The Economics of Tax Issues in G20

International Tax Research and Analysis Foundation (ITRAF)
November 8th, 2016
Bangalore

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Economics of taxation issues at global level

- Economics: Efficiency, equity
  - Minimize distortions; maximize output

- G20, Global Taxation: New conceptual issues
  - Arbitrage
  - Compliance cost
  - Stability, equity, political economy
  - Co-ordination

Objectives of this Paper

- To present implications of the evolution of global views on cross-border taxation for India
  - Tax related controversies and India's reputation; global solutions?
  - Arbitrary taxation or fair tax?

- MNEs in India
  - Opportunity in BEPS

- To conduct an empirical exercise to find if there is evidence of BEPS by MNEs operating in India

Why issue of BEPS is important

- MNE's tax planning $\Rightarrow$ low effective tax rates
  - Double taxation avoidance treaties: as cross border flows started
  - But used to pay no tax: against the spirit of the treaties
- OECD model tax convention, residence-based taxation (PE): Strategic use of cross-border location to avoid taxes
- Taxes should be paid where the economic activity creating profits and value is created
- Since firms are mobile, so countries have to act together to reverse BEPS
- Global coordination most productive for G20

Why it is important for India

- Fair tax without provoking fight or flight
  - Legitimate tax by participating in global initiatives; avoid unilateral action
  - Share of corporate tax high; since informal activity large
  - Evidence MNEs do tend to shift profits to lower tax destinations.
  - ‘Make in India’ initiative will bring in more foreign capital

- Geographical dispersion of Foreign Portfolio Investment (FPIs) into India indicate misuse of DTAA’s in investment treaties (BITs)

Evolution of global thinking

- Domestic firms and young start-ups cannot afford to set up dummy PEs, end up paying more tax; anti-competitive

- MNE resources are tied up in tax planning and in non-commercial arbitrage

- 2013 G20 meeting in St. Petersburg: 'Mutual agreement on place of residence'
- PE concept no longer be a good measure of dominant economic activity; favour source country
- Global capital had become too mobile: 21st Century business practice
- Increase disclosure by MNEs; benefits from information sharing across tax administrations

Costs and benefits

- Compliance: End 2017 detailed tax reports for each country, not just cross border transaction flows

- Initial standardization and consistency requirements

- Information exists since necessary for commercial decisions

- Global initiatives, however, also requires following best practices in tax administration
- Fair, reliable and transparent dealings, providing quality information
- Communicating rights as well as pointing out obligations to taxpayers
- Responding promptly to their queries; opportunities to comment on changes
- Reducing compliance costs for firms and for consumers
- Business friendly tax administrations

Alternative proposals

- Allocate profit across countries on some combination of sales, employment and capital (tax federation)
- But profit is not always highly correlated with these variables

- Do away with corporate tax and tax shareholders
- But more profit would then be retained in firms

Indian leadership

- Smaller DEs looking to India

- G20 discussion on DEs has emphasized transfer pricing, profit shifting in supply chains, and lack of information
- May be challenging to enforce information sharing with DEs
- If one loophole is closed, incomplete rules create another loophole that could be utilized
- Information available to tax authorities and their technical capacity both have to be strengthened

- Competitive tax incentives not effective way to attract FDI
- Although lobbying by firms for such incentives

- Leadership requires Indian policies and stances to be consistent
- But often worked at cross purposes

Case studies

- Vodafone: Tax demand on Cayman Island share purchase
- IMF (2014) classified indirect transfers, involving sale of shares rather than of the asset itself, as a form of abuse

- Bombay high court used the principle that it is tax avoidance if an arrangement serves no commercial purpose
- Supreme Court chose to interpret existing law under which asset sales abroad could not be taxed
- Retrospective amendment : large outflow of foreign investment that put pressure on the government to change course

- Loopholes in tax laws should if possible be closed prospectively
- Else interferes with tax transparency and corporate business plans

- But Apple case (Ireland)
- If treaty abuse then taxes on past incomes

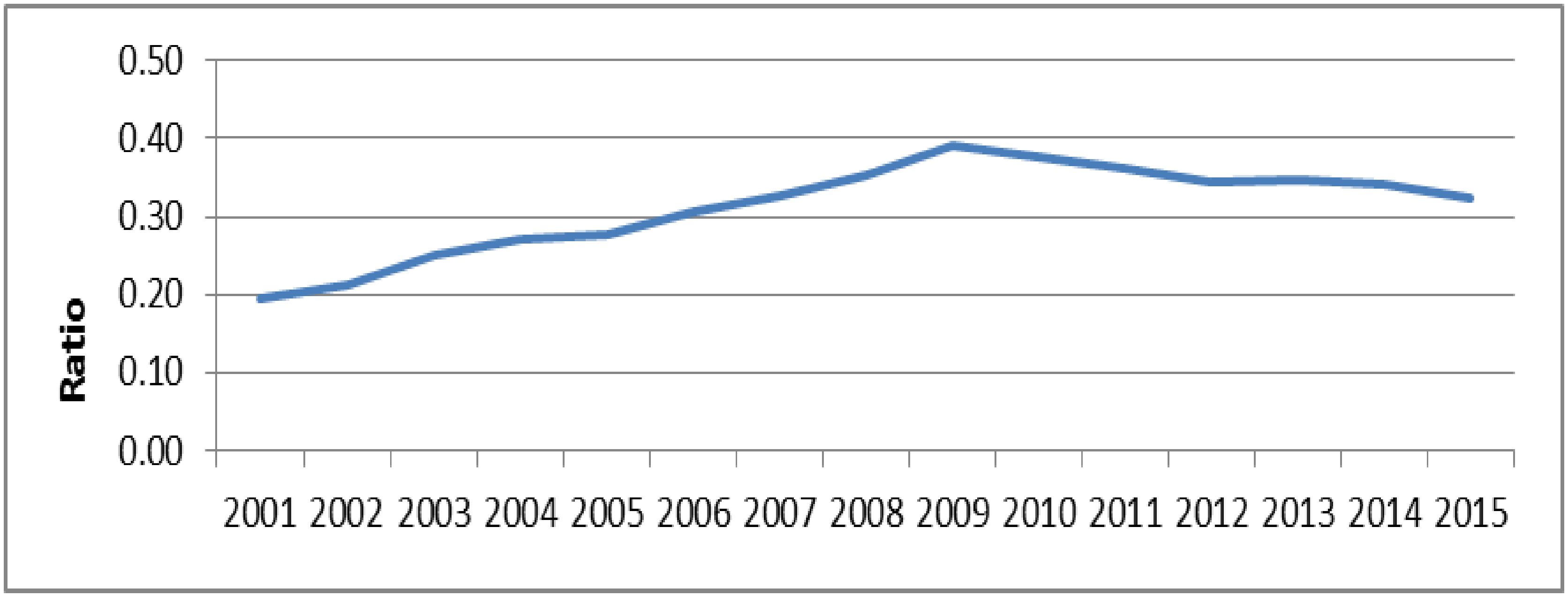
Mauritius DTAA: Disproportionate share in cross border flows to India

Table 1: Share of Top Investing Countries FDI Equity Inflows in India (Rs. Crore)

	2012-13	2013-14	2014-15	Total 2000-14	% with total FDI Inflows
Mauritius	51,654	29,360	55,172	395,600.65	**35.65**
Singapore	12,594	35,625	41,350	140,319.70	**12.01**
U.K.	5,797	20,426	8,769	105,903.36	**9.31**
Japan	12,243	10,550	12,752	86,267.33	**7.41**
Netherlands	10,054	13,920	20,960	68,169.41	**5.69**
U.S.A.	3,033	4,807	11,150	62,942.67	**5.65**
Germany	4,684	6,093	6,904	33,898.73	**2.97**
Cyprus	2,658	3,401	3,634	38,065.75	**3.38**
France	3,487	1,842	3,881	20,991.99	**1.83**
Switzerland	987	2,084	2,066	14,013.36	**1.23**
Total FDI Inflows from All Countries	121,907	147,518	86,939		

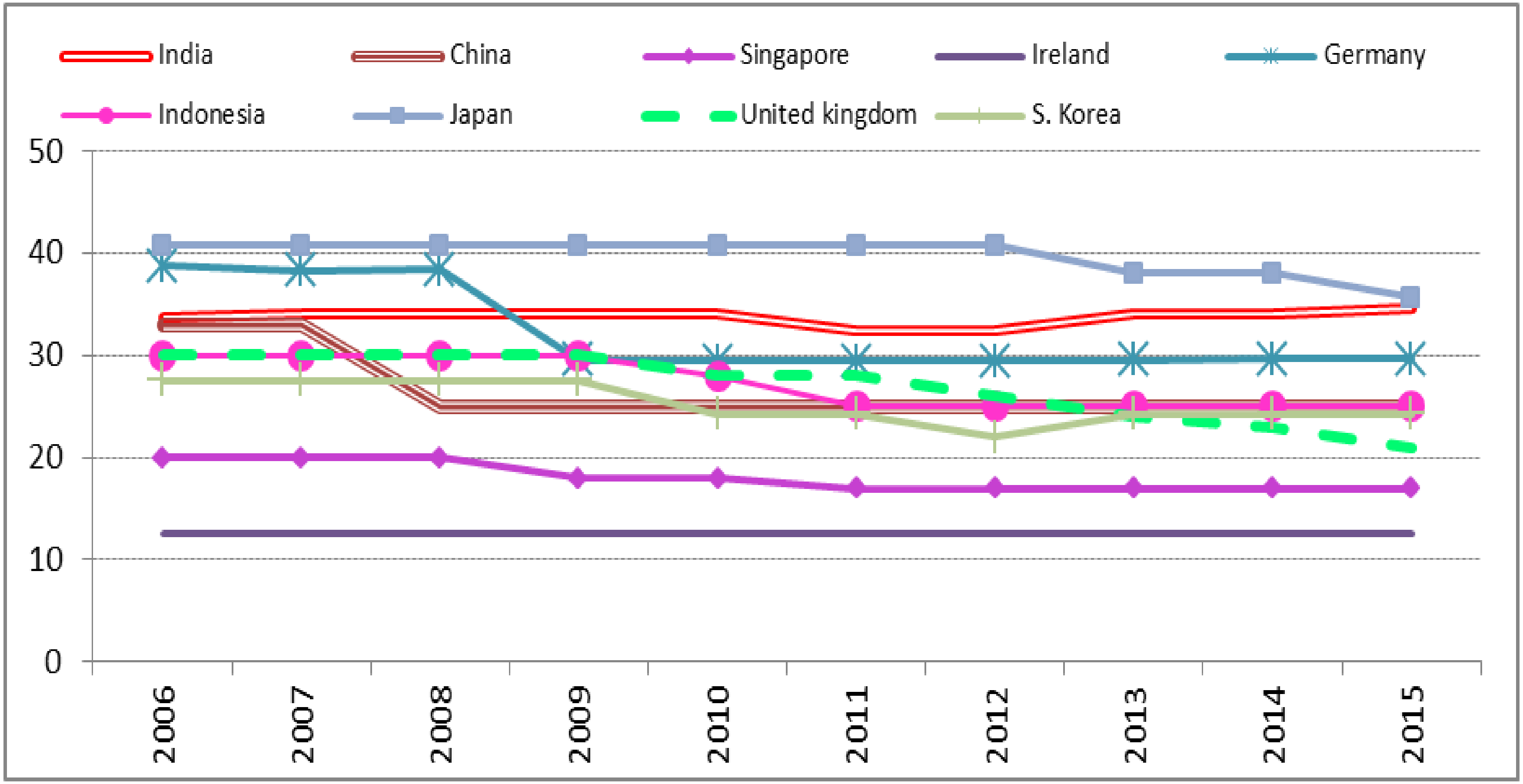
Note: Based on authors' calculations. Data Source: RBI (2015)

Share of Corporate Tax Revenue in Total Tax Revenue of Central Government in India: 2001-2015



India among countries with higher corporate tax rate

Figure 1: Country-Wise Comparison of Corporate Tax Rates



Literature on Empirical Evidence of BEPS

- **Hines and Rice (1994)** show negative association of pre-tax profit reported by US MNEs corporate tax rate in the US;
- **Huizinga and Laeven (2008):** Many European countries gained tax revenue due to higher taxes in Germany. Thus, tax must have been effectively diverted from Germany;
- **Dharmapala and Reidel (2012):** Pre-tax profits of affiliates in low tax countries increased more than those of affiliates in high tax countries if there was any earning shock at the parent firm;
- A meta data study by **Heckemeyer and Overesch (2013):** collate evidence from 25 studies that countries with lower tax rates tend to gain in terms of tax revenue at the expense of countries with higher tax rates.
- **Studies on India**
  - **Rao and Sengupta (2014):** Non-domestic firms are found to report higher levels of both interest rate and royalty payments than domestic firms in India.
  - **Janksy and Prat (2013):** MNEs operating in India with some linkage to tax havens, reported 1.5 per cent less profits as compared to MNCs with no connection to tax havens.

Methodology

- Following Dharmapala (2014); Dischinger et al. (2014); Huizinga and Laeven (2008), We use the following model specification:
  - $\text{Log PBT}_{it} = \beta_0 + \alpha_i + \beta_1 \text{Tax Rate\_India} + \beta_2 X_{it} + \varepsilon_{it}$
  - $\text{Log PBT}_{it} = \beta_0 + \alpha_i + \beta_3 \text{Tax Rate\_headquarter} + \beta_4 X_{it} + \varepsilon_{it}$
  - $\text{Log PBT}_{it} = \beta_0 + \alpha_i + \beta_1 \text{Taxdiff} + \beta_2 X_{it} + \varepsilon_{it}$

(PBT – Profit Reported Before Tax by MNEs operating in India)

Variable description

- Dependent Variable:
  - Profit Before Tax (PBT)
- Independent Variables:
  - India's Corporate Tax Rate
  - Firm's Parent Country's Tax Rate
  - Tax differential = Corporate tax in India – Corporate tax in home country of MNEs operating in India
- Control Variables:
  - India's GDP growth rate; Total Net Sales of a Firm, Average Total Assets of a Firm.

Data base

- PROWESS CMIE
  - Micro Level Financial Data for Foreign Business Groups, Private Foreign Firms, NRI Firms.
- Data consists of
  - 575 foreign firms for the time period of 2006-07 to 2014-15
  - Total 2848 observations

A priori expectations

- A negative link of PBT with Indian tax rate and a positive link of PBT with parent country's tax rate will show indirect profit shifting behaviour of MNEs operating in India.
  - Lesser corporate tax rate in India may lead to higher profits reported
  - Higher corporate tax rate in parent country may lead foreign firms to report higher profits in India.
- We divide sample in two parts:
  - Positive tax differential = Indian tax rate > parent country's tax rate (268 Obs)
    - we expect PBT to decline
  - Negative tax differential = Indian tax rate < parent country's tax rate (2438 Obs)
    - we expect PBT to increase

Limitations of the econometric exercise

- Due to data limitation we could include information only on India's Corporate Tax Rate and the tax rate of the parent country.
  - Although profit shifting could be taking place from:
    - Host country to Parent Country of the firm or vice-versa;
    - Host country to any country where its other affiliates have physical presence or vice-versa;
    - Within affiliate countries.
- Literature includes such analysis, which includes information of all subsidiaries of MNEs.

Empirical results

Dep Var: Ln(PBT reported in India)	(1)	(2)	(3)	(4)	(5) Tax Diff > 0	(6) Tax Diff < 0
Corporate Tax in India	**-0.672*** **					
	(0.000)					
Corporate Tax in Headquarter		0.009**				
		(0.01)				
			-0.01* **	**-0.01** **	**-0.012** **	**-0.029**
Tax Differential			(0.009)	(0.012)	(0.020)	(0.622)
	0.60***	0.60***	0.595***	0.597***	0.61***	0.568***
Ln (Total Asset)	(0.000)	(0.000)	(0.00)	(0.00)	(0.00)	(0.00)
	0.34***	0.34***	0.341***	0.337***	0.333***	0.353***
Ln (Net Sale)	(0.000)	(0.000)	(0.00)	(0.00)	(0.00)	(0.00)
				0.041***	0.036**	0.095**
India GDP Growth Rate				(0.003)	(0.013)	(0.024)
	0.154	0.03	0.006	0.032	0.035	0.116
Type Dummy	(0.216)	(0.813)	(0.961)	(0.813)	(0.812)	(0.645)
	1.165	1.00	0.891	1.004	0.886	
Bank Dummy	(0.293)	(0.364)	(0.411)	(0.364)	(0.424)	
	20.64***	-1.93***	-1.63***	-2.02***	-1.91***	-2.72***
Constant	(0.003)	(0.000)	(0.00)	(0.00)	(0.00)	(0.00)
Time Dummy	Yes	Yes	Yes	Yes	Yes	Yes
N (R-Square)	2706 (0.77)	2706 (0.77)	2848 (0.76)	2706 (0.77)	**2438 (0.76)**	**268 (0.82)**

Note: (i) P value is given in brackets; (ii) Fixed effect dummy could not be considered due to type dummies and bank dummies.

Contd…

- -ve association of foreign firms' PBT with Indian corporate tax rate (Model 1)

- +ve associated with corporate tax rate in their parent country (Model 2)
  - If the corporate tax rate in India decreases, then profit reported in India would increase
  - Similarly, if corporate tax in the parent country rises, then foreign firms would report higher profits in India

- A negative and significant association of PBT with tax differential
  - Given parent country tax rate remains constant, if Indian tax rate increases, then foreign firms report lower profits in India and vice-versa

Contd…

- Negative association with tax differential when Indian corporate tax rate is **higher** than parent country tax rate (Model 5) (2468 cases)
  - Profit shifting is taking place out of India

- A positive and significant association is, however, not found between the two when the Indian corporate tax rate is **lower** than parent country tax rate (Model 6) (268 cases only)
  - Other factors make India less attractive as a tax haven

Policy Implications

- BEPS: well founded; enable DEs to get fair tax?
- Reporting and information sharing: ↓ scope for tax evasion
  - 2017: country by country reports

- As evasion falls tax rates can converge; primary motivation for tax arbitrage goes; revenue not ↓
  - Indian tax rates ↓ to East Asian levels even as they ↑

- Friendly tax administration
  - Co-od across government ministries in giving tax incentives,↓ exemptions
  - ↓ multiple centres of power and discretion
  - SAAR not GAAR; tax councils

- General awareness
  - Vodafone , MAT, Google

Thank You

Summary Statistics

Variable	Observation	Mean	Std. Dev.	Min	Max
Number of Firms	575				
Period	2006-07 to 2014-15				
Profit Before Tax (Rs. million)	2848	1190.6	3647.0	0.1	61526.1
Net Sales (Rs. million)	2848	8895.5	28442.7	0.1	495748.0
Total Assets (Rs. million)	2848	9445.5	25658.6	0.3	426847.0
Corporate Tax Rate (India) (per cent)	2848	33.6	0.6	32.4	34.0
Corporate Tax Rate (Headquarter) (per cent)	2848	7.5	14.0	0.0	40.7
Tax Differential (percentage point)	2848	26.2	14.0	-8.3	34.0
Indian GDP Growth (per cent)	2848	7.3	1.89	4.50	9.6