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RESEARCH NOTE

The G7 Deal on a Global Corporate Tax: Revolution or PR Stunt?

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Fairness in taxation has been a rallying cry for a number of years. The Biden administration's proposal of a 15% global minimum corporate tax rate meets age-old efforts by the Organisation for Economic Co-operation and Development (OECD) to coordinate global taxation and avoid tax-shifting opportunities for large corporates. Multinationals are estimated to shift around 12% of profits to tax havens, and the proposal would add 14% to corporate tax revenue every year in the U.S. and up to 30% in Europe, which would help governments finance public goods. Large global companies may see their average tax bill increase 9%—a hit to profits, but not an unsurmountable one. Single companies could however face a much larger bill.

WHY RAISE TAXES NOW?

President Joe Biden and Treasury Secretary Janet Yellen plan to institute a minimum global tax on corporate profits that would generate over $2 trillion in the next 15 years and fund the massive spending plans imagined by the administration. This would more than cover the American Jobs Plan and could help reduce the ballooning U.S. fiscal deficit too, if the president decides so.[1]

It is clear that the plan's intention is not to "punish" multinational corporations (MNCs). **As with anything in politics, the headline and public relations effect may have been welcome, but the need to raise huge amounts of public resources makes the Biden administration's motive sincere**.

Tax revenue lost by the U.S. and other countries due to tax avoidance is substantial, and country-by-country statistics on profit flows make these losses estimable with some precision.[2] **The U.S. appears to lose 14% of its corporate tax revenues ($57 billion) every year**. **European countries fare even worse**, however. Germany foregoes 28% of corporate tax revenue, the most in the world. France, Italy, and the U.K. are close behind, estimated to lose around 20%.

Equality in the face of taxation has been a rallying call from the masses. High-income earners, as shareholders, benefit the most from profit-shifting techniques. It is also clear that avoiding that countries compete on taxation by driving rates to the bottom is crucial for public policy. Governments have a clear incentive to close tax loopholes to fund ambitious and necessary investment plans—without introducing unpopular tax hikes. There is also an argument to be made about fairness of competition, given that some multinational firms manage to pay a fraction of the tax rate their smaller domestic competitors face.

[1] See "The Made in America tax plan" U.S. department of the Treasury, April 2021.
[2] See "The missing profits of nations" by Thomas Torslov, Ludvig Wier and Gabriel Zucman.

IS IT GOING TO HAPPEN?

The OECD has been trying to harmonize tax rates for years, albeit unsuccessfully. **Global coordination will require the largest players to be not only be part of the conversation, but also the agreement**. The U.S. had not been keen to engage, until now. The change of guard in the U.S. and the proliferation of unilateral taxes on digital services in Europe seem to have united governments in making an effort towards better global coordination.

The OECD negotiations and the U.S. proposal converged on a two-pronged approach. The so-called first pillar would give countries the right to tax some profits based on the location of global firms' sales, while the second pillar would introduce a 15% minimum tax on their global income, to be paid in the country where the firm is headquartered. Unsurprisingly, the U.S. is mostly interested in the second pillar (most global firms hit by the new rules would be headquartered in the U.S.), while Europe is mostly interested in pillar one.

Beneath the surface and the celebratory tones, doubts remain about the feasibility and effectiveness of the deal reached at the G7 meeting last week.

- First, the scope of pillar one, i.e., **the revenue gains for EU countries under the OECD/G7 deal, would be limited** to roughly $100 billion of profits, out of the total $700 billion to $1 trillion in profits estimated to be shifted to tax havens each year.

- Second, the U.S. government is asking, as a precondition for the deal, that all digital taxes already introduced by European countries, including the U.K., be scrapped. To focus minds, the U.S. Trade Representative office has already slapped sanctions on these countries, temporarily suspending them in order "to complete the ongoing multilateral negotiations on international taxation at the OECD and in the G20 process." **This feels more like a shotgun wedding that a shared path.**

- Third, **the devil is, as ever, in the details, and these are still very scant**. Depending on how these emerge, the G7 tax plan could still turn out to be fairly ineffective.

- And there is still the small issue of voting on the measure. The Biden administration does not seem to have the majority in Congress needed to pass a tax treaty. In Europe, countries taking advantage of profit-shifting practices (Luxembourg, Netherlands, and Ireland in particular) are likely to oppose the plan, although there are surely bargaining chips on the table (for example, transition paths).

Success depends on gathering the support of the G20 in July. Biden is showing his commitment to global cooperation by removing another part of his plan to raise the corporate tax rate from 21 to 28%, as well as conceding some tax sovereignty for pillar one. EU countries are showing openness to canceling the digital taxes. China has not showed its cards, so far. There is still negotiating room, but serious coordination will be needed. Any country moving unilaterally would put its own multinational firms at a disadvantage versus others—and would likely end up in WTO disputes over discriminatory policies. This is what has prevented progress in this area for decades.

WHAT IMPACT TO MULTINATIONALS PROFITS?

Assuming that an effective and comprehensive 15% global corporate tax on worldwide book income is introduced, the tax bill for the average global firm could almost double[3]**.** The U.S. Congress' Joint Committee on Taxation[4] founds that, in 2018, the average U.S. multinational firm paid 8.8% of its worldwide book income in corporate tax, much below the 21% official tax rate. The report also found that 91 of the Fortune 500 companies in 2018 paid no federal taxes on U.S. income; U.S.-based multinational companies paid only 8.7% taxes on their European income.[5] **Should the plan raise effective tax rates to 15%, the average tax bill for global firms would rise by 70%**.

The final impact is likely to be lower. The Biden-Yellen report makes clear that only about 45 mega-companies declaring more than $2 billion in annual profits would be impacted by the 15% minimum. The OECD proposal casts wider coverage but many details, including how many countries will join in—a key condition for its success—remain unclear.

A more conservative estimate of the tax bill's impact suggests the average global firm's tax bill would increase only 9%. U.S. multinational firms generate 33% of their pre-tax profits outside the U.S.[6] and shift 37% of these profits to tax havens. Hence, roughly 12% of total U.S. global firms' profits are shifted to tax havens, where they pay an average 3.5% tax rate. Assuming that the plans lift the effective tax rate on foreign profits of global firms to 15%, the average tax bill would rise by 9%. This is a conservative estimate, as it assumes that effective tax rates on global multinationals' domestic profits will not increase, and that those headquartered in economies smaller than the U.S. have the same portion of foreign profits than U.S. ones.

The average increase may however mask very different impacts in different sectors and companies. Sectors where most of the capital is intangible, like pharma and technology, should be more affected than others. It has been easier for them to engage in more aggressive profit shifting than those where tangible is a bigger part of capital. For example, before its IPO, Google transferred the property of its search algorithm from its U.S. to its Bermuda-managed holding company[7], where corporates are not taxed. Since there was no equivalent to the search algorithm, it was nearly impossible for U.S. tax authorities to establish whether the Bermuda company paid the U.S. company a fair price for the algorithm. The value of tangible capital, and thus of its transfer among companies in the same group, is easier to assess.

A few global companies aggressively shifting profits to tax havens will be most impacted. The median tax paid in the EU by U.S. multinational firms is, at close to 14%, 1.5 times higher than the average tax paid in the EU by the same firms. That average is pulled down by the very low rates paid by a few large companies, which confirms from an aggregate point of view the many

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[3] The following analysis is based on U.S. multinationals and assumes multinationals headquartered everywhere have similar profit shifting techniques. This is because only the U.S. publish detailed aggregate data on multinationals balance sheets.
[4] See Joint Committee on Taxation. 2021. "U.S. International Tax Policy: Overview and Analysis." JCX-16-21, 19 March
[5] Interestingly, U.S. MNCs paid 15.1% average tax on their foreign income in all regions, almost double as that paid in Europe. This shows how profit shifting is particularly aggressive in the EU.
[6] See "Activities of U.S. Multinational Enterprises: U.S. Parent Companies and Their Foreign Affiliates" BEA 2018 preliminary statistics database.
[7] Google has subsequently announced the end of this arrangement, with its intellectual property to be licensed again from U.S. and not Bermuda-based companies.

reports on specific companies. The latest of these articles shows, for example, that in 2020 Amazon made €44 billion in sales in Europe but its EU holding company located in Luxembourg, Amazon EU, closed the year with a €1.2 billion loss. Not only did the company pay zero taxes, but it also received a tax credit that reduces future tax liabilities.[8]

Generalizing the average small impact and assuming all companies would be little affected can thus be misleading. If a company is not engaging in aggressive profit shifting, it will obviously not be affected by even a serious global tax rate. Conversely, **if a company is currently paying close to no taxes in various high-tax jurisdictions, it could face a substantial hit to its profitability**. Evidence suggests that, indeed, there is such a wide dispersion in the aggressiveness of profit shifting usage across sectors and firms, and thus a more granular analysis of a company balance sheet is needed to assess its exposure to an effective global tax.

[8] One of the clauses in the G7 deal specifies that the 15% minimum tax will apply only to companies with pre-tax profit margins above 10%. As Amazon margin was below the threshold last year, it would not be subject to the tax, *sic stantibus rebus*.

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