Unified Approval to the New Digital Tax Framework, What Next?

Nangia Andersen LLP
The Global Tax Deal

Radically reforming international taxation system and addressing tax challenges emanating from digitalisation of global economy, a broad framework was adopted by OECD/ G20 members in July 2021, accepting the two-pillar solution. Out of the various parameters left open for negotiation, certain key factors including thresholds and tax rates have now been agreed upon by the 136 participating countries, well within the targeted October timeline.

Broadly, Pillar One seeks to create a new nexus rule, allowing a reallocation of the residual profits of 100 of the largest and most profitable MNEs to their market jurisdictions, i.e. jurisdictions where businesses create or harness value without having a physical presence. All multinational groups barring the ones operating in extractives and regulated financial services sectors, with global sales above EUR 20 billion and profitability above 10% will be covered by the new rules. The profit to be reallocated to markets will be calculated as 25% of the profit before tax in excess of 10% of revenue.

Pillar Two on the other hand, is a global minimum tax regime, intended to lessen the incentive for MNEs to shift profits to low/no tax jurisdictions. The rate of the minimum tax has now also been agreed at 15%, as against open to a rate of “at least 15%” disclosed in the July statement. Companies with global turnover above EUR 750mn will be within the scope of Pillar Two, with headquarter jurisdictions retaining the option to apply the rules to smaller, domestic MNEs. The agreement does not restrict a country’s flexibility to set its corporate tax rates, but if companies shift profits to low/no tax jurisdictions, then their country of residence would get the right to 'top-up' their taxes to the agreed global minimum tax rate.

India’s Stance

There has been rapid growth of digital businesses in the past few years. Digital channels provide innovative ways of conducting business, and nowadays, the entire setup runs without any requirement of physical presence. The existing international tax rules, tax the profits of a foreign company, in a country other than the country of residence, only if the foreign company has a Permanent Establishment (PE) in another country. Creation of PE is largely dependent on physical nexus. Cataclysmic tax-related changes brought about by rapid digitization, have made such taxation rules redundant, compelling countries, including India, to put in place unilateral measures such as Equalisation Levy (EL) and Significant Economic Presence (SEP), to tax digital transactions.

Pertinently, the two-pillar solution requires withdrawal of these unilateral digital services tax measures. This might have revenue implications for India as Equalisation Levy captures more digital companies in the tax net, on account of much lower threshold of INR 2 crore (Euro 0.2 million) as against Euro 20 billion agreed in the OECD deal. However, it also cannot be disregarded that digital tax provisions introduced by India have drawn a lot of flak from businesses as well as Governments across the globe.
The equalisation levy, when it was first introduced, even triggered interrogations regarding its constitutional validity and compliance with international obligations. Therefore, India is likely to embrace the co-ordinated approach, which would ensure meaningful and sustainable revenues in its tax kitty as against proliferation of unilateral actions only leading to more uncertainty for taxpayers and trade retaliation.

Notably, Pillar-1 threshold shall be reduced to 10 billion Euros after seven years from the implementation of the pact (i.e. 2030) and this will gradually cover more companies. Hence, while the fine print is awaited, it can be safely stated that India does not have anything to lose over the course of next few years on account of implementation of the two-pillar approach. In fact, the tax deal may ensure tax certainty, end tariff wars between countries and make tax competition amongst nations unworkable by tapering down any such opportunities to bare minimum.

The global tax agreement is the culmination of years of proposals and negotiations. Its implementation is likely to be a significant amendment in most countries’ tax code. Importantly, a multilateral convention (MLC) is under development which would be signed by all the participating countries during 2022 to effectuate the new rules from 2023. Besides, model rules will also be developed by the OECD for bringing Pillar Two into domestic legislation during 2022.

Essentially, MLC will be the mechanism for implementation of the newly agreed taxing rights under Pillar One, as well as for the removal of provisions pertaining to all existing Digital Service Taxes and other unilateral measures. The approach of the Convention and how its provisions will affect tax agreements is still unmapped. It would be interesting to see the possible interplay of 3 treaties simultaneously- the Bi-lateral Treaties between two nations, the MLI if in force and the MLC for Digital Taxation.

The decision of the global pact is a breakthrough toward the global consensus necessary to modernize the international tax system. However, significant amount of work is up in the air. Most importantly, in order to levy taxes, a definite standard base/ taxable income needs to be defined. However, accounting rules/ standards to be followed for computing “taxable base” are yet to be prescribed.

Further, it has been provided that “extractives” and “regulated financial services,” sectors will not be subject to the requirements of Pillar One. However, more clarity to understand the scope of these terms is required in due course. Discussions and negotiations pertaining to how transfer pricing provisions and dispute resolution mechanisms such as Advanced Pricing Agreements (APAs) would co-exist with the newly introduced proposals are also impending. All such questions will have to be timely addressed to ensure efficacy in the implementation of the proposed rules.

Companies have been rooting for the ‘unified approach’. It is hoped that the new global framework will help achieve a uniform taxing regime for the digitalised economy, making management and compliance easier and effective. If successfully implemented, it may help avoid unfair unilateral taxation on global tech companies, and eventually lead to reduction in overall tax costs.
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