TIF - The Global Minimum Corporate Tax: Not High Enough, Not Fair Enough

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Avoiding billions in taxes: Aerial view of Apple Park located in Cupertino, California | Arne Müseler/Wikimedia

'While the global minimum tax proposal is a step forward, that step is disappointingly short of what is needed and possible.'

Following years of negotiations, most nations in the world now appear to be willing to align their corporate tax regimes to prevent multinationals from evading taxation in the jurisdictions in which they operate. They have now tentatively agreed on the need for a global minimum corporate tax rate and a system of allocating the global profits of multinational firms to the different national markets in which they operate, where they can then be taxed. After the G-7 and G-20 finance ministers agreed at meetings in London (June 4-5) and Venice (July 9-10) on the principal elements of a compact that can address the issue, 130 of the 139 countries engaged in talks on an "Inclusive Framework on Base Erosion and Profit Shifting" signed onto the proposal.

Problem of taxation of multinationals

The need for aligning corporate tax regimes through a common global minimum corporate tax rate arises because while goods and services are increasingly produced and sold by multinational firms, the markets they serve remain segmented and subject to national rules. This creates claims for tax revenues by multiple governments from these corporations: in countries where the multinational firms are headquartered, countries where their subsidiaries operate, and countries where the global firms market their goods and services and earn revenues even if they do not have a commercial presence.

Corporate taxes allow governments to appropriate a portion of the net revenues or profits of firms from their activities either in a particular jurisdiction or globally. A simple way to do that is to tax profits directly where they are recorded. But in the case of multinational firms, profits are partly recorded in the accounts of their subsidiaries in other countries and are subject to taxation by governments of those countries. Another portion is often recorded in the accounts of the parent, either as dividend repatriated by the subsidiary or as net revenues from exports of capital equipment and intermediates, or intangibles such as intellectual property or goodwill.

A range of developments have increased the flexibility that multinational firms have of where they can record their profits. They can shift profits out of a subsidiary as payments for the use of intangible assets to the parent or a to a third country subsidiary, thus depriving the host country of taxes. They can shift the headquarters out of the country in which the parent was originally located. They can focus on cross-border provision of goods and services rather than local production and earn profits from a national market in which they do not have a commercial presence.

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This flexibility for multinational firms in deciding where to record their profits matters because rates of taxation of corporate profits differ significantly between countries. Some that want to attract multinational firm investments keep taxation rates deliberately low. There are others that do not attract actual investment but set themselves up as low-tax havens to serve as locations where international firms register shell companies to park their profits and manage their financial transactions. For profit-maximising multinational firms, evading taxes by reporting profits in these jurisdictions and not transferring any to the home country of the parent is the best strategy. This deprives the government of countries in which the multinationals sell their goods and services or in which they are headquartered of a share of taxes.

Tax avoidance by Apple

An egregious instance of this kind of tax avoidance is Apple's use of Ireland as a tax haven, by locating two of its subsidiaries—Apple Sales International (ASI) and Apple Operations Europe—in that country. Apple Inc, the parent firm in the US, has given ASI the rights to use its "intellectual property" to manufacture and sell its products outside of North and South America. In return, Apple Inc receives payments of more than $2 billion per year. The arrangement implies that any Apple product sold outside of the Americas is first acquired by ASI Ireland from Apple-contracted manufacturers and sold along with the intellectual property to buyers. All profits from these sales accrue to ASI and are recorded in Ireland. These profits are large because the payment made to Apple Inc for the right to use intellectual property are a fraction of the net earnings of ASI. That helps because corporate tax rates in Ireland are much lower than in the US and most other countries.

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The evasion of taxes potentially payable does not end there. The Irish tax authorities have allowed ASI to split it profits into two parts: one accruing to the Irish branch of Apple and another to a "Head Office". That "Head Office" exists purely on paper, with no formal location, actual offices, employees, or activities. Interestingly, this shell office gets a lion's share of the profits that accrues to ASI, with only a small fraction going to the Irish branch office. An investigation by the European Competition Commissioner found that in 2011 out of ASI's

profits of $16 billion , less than $50 million was retained by the Irish branch. The rest was allocated to the "Head Office" and remained untaxed. The effective tax rate on Apple's aggregate profits that were shifted to Ireland was less than 1 per cent. For the books, however, the taxes due on "Head Office" profits were treated as including a component of deferred taxes, which, it was claimed, will have to be paid to the US government when a part of the profits are finally repatriated to the US parent. In practice, though, Apple holds large volumes of surplus funds abroad to avoid US taxation and the evidence is they take very little of it back to the home country. Apple is no exception. According to one estimate, from Jannick Damgaard, Thomas Elkjaer, and Niels Johannesen of the IMF and the University of Copenhagen, 40 per cent of foreign direct investment 'passes through empty corporate shells', in order to save on tax payments by 'locating' in low tax jurisdictions.

Case for a global minimum tax

Allowing multinational firms such opportunities encourages the transfer of profits to low-cost locations resulting in tax losses to the parent and/or host country. An agreement on a global minimum corporate tax rate seeks to address this problem. If all countries adopt a corporate tax rate of at least 15%, it is presumed there would be no incentive for transnational firms to shift the location in which they record profits. Moreover, the government in a parent country such as the US, which accounts for a disproportionate share of the world's multinationals, could even set its corporate tax rate above the minimum, since the cost of relocating headquarters and operating from an alternative location may outweigh any marginal benefit in terms of tax saving.

All this applies only to locations in which multinationals have a commercial presence, either in the form of a parent firm or a subsidiary. There are many jurisdictions where multinational firms do not have a commercial presence, but where they record significant sales through cross-border provision. The prevalence of this trend has intensified with the growth in digital services provision, where digital platforms offer a range of services to a large clientele, garnering revenues and profits in jurisdictions in which they do not have a registered office or operation. If the advanced nations want the right to tax the global profits of firms that originated in their geographies and grew to global scale, then countries where sales by these same firms "contribute" a significant share to total profits must also have a right to tax that share.

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It was a principle of that nature that encouraged countries such as Austria, India, Italy, Spain, Turkey, and the United Kingdom, among others, to impose or propose imposition of a tax on digital services delivered across borders. India, for example, introduced in 2016 an equalisation levy of 6% on payments for online advertisement services to non-resident agents. In 2020, the ambit of the levy was extended to include payments to non-resident e-commerce operators deriving revenues from provision of e-commerce services, such as digital platform services, digital content sales, and data-related services, with the rate fixed at 2%.

While the US wanted these taxes rescinded because they 'discriminated against US. digital companies, were inconsistent with principles of international taxation, and burdened U.S. companies,' it has had to accommodate the demand for a share of taxes on profits of multinational firms from countries that were targets of cross-border supply.

The new agreement

In the event, the proposed compact of the "Inclusive Framework on Base Erosion and Profit Shifting" on globally

aligned taxation of multinationals that was finalised earlier this month by the G-20/OECD has two pillars.

Pillar 1 of the proposal drafted by the G-7 finance ministers, is meant to appease and win the support of nations where multinationals earn profits without a physical presence. "The largest global companies" with annual global turnover of more than €20 billion and pre-tax profit margins of at least 10% of revenue must allocate around 20% of their global profits, which are more than that 10%, to countries where they make their sales, thereby allowing the latter to tax that allocation.

Pillar 2 requires each country to impose a minimum corporate tax of 15% on firms registered and recording profits in their jurisdiction.

Many features of this still incompletely defined plan have disappointed those who had been campaigning for "unitary taxation" that would treat a multinational group of companies rather than subsidiaries in different countries as the taxable unit. The G-20 proposal does move in that direction by disincentivising profit shifting and distributing the tax base across countries. But the reasons for disappointment are many.

First, to win agreement, the floor of the proposed common minimum tax has been set at 15%. That is far below the current average global corporate tax rate of 25% and not very much higher than that in the three OECD countries with rates lower than 15% —Ireland (12.5%), Chile (10%) and Hungary (9%). While a 15% minimum tax will hit tax havens with low rates and prevent a race to the bottom, the concerns are that it would trigger a "race to the minimum", with countries seeking to match tax rates elsewhere for fear of driving foreign investors away.

Many developing countries currently have tax rates higher than 15%. If they persist with those rates, they will remain victims of profit shifting to locations where the rate is kept at the minimum. If they lower rates to 15% they will lose much needed tax revenues.

The EU Tax Observatory estimates that a 15% tax rate, would deliver an additional €500 million, €600 million, and €900 million to Mexico, South Africa and Brazil, respectively, of corporate income tax revenues in 2021. In contrast, the Independent Commission for the Reform of International Corporate Taxation estimates that with a minimum rate of 25%, which many campaigners had long argued for, the additional revenue for these three countries would be €1.3 billion, €3 billion, and €7.4 billion, respectively. The US had initially suggested fixing the minimum global rate at 21% and many African countries had suggested 20%. With a minimum rate of 15%, the cause of making the world's most profitable multinational firms contribute a far share to public revenues to finance a green and inclusive global recovery is unlikely to be advanced. Moreover, much of the additional revenue would accrue in the advanced nations. The EU Tax Observatory estimates that a 15% minimum rate will pull in around $100 billion in a year for the US and Europe.

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Second, the proportion of profits for which the right to tax is shifted from the place of residence to place of sale has been kept low. That right is restricted to the world's largest companies with annual global turnover exceeding €20 billion and pre-tax profit margins of at least 10% of revenue. They will pay tax on 20-30% of the profits they make, over and above the first 10% of profits. Developing countries had been demanding reallocation of 30-50% of residual profits. Restricting the universe of companies to be taxed in foreign jurisdictions and the share of profits allocated for such taxation substantially reduces the scope of Pillar 1. The number of firms in the taxable universe may not exceed the top 100. Some of them like Amazon do not even record a profit margin of 10%. Others are likely to resort to accounting devices to reduce their margins to below 10%. And taxes on one-fifth of the excess where profit margins exceed 10% are unlikely to yield much.

An estimate by researchers Michael Devereux and Martin Simmler places the volume of profit that will be allocated to "countries of sale" for taxation at $87 billion. Another from France's official Council of Economic Analysis (CAE) places the figure at $130 billion. But in return for this "historic shift" away from taxation based on physical presence, countries imposing or planning to impose digital service taxes would have to give up ambitions to tax firms from abroad that earn revenues and profits by providing digital services in their jurisdictions. The resulting loss can be large and significantly more than the gain from the new Pillar 1. For example, the office of the US Trade Representative estimates that India collects $55 million annually from the 2% digital services tax it imposes on revenues of foreign e-commerce companies serving Indian buyers.

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Third, in return for participation in the final agreement, individual countries have negotiated or are in the process of negotiating carve outs. To persuade China, India and some eastern European nations to sign up, the OECD has proposed a carve-out from the global minimum tax plan, based on "substance". The new rules would not apply to corporate tax incentives for investment in tangible assets such as manufacturing factories and machinery. The global shipping industry has also benefited from an exemption because it is almost impossible to determine where entities are located. The UK's case that the financial services industry be carved out of the proposed new global tax system has been accepted on the grounds that it "profits from … activities that arise in a particular market jurisdiction [and] will generally be taxed in that market location". Natural resource sectors have also been exempted. Cumulatively such exemptions can significantly reduce the tax generated globally by the new regime.

Finally, it appears that under the new regime, not only will developing countries give up their option to impose taxes on cross-border sales of commercial digital services in their markets, which can be substantial, but taxes on profits would disproportionately accrue to governments of developed countries in which these firms are headquartered. Since only a small share of profits of a few large firms are to be allocated to markets where they earn substantial revenues, the tax revenues garnered in those jurisdictions would be low.

Conclusions

Thus, while the global minimum tax proposal is a step forward, that step is disappointingly short of what is needed and possible. If yet the proposal has caught the media's attention, it is because it speaks of a new effort by the richest nations to enforce tax rules on powerful multinationals. Whatever that delivers would increase their own room for manoeuvre but leave little for the rest of the world.

Among the nine of the 139 countries who have not signed on to the Inclusive Framework on Base Erosion and Profit Shifting are, significantly, three OECD members, Ireland, Estonia and Hungary. The other dissenters are developing countries: Barbados, Kenya, Nigeria, Sri Lanka, and St Vincent & the Grenadines, with Peru abstaining on the grounds that at the time it was in the midst of electing a government that must take the decision. But the views of these countries are unlikely to stall progress to the next stage. Once all required features of the framework have been spelt out, a version is likely to be soon available for ratification by national governments.

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However, there is no guarantee of ratification by all nations. Ratification is unlikely to be easy even in the US, though the Biden administration's call for a 21% global minimum corporate tax rate is what hastened to conclusion talks that have been prolonged for years. American participation in a final agreement would require approval of the Senate where Democrats have a majority only when Vice-President Kamala Harris exercises her tie-breaking vote. However, parts of the global agreement must be preceded by revision of US treaties with other nations, which require at least 10 Republican Senators besides 50 Democrats in the Senate to approve the proposal under "filibuster" rules that apply. That seems difficult.

For all the hype then, the new agreement is unlikely to extract much surplus from multinational firms or provide a fair share of whatever is extracted to the poorer countries.

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