Letter 36

International corporate taxation: A big step for fairness, a small step for revenue

"*Much Ado About Nothing"* Shakespeare

A minimum rate of 15% will be imposed on profits made abroad by multinationals and taxes on at least 20% of the profits made in the country of establishment for multinationals whose turnover exceeds $750 million and the net margin 10%. Such are, in two sentences, the axes of an international taxation reform of multinational companies. To summarize the good and the limits of this proposed corporate tax reform, intended by Joe Biden, approved by the G7, presented at the G20 in July and, hopefully, approved by the end of the year by 135 countries for possible implementation in 2022 or 2023, the title of Shakespeare's famous comedy, quoted in the opening, is appropriate.

Ironically, this reform, a revolution some would say, is led by Biden, a former senator from Delaware, the largest tax haven in the United States. But it is true, the evolution is dictated by the principle of "America first" and motivated by the size of the post-Covid budget deficit.

Nevertheless, while the reform is timely, implementation may not be imminent. If the desire for fairness - rebalancing of public finances for once to the detriment of societies and not to that of households, rebalancing to the advantage of large states in relation to tax havens, rebalancing to the detriment of low-taxed sectors such as the tech stocks - is affirmed, the outcome of this reform is such that the losses of both the two will probably be more modest than expected.

- ***A reform that is fourfold timely and dictated by a principle of fairness :***

This is a timely reform because the main principles of international tax rules date back to a century ago. At that time, income generated by the internationalization of corporations and non-material assets was hardly codified. Thus, over the last forty years, multinationals have had every opportunity to structure their international network, for example, to allocate high amounts of profits to intellectual property that is in tax friendly countries and can be easily moved if an opportunity arises.

This is a timely reform because if 30 years ago, the average corporate tax rate in the OECD was 40%, today it is 25%. Many were worried that this race to the bottom would continue, and it is good to put a stop to it. Corporate tax cuts seem even more unhelpful since cuts in recent years have not resulted in increased investment, but often in increased share buybacks or higher dividends. Trump's tax cut is emblematic in this regard.

This is a timely reform because, faced with the Covid crisis, states must look for additional revenue and are aware of the unpopularity of income tax increases. The United Kingdom, for example, was in the process of reducing this tax to 17%, but Boris Johnson wants to increase it to 25%. Biden has a target rate of 28% versus 21% today but, as the days go by, he seems to be on the verge of forgetting this reform as the Republican opposition is strong and some Democratic senators are reluctant.

This is a timely reform because never before have big businesses weighed so heavily in the world economy and, for many of them, taxation has never been so minimal. The capitalization of the world's top 50 companies represents more than 30% of global GDP compared to less than 5% in the early 1990s,

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but corporate tax revenues represent little more than 2 to 3% of GDP, far behind consumption taxes (VAT) and income taxes.

While the reform is timely, it also responds to the principles of fairness:

A principle of fairness because companies will be taxed where they do business and not in a tax haven of their choice.

A principle of fairness, because a minimum rate of 15% will be imposed on the profits of multinationals and the difference between the rate in force in the country and this 15% will be collected by the country of the parent company of the group.

A principle of fairness because, thanks to this reform, the tax optimisation carried out by large groups is being undermined.

A principle of fairness because Biden wants to focus on the effective rate and not just the face rate. What was the point of debating the corporate tax rate in the United States, 21% today, when the effective rate is less than 10% and when many of the large American companies escape federal tax?

A principle, however, easier to state than to implement because companies will have to calculate the effective profits in each country and then consolidate them.

- ***A quick implementation?***

An undeniable success, the major countries have agreed at the G7, but the obstacle course is still long: the assent of the American Congress is required, a consent of the G20 countries, in particular China, is necessary, a unanimous acceptance by the countries of the European Union is needed because it is a question of taxation and finally, the approval of the 135 countries of the OECD will probably be required in the fall.

While the principle is simple, the implementation is complex because many will look for loopholes. In three sectors - aviation, finance, and mining - some companies or countries, such as the United Kingdom for its financial sector, are seeking an exemption from Pillar 1, the minimum tax rate.

Finally, the agreement of the US Senate will be difficult to obtain because, in the eyes of many senators, the majority of the large companies affected by the implementation of this measure, especially digital companies, are American and therefore, the competitiveness of the American economy could be impacted. Normally, a simple majority should suffice, but a 2/3 majority could be required if there is an adjustment to the tax treaties.

- ***Losers?***

Intuitively everyone thinks of small states, tax havens and companies in the technology and pharmaceutical sectors, but what exactly is the case?

There is no doubt that such an agreement is a means of pressure from large states against the national sovereignty of the small states, and the latter deplore a diktat from the G7. As much as the minimum rate can be applied without their agreement, the taxation on a subsidiary in a specific country presupposes the approval of that country. Hungary (with a 9% rate) will want to benefit from exemptions and, as unanimity is required in tax matters in the EU, it will negotiate its support.

In order to compensate for real or supposed handicaps – small market size, unattractive geographical location, absence of industrial tradition, lack of raw materials – small states like to be able to leverage the fiscal lever as a factor of attractiveness.

Switzerland will hardly be affected because, according to the cantons, the tax rate is close to the 15% rate suggested by Biden and because it offers many other advantages such as the quality of infrastructure, its location in the heart of Europe, the high level of its workforce.... The victims of this reform could be those, such as the Bahamas, the Virgin Islands, the Baltic countries, the Emirates, which practice a zero or very low rate.

The second aspect of this tax reform is that companies with a turnover of more than 750 million and a profit margin of more than 10%, will have to pay taxes on at least 20% of the profits made in the countries where they are based. This is an additional source of revenue of around ten billion each year for the large countries and a loss of tax revenue for small countries where multinationals are headquartered, because these companies make the bulk of their sales and profits outside the country.

Ireland would be the biggest loser, ahead of Singapore, the Netherlands, the Caribbean, and Switzerland.

In Ireland, the nominal rate has been 12.5% since 1999 and the effective rate is close to 10%, but corporate tax accounts for almost 20% of the country's tax revenue. According to calculations by the Irish, the minimum tax sought by the Americans would cut corporate tax revenues by 20%, or a little over €2 billion. 8 of the 10 largest companies in Ireland are American, mainly in the tech and pharmaceutical sectors, and these top ten contributors account for half of the corporate tax revenue. Paradoxically, where tax unanimity had prevented any development within Europe, this time neither Ireland, nor Malta, nor Luxembourg will probably dare to oppose the American will, and the Netherlands has already approved it.

From a corporate perspective, technology and pharmaceutical groups will be the losers in the deal. Nevertheless, for the former, the abandonment of European tax measures against GAFA envisaged by France, the United Kingdom, Italy, and Spain, will provide compensation. Moreover, large companies will prefer the visibility of a minimum rate to the risk of trade wars and will be pleased to avoid the transatlantic tax war, which was once contemplated by Trump.

From a tax point of view, while the 15% rate satisfies many supporters of this tax reform, companies, such as Airbnb or Uber, showing losses, are not affected and Amazon, despite its position as a leader in e-commerce or its turnover of $386 billion, is not affected either because its operating margin , 6.2%, is below the tax threshold of 10%.

In addition, we still have to determine the basis for this reform, to examine the loopholes and to evaluate the exemptions: How will the research tax credit be dealt with? How will the dividends from subsidiaries be taxed?

Finally, although the 15% rate is attractive, in many countries, corporate tax is only a fraction of the taxes levies on companies. States, anxious to increase their tax attractiveness, may be able to reduce social contributions or production taxes.

- ***Winners?***

The large countries will have an advantage over the small ones because it is a question of taxing activity in a territory but, the figures on optimization differ. Zucman, a French professor at Berkeley and advisor to the American Democratic Party, has estimated that more than $600 billion in profits have been relocated to tax-friendly countries but, the OECD, who is more measured in its assessment, puts forward a figure of $240 billion.

Thus, according to the OECD, with the implementation of the reform, the annual revenues of the states would increase by $100 billion, and the European Union advances the figure of €50 billion in additional revenues.

Conclusion : "The world, poor in effects, is always magnificent in promises" Bossuet

Bossuet had warned; today, the reform has the merit of being initiated but there is still a long way to go before its implementation, probably not before 2023, and the imagination, always fertile in fiscal matters, will allow countries that consider themselves wronged to try to circumvent taxation by reducing the burden or providing subsidies.

In addition, the amounts recovered by the states will be minimal in relation to existing levies or needs and they will not solve the debt problem: insignificant revenues in relation to a public debt close to one time the world GDP, a negligible gain compared to the expected budget deficits and the financial needs of the states, a minimal amount compared to profits estimated at $6000 billion, a sum that is inevitably modest because the corporate tax in the OECD represents only 3% of GDP.

Should we be offended by the low tax revenue from corporate tax, or should we deplore the fact that there will be less competition between states, to the benefit of the most powerful among them? Should we welcome this redistribution to the detriment of shareholders and to the benefit of the greatest number of people or should we regret increased taxation by states on the wealth created by companies, which is the source of many jobs? It is up to each of us to make up our minds. Notwithstanding these remarks, these additional revenues can be invested in infrastructure and, this is the ambition of Joe Biden, who is eager to finance his plan. ***"I believe because I hope"*** as ***Léon Blum*** said, but the appreciation of the stock markets will not be questioned.

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