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New Global Tax Rules: Framework to Benefit the South Asian Countries

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Summary

So far, 141 countries have agreed to implement the Organisation for Economic Development and Cooperation (OECD)/G20 two-pillar solution to reform global tax rules. From South Asia, India and the Maldives have agreed thus far. The remaining South Asian countries should join the initiative to earn more taxes, commit to the 21st century global business rules and facilitate greater regional economic integration.

Global tax rules are going to change substantially following the G20's acceptance of a new global tax framework at its recently concluded Leaders' Summit in Rome. The new rules will be based on the two-pillar solution suggested by the Organisation for Economic Development and Cooperation (OECD)/G20 framework to reform international tax rules. The solution follows more than seven years work by the international community under the Base Erosion Profit Shifting (BEPS) framework. The key objective of the initiative was to ensure equity in global tax rules so that multinational enterprises (MNEs) pay a fair share of taxes on the revenues they earn digitally from various locations.

The imperative behind the effort to reform tax rules arose from the realisation of the difficulty of taxing MNEs from their digital operations. Domestic corporate tax rules of various countries tax businesses based on physical presences in national tax jurisdictions. Businesses earning profits through large-scale digital operations are able to avoid these taxes due to their physical absence from most locations.

Typically, global businesses digitally delivering physical goods and services (for example, online retail), digitally enabling such transactions (for example, digital payment modes) and trading cross-border in digital products (for example, apps, software) can sell to consumers in various countries without being physically present in these markets.

The digitalisation of the world economy and rapid growth of digital trade have created major taxation challenges for countries. Most countries are unable to tax profits from revenues generated digitally from their tax jurisdictions. Furthermore, digital businesses, because of their nature of operations, can easily transfer taxable incomes from high-tax jurisdictions to lower ones. Within the same MNE group, this is possible if an entity from the group, headquartered in a high-tax location 'transfers' incomes and profits to other group subsidiaries in lower-tax jurisdictions. The practice of shifting incomes and profits to lower tax jurisdictions is defined as BEPS.

The wide employment of the BEPS by digital MNEs has been depriving countries of taxes they could have obtained on profits earned by the former from their jurisdictions. Globally, the BEPS has also been encouraging the unhealthy practice of tax arbitrage, wherein countries are incentivised to lower tax rates for attracting investments.

The two-pillar solution proposed by the OECD/G20 BEPS inclusive framework, and accepted by the G20, addresses the above issues. It gives countries rights to tax profits on revenues earned by MNEs from their jurisdictions through digital operations. It also fixes a global minimum tax of rate of 15 per cent to be adopted by countries accepting the solution. The minimum rate fixes a floor on global taxes that would discourage profit shifting and unhealthy tax competition.

As on 4 November 2021, 141 countries have agreed to join the collaborative framework to reform the global tax rules. However, from South Asia, only India and the Maldives have agreed to join till date. It is important for the remaining South Asian countries to join the new global tax rules framework. There are compelling reasons for doing so.

Adopting the new rules will enable these countries to earn more taxes on profits earned digitally from their jurisdictions. Once implemented, the rules will result in major redistribution of global tax revenues. The OECD estimates around US$125 billion (S$169.26 billion) of profits from around 100 of the world's most profitable MNEs to be redistributed among the markets from where they have been earning, but not paying taxes. Furthermore, the new rules would generate around US$150 billion (S$203.12 billion) of new revenues annually as taxes.

Intuitively, developing countries are poised to gain more from the reallocation of profits and new tax revenues than the developed countries. The former has hardly been able to tax digital MNEs on earnings from their jurisdictions due to their physical absence. Developing South Asian countries – Pakistan, Bangladesh, Sri Lanka and Nepal – should capitalise on the opportunity of earning these taxes henceforth. By becoming part of an inclusive global tax rules framework, the South Asian countries currently out of it will send strong signals to the global community about their commitment to new generation 21st century global business regulations. The commitment will increase confidence of global investors in these economies. As a region, South Asia has an excellent opportunity of integrating with global tax rules by joining the new deal. Joining the deal will also, by default, make the region internally integrated on corporate tax rules and facilitate greater intra-regional investments and trade.

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