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POLICY BRIEF

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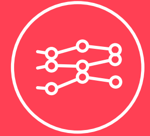


Effective Minimum Tax Implementation: Alternatives to Unanimity

Key Points

- 136 members of the Inclusive Framework at the OECD agreed on a global minimum tax rate of 15% (Pillar 2). Far from being perfect, the agreement marks an important milestone in the fight for corporate tax justice, which gives the EU and its member states the chance to make important progress in ending profit shifting and tax competition, and to raise highly needed revenues to fund a sustainable post-COVID recovery.

- While the deal brings (more) clarity for implementation, it also showed the uneven power balance between developing and developed economies in international corporate taxation. While Ireland and Hungary managed to water down the proposal somewhat to be able to join, developing economies got nothing in return. It remains to be seen whether this outcome hurts the long-term stability of the agreement.

- For the EU, implementation is getting easier, as all member states now endorse the international agreement. However, given that significant implementation risks remain, a Minimum Tax Directive is not in the bag yet.

- Against this background, the Policy Brief explores the political and legal challenges of effectively implementing the global minimum tax in the EU and discusses the need for alternatives to unanimity as well as their potential.

Background

On October 8th 2021, 136 members of the Inclusive Framework at the OECD agreed on a comprehensive statement to rewrite international corporate tax rules (OECD 2021).

The statement is based on two Pillars (that are very briefly presented here):

Pillar 1 shall reallocate 25% of the profits of the largest multinationals to market economies, using a revenue-based allocation key and nexus definition. The idea is that existing allocation rules are no longer fit for the highly digitalised and globalised economies. In scope of this new system are around 100 multinational enterprises (MNE) with global revenues above 20 bn USD and a profitability above 10%. The agreement demands the removal of all Digital Services Taxes and the commitment to not introduce such measures in the future.

Pillar 2 defines the guidelines for a global minimum effective tax rate of 15%. Its core element is the Income Inclusion Rule, a top-up tax on the multinationals parent company for the “undertaxed” profits of its foreign subsidiaries. The minimum tax shall ensure a global floor on the taxation of MNE profits and is calculated on a jurisdictional basis, using a common definition of covered taxes and tax base. In scope of the minimum tax are 8.000-9.000 multinationals with a global turnover above 750 m USD. The statement on Pillar 2 involves a substance-based carve-out of 8% of the carrying value of tangible assets and 10% of the payroll (that is reduced to 5% after a “transition period” of 10 years).

While Pillar 1 is all about the reallocation of taxing rights, Pillar 2 shall bring additional revenues of around 150 bn USD globally. It takes the form of a “Common Approach” for those countries that wish to introduce the minimum tax. The technical details are scheduled for the end of November. The implementation shall take place in 2022.

Main Findings

Overall assessment for the deal

Trade Unions have been taking a clear position on the reform of international corporate taxation all along the OECD-process. This position is still valid. While Pillar 1 is too complex and not ambitious enough, the minimum tax is an effective tool to increase public revenue and to curb both profit shifting and tax competition of large MNE.

However, the final outcome on the minimum tax is to be watched with mixed feelings. On the one hand, it is positive to have a final agreement that involves nearly all members of the Inclusive Framework and brings clarity for implementation. On the other hand, the negotiation outcome has clearly highlighted the uneven power balance between developing and developed nations in international corporate taxation. While we saw no movement in the direction of developing countries, that demanded a higher reallocation percentage and a higher minimum tax rate, the EU tax havens Ireland and Hungary manged to cap the minimum rate at 15% and even increase the substance-based carve-out.

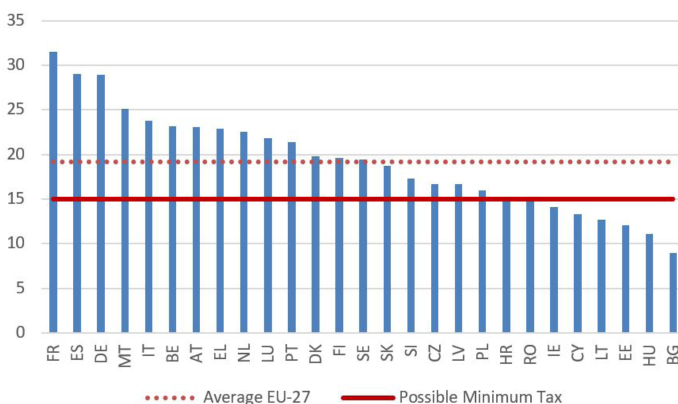
It remains to be seen whether this uneven outcome hurts the political stability of the agreement in the medium- to long-term.

The economics of the substance-based carve-out

While much of the discussion has focussed on the cap of the minimum rate, the negative effects of the (higher) carve-out should not be underestimated.

The substance-based carve-out agreed allows the MNE's to reduce the low-taxed profits of their affiliates (and the tax base for the top-up tax) by 8% of tangible asset depreciation and 10% of payroll costs in these affiliates. This means that, with enough substance, the effective minimum rate for MNE profits can continue to stay well below the floor of 15%. This is a problem in itself, as 15% is already below the EU-average (see chart 1). Going beneath that effective level of 15% is thus jeopardizing the goal of finding a fair level of minimum corporate taxation. In addition, there are budgetary consequences. The EU Tax Observatory calculated that already a 7.5% carve-out could reduce the additional tax revenues of a 15% minimum tax rate by 23% (EU Tax Observatory 2021). However, the most important (and somewhat hidden effect), is the carve-out's effect on tax competition.

Chart 1 Effective Tax Rate for large Corporates in the Non-Financial Sector, in%



Without the carve-out, the minimum tax rate implies an effective floor for tax competition in all its forms. Irrespective of whether the profits in a tax haven are based on real economic activity or wholly artificial arrangements, the minimum tax demands a minimum effective taxation of 15%. This would create an incentive for havens to increase their effective tax rates and create a disincentive for multinationals to shift profits and/or investments in these countries.

With the carve-out, these actually very important competition effects are (almost) reduced to paper profits, because if there is substance, the effective minimum rate won't bite. This not only reduces the incentive for havens to increase their tax rates, it also increases existing incentives to locate investments in these countries.

In other words: The minimum tax could be an effective floor on tax competition "ending the race to the bottom" (Yellen) or it could end up being a minimum tax light only addressing profit shifting. For the EU this question is crucial, as most of EU profits are shifted within the Union and havens like Ireland or Hungary are well known to have high levels of substance.

Remaining implementation risks in the EU

The EU-Commission announced its implementation strategy in May by stating that "the principal method for implementing Pillar 2 will be an EU Directive that will reflect the OECD Model Rules with the necessary adjustments" (European Comission 2021). Given that all EU member states now support the Pillar 2 agreement, the Commission's implementation strategy has clearly become more promising. With Estonia, Hungary and Ireland, all three EU holdouts from July endorsed the October consensus. Also Cyprus (which is not part of the Inclusive Framework) sent positive signals. However, despite these positive developments, the Minimum Tax Directive is not in the bag yet, as there are significant implementation risks remaining.

- So far, we do not know all the necessary details of the international agreement. The OECD Model Rules explaining effective tax rate calculation, filing obligations etc. are scheduled for the end of November. Clearly, EU havens will use their influence to shape these (important) technical questions at the EU-level, with a potential for conflict.

- Secondly, there are still significant political risks. Currently it is unclear whether POTUS Biden and the majority Democrats will manage to increase the US minimum rate. If the US fails to lead implementation, this could change the landscape completely.

- Moreover, it is worth remembering that Pillar 2 is no binding treaty but just a guideline for countries that wish to implement the minimum tax. That means, formally, no EU country has agreed to do so. And no EU country has agreed to the necessary adjustments to effectively implement Pillar 2 in the European Union yet.

These adjustments are needed for legal reasons, as the European Court of Justice could consider the minimum tax a violation of the freedom of establishment (Becker and Englisch 2021). A problem well known from the Controlled Foreign Company legislation, introduced a few years ago.

Of course, a lot will depend on the concrete design of the EU Commission's proposal. But the further away it is from the international agreement, the more likely there will be political disputes.

Are there alternatives to unanimity?

From the Commission's perspective, it makes sense that a Directive (based on unanimity) is the primary minimum tax implementation strategy. However, to have a plan B is of crucial importance in the upcoming negotiations since important implementation risks remain.

Table 1 compares the classical EU tax Directive based on article 115 of TFEU with its most obvious alternatives on political and legal feasibility. Article 115 of the Directive has many legal and technical advantages (Becker and Englisch 2021) as compared to its alternatives; it, however, (potentially) lacks unanimous support of member states. Article 116 of the Directive on the other hand should be politically feasible, as it only demands qualified majority; however, it is highly uncertain if it can be applied to a Minimum Tax Directive (Englisch 2020). Obvious alternatives are enhanced cooperation and unilateral action (Englisch 2021). Both options should work politically and legally, although it would be somewhat harder to realize the necessary adjustments to minimum tax rules and existing directives in these cases.

Although the EU Commission would lose (some) control over the implementation process, it should be prepared to use alternatives to unanimity to secure effective implementation.

The alternatives to unanimity could also lay the groundwork for improvements over the international agreement. Currently, the scope of the minimum tax is given by a turnover threshold of 750 million euros, but countries are free to apply the Income Inclusion Rule to smaller MNE as well. The EU could (after a short period of transition to ease the implementation) decrease the threshold to get more corporations in scope. As profit shifting is also a matter with smaller MNE, reducing the threshold could increase extra revenues and enhance the effectiveness of the minimum tax. Given that the COVID crisis and its hardships make the case for corporate tax justice even more pressing, this would be an important political signal to European citizens.

Table 1: Potential alternatives to unanimity

	Directive (Art 115 TFEU) Unanimity	Directive (Art 116 TFEU) Qualified Majority	Enhanced Cooperation	Unilateral Action
Political feasibility	?	✓✓	✓✓	✓✓✓
Union competence	✓✓✓	?	✓✓	-
Compatibility with EU freedoms (with adjustments)	✓✓✓	✓✓✓	✓✓	✓✓
Compatibility with existing directives	✓✓✓	✓✓✓	✓✓	✓✓

Demands

- Although the global tax deal is a huge milestone on the way to corporate tax justice, it is clear that progress cannot stop here. Concerning the minimum tax rate, AK demands a higher rate than 15% and the complete elimination of the substance-based carve-out.
- Concerning EU implementation, AK asks the EU Commission to consider alternatives to unanimity (like unilateral implementation or enhanced cooperation) to secure effective implementation. Given that the international agreement already is a compromise, no further watering down is to be accepted.
- The EU should use the common tax base that comes with the minimum tax to push unitary taxation with formular apportionment in the EU.
- To enhance the scope of the minimum tax and to increase its extra revenues, the EU should make use of the international agreement's flexibility and consider applying the Income Inclusion Rule to MNE below the turnover threshold of 750 million euro.
- To speed up EU implementation, the submission of the proposal for a Minimum Tax Directive in 2021 would be desirable.

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