.e., where they sell their products /provide services). Key elements of Pillar One are as follows:

'Amount A' would be a new taxing right in the hands of the market jurisdiction, reallocating a 20-30 percent of residual profit (defined as profit in excess of 10 percent of revenue) earned by a TNC group.

'Amount B' would be a fixed return for routine marketing and distribution activities taking place in a market jurisdiction.

Pillar One aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest TNCs, which are the winners of globalisation. Its proposals aim to set new rules about how different activities are taxed, focusing particularly on sales location. Put differently, Pillar One aims to relocate the jurisdiction where companies pay tax, particularly TNCs that generate revenues from Indian customers or users.

It is worth noting that the Pillar One proposal brings within its fold TNCs whose turnover exceeds the threshold of EUR 20 billion. This is a shift from earlier proposals, which were focused on businesses that can be classed as automated digital services and consumer facing firms: such as online advertising services, search engines, online gaming, online intermediation, social media platforms etc. With the increasing digitalisation of all business models, a sector neutral approach is more likely to create a sustainable international tax framework in the long term. This is in line with the Ottawa principles of neutrality, efficiency, certainty and simplicity. A sector-neutral approach is also in line with India's SEP clause, which covers all kinds of activities and income derived from a nexus with India, without limiting it only to digital activities.

Tax certainty under Pillar One

Pillar One aims to significantly improve tax certainty by introducing innovative dispute prevention and resolution mechanisms. According to the OECD, a critical element of Pillar One is ensuring tax certainty for member countries. The tax certainty dimension of Pillar One is divided into two segments: dispute prevention and resolution for Amount A, and dispute prevention and resolution beyond Amount A. For Amount A it contains a clear and administrable mandatory binding dispute prevention process that would provide early certainty, before tax adjustments are made, to prevent disputes related to all aspects of Amount A. For issues beyond Amount A, the OECD proposes a three-step approach: dispute prevention (Step 1) and the existing MAP (Step 2) to mandatory binding dispute resolution (Step 3).

Besides dispute resolution, it provides for appropriate coordination between the application of the new international tax rules and the removal of all digital service taxes and other relevant similar measures on all companies.

It is worth noting that the success of the Pillar One proposal hinges on international consensus and the amount of tax revenue ultimately allocated to market jurisdictions like India. At present, 140 countries are participating in the OECD proposal. Of these 134 have agreed to establish a two-pillar framework for international tax reform.

Alignment with India's policy priorities

A consensus-based multilateral solution is in line with the overarching policy priority of minimising the cost of doing business in India. In this regard the Indian government has taken several steps over the years. These include the recent decision to repeal the retrospective tax amendment introduced in 2012-13, and the introduction of a Taxpayers' Charter in 2020 enlisting the rights and obligations of taxpayers. The decision is an explicit recognition of the fact that taxation policy not only impacts the sovereign purses but has a larger effect on the investment environment.

Unlike earlier Charters, which were largely administrative, the Taxpayers' Charter of 2020 that aims to 'honour the honest taxpayer' is first one having statutory backing. The 2020 Charter is divided into two parts – 14 commitments from the tax department and 6 expectation from the taxpayer. These include a commitment to provide a fair, reasonable and courteous treatment, maintain confidentiality, and collect the correct amount of tax. The Charter is expected to encourage the belief of tax predictability among investors.

It is important for decision makers to weigh the impact of a multilateral solution to taxation challenges on the investment environment. Unilateral measures such as the EL may negatively influence investor sentiment as they deviate from internationally accepted taxation principles of certainty, efficiency, and neutrality. It threatens to increase the cost of doing business, and several TNCs may find themselves at the centre of trade frictions arising from unilateral measures.

OECD Pillar Two Proposal: Distributional Effects of the Global Minimum Tax

The Pillar Two proposal focuses on a global minimum tax of 15 percent to address BEPS issues (Box 4). Countries are likely to gain considerable additional tax revenue, as realised undertaxed profits, under this Pillar Two proposal. The worldwide additional tax revenues are estimated at USD 275 billion (Table 2). While high income countries, particularly the G7, will account for approximately 61 percent of global tax revenue gains, lower and middle income countries are likely to earn a lower share. India's gains from

the proposed changes in the global tax system are likely to be USD 4.03 billion, or nearly 4.3 percent of its current corporate tax revenues. Overall, it will rank among the top 15 countries in terms of absolute gains in tax revenue.

In addition to this gain of USD 4.03 billion, India may also gain significantly from onshoring those homebound TNCs that currently operate through low-tax jurisdictions like Mauritius, the Netherlands and Singapore. Once the Pillar Two proposal is implemented, offshore structuring may no longer be lucrative for these Indian TNCs, as tax incentives would effectively be removed. According to the State of Tax Justice Report 2020, India's gains from onshoring these TNCs are expected to exceed USD 10 billion.

Box 4 OECD Pillar Two Proposal

Under Pillar Two, OECD proposes a set of rules that attempt to ensure that large internationally operating businesses pay a minimum level of tax of at least 15 percent regardless of where they are headquartered or the jurisdictions in which they operate. The Organisation discusses four mechanisms to establish the framework for global minimum tax:

- The income inclusion rule (IIR) that will operate as a top-up tax when income of controlled foreign entities is taxed below an effective minimum tax rate.
- The switch-over rule (SoR) to complement the IIR by removing treaty obstacles in situations where a jurisdiction uses an exemption method that could frustrate the application of a top-up tax to branch structures.
- The undertaxed payments rule (UTPR) that will serves as a backstop to the IIR through application to certain constituent entities;
- The subject-to-tax rule (STTR) to help source countries protect their tax base by denying treaty benefits for deductible intra-group payments made to jurisdictions with low or no taxation.

Table 2 Tax Revenue Distribution at 15 percent Global Minimum Tax Rate, Top 15 Countries

Country	Additional tax revenue, USD billion	Share in country's corporate tax revenue, percent	Share in aggregate corporate tax revenue gain, percent
US	83.92	20.70	30.53
China	31.97	6.21	11.63
Japan	29.80	15.35	10.84
Germany	19.99	29.11	7.27
France	12.81	21.97	4.66
UK	11.19	15.12	4.07
Cayman Islands	5.88	4537.34	2.14
South Korea	5.60	10.22	2.04
Canada	5.50	9.67	2.00
Italy	5.03	11.97	1.83
Belgium	4.95	27.60	1.80
Australia	4.47	7.25	1.63
India	4.03	4.30	1.47
Brazil	3.34	6.02	1.21
Mexico	3.08	7.86	1.12
Global	274.92	-	100.00

Notes: Tax revenue gains are estimated as the undertaxed profits which would now face the tax topped up to the global minimum tax rate of 15 percent. The top-up tax is calculated as the product of undertaxed profits and the difference between the minimum tax rate and the effective tax rate. The estimation accounts for factors such as subsidiaries facing tax rates below the minimum tax rate, differential between effective and the minimum tax rate, and the location of real economic activity. Source: OECD CBCR

A look at the regional distribution of tax revenue gains suggests that North America, the Asia-Pacific (high-income countries and China) and Western Europe account for the lion's share, estimated at USD 213.6 billion, or nearly 78 percent of the total tax revenue gains worldwide (Table 3). South Asia accounts for a moderate gain of USD 4.4 billion (1.6 percent of the total) of which India accounts for USD 4.03 billion (1.47 percent of the total).

Table 3 Regional Distribution of Tax Revenue Gains at 15 percent Global Minimum Tax Rate

Region	Additional Corporate Tax Revenue, USD billion	Share in Aggregate Corporate Tax Revenue Gain, Percent
North America	89.92	32.71
East Asia & Pacific (high-income countries and China)	79.79	29.02
Western Europe	43.87	15.96
Northern Europe	17.39	6.33
Latin America & Caribbean	14.69	5.34
Southern Europe	8.72	3.17
East Asia & Pacific (excl. high-income countries and China)	6.22	2.26
South Asia	4.41	1.60
Middle East & North Africa	3.13	1.14
Eastern Europe	2.59	0.94
Sub-Saharan Africa	2.30	0.84
Central Asia	1.89	0.69
Total	274.92	100.00

Notes: Tax revenue gains are estimated as the undertaxed profits which would now face the tax topped up to the global minimum tax rate of 15 percent. The top-up tax is calculated as the product of undertaxed profits and the difference between the minimum tax rate and the effective tax rate. The estimation accounts for factors such as subsidiaries facing tax rates below the minimum tax rate, differential between effective and the minimum tax rate, and the location of real economic activity. Source: OECD CBCR

Two features make India's prospects from the new tax regime attractive. First, the country is on the 'growth' part of the S-shaped technology adoption curve, while the US, China, Japan, Germany and France (the top five countries appropriating tax revenue gains under the new regime) are on the 'saturation' part of the same curve. This implies that the quantum of tax revenue appropriation, from the total additional tax gain under the new regime, is likely to grow at a higher rate for India than for these benchmark countries.

Second, within the global innovation landscape, India's transition from an imitator to an innovator is happening at a fast pace. Foreign as well domestic businesses see India as part of the epicentre that stirs the production-consumption nexus. This implies that economic activity within the country is likely to increase appreciably in the coming years, which would in turn lead to a higher rate of tax revenue appropriation in the new regime – over and above the revenue that would accrue purely due to mobility on the 'growth' part of the S-shaped technology adoption curve. Thus, India's alignment with the OECD-proposed corporate tax regimes presents a win-win scenario.

Conclusion

Updating the century-old taxation rules that govern the present digital economic reality is a key focus of countries around the world. If the current trajectory of increased unilateral actions is allowed to continue, tax discord risks weakening multilateral cooperation. In essence the debate around digital tax is less about how much tax TNCs should pay, but where they pay it. While India supports a consensus-based multilateral solution, it has at the same time adopted measures that contradict the multilateral ethos. Absent a global multilateral agreement, we will likely see a proliferation of uncoordinated and unilateral tax measures (e.g., digital services taxes) and an increase in damaging tax and trade disputes. This would undermine tax certainty and investment and result in additional compliance and administration costs.

Therefore, we suggest that India's response to taxation challenges arising from digitalisation should reflect the following:

- **Revisiting Unilateral Taxes:** A closer look at the design and efficacy of instruments like the EL suggests that the burden of these taxes falls on domestic consumers. The EL also impacts MSMEs and domestic startups that rely on digital platforms to distribute their goods and services. For businesses any tax, whether direct or indirect, is a cost passed on to sources other than the corporate body. In the case of a corporate tax on profits, the burden of the tax is borne by shareholders, employers and creditors, while indirect taxes levied on transacted value are borne by consumers, i.e end-users and suppliers. India's EL appears to be based on the assumption that any cost on business revenue or profits will ultimately fall on business shareholders through lower returns. But the EL's design has meant that much of the burden is being passed on to the users of the platform, i.e domestic startups and consumers. It is worth noting that the EL's wide scope brings B2B transactions such as intercompany transactions within its fold. In such cases, while a TNC may have to absorb the tax incidence, eventually the burden will be passed on to the Indian economy, as it will increase the cost of producing or providing goods and services. Ideally an in-depth study of the cumulative effects of every new tax should be undertaken to assess how the cost will be apportioned between shareholders and users. In addition, the broader economic impact on investment inflows and India's trade competitiveness should also be examined. **In the absence of such an assessment and based on the reasons highlighted in this paper, it is important for policymakers to work towards a consensus-based multilateral solution, instead of relying on digital taxes like the EL.**

- **Opportunity for Trade Negotiations:** Aligning with a multilateral solution for taxation issues would provide an early opportunity to negotiate trade deals with strategic partners. **The absence of a consensus based approach may yield a beggar-thy-neighbour protectionism, weakening cooperation on several issues.** According to OECD estimates, trade discord triggered by unilateral taxes can reduce global GDP by more than one percent in a year. Coming at a time when India is exploring the potential of a comprehensive trade deal with partners such as Australia, the EU and the US, a unilateral approach threatens to disrupt the progress achieved.

- **Tax Certainty under Pillar One:** The OECD-led multilateral approach provides for tax certainty to businesses and uniformity in international taxation rules, both of which are crucial for cross-border trade and a favourable investment environment. The design of Pillar One also aligns with India's effort to improve the ease of doing business in the country. **The condition to remove or withdraw unilateral taxation measures on digital services in order to implement Pillar One would ensure that the Indian domestic ecosystem can compete with global players on a level playing field.**

- **Intertemporal Revenue Maximisation under Pillar Two.** While the size of expected tax revenue gains is an important aspect in evaluating and technically refining the OECD tax proposal, countries should also consider related questions for the future. For example, while India's gain from the OECD Pillar Two proposal is likely to be USD 4 billion on account of the global minimum 15 percent corporate tax rate, additional gains of up to USD 10 billion may also accrue with onshoring of Indian TNCs that currently operate through low-tax countries. **As India grows, with commensurate growth in domestic TNC business activities, the future size of tax revenue gains should be considered in evaluating the OECD proposal.**

- **Countrywide Net Gains.** Transitioning to a new, multilateral corporate tax regime will have two effects: the government will appropriate additional tax revenues, while end-users will face higher prices for goods and services on account of pass-through by the TNCs. **The net welfare gain countrywide will be positive if the efficiency of government spending using the additional tax receipts outweighs the burden on end-users.** In the case of a cascading effect of cost burdens, both monetary and fiscal policy adjustments will be needed to accommodate the impact of the tax burden passed through to end-users.

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