Tax challenges of digital economy

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M ZIAUDDIN

Pakistan is too small player - in fact, an insignificant player in the new global game called digital economy, advancing fast in the wake of fourth industrial revolution (4IR). Therefore, instead of rushing thoughtlessly into a world that is being trodden with a lot of caution even by those countries which not only have given birth to 4IR but are actually innovating the digital economy on the go.

We need to wait and see how the developed world would try to cope with the massive disruption being caused by the era of digital economy. The OECD is already trying to resolve the taxation challenge of the digitalized economy.

The menace of transfer pricing has already been robbing the developing countries of billions for ages. And they have also been robbed dry by the multinationals which transfer their headquarters to offshore islands to escape paying taxes in countries where they make the most profits.

And now with the digital economy obliterating physical borders as cross-border trading via digital route has become almost seamless, the producers and sellers have become even more invisible to tax collectors in most countries, especially those stuck up at the undergraduate level in digital economy.

Moreover, framing of any new regulations aimed at regulating the social media in Pakistan at this point in time would require a lot of thought and consultation in order to avoid impacting adversely, in the process, on the fledgling start-up activities that have started in Pakistan only recently and rather tentatively.

No doubt, on-line hate speeches, fake news, defamatory messages, security-related breaches, harassments and blasphemous trolls need to be brought under a strict monitoring system. But while attempting to regulate these undesirables, we should be extra-careful not to let these rules curtail free flow of on-line information that has become, in view of social media being a double sword, even more important for safeguarding the rule of law and democracy. Also, this will ensure hiccup-free digital economic activities like e-commerce which would also ensure complete freedom online for developing systems for navigating and search plus creating enabling conditions for such well-known and reliable payment facilities like PayPal to come to Pakistan. Also, it would ensure a trouble-free introduction in the country to what is called Blockchain and Internet-of-things (IoT) which would further boost e-commerce.

Meanwhile, the international community is said to have agreed on a roadmap for resolving the tax challenges arising from the digitalization of the economy, and committed to continue working toward a consensus-based long-term solution by the end of 2020.

The 129 members of the OECD/G20 have adopted a Program of Work laying out a process for reaching a new global agreement for taxing multinational enterprises.

The document, which calls for intensifying international discussions around two main pillars, was approved during the May 28-29, 2019 plenary meeting of the Inclusive Framework, which brought together 289 delegates from 99-member countries and jurisdictions and 10 observer Organizations. It will be presented by OECD Secretary-General Angel Gurría to G20 Finance Ministers for endorsement during their 8-9 June ministerial meeting in Fukuoka, Japan.

Drawing on analysis from a Policy Note published in January 2019 and informed by a public consultation held in March 2019, the Program of Work will explore the technical issues to be resolved through the two main pillars. The first pillar will explore potential solutions for determining where tax should be paid and on what basis (“nexus”), as well as what portion of profits could or should be taxed in the jurisdictions where clients or users are located (“profit allocation”).

The second pillar will explore the design of a system to ensure that multinational enterprises – in the digital economy and beyond – pay a minimum level of tax. This pillar would provide countries with a new tool to protect their tax base from profit shifting to low/no-tax jurisdictions, and is intended to address remaining issues identified by the OECD/G20 BEPS (Base Erosion and Profit Shifting) initiative.

In 2015, the OECD estimated revenue losses from BEPS of up to USD 240 billion, equivalent to 10% of global corporate tax revenues, and created the Inclusive Forum to co-ordinate international measures to fight BEPS and improve the international tax rules.

“Important progress has been made through the adoption of this new Program of Work, but there is still a tremendous amount of work to do as we seek to reach, by the end of 2020, a unified long-term solution to the tax challenges posed by digitalization of the economy,” Gurría said. “The broad agreement on the technical roadmap must be followed by a strong political support toward a solution that maintains, reinforces and improves the international tax system. The health of all our economies depends on it.”

The Inclusive Framework agreed that the technical work must be complemented by an impact assessment of how the proposals will affect government revenue, growth and investment. While countries have organized a series of working groups to address the technical issues, they also recognize that political agreement on a comprehensive and unified solution should be reached as soon as possible, ideally before year-end, to ensure adequate time for completion of the work during 2020.

New economic analysis shows that a proposed solution to the tax challenges arising from the digitalization of the economy under negotiation at the OECD would have a significant positive impact on global tax revenues.

The analysis, released recently, puts the combined effect of the two-pillar solution under discussion at up to 4% of global corporate income tax (CIT) revenues, or USD 100 billion annually. The revenue gains are broadly similar across high, middle and low-income economies, as a share of corporate tax revenues. The analysis was released just weeks after the international community reaffirmed its commitment to reach a consensus-based long-term solution to the tax challenges arising from the digitalization of the economy and will continue working for an agreement by the end of 2020, according to a statement by the OECD/G20 Inclusive Framework on BEPS.

The Inclusive Framework on BEPS, which brings together 137 countries and jurisdictions on an equal footing for multilateral negotiation of international tax rules, decided during its Jan. 29-30 meeting to move ahead with a two-pillar negotiation to address the tax challenges of digitalization.

The economic analysis and impact assessment of the Pillar One and Pillar Two proposals are being undertaken to inform key decisions on the design and parameters of the tax reform to be agreed by Inclusive Framework members as part of the negotiations underway at the OECD. The analysis covers data from more than 200 jurisdictions, including all members of the Inclusive Framework, and more than 27,000 Multinational Enterprise groups. Assumptions in the preliminary analysis are illustrative, and do not pre-judge decisions to be taken by the Inclusive Framework.

The analysis shows that the Pillar One reform—designed to re-allocate some taxing rights to market jurisdiction, regardless of physical presence—would also bring a small tax revenue gain for most jurisdiction. Under Pillar One, low and middle-income economies are expected to gain relatively more revenue than advanced economies, with investment hubs experiencing some loss in tax revenues.

The analysis shows that Pillar Two could raise a significant amount of additional tax revenues. By reducing the tax rate differentials between jurisdictions, the reform is expected to lead to a significant reduction in profit shifting by MNEs. This will be important for developing economies as they tend to be more adversely affected by profit shifting than high-income economies.

The overall direct effect on investment costs is expected to be small in most countries, as the reforms target firms with high levels of profitability and low effective tax rates. The reforms would also reduce the influence of Corporate taxes on investment location decisions. In addition, failure to reach a consensus-based solution would likely lead to further unilateral measures and greater uncertainty.

The OECD's work on the digitalization of the economy is part of wider efforts to restore stability and increase certainty in the international tax system, address possible overlaps with existing rules and mitigate the risks of double taxation.