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The Global Minimum Tax: A Transformational Proposal?

By Dipinder S. Randhawa

SYNOPSIS

The Biden administration's endorsement of the OECD proposals on tax reforms clears the deck for a major multilateral overhaul of the global taxation of multinational corporations. This can potentially quell discord over digital tax policies at a time when fiscal positions of most countries are under considerable stress.

COMMENTARY

IN A speech on 5 April 2021, the US Treasury Secretary Janet Yellen endorsed the suggestion of the Organisation for Economic Cooperation and Development (OECD) for a global minimum tax on corporate income.

The path to a potential multilateral agreement opened when Yellen consented to remove the 'safe harbour' provision demanded by the Trump administration that sought to make compliance by US tech groups voluntary – a major stumbling block to reaching consensus within the OECD.

What a Global Tax Treaty Will Do

Since October 2019, the G-20 has been negotiating for a global tax treaty drawing upon a framework developed by the OECD that includes a minimum tax rate and a new way of assigning how profits are to be taxed among countries. The OECD proposals were split into two parts: 1) global minimum corporate income tax rate; and 2) a new tax regime that calls for large multinational corporations (MNCs) to pay taxes to national governments based on their sales in each country.

Acceptance of the deal by several OECD member states, including France, Italy and Spain, is contingent upon both pillars of the tax reform being passed. The

endorsement of Yellen's proposals from the European Union, G20 members as well as the IMF and the World Bank was swift.

The G20 is pushing for a multilateral agreement and hoping to unveil a proposal by July 2021. A stable international tax system will stop proliferation of national digital taxes, such as those under consideration in France, Spain, India and Australia, and mitigate tax avoidance and profit-shifting by MNCs. Estimates of the minimum tax rate under negotiation range between 12.5 percent and 21 percent.

The reform aims at ending tax competition between countries and the use of tax havens by companies, described by Yellen as a race to the bottom, a self-defeating competition in which countries undercut each other in their efforts to draw foreign investments and jobs. In the process, governments deprive themselves of revenues, estimated at US$240 billion, needed to fund key public goods and services.

The OECD plan applies to global profits of approximately the 100 largest companies, including US tech groups, regardless of physical presence in a given country or where it is headquartered. It taxes MNCs in consonance with their real activities in each country with tax liability determined by revenues in the countries where the MNC operates and has customers.

Consequently, US technology companies in Europe and other countries will be taxed there rather than in the US. In return, the US would be able to raise more taxes from European and other companies selling to American customers. The proposals will deny tax deductions to companies that send payments from the US to related entities in low-tax jurisdictions, where they pay less than the internationally agreed-upon minimum tax.

The Global Impact

The ramifications of the tax reforms are of global significance. In the US, the proposals can address some long-standing inequities and imbalances in the tax system. Arcane regulations have long shaped the financial structure of MNCs, which exploit loopholes to save on taxes. As a result of continuing use of tax havens by US corporations, approximately 60 percent of corporate income generated in the US is recorded in locations outside the reach of the tax authorities.

An IMF-University of Copenhagen study revealed that nearly 40 percent of global foreign direct Investment with a value of $15 trillion passes through empty corporate shells with no real business activities. While the share of profits in GDP in the US has been rising and the share of labour decreasing, the contribution of companies to tax revenues has been shrinking, while that of labour has increased steadily in recent decades.

The higher marginal tax rate on labour than on capital investments induces firms to pursue automation, rather than invest in training and skills development of workers, and thus depressing real wages. A level playing field between capital and labour can induce companies to invest in technologies that boost labour productivity.

By altering corporate ownership into private partnerships or S-Corporations, meaning

US companies that are exempt from corporate income taxes, large firms further reduce tax liabilities. A minimum global tax rate will reduce incentives for tax arbitrage, and thus tax avoidance by MNCs, at a time when governments find themselves under severe fiscal pressures.

The Biden administration proposals add an element of progressivity to the US tax system at a time when inequality has been increasing for decades. The COVID-19 pandemic has lent an added urgency to the problem. Governments have to date committed $16 trillion to fighting the pandemic and its economic fallout. As a result, government debt rose to 97 percent of GDP in 2020 from 84 percent in 2019, putting pressure on governments to boost revenues.

The proposals dovetail with US fiscal policy as the Biden administration seeks to finance the $2 trillion stimulus package, and governments across the world seek to close tax loopholes, especially those exploited by the largest corporations. Plugging leaky international tax systems is an obvious target. The decision to concentrate tax increases on a relatively small group of companies is recognition of the winner-takes-all nature, especially of tech firms in the global economy.

Looking Ahead

Several issues will need to be resolved, including overcoming resistance from tax havens and the corporate behemoths themselves. The plan will need to extend to mid-tier companies and keep a check on exploitation of new loopholes.

Countries such as Switzerland and Singapore that hitherto attracted investment partly because of lower tax rates will continue to attract investment with their superior world-class infrastructure and competitive liberalised services sectors. The setbacks may be felt by economies that deploy pure tax arbitrage to draw investments.

Today’s tax system was designed for an age when investment was primarily in physical assets, plant, equipment, factories etc. The G20-OECD Base Erosion and Profit Shifting action plan is a step towards modernising the international tax regime. It is cognisant of rapid growth in intra-firm trade, the vagaries of transfer pricing, the growing importance of services and intangibles, and the ever-growing digital sector.

MNCs will of course find other loopholes and governments will use other carrots to draw investment – the imperative is to engender transparency and create a level playing field. The tax proposal is a step in that direction that could spur innovation, growth and productivity in an Internet/digital age.

The proposal aims for fair sharing of the burden of financing government, ensuring that governments have stable tax systems that raise sufficient revenue to invest in public goods, and respond to crises, with all citizens fairly sharing the burden of financing government. This is not possible without international cooperation and transparency in reporting and monitoring corporate incomes.

There is little reason for developing economies to not agree with the principles of an accord on taxation of MNCs. With the US and most of the OECD members on board,

an agreement by late July is within reach, offering a much-needed boost to multilateralism on a challenge that has eluded a solution for decades.

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