Global Minimum Tax - An Analysis

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In India, sales tax is levied by the State and before implementation of value added tax which ushered in to some extent uniform VAT rates, there was a continuous tax rate war. States reduced tax rates to attract investments and also offered exemptions or refunds or deferment of taxes in order to attract investment into a particular state. In US, it is quite common to see one particular state not imposing sales tax (use tax) or imposing a lower rate and customers from neighbouring states would travel to buy these goods for the tax arbitrage. An interesting dispute arose between Massachusetts and New Hampshire which did not have sales tax. People from Massachusetts would just drive down to New Hampshire and buy goods. Since the residents of Massachusetts were not voluntarily paying the use tax, demands were raised on businesses in the other State on the ground that the Company should have known, based on the address of the customer that the products would be used in Massachusetts. Apart from the tax disputes which were won by the business entity, New Hampshire passed a law that the Companies need not give private customer information to other States taxing authority. While things have taken a new turn with the decision of the US Supreme Court in the Wayfair ruling, the dispute is testimony to the fact that rate of tax arbitrage is a very important facet for a state/nation.

Countries have discovered that investment and capital have a fascination for nil tax or lower tax regimes and what was seen as commodity tax wars within a country has become a global corporate rate of tax war. Governments are keen to attract investments which would drive foreign exchange inflow and employment opportunities. Further tax rates were compelled to be reduced to match neighbouring nations that had lowered their taxes.

Ending corporate tax avoidance and international tax competition (as between states, in imposing lower taxes, rather than healthy competition) has been at the helm of the program of work to arrive at a suitable environment that promotes both, globalization as well as ease of doing business. Between 1985 and 2019, the global average statutory corporate tax rate has fallen from 49 percent to 23 percent.[1] This 'race to the bottom' has always been sought to be replaced with a 'race to the top'. Through 'global minimum tax', the G7 nations seek to address the pressing issue of a tax deficit that is created when multinationals have very low effective tax rates in foreign countries.

Global corporate tax co-ordination has been the goal sought to be achieved by the OECD and the UN in promoting the respective Model Tax Conventions. It is an interesting irony that rich democracies are now propagating global minimum tax.

A Pressing Need

Few of the biggest economies in the world and most developing nations are facing the issue of profit shifting which comes in the form of tax planning by the multinationals, which shifts profits - and tax revenues, to low-tax countries regardless of where their sales are made. This issue if far more significant in the context of the digital economy, where both, the traditional rules of taxation as well as jurisdictional boundaries collapse. From drug patents to software royalties there have been issues with reference to profits being generated in jurisdictions which have lower rate of taxes as against the home country..

The discussions and the proposal by the G7 forms another limb of the extensive deliberations held for several years by the OECD and G20 nations, aiming to tackle the issue of profit shifting and base erosion.

Is Global Minimum Tax the Vaccine?

The pandemic has opened up a can of worms. Whether vaccines should be exported or kept for own use? Whether raw material exports to a vaccine manufacturing country can be curtailed? Whether the intellectual property law has to give in at times of a pandemic? Whether countries have to find new tax revenues to meet the huge expenditure in providing health infrastructure? These are complex questions which leaders of various countries debate and try to arrive at solutions through negotiations and diplomacy. Drawing a parallel, will a country agree to impose a minimum tax rate propelled by an international commitment of global minimum tax when the said country is not keen to lose its attractive investment status on account of the change in tax rates? Can a country forego other collateral benefits of employment and consumption propelled by investments based on tax reliefs?

The Global Minimum Tax is to function in such a way that the effects of profit shifting that benefits the multinationals are negated and thus accords a fair share of revenue to the countries. Thus, the applicability of the GMT will be on overseas profits, with the nations retaining the right to impose any rate of corporate tax. However, what the GMT enables, is the home nation to adjust their taxes in order to meet the deficit caused by the low rates of taxes paid by the multinationals in the foreign nations.

The discussions by the nations have arrived at this mechanism for the matching of tariffs in order to establish uniformity across international corporate tax, however the rate at which the GMT would be applicable is still tabled for discussion.

The ideal solution apparently is for all countries to start collecting the tax deficit of their multinationals. Just like the vaccine the global minimum tax comes with its host of challenges.

Tackling Tax Havens

Tax havens are jurisdictions with very low, often near zero, tax rates. Multinational companies also shift paper profits between their various subsidiaries, including subsidiaries incorporated in offshore tax havens with zero or close to zero rates. As a consequence, there is increasing concern about corporate tax base erosion due to such profit shifting. The scale of this problem is quite large. As one example, in 2017 data for US multinational companies, they report offshore accumulated earnings of $4.2 trillion, $3.0 trillion of which was in tax havens.[2]

In combatting the issue of zero corporate tax rates and tax havens, nations that are home to the multinationals or the business conducted by the multinationals, there is but one solution; coordination. The first step in the battle is to fix the issue of the tax deficit. Tax competition between nations will only rob both the nations of their fair share of taxes. Thus, collecting the deficit will be the order of the day in starting off the battle against tax competition. As defined above, tax deficit would mean the difference between what a corporation pays in taxes globally and what this corporation would have to pay if all its profits were subject to a minimum tax rate in each of the countries where it operates. GMT is nothing but another form of MAT or AMT. The rate at which the corporates with a foreign presence can be taxed can be the rate at which domestic corporates without a foreign presence is taxed. Any difference in the effective rates on the former, can be matched and the tax deficit maybe so collected. Suitable provisions will have to be created, both in domestic laws and the tax treaties as applicable.

Such minimum tax increases the incentives of tax havens to raise their own tax rates. When any income booked in havens immediately generates minimum tax liability, there is no longer a reason for havens to lower their tax rate below the minimum rate. However, an issued posed by the Global Minimum Tax, is that if all income and tax streams across all jurisdictions are averaged, then the tax havens will still be in a position to offer beneficial arrangements to multinationals as the excess of credits from such combined sources will offset any minimum tax liability.

Non-Compliance

The General Agreement on Trade and Tariffs which subsequently became the WTO is classic proof of international cooperation and agreements which set in place a common set of rules. Disputes with reference to breach of WTO commitments have gone before the Dispute Settlement Body created by WTO. The one-sided nature of the WTO is evident by the fact that if a country loses a dispute and still does not comply with the decision of the judicial body, the winning complainant gets a right to impose trade sanctions which could be suspending concessions or other obligations under the covered agreements. Sanctions can be imposed only by countries which are in a position to impose them. A small underdeveloped or developing country may win a battle against a rich, developed nation but if there is non-compliance, what sanctions can the poor nation impose? Recent developments have completely stalled the WTO's Appellate Body that rules on trade disputes of disputes are still pending resolution. In the digital world, there are unilateral actions by nations across the world which has attracted the attention of the United States where US 301 has been applied. Interestingly, US seems to be in Agreement with this G7 exercise but has not been part of the earlier OECD initiative to arrest base erosion and the US seems to be conspicuously missing from the framework of Multi Lateral Instruments (MLI).

The ideal solution presents in itself a challenge in the way of international cooperation and coordination as never seen before. The leading nations however may be able to spearhead the progress.

In the context of the corporate tax, nations may apply sanctions on non-cooperative tax havens however, this exercise is unlikely to be easy given the differences in political ideologies among nations. An effective tax rate of 21 percent is not so high but in the absence of enforceability, it will very well go down the way the Agreements on climate change have progressed. Viewed from another angle, there are other equity aspects at play. A developed country with rich resources being worried about tax rates and the existence of low tax regimes is not the same as a developing country or a poor nation which is trying to climb up the ladder of development and seeks investments through tax incentives. For many countries, the journey of growth is yet to happen while in some countries it is the problem of plenty. This is not a simple disparity which can be addressed through a minimum tax deal.

On the other hand, compliance to such provisions is not an insurmountable issue. If it is argued that costs of compliance is high and the information on the basis of such work would proceed is scarce, the same is not true. The information necessary to compute this tax already exists in the country-by-country reports of multinational companies, which are exchanged between governments globally. For the computation of the share of global sales made in a particular jurisdiction, that nation could simply exclude the sales made to low-tax states. This would make it hard for foreign firms to dodge the tax by routing their sales to a nation’s customers through independent re-sellers located in tax havens.

The American Perspective

For the minimum tax to be effective, all foreign earnings should be subject to the tax. In contrast, the current US GILTI minimum tax only applies to foreign earnings in excess of a rate of return of 10 percent on capital. This raises two problems. First, it incentivizes the offshoring of real capital investment, since increased capital investment abroad lowers the burden of the minimum tax.

Second, it substantially reduces revenue, since many foreign earnings are removed from the base of the tax by virtue of the 10 percent return on capital exclusion. When the Joint Committee on Taxation scored the revenue effects of the Tax Cuts and Jobs Act, GILTI was projected to raise less than $10 billion a year in 2020–2025.[3]

Several domestic and political reasons prompted the US to propose a higher rate of 21% to the minimum corporate tax rates coupled with embargoes on those nations that do not legislate a minimum tax to discourage the shifting of multinational operations and profits overseas. Given the fact the Biden administration has increased the internal corporate tax rates, the proposed higher rates of the Global Minimum Tax is to offset any effect created by the GILTI.

Foreign Account Tax Compliance Act (FATCA), signed into law by President Obama in 2010, FATCA imposes an automatic exchange of data between foreign banks and the IRS. Financial institutions throughout the world must identify who among their clients are American citizens and inform the IRS what each person holds in his or her accounts and the income earned on them. Failure to take part in this program carries stiff economic sanctions: a 30 percent tax on all dividends and interest income paid to the uncooperative financial institutions by the United States. Under that threat, almost all countries have agreed to apply this law.[4]

Such unilateral action may not be easy for a global minimum tax. While the US can impose a tax rate to cover the deficient, it would not be easy to compel the rest of the world to adopt a global minimum rate of tax.

The Indian Narrative

While the proposal by the G7 has seen support from the IMF and the World Bank, developing nations are unlikely to provide their full support as such a proposition fully impinges on the sovereign right to impose tax rates and decide a nation’s tax policy. Moreover, such economic sanctions in the form of taxes are often used by nations in policy battles and such a bargaining power will have to be discarded in order to arrive at a universal tax.

In order to revive investments and economic activity, the FM through the 2019 Budget brought in sharp cuts to the domestic tax rates on manufacturing companies to 15%. The Budget also introduced section (115BAA) to the Income-Tax Act, 1961 to provide for the concessional tax rate of 22% for existing domestic companies (subject to certain conditions). This brought the effective corporate tax on par with the Asian average of 23%, with Indian rates clocked ~ 25% inclusive of surcharge and cess.

India may benefit from the proposed rate of GMT @ 15% as the effective domestic corporate tax rates are higher, and will not hamper foreign investment into the country.

Un-Addressed Digital Economy

The Global Minimum Tax is founded on traditional rules of taxation and proceeds on the same footing. While it is a laudable development in international corporate taxation, it is amiss when it comes to taxation of the digital economy. Multinationals of today, primarily the digital giants profit out of maintaining a digital/virtual presence in a market jurisdiction which more often than not, separate from the jurisdiction they are incorporated in. Therefore, even if the GMT provides for a way for the home countries of such multinationals to acquire their fair share of tax, the plight of the market jurisdictions remain unheard.

The GMT as proposed does not account for the need of market jurisdictions, which are mostly developing nations to acquire their fair share of taxes. Taxing rights demanded by market jurisdictions in the context of digital economy is not at all addressed by the GMT.

Conclusion

Global Minimum Taxes come as a whirlwind to globalisation, having the potential to change the phenomenon inside out. If the touted tax has a high enough floor, i.e. the rate at which it will be charged is high enough, then 'tax competition' will be a thing of the past. There will no longer be any incentive for tax haven to offer "competitive" rates. If there is no longer a question of taxes, then the most attractive location for a multinational 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.* The GMT can work if in addition to the home country, the market jurisdiction also gets a right to tax at least in the context of digital transactions. Thus the competition will no longer be about which country can slash rates without incurring a loss, but will be directed towards constructive practices. 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.

[1] Kimberly Clausing, Emmanuel Saez, Gabriel Zucman, *Ending Corporate Tax Avoidance and Tax Competition: A Plan to Collect the Tax Deficit of Multinationals,* UC Berkeley Publications (2021)

[2] IRS Reports, SOI *Tax Stats - Country by Country Report,* (2017)

[3] Dowd, Giosa, and Willingham, *Corporate Behavioral Responses to TCJA for Tax Years 2017–2018*, SSRN (2020)

[4] supra Note 1 at 11.