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G7 Summit 2021: TAX Reform

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Global Tax Regime: Unprecedented Agreement between Major Economies How will it work and Whom will it affect?

"That global minimum tax would end the race-to-the-bottom in corporate taxation, and ensure fairness for the middle class and working people in the U.S. and around the world,"

Janet Yellen, Secretary of the Treasury, United States of America

Key Points

- ✓ Under the agreement, G-7 nations will back a global minimum corporate tax of at least 15%
- ✓ The reforms will affect the largest companies in the world with profit margins of at least 10%.
- ✓ Major economies are aiming to discourage multinationals from shifting profits — and tax revenues — to low tax countries regardless of where their sales are made.
- ✓ Increasingly, income from intangible sources such as drug patents, software and royalties on intellectual property has migrated to low tax jurisdictions, allowing companies to avoid paying higher taxes in their traditional home countries.
- ✓ The move is being hailed as significant and transformational after the GATT and is hopefully likely to shape how large corporates operate their business globally.
- ✓ However, many more rounds of discussion with other major global players viz., G-20 economies are required before a final shape can be provided to the new regime.

What has the G7 agreed?

OECD has been coordinating tax negotiations among 140 countries for years on rules for taxing cross-border digital services and curbing tax base erosion (including exploitation of transfer price regime), including a global corporate minimum tax. The talks on a global corporate minimum are technically simpler and less contentious. If a broad consensus is reached, it will be extremely hard for any low-tax country to try and block an accord. There are two main rules to the agreed reforms:

- ✓ **Rule I:**
  This will enable countries to tax some of the profits made by large profitable MNCs based on the revenue they generate in a particular jurisdiction, rather than where the company HQ is located for tax purposes. Under the first rule, countries where multinationals generate revenue would be awarded new taxing rights on at least 20% of profit exceeding a 10% margin for the largest and most profitable firms.
- ✓ **Rule II:**
  The G7 committed to a global minimum tax of at least 15%, lower than a 21% proposal put forward by the US president, Joe Biden, earlier this year. However, it is still regarded as a turning point, and the inclusion of "at least" in the agreement means it could be negotiated to a higher level.

Who would this impact?

- ✓ The US has been pushing for a new global corporate tax regime to check tax avoidance. The Trump administration had put a brake on the on-going negotiations. The Biden administration had suggested about 100 MNCs would be within the scope of rule one. However, it is not clear how many are caught by this London agreement.
- ✓ However, many very large global firms viz., Amazon is not expected to be caught by this element of the reform. This is because its profit margin in 2020 was only 6.3%.
- ✓ The plans for a minimum global corporation tax rate, under Rule Two, are expected to capture up to 8,000 multinationals. Amazon and Facebook are expected to fall under the global minimum rate.
- ✓ Analysis by the EU Tax Observatory indicates it would also catch companies such as the oil giants BP, Shell, Iberdrola and Repsol, the mining firm Anglo American, telecoms firm BT, and banks such as HSBC, Barclays, Citi and Santander and highly profitable global consulting and investment firms.
- ✓ Large global digital / technology companies will be affected the most under these modified rules.

How much additional global tax revenues would be raised?

The minimum tax rule is expected to make up the bulk of the $50 billion-$80 billion in extra tax that the OECD estimates firms will end up paying globally under deals on both fronts. The OECD estimated in October 2020 that as much as $81bn in additional tax revenues each year would be raised under the proposed reforms. Rule one would bring in between $5bn and $12bn, while Rule two, the global minimum rate, would collect between $42bn and $70bn.

Can tax rules be avoided?

- ✓ We believe once implemented the rules would be difficult to avoid, especially with the backing of G7. But it needs to be seen if the other large economies of G20 (including China, Russia and India and the ASEAN) will agree to the G7 formula.
- ✓ In addition, many western economies with lower than 15% corporate taxation rate may find it difficult to avoid this potential agreement. EU finance ministers also believe the strength of the G7 deal will mean low-tax member states – such as Ireland, Hungary, and Cyprus, which all have corporate tax rates below 15% – cannot afford to isolate themselves from the world's biggest economic powers.
- ✓ Under the global minimum tax, each country would collect the underpaid taxes of its own multinationals. For example, if a UK firm has operations in Singapore, if taxes were lower there than the minimum rate, it would impose an additional tax on those profits to reach the minimum rate.
- ✓ If a company moved its headquarters to a low-tax jurisdiction, the rules would allow a country to apply the minimum rate to the firm's operations within its borders if its new parent country did not apply the minimum rate.

Will there be segmentation of enterprises?

- ✓ From what is understood the future talks will focus on an approach known as "segmentation", meaning profitable parts of businesses would pay tax. Under such a rule, for example, Amazon would pay tax in countries such as the UK on profits of subsidiaries such as Amazon Web Services, its profitable web hosting arm. AWS made a margin of 30% in 2020.
- ✓ Companies like Amazon avoiding the first suggested rule is expected to lead the UK and EU to push for a broader scope to be applied to capture parts of the company's business and to raise more tax from other big firms.

Will zero tax jurisdictions be at a disadvantage?

- ✓ As on date, often, MNCs are known to shift their tax liability by assigning a share of costs and profits to a subsidiary in a low-tax jurisdiction or by parking intangible assets such as intellectual property in subsidiaries in tax havens, so that royalties would accrue there. If implemented, the new tax regime could majorly halt such income shift.
- ✓ The new system agreed in London is aimed at negating tax avoidance techniques by using jurisdictional arbitrage. Now, let us be clear. A single corporate entity located in a 0% tax jurisdiction like the Cayman Islands or Bermuda is unlikely to be used for tax avoidance purposes nowadays, since there are enough anti-avoidance rules to ensure that it cannot. Nonetheless, subsidiaries in Cayman, Bermuda - or the Netherlands, Luxembourg, Switzerland, Ireland, or Singapore - are often used as components in complex jurisdictional arbitrage schemes. Zero taxation plays an important role in these schemes. By implementing a new tax regime, the jurisdictional arbitrage may get negated.

Our view

Pros

- It is our view that by agreeing to streamline and simplify global tax regime, the G7 finance ministers have done well to secure a historic agreement to have a minimum tax of 15% on corporate incomes in every country, and to accord every market where MNCs undertake sales the right to tax their earnings. The reform in the global tax system will, if carried through into binding, multilateral tax pacts, deter MNCs from using differences in tax rules to shift profits to tax havens, prevent base erosion and profit shifting, and help governments to collect more tax.
- While many technical details still need to be decided in the coming weeks, the G7 signaled a breakthrough on the question of how to share the spoils of taxing large manufacturing and tech companies which had over the years been able to exploit high taxes.
- For the first time in several years, G7 members have broadly defined rules for the international system of taxation in the 21st century. Several years of negotiations in all European and international forums, have been stalled on a fair system taxation of digital giants and for a minimum corporate tax. It has always proved difficult since the U.S. refused any ring-fencing of digital firms in the new rulebook. That seems to have ended now.

Cons

- The deal refers only to very large firms, criteria for which is undefined. It will also only affect firms with a minimum 10% annual profit margin. If the new regime is sufficiently robust, the "very large" rule could see the biggest firms being broken up. Instead, we might see groups of technically independent companies acting as an alliance to ensure the whole operation is below the threshold of 10% profit margin.
- We saw something similar with the rise of the so-called "shadow banking" industry, where onerous banking regulations gave rise to apparently independent sets of companies acting in effect together as banks to avoid the need for a banking license.
- So, while we agree that the suggested rules are transformational, we do have some lingering doubt whether the additional tax collection will materialize.