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INTERNATIONAL CORPORATE INCOME TAXATION FOR DIGITAL ECONOMY -- A CASE STUDY IN POLICY MAKING AT GLOBAL LEVEL

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Abstract *Weaknesses in the outdated international corporate income tax system and digital economy create opportunities for tax base erosion and profit shifting (BEPS). OECD is addressing the tax challenges of BEPS and those of digitalization, an attempt that deserves a research study. Present international corporate income tax policy for digital economy is based on characteristics of digital businesses. It has failed to end BEPS completely. Proposed two pillar approach, an add on layer to tax policy based on the concept of structure of multinational enterprise groups is a major departure from this. Proposed approach divides the taxing rights between the source and residence jurisdictions and ensures that businesses pay a global minimum tax putting an end to tax havens and BEPS.*

Developed countries do not agree to sharing taxing rights with the source countries. In its place, UN tax proposal, article 12B, based on the bilateral treaty mechanism is worth considering. Pillar 2 unchallenged, is accepted widely, though in some aspects it favours the developed countries. The above is a lesson in tax policy making exercise at the global level in a volatile time. It also highlights the importance of interdisciplinary research.

Keywords*: International corporate income tax, digital economy, BEPS, two pillar approach, UN tax proposal, MNE groups.*

1 INTRODUCTION:

Digital economy is an umbrella term that describes how traditional economic activities (production, distribution and trade) are being transformed by the Internet and World Wide Web technologies. As economies integrate more and more globally due to globalisation, so do corporations**.** Multinational enterprise (MNE)s now represent a large proportion of global GDP. Many technology enabled startup enterprises are global from day one.

Weaknesses in the outdated corporate international tax system create opportunities for tax base erosion and profit shifting (BEPS). The digital economy accentuates the problem of BEPS. Large profitable digital multinationals use this opportunity of tax savings through BEPS leading to loss of tax revenue especially to developing countries.

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Hence today globally international and digital tax issues have been high on national agenda.

OECD (Organisation for Economic Cooperation and Development) Base Erosion and Profit Shifting (BEPS) Project, 2013, announced a 15-point Action Plan and the first point was to address the tax challenges arising from digitalisation . This work by OECD team of about 140 countries representing more than 90% of global GDP is hailed as historic global mile stone in a century in international taxation. United Nations (UN) has tried to distinguish its efforts by underlining the concerns of developing nations.

2 REVIEW OF LITERATURE:

Spinosa and Chand (2018) is a very comprehensive study in the global arena comparing different policy options like modifying the definition of permanent establishment and modifying shared taxing rights mechanisms. Budak T (2017), Basu S (2017), Sokolovska and Belozyo Rov (2018) are studies presenting an overview of the theme. Tandon.S. (2018) critically evaluates Indian direct digital taxation policy. Navarro(2021) critically evaluates pillar 1 tax proposal. International corporate income tax policy making exercise has lessons for researchers and policy makers and hence deserves research effort. The present paper attempts this exercise.

3 OBJECTIVES AND METHODOLOGY:

The study examines issues involved in corporate income tax policy making at the global level. Indian tax profile is studied for highlighting issues at the level of a nation.

The specific objectives of the study are

- to describe the international corporate income tax environment and BEPS(Base Erosion and Profit Shifting).
- to critically evaluate the present tax policy for digital economy, at the global level.
- to review aspects of Indian international corporate income tax system for digital economy.
- to make a comparative study of the proposed add- on layers by OECD and the UN tax committee to the existing digital corporate income taxation system, and to make suggestions to appropriate stakeholders.

This is an exploratory, conceptual study mainly based on secondary sources. It uses OECD reports and other relevant material. This research is limited to policy for charging of tax and the consequent tax revenue for the nations. International tax administration, vital link in the process , gets only a passing reference. Detailed critical evaluation of the tax administration of the proposals is beyond the scope of this study. This poses serious limitations to the study.

3.1 INTERNATIONAL CORPORATE INCOME TAX SYSTEM, MULTINATIONAL ENTERPRISES AND BEPS:

The international corporate income tax system consists of domestic tax laws, bilateral tax treaties and multilateral legal instruments.

The differences between preferences of developed countries that are technology exporting countries and developing economies most of which are technology importing ones are well documented. While OECD Model Tax Conventions (MTC) give taxing rights to residence (home countries of MNEs) countries, the UNMTC divides it between source and the residence jurisdictions. If this difference in the position of OECD countries and developing countries like India are an indication, it is difficult for the international community to arrive at a consensus on tax policy issues. This, is a constraint on the development of digital economy globally. and also in India.

Base erosion and profit shifting ,BEPS uses tools within tax laws, to shift profits from high tax jurisdictions to low or no tax jurisdictions ie tax havens resulting in

- tax base erosion and hence under taxation and loss of tax revenue to nations,
- profit shifting and hence mismatch between the place of value creation and tax payment.

BEPS costs 4-10% of global corporate income tax revenues.

Corporate ownership through company groups is going up and is set to be a dominant pattern of shareholding in an important number of markets (OECD, 2020[1]). This is so for India as well . MNEs enable undesirable practices like BEPS (and on positive side, lead to higher value creation too as compared to stand-alone businesses.)

3.2 PRESENT APPROACH TO INTERNATIONAL CORPORATE INCOME TAX POLICY FOR DIGITAL ECONOMY:

Present tax policy for digital economy is based on the characteristics of digital economy. Following are the challenges and responses to direct tax policy according to OECD due to digitalisation. (Some are challenges only, some are general responses, one is challenge and response both.)

3.2.1 Nexus:

Permanent Establishment (PE) concept was introduced to establish a business connection between income and place of value creation in international taxation. This was in response to traditional business models, like factories and commercial establishments. It has evolved to include service PE, agency PE and the like. Then comes virtual PE for digital economy . Further, significant economic presence (SEP) for digital economy considers location of users

number of users and similar other indicators relevant for digital business models.(In the digital businesses, users participate in the process of value creation and thus revenue generation.)

India and Israel are among very few early adopters of this concept in the domestic law (OECD 2018, p 135). It needs to be incorporated in the bilateral treaties .But developed countries refuse to accept that user participation forms the basis for attributing value.

3.2.2 Use of Withholding Taxes:

The objective of withholding taxes, is to assert taxing rights by the source state, even when the non-resident enterprise has no physical presence but has a nexus ,with the jurisdiction.

The source state (host country of MNE, where revenue is generated) imposes a withholding tax on a gross basis with the residual right to tax belonging to the residence (home country of MNE) of the enterprise. The domestic suppliers of similar products are subject to net basis taxation. The imposition of a gross basis final withholding tax on foreign suppliers for remote sales of goods and services is likely to raise substantial conflicts with trade obligations. Hence the rate is generally low (10 to 15%).

Withholding tax on a gross basis is applicable on royalty and fee for technical and managerial services to non-resident entities. These services are now supplied remotely. India adds to tax revenues by adopting a wider definition of royalty as per UN model (IT, Department 2014,p 33).

3.2.3 Specific Measures Targeted at Large MNEs:

Countries have introduced measures targeted at large MNEs, such as diverted profits tax U.K, Australia, and base erosion and anti abuse tax ,United States. Large MNEs are required to be more transparent about their global value chains in situations presenting tax risks. These countries have reported positive behavioral changes and reported increase in corporate income tax revenues. (OECD 2018, p 147)

3.2.4 Equalisation Levy (Digital Services Tax):

Some countries have taken a unilateral action outside the framework of income taxes to assert taxing rights over non-resident enterprises not having a PE in the jurisdiction, such as foreign based suppliers of digital products and services. These include tax on online advertising services such as India's equalisation levy, France's tax on online and physical distribution of audiovisual content. (Such levies are also called digital service taxes (DST)in Europe).

This levy aims to equalize the disadvantage faced by digital companies of the source state,

facilitating an environment where such digital companies can compete with foreign players without having to locate outside the source state. Ex. France and Hungary tax the non-resident payees for the online advertisements targeted at their ie French and Hungarian nationals even though the payers are also non-resident.

The equalisation levy raises total tax revenue. But it comes with some risks. The same income would be subject to both corporate income tax in the country of residence and the equalisation levy in the source country. It invites retaliatory measures by residence jurisdiction . It may also be passed on to consumers adding to inflation (OECD 2018, p 140).

3.2.5 Summing up ,the present policy adds to tax revenue but has failed to address the operation of tax havens hence failed to tackle BEPS completely.

3.3 INDIAN INTERNATIONAL CORPORATE INCOME TAX SYSTEM WITH REFERENCE TO DIGITALISATION:

Most technology startups, small in size, both Indian and foreign, transact globally and thus are subject to international taxation systems.

3.3.1 Permanent Establishment (PE):

The concept significant economic presence (SEP) introduced in the Income Tax Act,1961, from 1st April 2018, expands the definition of business connection to include the transactions in respect of any goods, services or property, carried out in India by a nonresident above a specified value including digital goods or provision of, download of data, or software in India, digital services or systematic and continuous solicitation of business from India from prescribed number of users through digital means. (IT Act, 1961 sec 9)

3.3.2 Withholding Taxes:

Withholding taxes apply in case of royalty and fee for technical services, (IT Act,1961,sec 195).

3.3.3 Equalization levy – India :

Equalization levy of 6% on online advertising services was introduced in 2016. (Finance Act,2016, Chap 8). In 2020, a levy of 2% on e-commerce services was added.

3.3.4 India Profile in Brief:

Out of ten successful case studies referred to in a OECD report, two viz., significant economic presence and equalization levy are from India. (OECD,2018 p135-59) India ,the 5th largest economy ahead of U.K., has shown ,it is progressive in digital taxation.

3.4 COMPARAIVE STUDY OF THE PROPOSED OECD AND THE

PROPOSED UN ADD- ON LAYERS TO TAXATION OF DIGITAL ECONOMY:

The present international tax policy for digital economy has addressed BEPS issues ,but not been successful in tackling BEPS completely, hence efforts at the global level continue.

In OECD's two pillar approach, pillar 1 aims at dividing the taxing rights of large profitable MNEs between residence and market jurisdictions. Pillar 2 ensures that businesses pay a minimum level of tax regardless of where they are head quartered or the jurisdictions they operate in. Global minimum tax will end tax havens.

The UN tax proposal too divides taxing rights between source and residence jurisdictions and thus it competes with pillar 1 of OECD. Pillar 2 of OECD is unchallenged .

3.4.1 OECD's Two Pillar Approach:

OECD's two pillar policy with a holistic view is a major departure from the present policy direction. MNE groups are viewed as single entities rather than a network of separate businesses. Whilst the proposed two-pillar approach of OECD is not only meant to address tax challenges of a digitized business but will also apply to several MNE groups across the world. So the two pillar policy, addresses the BEPS at large, not just the problems of digitalized businesses.

3.4.1.1 Pillar 1:

Scope:

Groups with global turnover above 20 billion euros and profitability (i.e., Profit before tax / revenue) above 10% with the turnover threshold to be reduced to 10 billion euros over 7 years are in scope of pillar 1. Consolidated financial accounts prepared by the parent in accordance with an acceptable financial accounting standard is the starting point.

Constituent entities are separate business units of an MNE group that are included in the consolidated financial statements of the MNE group for financial reporting purposes. Subsidiaries, joint operations, permanent establishments are constituent entities. Associates and joint ventures are treated in a different way, specified in the report. Investment funds, pension funds, government entities, international organizations, non-profit organizations, are excluded from the scope.

Nexus:

Amount A is allocated to a market jurisdiction when the in scope MNE group derives at least one million euros in revenue from that jurisdiction. The nexus, now, has evolved into a place where revenue beyond a threshold is generated.

Quantum:

For in scope MNE groups, 25% of residual profit, defined as profit in excess of 10%

revenue will be allocated to market jurisdictions.

Tax Base Determination

The amount A tax base will be quantified using profit before tax measure derived from the consolidated financial statements of in-scope MNE groups.

Specifics regarding determining income of permanent establishments and head office, and certain adjustments are described in detail. (OECD,2021)

3.4.1.2 Pillar 2:

This applies to MNEs that meet the global turnover threshold of 750 million euros.

Computation of Effective Tax Rate (ETR):

Effective Tax Rate (ETR) is calculated for a jurisdiction. Profit determined in accordance with financial accounting standard used by the parent is the starting point. Global minimum effective tax rate is fixed at 15%.

Pillar 2 consists of a number of interlocking rules that seek to ensure minimum taxation. The principle mechanism is the income inclusion rule (IIR) together with under taxed payment rule (UTPR) acting as a backstop. Then there is the Subject to Tax rule (STTR) - a treaty based rule.

Under IIR, a top down approach, ultimate parent will have to pay tax in case of a foreign low taxed constituent entity. If none of the parent entitles have implemented IIR, then UTPR a complex rule becomes the choice. STTR, a treaty based rule targets those cross border structures relating to intragroup payments that exploit certain provisions of the treaty in order to shift profits from source countries to jurisdictions where those payments are subject to no or low rates of nominal taxation.

Multinational company group structures - hierarchical (pyramidal) with several layers, and with cross holdings, direct and indirect holdings- are complex. Further the application of the pillar 2 rules through this maze is even more complex.

Rule Status: Whether pillar 1 is mandatory is yet undecided. Pillar 2 is optional. It has incentives for raising tax revenues of jurisdictions.

Unilateral measures such as equalisation levy (digital services taxes) are to be withdrawn by 2023. The other parts of present policy (except equalization levy) will continue along with the two pillar approach- an add on layer. (OECD,2021)

3.4.1.3 Economic Impact Assessment of the Two Pillar Approach :

Under the two pillar approach, present tax havens will move away from the bottom tax rate competition and will charge a reasonable rate. Global effective tax rate (ETR) is estimated to increase by 1.85 percentage points. This will contribute to tax revenue . Investment will decrease marginally due to absence of low tax

rates ,digital services taxes will be withdrawn. The net effect will be , global tax revenue would increase by USD 56 to 102 billion ie 2.3 to 4%.

Under Pillar 1, taxing rights of about USD 100 billion of profit could be relocated to market jurisdictions. About 68 MNEs headquartered in USA, China and some European countries will qualify for relocation of tax base to developing countries under pillar1 as in 2021.But pillar 2 , favours MNEs mainly of USA and the EU ie developed countries. (OECD,Economic Impact Assessment,2020,Tandon, Rao 2022 p 41)

Summing up, this policy will match value creation with tax liability, add to tax revenue and end tax havens, thus addressing all problem areas of BEPS.

3.4.2 UN Tax Proposal -Article 12B:

The UN tax proposal called article 12B formalises equalization levy (digital services taxes). It allots the taxing rights of income arising from automated digital services (ADS) in the source country to the source country and thus is similar to pillar 1 of OECD. This is proposed to be a part of the UN model tax convention and hence the name.

UN tax proposal, gives an opportunity to the tax payers to choose from two options. Option 1, gross revenue based tax liability, is a modest 3 or 4% of gross revenue from ADS sector to be bilaterally agreed to. In option 2 ,a formulaic approach based on net profit from the ADS sector for tax base determination is prescribed, on which the domestic corporate income tax is applied. (Starkov ,2022 p 36)

3.4.3 Comparison:

Table 1 presents a comparison of pillar 1 and UN Tax proposal.

Sl. No.	PILLAR 1	UN Tax Proposal
1.	Pillar 1 will leave out digital entities whose annual revenue is less than Euros 20 billion.	This will cover all digital businesses.
2.	This needs a new administrative mechanism for its implementation. Doubts are raised by some regarding the success of Pillar 1 because of the dispute resolution mechanism.	This is based on time tested administrative infrastructure of bilateral treaties.

Table 1- Comparison of Pillar 1 and UN Tax proposal

Above comparison upholds UN tax proposal. Analysis shows that, for India the UN tax proposal gets better revenue than the pillar 1 even in the long run. (Starkov ,2022 p 36). So India should prefer the latter. Also, bilateral treaty mechanism gives bargaining power to India. India from its position of strength, should plead for Article 12B, of the UN tax proposal, so that she can make the best in her deal with developed countries.

However, UN tax proposal is a multilateral issue. A bilateral solution to a multilateral issue could result in imbalances, where developing nations might be at a disadvantage. So the UN tax proposal should have a supporting multilateral tax legal instrument.

4 CONCLUDING REMARKS:

The stake holders mainly the MNE groups find these rules complex. The expert view is that any solution in this complex environment will be as complex as this if not less. This system is modifying a system designed about 100 years ago, when the business environment was relatively less complex.

The developed economies refuse sharing taxing rights with source jurisdictions. Whether pillar 1 of OECD is mandatory, is undecided. So, India should plead for the UN tax proposal with a multilateral instrument.

Pillar 2, as noted above, favours developed countries. Still all developing countries, in the overall interest have compromised. So pillar 2 is widely accepted and is unchallenged.

While the developed countries will push for the OECD to be the forum for negotiations, developing countries should move this discussion to the United Nations.

Taxation policy making for digital economy is a multidisciplinary area spanning Information Technology, International Business, Law, Accounting, Taxation, International Trade and Economics and Political Forces. Research in this area needs knowledge of these areas. Interdisciplinary teams of researchers will be a good way-out.

Global economy consisting of developed and developing countries with their conflicting preferences on one hand and very fast evolving digital economy on the other makes the corporate international income taxation environment volatile, uncertain, complex and ambiguous. Global taxation policy making, in such environment will be a slow process, and success rate partial as in this case.

Detailed focused research on various aspects of digital taxation with reference to international corporate income taxation is a upcoming area of study. With the basic frameworks of pillar 1, 2 and the UN tax proposal as the starting point, modified systems of these frameworks can be designed and their working simulated. Ex, in pillar 2 the IIR instead of being a top down approach as at present ,how if it is a bottom up

approach. Does it still favour developed economies ? With these simulated profiles on the table, negotiations can proceed.

Proposed tax policy brings research focus on company groups both global (ie MNEs) and domestic. Research in areas such as company group structures for optimal stakeholder value creation, regulatory reforms, supporting corporate governance, management, accounting and taxation tools for prevention of misuse of company group structures is the need of today.

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