Taxation Issues in the G 20

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Structure of the Presentation

- Evolution of global views on cross-border taxation
- India emotive issue
  - Extreme views
    - **Which lag the international debate**
- G-20 and OECD led debate on BEPS
  - What are the key issues, especially for
  - Growing digitalization
  - Developing economies
- Application to Indian issues
  - Vodafone, GAAR, retrospective taxation
  - Tax terrorism
- Expansion to
  - BITs
  - Financial sector stability and reform

Evolution of Thinking

- OECD: to encourage cross-border trade and investment
  - Focused on eliminating double taxation for decades
  - But rules did not keep up with 21st century business practices
  - Allowed tax avoidance or evasion leading to double non-taxation
  - Legal tax planning by MNCs: very low effective tax rates
    - **US corp tax rate 35+, average amount firms pay 11%**
- Post 2008 OECD, G-20: eliminate double taxation but also tax avoidance
  - Add to conventions and treaties to close loopholes, increase disclosure by MNCs
  - And information sharing across tax administrations
  - Yet reduce compliance costs for firms and consumers
  - With a business friendly tax administration
  - Firms have the advantage of mobility, so countries have to act together to reverse BEPS
    - **Unilateral action by one country can be more costly for firms**

New Thinking

The Key Issues

- Principles embodied in earlier treaties
  - Most countries residence based income taxation
    - **OECD model tax convention: only tax profits of non-resident company with 'permanent establishment'**
  - GST/VAT on cross border trade consumers pay, firms just collect
    - **Exports zero rated, withheld input taxes credited**
    - **Imports taxed at same rate as domestic goods**
  - But above in practice turned out to flout basic principles
    - **Neutrality; efficiency; certainty and simplicity; effectiveness and fairness; flexibility (Ottawa (1998) for E-commerce)**
    - **Costs for MNCs also: Resources tied in tax planning, non-commercial arbitrage—e.g. profits made abroad not taxed if reinvested so borrow at high cost increase balance sheet size to defer tax; uncertainties**

The Key Issues Contd.

Loopholes and response

- PE shown in third country with low taxes, source and market country both lost taxes
  - **Low VAT collected from remote supplies, exempt and multi-location businesses**

- Business in one source, HQ in low tax base, income from multiple countries

- Transfer pricing: artificially segregate income from activities that generate it

- MNC aggressive tax planning implies domestic firms pay more, competition hurt

- G-20 Petersburg (2013): BEPS; ‘Profits should be taxed where economic activities deriving the profits are performed and where value is created’

- Proposal replace OECD model tax convention by ‘mutual agreement on place of residence’

The Digital Economy

- Easy to allocate key functions to minimize taxation
  - In ways that do not correspond to functions performed or to risks taken
    - **Contractual arrangements allocate capital, intangibles, risks, to low tax environment**
    - **US firms profits from abroad > than sales abroad**
    - **Maximize deductions (interest, royalties, service fees): violate arms length pricing**
    - **Use low corp tax locations (Ireland 12%, Singapore 20%); VAT rates (Luxembourg 3%)**
- India especially vulnerable
  - 2012 world's largest exporter of ICT services (USD 50 bn)
    - **Followed by Ireland, USA, Germany, UK, China in that order**
    - **These 6 countries account for 60% of total exports**
- Example, VAT on retail sales, exempt industries
  - Financial services VAT exempt
    - **But self-assess input VAT; escape using inputs from abroad or from related firms**
    - **Easy to locate using treaties; India-Mauritius tax by domicile, Mauritius allows**
    - **Registration as domicile; FIIs into India through Mauritius route: double non-taxation**

The Developing Economy

- Similar issues: But emphasis on
  - Transfer pricing; profit shifting in supply chains; lack of information
  - Obtaining treaty benefits in situations where they were not intended
    - **Withholding taxes on royalties (10-20%) brought to zero**
  - Pressures to offer competitive tax incentives; ineffective ; base erosion
    - **Estimates of yearly tax foregone: 9.5-16% of GDP; infrastructure suffers, harms FDI**
    - **DCs tax GDP ratio 15 % lower than AEs 25-30%, India 11%**
    - **Informal economy so corporate tax share about 8% in AEs, 12-17% in DCs**
    - **Coordination required, Singapore, Ireland low corp income tax, Lux exemptions**
    - **Towards harmonization of tax rates, exemptions**
    - **India even High Courts, Supreme Court contrary judgments; G inconsistent**
    - **1. Tax avoidance if no commercial purpose. 2. Just interpret existing tax laws**
    - **Government: FIIs double non-taxation of income; Vodafone tax sale of assets**

The Developing Economy Contd.

- Use of techniques to avoid paying tax when DC assets are sold
  - **Vodafone: bought shares from Hutchison India in Cayman Islands**
  - **Indian tax demand, SC chose to interpret existing law—cannot tax asset sales abroad**
  - **IMF form of abuse: indirect transfer—sale of shares rather than of asset itself**
  - **Retrospective amendment: Media negative, FI outflow; arbitration on Netherland BIT**
  - **But Netherlands itself: reviewing tax treaties with DCs—to reduce abuse**
  - **UK retrospective tax: specified tax evasion schemes, upfront payment before case decided**
  - **DCs tax officers often no match for clever MNC tax lawyers and opinion-making ability**
  - **Capacity building, awareness**

The Developing Economy Contd.

- **Solutions**
  - Enable DCs to tax foreign entities in line with economic substance of operations
    - **Make it easier to establish taxable presence**
- **International standards, automatic information exchange**
  - Banks identify clients tax residence; offshore accounts; other types of tax evaders
- **Country-by-country data reporting from MNCs**
- **Awareness, capacity building**
  - Public opinion also; reputational risks for tax avoiders; code of conduct for banks, deal-makers; Example US: ST trades routed to 'basket' options of securities held for a year to claim lower LT capital gains tax at 20%.
- **Reduce arbitrary powers with tax officials**
  - Tax terrorism; unreasonable target related or protective tax demands
    - **SAAR instead of GAAR; tax councils; appropriate not excessive taxation**
- **Coordination across Govt. ministries**
  - In giving tax incentives
  - Decisions affecting finance, trade, investment—example, BITs

Possible Extensions

Bilateral Investment Treaties

- Give investors rights against States' abuse of sovereign power
  - To encourage investment, but used to extract lucrative penalties from countries
    - **Easier to do this with developing countries, part of aggressive tax planning**
    - **But Germany also a recent victim**
    - **Again clever use of treaties for purposes which were not intended**
- White industries: Aus $10m award for delays in Indian courts
  - MFN clause used to import 'effective means' clause from India-Kuwait BIT
    - **Other cases of arbitration against State; so DIPP to renegotiate 82 Indian BITs**
    - **Global backlash against investment treaty arbitration (ITA)**
    - **Germany, Australia stopped signing BITs with ITA clauses**
    - **Arbitration done by small non-diverse non-transparent club**
- OECD: New model BITs?
  - Replace dominant US, Japan template
    - **MNCs need to be protected from sovereign risk, but not given too much power; ex BEPS**
    - **India allowing for State-initiated arbitration**
    - **Avoid umbrella clauses; exemptions for other valid policy objectives**

Harmonization of Financial Sector Taxes

Objectives of Financial Taxes

- G-20 financial taxes discussed in the context of revenue raising
- But financial sector undertaxed
  - Often exempt, tax arbitrage easier in this sector
    - **Cross border context even escapes input VAT**
- But another function of taxes: a less intrusive complement to regulation
  - Regulation forbids activities, outcome more certain
    - **Taxes allow more degrees of freedom while reducing risky activities**
    - **Lower upfront cost for FIs compared to capital charges**
  - Compensate partially for delays in implementation of financial reforms
  - Easier to apply universally
    - **So discourage shadow banking: addressing a weakness in regulatory reform**
  - Help moderate surges and sudden stops in capital flows that have affected EMs
    - **Large impact of global risk-on risk-off on EMs**
    - **Which G-20 has not been able to address**

Corporate income tax (CIT) paid by the financial sector (%)

	Period	Share of Corporate Taxes	Share of Total Tax Revenue
Italy (max)	2006-2008	26.3	1.7
Argentina (min)	2006-2008	6.0	1.0
Unweighted Average		17.5	2.3

Note: Italy had the maximum share of corporate taxes paid by the financial sector and Argentina the minimum

Source: IMF Staff estimates based on G-20 survey, IMF (2010)

Examples of Taxes Against Volatile Inflows

- Post global crisis reversal of capital account convertibility
  - Aimed at reducing short-term inflows given global excess liquidity
  - Indonesia (2010), Philippines (2009), Russia (2010), South Africa (2010),
  - Thailand (2010), South Korea (2009-10), Turkey (2010), Brazil (2010), Taiwan (2009)
    - **Brazil, 2% tax**
    - **Indonesia lengthen debt maturity; limits on banks net FX open positions**
- Korea
  - Reserves security led to high short-term debt
  - So restriction on use of banks foreign currency loans
  - Limits on use of FX derivatives: banks and companies
- Pure controls: restrictions on cross border flows by residence
  - Market based controls: margin requirements, taxes

Different Types of Financial Taxes

- Taxes to complement regulation
  - Example (Shin 2011): on banks foreign and non-core liabilities (short-term rate higher)
    - **To reduce leverage and systemic risks**
  - Would reduce pro-cyclical expansion of balance sheets
    - **Macroprudential: compatible with development of markets**
    - **Automatic stabilizer, base larger during booms**
  - Compensate for discretionary element, delays in macroprudential policies
  - Better incentives for markets, less discretion for regulators
- But many different types of financial taxes
  - FAT, FTT, stamp duties, short and long-term capital gains, margin requirements
  - Generally higher in EMs compared to AEs, K gains; resistance to giving up tax sovereignty
  - But agreement to a simple universal lower bound possible? Draw on BEPS experience

Special financial sector taxes levied/ planned in G-20 countries in 2010

Developed countries	
Australia	Australia had a bank debit tax for cash withdrawals between 1982 and 2002/2005, but is now concerned about the competitiveness of its domestic institutions with foreign entrants. No bank levies anticipated.
European Union	Provisional plans envisage ex-ante fund for orderly wind-downs funded by levy on banks and built on harmonized system of national funds.
France	Temporary tax of 50 percent on excess bonuses paid in 2009. A tax on high-risk activities of large banks, to finance rescue fund, is expected to be imposed in 2011.
Germany	Banking sur-tax to compensate for crisis costs.
Italy	Permanent tax on financial sector bonuses and stock options exceeding three times base salary.
Japan	A securities transaction tax was abolished in 1999. A change in the tax system on cross-border transactions is aimed to promote participation from foreign investors in the Japanese securities markets. These are aimed to enable Islamic finance in the region, and will go alongside changes designed to increase securities lending and to change international taxation principles from an 'entire income principle' to an 'attributable income principle'.
U.K	The stamp duty on secondary sales of shares and trusts holding shares raised over the three years on average about 40% as much as the CIT on financial institutions. A bank levy is to be imposed at the rate of 0.05 per cent of global balance sheet in 2011, rising to 0.075 per cent in 2012. Stamp duty on stock market transactions (0.5%). Surtax on bonus pay--temporary bank payroll tax 2009-10.
US	Funds needed for liquidation in crisis resolution to come from Treasury, clawed back from industry ex-post. The Government wanted in 2010 to impose a 0.15 tax on the liabilities of large financial institutions as a financial crisis responsibility fee.

Special financial sector taxes levied/ planned in G-20 countries (contd.)

Emerging markets	
Argentina	Credits and debits on current accounts have been taxed since 2001. This raises significantly more than CIT on financial institutions. The recently created Banco del Sur is expected to levy parts of its funds through a financial transaction tax.
Brazil	Until the end of 2007, Brazil levied a bank debit tax that raised about three times the amount raised by the CIT on financial companies. In 2009 Brazil announced a 2% tax on foreign purchases of fixed-income securities and stocks. Banco del Sur is expected to levy parts of its funds through a financial transaction cost.
China	Stock trading stamp duty (0.3%) is being charged.
India	In 2004 India introduced a Securities Transaction Tax (STT) in equity markets. STT is charged at the rate of 0.125 percent on a delivery-based buy and sell transactions and 0.025 percent on non-delivery-based sale transactions. The rate is 0.017 percent on F&O sale transactions. Imposed on both foreign and domestic investors, the STT is collected by the stock exchanges from the brokers and passed on to the exchequer, and has worked neatly and efficiently. Stamp duties are imposed on bonds.
Indonesia	A capital account prudential measure, serving as an implicit tax, requires a one-month minimum holding period for Bank Indonesia Certificates (SBIs) of all maturities.
South Korea	Korean government is considering various measures from a "Tobin" tax on foreign exchange transactions, a tax on capital flows, further limits on derivative positions and the reintroduction of a 14 per cent withholding tax on foreign bondholders' earnings. The regulator plans to impose a bank tax on foreign currency wholesale funding by maturity with a maximum cap of 50 bp—20 bp for less than one year, 10 bp for 1-3 years maturity, and 5 bp for longer than three years. The relevant bill (i.e., the FX transaction act) is planned to be passed at the temporary session of the National Assembly in later months of 2011.
Turkey	The banking and insurance transactions tax falls on all transactions of banks and insurance companies. It raises as much revenue as CIT on financial companies, and about 2% of total tax revenue.

Designing a Simple Universal Financial Tax

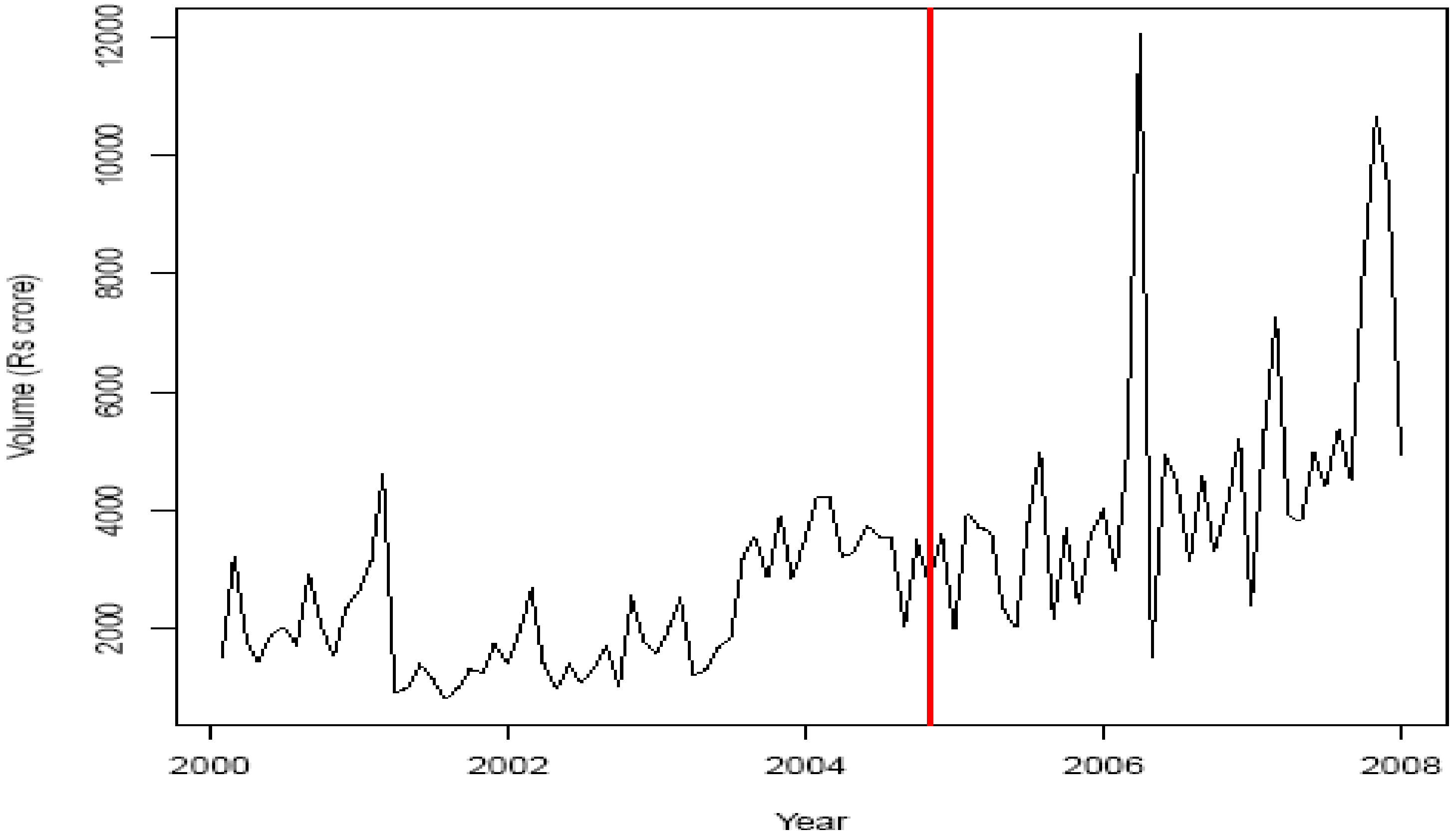
- Should be simple to implement, keep transaction costs low
  - Broad tax raises more revenue at low rates; narrow tax induces migration of activities
  - IMF: FAT not FTT
    - **Better to tax VA; not business transactions-distorts decisions, passed on to C**
    - **VATs undertax the financial sector, so OK if universal tax passed on to C**
    - **On BS liabilities since cap ad on assets; more on riskier activities and institutions**
    - **20 basis points: average G support to TBTF activities**
    - **No agreement in G-20 Seoul meet: left to individual countries**
- Arguments for FTT: a BS based levy may not effect risky flow activities
  - Small BS margin leveraged many times in derivative trade (Schulmeister 2010)
  - To arbitrage tax positions closed on date BS to be measured
  - Intraday trade often not business transactions so tax would not cascade
    - **Procyclical, account for 90% trading volume, 100 times GDP**
  - FTT could reduce ST trading and excess volatility
    - **Without affecting hedging and LT positions or market depth**
  - Simplicity: low cost of collection through exchanges and clearing agents (OTC)
  - BEPS: Levied where profits earned

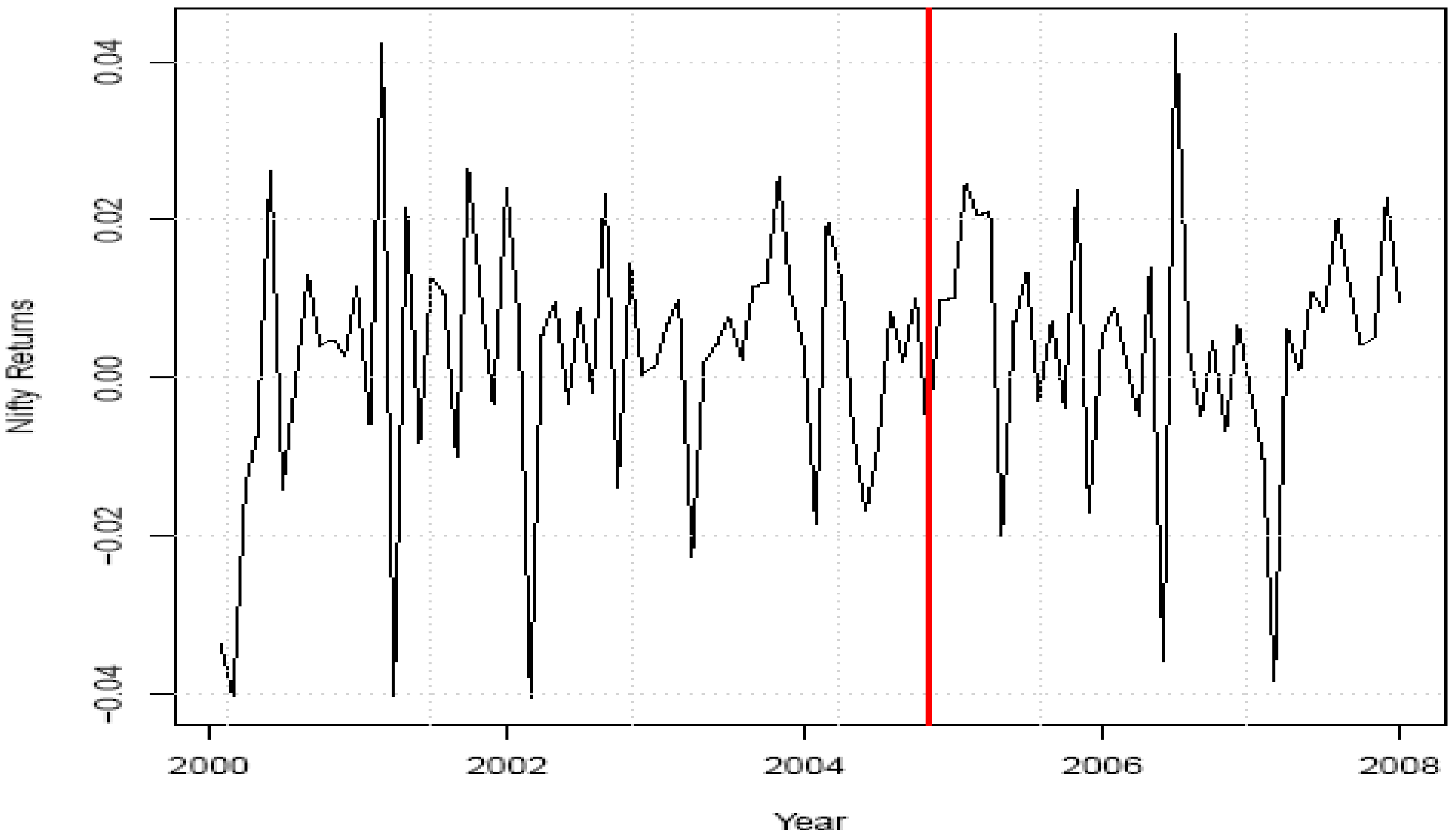
EU FTT

- Low FTT: French proposal
  - Initially demonstrate feasibility and absence of adverse effects
    - **Only 0.005 % of turnover proposed, but would raise 30-40b USD**
  - Broad base also cover derivative markets
  - Restrict recent technology driven steep rise in market transactions: flash trading
    - **This level of turnover not necessary for markets to work well**
- Eleven EU countries planning to go ahead
  - FTT: 0.1% on stock and bond trades, 0.01% on derivatives transactions
  - In tax area and on instrument issued in the tax area but traded anywhere in the world
  - But problems in application due to lack of universality
  - Resistance to EU FTT applying in other tax jurisdictions
  - FIs worried about double taxation

Country Experience with Such Taxes

- Low cost implementation of financial taxes
  - Exchanges can deduct these taxes at the press of a button
  - UK: electronic stamp duties on bonds
- India STT October 1, 2004
  - Chow test structural break in monthly turnover, continued positive growth; no break in returns; but shift to options since tax applies only on premiums
  - Even though taxes high
    - **STT for equity 0.125% on delivery; 0.025% of turnover for intraday sell**
    - **Plus service tax of 12.5%**
    - **Necessary to rationalize across instruments: 2013 CTT also**
  - In contrast TCs charged by exchanges are only about 0.002-3% of turnover
  - Harmonization to low universal requires EMs ↓ as AEs begin to impose taxes


Volume (Rs crore)
2000
4000
6000
8000
10000
12000
2000
2002
2004
2006
2008
Year


Nifty Returns
0.04
0.02
0.00
-0.02
-0.04
2000
2002
2004
2006
2008
Year

Summary

- Experience based readjustment of international tax regime
  - Course correction to improve balance
    - **Reduce both double taxation and tax evasion**
    - **Useful insights for domestic debate**
    - **One country cannot do it alone—very useful area for coordinated measures**
- Rebalancing can be extended to investment treaties
  - Different aspects when used in conjunction give firms too much power
    - **Re-balance, remove international arbitration clauses**
- And low universal financial tax
  - Complement financial reforms, compensating for delays, and lack of universality
  - Use experience gained in BEPS negotiations and dialogue

Thank you