



# Draining Our Pockets

## How the global tax cartel could cost Britons billions

By Julian Morris

BRIEFING PAPER

### EXECUTIVE SUMMARY

- One-hundred and thirty six jurisdictions, including the United Kingdom, have agreed to negotiate two new treaties that would, if implemented, change how many large companies are taxed in the name of ‘tax fairness’.
- Pillar One would implement a special tax on profits above 10% for companies with an annual revenue of over €20 billion, thus changing the recipient country for some of the taxes on profits of the world’s largest multinational companies.
  - Pillar One was originally targeted at digital companies, however in the final design it will apply to all companies except regulated financial service companies.
- Pillar Two would introduce a global minimum tax of 15% on multinational companies with annual revenues of over €750 million.
  - The main purpose is to prevent jurisdictions from competing with one another by offering lower taxes in order to attract companies.
  - The measure is designed to require companies to pay a minimum level of corporate income tax where they domicile, to be achieved through companies paying “top up” amounts. This is contradictory with Pillar One which aims to require companies to pay tax where they operate.
- The minimum tax has been justified by claims that there is a ‘race to the bottom’ in tax rates. But, in fact, corporate tax revenues, as a proportion of GDP, have risen in recent decades along with lower rates. This includes in the UK where corporate tax revenues rose from about 2% of GDP in 2000 to over 2.5% in 2019, at the same time as the topline rate was reduced from 30% to 19%.
- Corporate taxes are the most harmful of major taxes to economic growth because they significantly reduce investment and entrepreneurial activity. The minimum tax would lock in a corporate tax rate, which economic theory suggests should be lower if not closer to zero.
- There is no guarantee that every country will implement a global minimum tax, including the United States if President Biden is unable to get Pillar Two through Congress. This would create advantages for some countries.
- The minimum global tax could be seriously detrimental to the United Kingdom because it would:
  - be incompatible with key UK Government policies, including the super-deduction, free ports and the patent box;
  - undermine national sovereignty by locking the UK into a model of corporate taxes and reduce future policy flexibility; and

- result in some UK companies relocating to jurisdictions that do not implement the minimum tax, leading to the loss of as much as £7 billion in annual tax revenues to HM Treasury.
- If the UK Government and OECD do not abandon the process but want to reduce the negative impact of the treaties, the following changes could be implemented:
  1. Set the global minimum effective tax rate in proportion to the current global average effective tax rate, and at a lower rate, such as 10% rather than 15%;
  2. Permit full expensing of capital in the global minimum tax rate to enable ‘super-deduction’ and freeports;
  3. Calculate the minimum tax at an entity level (‘global blending’ in OECD-speak) rather than at each jurisdiction; and
  4. Expand the definition of an excluded fund to cover all regulated entities such as private equity funds, insurance company funds, and unregulated (private) funds.

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*The remarks are the author's alone and should not be attributed to any organization with which he is affiliated.*

***“There is no art which one government sooner learns of another than that of draining money from the pockets of the people”***

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**— Adam Smith**

## **INTRODUCTION**

On Friday October 8<sup>th</sup> 2021, the Organisation for Economic Co-operation and Development (OECD) announced that 136 jurisdictions had agreed to negotiate two draft treaties that would, if concluded and implemented, change the way many large companies are taxed.<sup>1</sup> When the statement was originally issued in June, the prospective treaties were hailed as a victory for tax fairness. Britain’s Chancellor of the Exchequer, Rishi Sunak, asserted that they will ensure, “the right companies pay the right tax in the right places.”<sup>2</sup>

The two draft treaties, known as Pillar One and Pillar Two, are being treated as a package but they approach the issue of taxation from fundamentally different and, in some respects, mutually incompatible perspectives.<sup>3</sup> Pillar One would reappropriate the recipient country for some of the taxes on profits of the world’s largest multinational companies. Pillar Two would introduce a global minimum tax on multinational companies with annual revenues of over €750 million.

It is unlikely that these treaties would achieve what their proponents claim. Pillar Two especially has the potential to inflict considerable economic damage on the world economy in general and the United Kingdom (UK) economy in particular. While the train to finalise and implement these treaties is now firmly in motion, there is still time to change course.

This brief assesses the potential effects of Pillar Two both in general and on the UK in particular. It also suggests ways those effects might be ameliorated. It begins with a summary assessment of Pillars One and Two. It then asks whether there has actually been a “race to the bottom” as a result of jurisdictions competing to reduce rates of corporate income tax (CIT). It looks specifically at the effects of reductions in UK CIT rates over the past decade and asks whether the Chancellor made the right decision to keep rates at 19%. It then looks at the likely implications of other changes to the UK tax system, including changes to rules on expensing, and offers some insights regarding these changes to the UK system for changes to the global rules. It also compares the relative merits of different ways to calculate the global minimum tax. And it considers other changes that might reduce the negative effects of Pillar Two.

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<sup>1</sup> <https://www.oecd.org/tax/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm>

<sup>2</sup> <https://www.nytimes.com/2021/06/05/us/politics/g7-global-minimum-tax.html>

<sup>3</sup> See the statement: <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf>

The original justification for Pillar One was that the global tax system is not well-adapted to the digital economy. Specifically, it was argued that because digital companies often make sales from outside the jurisdiction of the end users, there is a mismatch between the jurisdictions in which services are supplied and those in which taxes on sales, value-added tax (VAT), and corporate income are charged.

Governments have already responded to this digitalisation by introducing changes to the way digital services are taxed. About 90 jurisdictions now require suppliers of such services to register for VAT or sales tax in the jurisdiction in which the services are supplied.<sup>4</sup> In addition, more than 25 jurisdictions have introduced “digital services taxes” (DSTs) or other direct taxes on revenue derived in those jurisdictions.<sup>5</sup> But the proliferation of such taxes has raised concerns, especially in the US, that digital services companies could end up being overtaxed.

The main solution being developed under the auspices of Pillar One is the introduction of a new taxing right that will apply to companies with annual revenue in excess of €20 billion and profits of at least 10%. The taxing right, which would presumably replace existing DSTs, would apportion 25% of “residual profits” (defined as profits in excess of 10% of revenue) of in-scope companies to jurisdictions in which those companies supply goods and services of at least €1 million (€250,000 for jurisdictions with GDP below €40 billion).

While, in general, Pillar One will apply to companies as a whole, it also contains a provision permitting it to be applied to major divisions. The rationale for this is quite simple: Amazon. Amazon has a profit margin of 6%, meaning that as a company it would not be in scope. However, its Amazon Web Services division has a profit margin of more than 10%, which would put it in-scope under the division rule.<sup>6</sup>

In principle, Pillar One could have applied to financial services companies and mining companies, many of which have annual revenue in excess of US\$20 billion. However, according to the statement of 8th October, regulated financial service companies are excluded (reportedly on the grounds that their sales in any jurisdiction are made through regulated local entities, so are presumed to pay the appropriate amount of tax in each jurisdiction in which they operate), as are “extractives” (i.e. companies involved in mineral extraction).<sup>7</sup> Other than these exemptions, the tax will apply to all large and profitable multinationals, not just digital companies as was originally envisaged by the proposals.

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<sup>4</sup> As of July 22, 26 countries have implemented digital services taxes and more than a dozen have either drafted legislation or announced plans for implementation. <https://tax.kpmg.us/content/dam/tax/en/pdfs/2021/digitalized-economy-taxation-developments-summary.pdf>

<sup>5</sup> *Ibid.*

<sup>6</sup> <https://www.ft.com/content/1b16c49d-b8fd-4eac-9ff1-d5e8b9510110>

<sup>7</sup> <https://www.reuters.com/world/uk/uk-wins-financial-services-carve-out-new-global-tax-rules-ft-2021-06-30/> ; <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf>

In spite of also having started life as part of an attempt to address the challenges of digitalisation, Pillar Two's main purpose is to prevent companies from shifting profits from high tax to low tax jurisdictions—and thereby reducing corporate income tax (CIT).

Most jurisdictions already have measures intended to discourage profit shifting. This includes “controlled foreign company” (CFC) rules, which specify the circumstances under which a headquarters' jurisdiction may tax the profits of subsidiaries in other jurisdictions. Numerous other rules have been developed largely to prevent companies from circumventing these CFC rules. For example, transfer pricing rules and related-party debt rules seek to prevent companies from shifting profits to lower tax jurisdictions by inflating the cost of intellectual property, goods, services, and debt provided by subsidiaries. Moreover, these rules have been beefed up over the course of the past decade as a result of the OECD's Inclusive Framework on Base Erosion and Profit Shifting.<sup>8</sup>

But many large corporations still manage to use various strategies to reduce their effective CIT rate on foreign-sourced income. Hence Pillar Two, which would introduce a minimum effective CIT rate of 15% for companies with annual revenue over €750 million (under the current proposal, the 15% minimum would be calculated on a country-by-country basis, i.e. a minimum of 15% would be payable in relation to each country in which the multinational company has operations). This Global Anti-Base Erosion (“GloBE”) tax would be enforced through two rules:

- **Top down:** Under the “income inclusion rule” (IIR), companies paying an effective CIT rate of less than 15% may be required to pay a “top up” amount in the headquarters' jurisdiction or, if the CIT rate in the headquarters' jurisdiction is less than 15%, subsidiary jurisdictions may impose such top-up taxes.
- **Bottom up:** Meanwhile, as a backstop to ensure companies domiciled in low-tax jurisdictions pay the 15% minimum, the “undertaxed payments rule” enables jurisdictions from which payments are made to a headquarter company to deny deductions and/or impose top-up taxes on those payments.

In addition to the GloBE tax rules, Pillar Two establishes a “subject to tax rule” (STTR) under which jurisdictions would impose a tax at a minimum 9% average stated tax rate on certain transactions between related parties. Transactions subject to tax under this rule would be those that otherwise would be covered by a tax treaty. In effect the STTR over-rides the tax treaty provisions to the extent that they reduce the tax levels below the 15% minimum. For example, this might catch royalty payments made to a subsidiary holding company in Luxembourg that benefits from a preferential tax rate on its subsidiaries in Belgium and the Netherlands, which would otherwise be taxed at less than 15% and not subject to a withholding tax under the tax treaties between those countries.

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<sup>8</sup> <https://www.oecd.org/tax/beps/beps-actions/>

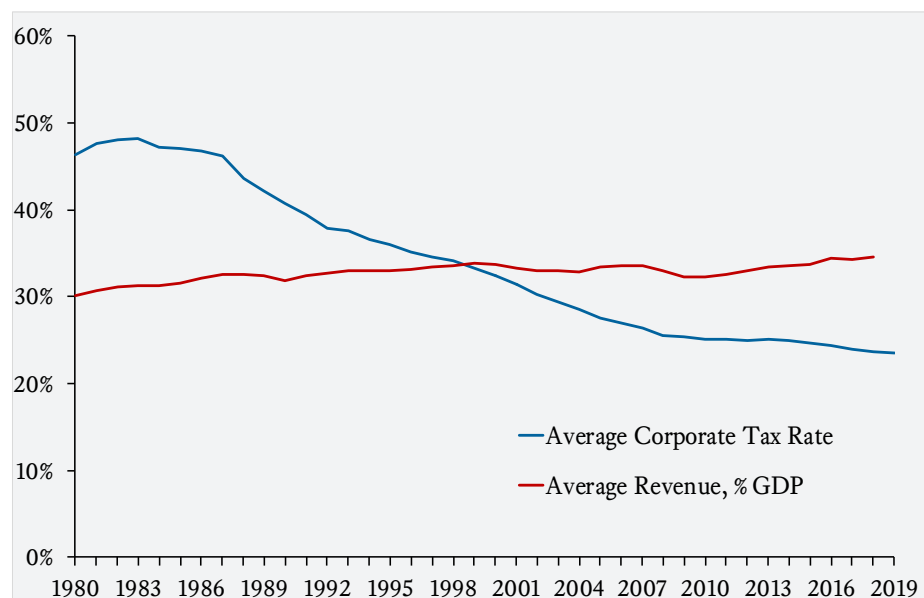
The premise of Pillar Two is that companies should pay minimum levels of corporate income tax wherever they have a domicile regardless of the amount of goods and services they supply in those domiciles. If that sounds contrary to the aims of Pillar One, that is because it is. It is also contrary to the rules on economic substance that were developed as part of the OECD’s BEPS Actions — even though Pillars One and Two were negotiated as an extension of BEPS Action One.<sup>9</sup> And it would seem, *prima facie*, to be contrary to Sunak’s assertion that “the right companies pay the right tax in the right places.” Pillar Two, in its present form, is essentially an attempt to cling onto an outmoded, inefficient and harmful form of corporate taxation by setting a minimum bound on tax competition.

### DOES TAX COMPETITION LEAD TO A RACE TO THE BOTTOM?

Some of the proponents of a global minimum CIT, such as United States Treasury Secretary Janet Yellen, have claimed that jurisdictions have been competing to reduce CIT, resulting in a “race to the bottom” that has eroded the tax base, making it more difficult to supply needed government services.<sup>10</sup> But has there really been such a “race to the bottom”?

Figure 1 shows that since 1980 headline CIT rates in the OECD have fallen from an (unweighted) average of over 45% to below 25%. Over the same period, government revenue as a proportion of GDP has risen from about 30% to about 35%. Clearly, the decline in CIT rates has not led to a fall in government revenue. It should be noted, however, that effective tax rates have not declined by as much, in part due to an expansion of the tax base and in part due to a reduction in deductions.<sup>11</sup>

**FIGURE 1: CORPORATION TAX AND GOVERNMENT REVENUE, OECD**



Source: OECD

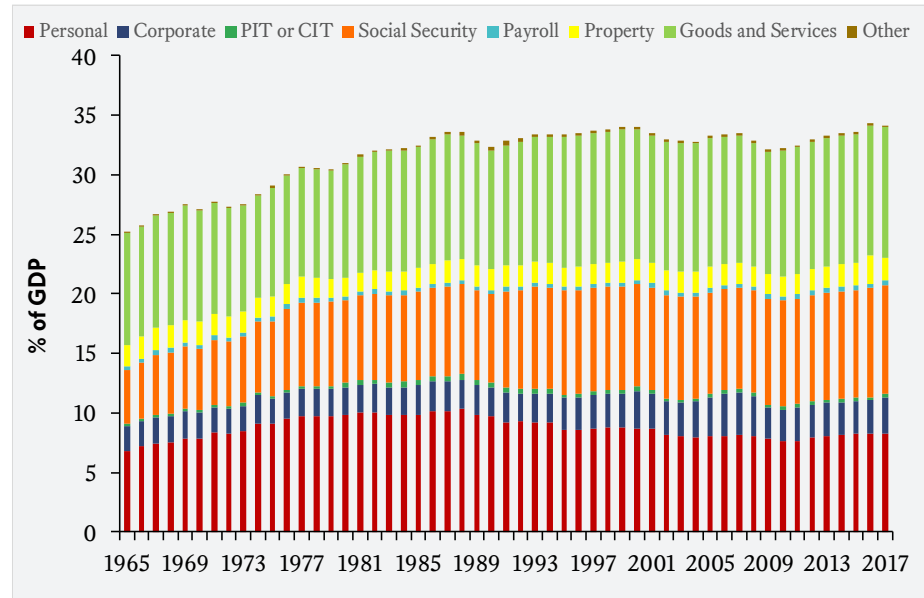
<sup>9</sup> <https://www.oecd.org/ctp/BEPS-FAQsEnglish.pdf>

<sup>10</sup> <https://www.bbc.com/news/business-56500673>

<sup>11</sup> <https://files.taxfoundation.org/legacy/docs/SR214.pdf>

Meanwhile, as Figure 2 shows, looking over a longer period — from 1965 to 2017, government revenue has risen considerably and CIT as a proportion of GDP has also risen.

**FIGURE 2: GOVERNMENT REVENUE, % OF GDP, OECD AVERAGE, BY SOURCE**



Source: OECD

Practically any way one looks at it, therefore, the decline in CIT rates in the OECD has not resulted in a “race to the bottom.”

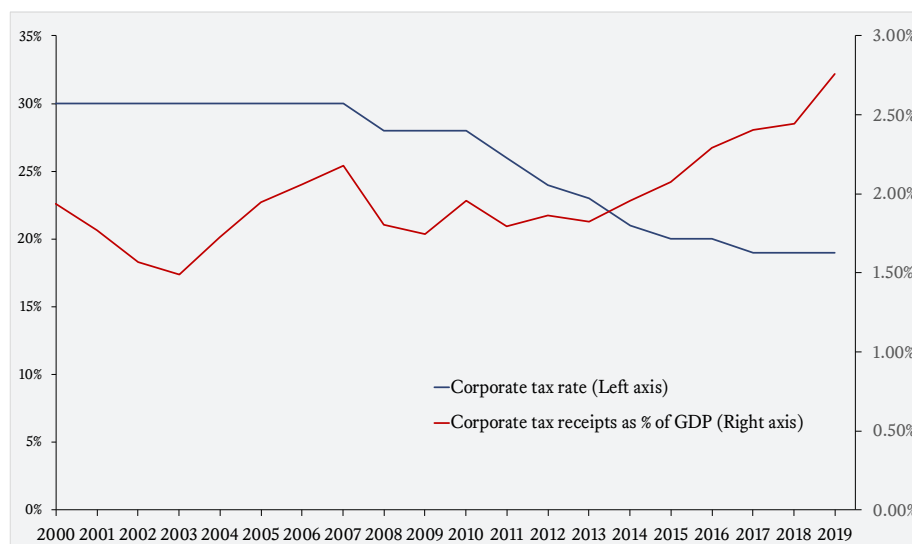
## THE EFFECT OF REDUCING CIT RATES IN THE UK

The UK’s experience with reducing CIT is also instructive. In 2000, the UK’s headline CIT rate was 30%. Starting in 2007, successive UK governments gradually lowered it to the current rate of 19%. In 2013, HMRC and the Treasury estimated that reducing the headline rate of CIT from 28% in 2010 to 20% in 2015-16 would increase investment by between 2.5% and 4.5%, leading to an increase in GDP of between 0.6% and 0.8%, and an increase in average household income of between £405 and £515.<sup>12</sup> Meanwhile, the increase in profits, wages and income would have the effect of generating additional tax revenue that would offset between 45% and 60% of the losses from the reduced rate of corporate tax.

As it turned out, the reduction in corporate income tax rates in the UK since 2010 has coincided with an *increase* in revenue from CIT, not a reduction — as can be seen in Figure 3. Moreover, this increase appears to have accelerated after the rate fell below 21%.

<sup>12</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/263560/4069\\_CT\\_Dynamic\\_effects\\_paper\\_20130312\\_IW\\_v2.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/263560/4069_CT_Dynamic_effects_paper_20130312_IW_v2.pdf)





*Source: HMRC and ONS. Note: receipts are total onshore receipts (i.e. excluding receipts from offshore oil and gas production) and excluding the bank levy.*

### GETTING THE INVESTMENT INCENTIVES RIGHT

More generally, the strong economic evidence suggests that CIT reduces incentives to invest. In 2008, a team of economists led by world-renowned economist and former Deputy Prime Minister and Minister of Finance of Bulgaria, Simeon Djankov, worked with PWC to investigate the effect of corporate taxes on the same standardized mid-size business in 85 different countries. After accounting for myriad other factors, the authors found that:

“The effective corporate tax rate has a large adverse impact on aggregate investment, FDI, and entrepreneurial activity. For example, a 10 percent increase in the effective corporate tax rate reduces aggregate investment to GDP ratio by 2 percentage points. Corporate tax rates are also negatively correlated with growth, and positively correlated with the size of the informal economy.”<sup>13</sup>

Another 2008 study, this one undertaken by a group of OECD economists, analysed the effect of different types of tax and found that:

“Corporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes. Recurrent taxes on immovable property appear to have the least impact. A revenue neutral growth-oriented tax reform would, therefore, be to shift part of the revenue base from income taxes to less distortive taxes such as recurrent taxes on immovable property or consumption.”<sup>14</sup>

<sup>13</sup> <https://www.aeaweb.org/articles?id=10.1257/mac.2.3.31>

<sup>14</sup> [https://www.oecd-ilibrary.org/economics/taxation-and-economic-growth\\_241216205486](https://www.oecd-ilibrary.org/economics/taxation-and-economic-growth_241216205486)

A recent study published in the *Journal of Accounting and Economics* constructed, “an alternative tax rate measure that aggregates cash effective tax rates of listed firms, which reflect not only statutory tax rates, but also other features of the tax code, enforcement, and firm’s tax planning.”<sup>15</sup> Using that alternative measure, the study found, “a strong robust negative relation between country-level effective tax rates and future macroeconomic growth.”

These and other similar studies suggest that lowering the effective rate of corporate income tax results in increased investment, entrepreneurial activity, and ultimately economic growth. For example, a widely cited 2010 study co-authored by Christina Romer, who chaired President Obama’s Council of Economic Advisors, evaluated the effects of all major tax changes in the U.S. made after WWII and found that a tax cut of 1% of GDP increased GDP by between 2.5% and 3% — and that between 45% and 90% of corporate tax cuts were self-financing.<sup>16</sup> Similarly, a recent study of the macroeconomic effects of tax changes in the EU found that a tax cut of 1% of GDP results in a cumulative increase in GDP over 5 years of approximately 2% when the tax is unanticipated and approximately 0.66% when the tax is anticipated.<sup>17</sup>

Meanwhile, empirical analysis of the effects of changes to the *structure* of taxation show that increases in consumption taxes and VAT have a less detrimental effect on growth than increases in CIT, as does the broadening of the tax base through the removal of tax deductions and incentives.<sup>18</sup> The clear implication of these studies is that corporate taxes should be as low as possible, if not zero, while revenue should be raised with less economically damaging taxes on land and consumption.

These studies suggest that over the past 40 years, the reduction in CIT rates in OECD countries and concomitant shift in the tax base towards less harmful forms of taxation, such as VAT, has stimulated economic growth which in turn has enabled governments to increase revenue in ways that are less economically harmful. In other words, the decline in CIT rates in the OECD has not resulted in a “race to the bottom”. *Au contraire*, from an economic perspective, it has resulted in a race to the top as countries compete to have *better* systems of taxation.

## **IS THE UK GOING IN THE WRONG DIRECTION ON CORPORATION TAXES?**

All of which raises questions regarding the Chancellor’s recent decisions regarding UK CIT rates. These were set to continue down to 17% in April 2020. Then COVID-19 hit. Instead of sticking to the planned reduction in CIT rates, Rishi Su-

<sup>15</sup> <https://www.sciencedirect.com/science/article/abs/pii/S0165410119300205>

<sup>16</sup> <https://www.aeaweb.org/articles?id=10.1257/aer.100.3.763>

<sup>17</sup> <https://www.sciencedirect.com/science/article/pii/S0264999319308296?via%3Dihub>

<sup>18</sup> <https://www.imf.org/en/Publications/WP/Issues/2018/09/28/Macroeconomic-Effects-of-Tax-Rate-and-Base-Changes-Evidence-from-Fiscal-Consolidations-46250>

nak announced that they would remain at 19% for the 2020 year.<sup>19</sup> And in the 2021 budget, he announced that CIT rates would increase to 25% in 2023 (for businesses with profits over £250,000).<sup>20</sup>

In announcing planned increases in CIT rates, Sunak is implicitly accepting a reduction in investment and economic growth. Furthermore, the wisdom of announcing a tax increase years in advance, before the full economic and revenue implications of the pandemic are known and scaring off forward-investment, is unclear. In the long-term, the higher corporate tax rate is likely also to lead to less government revenue, making it harder to pay back the debts incurred during the COVID-19 pandemic.

Sunak sweetened the pill by temporarily adopting the “super-deduction” of up to 130% of investments in “main pool” assets (i.e. most plant and machinery).<sup>21</sup> The expansion of deductions has been referred to by the Adam Smith Institute as abolition of the Factory Tax.<sup>22</sup> However, the super-deduction does not apply to all investments and it will only apply from 1 April 2021 to 31 March 2023. It is, nevertheless, good news for the UK economy in the short term, as it will almost certainly increase investment and growth over the next two years.<sup>23</sup> Come 2023, though, the removal of the super-deduction combined with a higher tax rate could lead to a dramatic decline in investment.

Another sweetener announced by Sunak was the introduction of eight freeports. Among other benefits, firms operating in these freeports will be able to expense in full all main pool assets until 2026.<sup>24</sup>

But the UK could have done much better in boosting investment. Modelling by the Tax Foundation finds that if the UK instead immediately increased CIT to 25% but also permitted full expensing indefinitely, it would lead to more investment than the whiplash policy currently on the table.<sup>25</sup> And, by extension, keeping the CIT at 19% and permitting full expensing would lead to even more investment and more sustainable growth.

Britain could maximise investment and economic growth by continuing to lower CIT rates, or at least not raise them. Now that it is out of the EU, it has an opportunity to become the world’s leading investment hub. The best way to do that might be to eliminate CIT altogether. That would enable the entire finance industry to become tax neutral. But barring that unlikely eventuality, the UK could at least lower its CIT rates to 10% or thereabouts and introduce fully tax-exempt structures (as

<sup>19</sup> <https://www.gov.uk/government/publications/rates-and-allowances-corporation-tax/rates-and-allowances-corporation-tax>

<sup>20</sup> <https://www.gov.uk/government/speeches/budget-speech-2021>

<sup>21</sup> <https://www.gov.uk/work-out-capital-allowances/rates-and-pools>

<sup>22</sup> <https://www.adamsmith.org/research/abolishing-the-factory-tax>

<sup>23</sup> <https://home.kpmg/uk/en/home/insights/2021/03/tmd-splash-out-to-help-out.html>

<sup>24</sup> <https://home.kpmg/uk/en/home/insights/2021/03/tmd-fb-freeport-tax-sites-enhanced-capital-allowances.html>

<sup>25</sup> <https://taxfoundation.org/2021-uk-budget-tax-proposals/>

was proposed by the Treasury last year).<sup>26</sup> A commitment to Pillar Two, however, would make this impossible.

## A BITTER PILLAR TWO TO SWALLOW

And here's the rub: full expensing, and almost certainly the 'super-deduction', is likely incompatible with the global minimum tax under Pillar Two, at least as it is currently envisaged. That's because, according to the 8th October statement, expensing is permitted only on the basis of "a formulaic substance carve-out that will exclude an amount of income that is at least 5% of the carrying value of tangible assets and payroll. In a transition period of 10 years, the amount of income excluded will be 8% of the carrying value of tangible assets and 10% of payroll, declining annually by 0.2 percentage points for the first five years, and by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years."<sup>27</sup> Translated into English that means in the first year companies can expense at least 8% of the current value of assets, such as buildings and equipment, and 10% of payroll. And the amount that can be expensed declines over time reaching 5% after 10 years. Importantly, companies can't expense intangibles such as intellectual property. So, no full expensing of investments in R&D or licenses.

It is perhaps not surprising that Ireland (with its 12.5% CIT rate, attractive IP box and other incentive programs<sup>28</sup>), Hungary (which has a flat CIT rate of 9%<sup>29</sup>), and Estonia (which exempts most undistributed profits from income tax and applies a CIT of 14% to enterprises that pay a regular dividend<sup>30</sup>), initially refused to sign up to the July statement. Their subsequent capitulation followed a combination of aggressive pressure from the US and changes in terms.<sup>31</sup> Even so, agreeing to the statement is not the same as signing up to the treaty, let alone implementing it.

But, ironically, two of the Chancellor's signature initiatives — the "super-deduction" and freeports — could end up being adversely affected by the global minimum tax. Of course, this rather depends on the timeframe for the introduction of the tax. But if it is implemented by 2023, as has been proposed, it would likely put off investors that meet the criterion for inclusion (i.e. global income of at least €750 million) from investing in freeports. Additionally, if the 'super-deduction' is determined to be a successful policy in boosting investment it would be impossible to extend beyond 2023 or to be brought back at a later date.

It is not just full expensing that would be affected. The UK also incentivises investments in intellectual property through its patent box, under which companies pay a

<sup>26</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/871767/200227\\_M8580\\_Condoc\\_Asset\\_Holding\\_Companies\\_Final\\_Condoc.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/871767/200227_M8580_Condoc_Asset_Holding_Companies_Final_Condoc.pdf)

<sup>27</sup> <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf>

<sup>28</sup> <https://taxsummaries.pwc.com/ireland/corporate/tax-credits-and-incentives>

<sup>29</sup> <https://taxsummaries.pwc.com/hungary/corporate/taxes-on-corporate-income>

<sup>30</sup> <https://taxsummaries.pwc.com/estonia/corporate/taxes-on-corporate-income>

<sup>31</sup> <https://www.nytimes.com/2021/10/08/business/oecd-global-minimum-tax.html>

tax of only 10% on profits deriving from eligible IP.<sup>32</sup> There is currently no carve-out planned for IP in Pillar Two, so UK-domiciled firms that are highly dependent on patents and would otherwise pay an effective tax rate of close to 10% (perhaps less given other deductions), would see that rate rise to 15%. That might make patent boxes in jurisdictions that do not implement the global minimum tax look quite attractive to MNCs currently domiciled in the UK.

This highlights what may be the greatest risks the UK faces, namely the potential for UK firms to redomicile to jurisdictions that offer more favorable tax regimes and don't implement the minimum tax. In the early part of the last decade, the UK was chosen as a domicile for several such "inversions" of US firms, no doubt in large part due to its lower CIT rate — and commitment to keep lowering it. But at the same time, a few UK firms redomiciled to Ireland.<sup>33</sup> Given the proximity of the Emerald Isle and the similarity of its laws and culture, Ireland would be a natural destination for UK firms.

It would be ironic if firms were to move out of the UK not because of Brexit but because the government gave up its newfound sovereignty in favour of a tax hegemony led by bureaucrats in Paris. Perhaps, instead, Sunak should take a leaf out of then-Chancellor Alistair Darling's book, who said in response to the problems businesses were facing in the wake of the financial crisis:

“Small and medium-sized firms are the engine of our economy. They make up the vast majority of businesses and employ around 60 per cent. of the private sector work force. They also face continuing difficulties with cash flow and credit. I know that many profitable businesses are concerned that those twin problems threaten their future, and I want to help them. So, my objectives today for businesses are threefold: first, to help equip them for the challenges of the future; secondly, to improve access to credit and ease cash flow; and thirdly, to reduce burdens on them at this difficult time. I will maintain a focus on the long-term competitiveness of the UK, to increase our attractiveness as a base for global businesses. **To do so, I will introduce an exemption for foreign dividends in 2009 for large and medium businesses, and improve our rules for taxing controlled foreign companies.**”<sup>34</sup> [emphasis added]

While Darling did undertake some modest reforms to the UK's CFC rules, the UK carried out more substantial reforms in 2012, moving it closer to a territorial system. Under the new rules, the UK applies taxes on subsidiaries on the basis of a number of tests. Of particular importance, taxes are in general payable in the UK on the profits of subsidiaries (on the basis of the profits of the overall entity) only if those subsidiaries are domiciled in a jurisdiction that has a headline CIT rate less

<sup>32</sup> <https://www.gov.uk/guidance/corporation-tax-the-patent-box>

<sup>33</sup> <https://www.wsj.com/articles/in-inversion-tax-deals-u-k-is-a-winner-1406551914>

<sup>34</sup> <https://hansard.parliament.uk/Commons/2008-11-24/debates/081124600002/Pre-BudgetReport>

than 75% that of the UK, or if profits in subsidiaries are artificially diverted from the UK.

## **AVOIDING ADVERSE SELECTION AND LOCK-IN TO A HARMFUL GLOBAL MINIMUM TAX: LESSONS FROM THE UK**

The UK has already introduced, through its CFC rules, a minimum tax of 14.25% (i.e. 75% of 19%). But it has done so at the level of the entity, enabling corporations to offset profits and losses across subsidiaries in different jurisdictions. If the UK raises its CIT to 25%, the minimum will rise to 18.75%. But if the UK reduces its corporation tax to 17%, the minimum tax would fall to 12.75%. These facts are significant, as they highlight dangers inherent in Pillar Two as it is currently envisaged.

By fixing the global minimum tax at 15%, the OECD (acting in the name of the 136 jurisdictions that notionally signed the global minimum tax agreement) is presumptively asserting that the optimal CIT rate is at least 15%. But as noted above, the economic evidence — including that from the OECD itself — suggests that the optimal CIT rate is much lower (and may actually be zero). So, locking the world into what is almost certainly a suboptimal minimum CIT rate seems like a very bad idea. Worse, numerous jurisdictions have already declared that they would like to see the minimum tax rise over time. Meanwhile, some lower-tax jurisdictions may not join the minimum tax. So, there is a serious risk of adverse selection, with higher tax jurisdictions gradually driving the minimum CIT higher and lower tax jurisdictions not ratifying or leaving the system. The risk of this materialising is magnified by the non-democratic manner in which decisions are made in intergovernmental forums such as the OECD and the so-called “Inclusive Framework” (the group of 140 jurisdictions that signed on to the BEPS Actions), whereby larger, higher-tax jurisdictions such as the US are able to dominate by offering sticks and carrots to smaller, lower tax jurisdictions. It seems strange for the UK to allow a domestic policy issue such as the optimal tax rate to be determined in a global forum.

### ***Recommendation 1: Set the global minimum effective tax rate in proportion to the current global average effective tax rate, such as 10% rather than 15%***

One way to overcome or even reverse this adverse selection would be to apply a similar rule to the one the UK currently applies, namely to set the global minimum effective tax rate *in proportion to* the current global average effective tax rate. For 2019, the average effective tax rate of the 73 jurisdictions for which data is available was 20.3%. So, if the global minimum effective CIT were set at 50% of the average effective CIT rate, that would mean a current rate of just over 10%. This would encourage all jurisdictions with effective CIT rates of 10% or more to ratify the global minimum tax agreement. And if jurisdictions continue to lower their rates, the global minimum would continue to fall.

Second, rather than limiting deductions to the current, narrow, formulaic substance-based carve-out, the OECD could permit full expensing of capital. That would enable the UK to implement full expensing with confidence.

**Recommendation 3: Calculate the minimum tax at an entity rather than jurisdiction basis, known as ‘global blending’**

Third (and perhaps most practicable, since it has already been considered by the OECD), the adverse effect on investment and growth of the global minimum tax could be reduced considerably by calculating the effective tax rate using an approach similar to the UK’s, namely at the entity level, rather than on a jurisdiction-by-jurisdiction basis. Such an approach, known as “global blending,” was evaluated by Michael Devereux and colleagues at the University of Oxford, who concluded that compared with the jurisdiction-by-jurisdiction approach envisaged in the 8th October statement it would not raise the cost of capital by as much, so would have a less negative effect on investment and would be less detrimental to economic growth.<sup>35</sup>

## **HOW MIGHT GOVERNMENTS AND BUSINESSES RESPOND?**

There has been a lack of consideration about how governments and companies could respond to Pillars One and (especially) Two. Companies and governments will respond differently under global blending than under jurisdictional blending. For example, the following are *likely* responses to Pillar Two — but are *considerably more likely under jurisdictional than under global blending*:

- Some MNEs will move their headquarters from higher- to lower-tax jurisdictions to reduce their total tax burden, depriving those higher-tax jurisdictions of the top-up tax.
- Some lower-tax jurisdictions will raise their tax levels (at least for within-scope MNEs) to the GloBE minimum, in order to capture the tax that would otherwise be paid in the jurisdiction of the headquarters. That means higher-tax jurisdictions are unlikely to see much additional revenue from the global minimum. (This is rather unlikely under global blending but seems a highly likely outcome under jurisdictional blending.)
- New taxes imposed in other jurisdictions in line with GloBE could result in additional domestic tax deductions, thereby reducing domestic tax revenue in Ultimate Parent Entity (UPE) jurisdictions.

Based on all the above, global blending might seem like the obviously better policy. In addition, the US currently applies global blending to determine the effective tax rate of corporations paying the minimum tax on some overseas-derived corporate income under the Global Intangible Low-Taxed Income (GILTI) rule (part of the

<sup>35</sup> [https://www.sbs.ox.ac.uk/sites/default/files/2020-02/OECD\\_GloBE\\_proposal\\_report.pdf](https://www.sbs.ox.ac.uk/sites/default/files/2020-02/OECD_GloBE_proposal_report.pdf)



2017 Tax Cuts and Jobs Act). As such, until this year there was some expectation that in order to bring the US on board, Pillar Two would adopt a global blending approach. (The UK also applies a version of global blending under its current CFC rules, so it might have been expected to have been more supportive of global blending too.)

But the obviously better policy is often not the politically expedient policy. In the OECD's Blueprint for Pillar Two released last year, the focus was firmly on jurisdictional blending, suggesting that it has been the favoured option for some powerful vested interests (likely including France, Germany and Italy) for some time.<sup>36</sup> Meanwhile, in his America Jobs Plan Act, President Biden is seeking to change the blending rule in GILTI from global to jurisdictional. And Biden pushed hard for the G7/G20/Inclusive Framework countries to adopt jurisdictional blending. In June, the G7 Finance Ministers stated that they had agreed on a "jurisdiction-by-jurisdiction" approach (i.e. jurisdictional blending) and this was adopted by the G20 and 130 members of the OECD Inclusive Framework in the Statement of 1<sup>st</sup> July.<sup>37</sup>

## WILD CARDS

While it would appear that global blending is thus off the table, this might change if Biden is unable to get his amendments to GILTI through Congress, since the US could then not implement Pillar Two if it were based on a jurisdictionally blending. And if the US does not implement Pillar Two, then US firms would be at a substantial advantage relative to firms based in other high-tax jurisdictions, so either the entire agreement could fall apart or there would be substantial pressure to shift to jurisdictional blending in order to get the US on board.<sup>38</sup>

Another wild card is the EU. While large, high-tax EU members have been among the strongest proponents of a global minimum CIT, smaller, lower-tax jurisdictions within the Union have previously been vehemently opposed. As noted, Ireland, Hungary, and Estonia initially refused to sign the 1<sup>st</sup> July statement. Meanwhile Cyprus, which has a CIT of 12.5% but which is not a member of the OECD Inclusive Framework, has also expressed opposition.<sup>39</sup> This should worry proponents of a minimum tax because under settled EU law, Pillar Two could be construed as a violation of two of the EU's constitutionally protected fundamental freedoms: the freedom of establishment and free movement of capital.<sup>40</sup> As such, for *any* EU

<sup>36</sup> <https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en.htm>

<sup>37</sup> <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf>

<sup>38</sup> The 8th October statement observes, "It is agreed that Pillar Two will apply a minimum rate on a jurisdictional basis. In that context, consideration will be given to the conditions under which the US GILTI regime will co-exist with the GloBE rules, to ensure a level playing field." Make of that what you will.

<sup>39</sup> Cyprus initially said it would block EU adoption (<https://www.theguardian.com/politics/2021/jun/03/cyprus-block-eu-adoption-joe-biden-minimum-corporate-tax-multinationals>) but seems to have softened its line recently (<https://www.pio.gov.cy/en/press-releases-article.html?id=23247#flat>).

<sup>40</sup> Case C-196/04 Cadbury Schweppes v Commissioners of the Inland Revenue. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=eli%3AECLI%3AEU%3AC%3A2006%3A544>



jurisdiction to apply Pillar Two to another EU member state would require at-minimum a new Directive and possibly an amendment to the constitution. In either case, unanimity would be required.

But even if EU member states are not permitted to apply Pillar Two to one another, they might still be able to apply it to third countries. As such, the agreement could lead to the perverse result that top-up taxes are imposed on EU-domiciled companies' subsidiaries in low-tax third countries but not on their subsidiaries in low-tax EU states. If that were the case, it is likely that at least some of those subsidiaries currently in the UK would move their domicile to low-tax EU member states.

## **SOME FUNDS MIGHT GET CAUGHT BY GLOBE**

Pillar Two might also, perversely, lead to a substantial increase in double taxation — which is clearly contrary to the claim that it taxes the right companies in the right places. The Blueprint explicitly states:

“The need to preserve the tax neutrality in respect of investment funds is a widely recognized principle that underpins the design of the international tax rules. ... The neutrality of funds is a specific and generally supported tax policy rationale, which would be undermined if the GloBE rules were applied to the income of the fund resulting in an otherwise tax neutral investment vehicle being subject to an additional layer of taxation under the laws of another state. Given this approach is already widely adopted in domestic taxation systems, an exclusion for investment funds from the GloBE rules also does not provide a competitive advantage or create economic distortions. It is therefore appropriate to preserve the tax neutrality policy, by ensuring that fund vehicles are not exposed to the GloBE rules”.<sup>41</sup>

Unfortunately, the definition of “investment fund” in the Blueprint may be too narrow to cover many funds that should be treated as tax neutral. Specifically, the Blueprint includes in its definition the condition that “the fund, or the management of the fund, is subject to the regulatory regime for investment funds in the jurisdiction in which it is established or managed (including appropriate anti-money laundering and investor protection regulation)”. In addition, “The definition also includes any entity or arrangement that is wholly-owned or almost exclusively owned, directly or indirectly, by one or more Investment Funds or other Excluded Entity and that does not carry on a trade or business but is established and operated exclusively or almost exclusively to hold assets or invest funds for the benefit of such Investment Funds or other Excluded Entity”.

<sup>41</sup> OECD/G20 Base Erosion and Profit Shifting Project Tax Challenges Arising from Digitalisation – Report

on Pillar Two Blueprint, Paris: OECD, 2020, at p. 34. <https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en.htm>

While this definition may be broader than some that could have been adopted, it is still too narrow. Among other things, it does not explicitly include unregulated funds. Meanwhile, funds that consolidate with investors and/or lower-tier entities and meet the revenue threshold could be deemed to be MNEs within the scope of the GloBE rules.

***Recommendation 4: Expand the definition of an excluded fund to cover all regulated entities such as private equity funds, insurance company funds, and unregulated (private) funds***

As such, some holdco funds, private equity funds, insurance company funds, and unregulated (private) funds might be deemed to be within the scope of GloBE. This could lead to serious distortions. The best solution would be to expand the definition of an excluded fund to cover all these entities. If that is not done, some fund holders would likely develop workarounds to avoid double taxation. But for those that are unable to use such workarounds, the cost could be large. Given the large number of funds managed from the UK, especially in London and Edinburgh, the failure to exclude all funds could have a significant adverse effect on those cities.

## **NEGATIVE EFFECT ON UK TAX REVENUE**

A recent study by economists in Italy's Ministry of Finance evaluated the extent of profit shifting around the world. Using confidential data supplied to tax authorities from companies with annual revenue in excess of €750 million (who under OECD rules are required to report profits and tax payments on a country-by-country basis), the economists found that about €43 billion in net profits were shifted to the UK in 2017.<sup>42</sup> At an effective tax rate of 18.9% that amounts to nearly £7 billion in taxes.

If the UK were to implement a global minimum tax, it is likely that at least some of those profits would be shifted elsewhere, with detrimental effects on the UK economy and government revenue. Indeed, if the above-mentioned study is accurate, Britons could lose tens of billions of pounds of business, which would adversely affect employment and income. In addition, Government revenue might fall by as much as £7 billion.

## **CONCLUSION: IS THERE AN ALTERNATIVE?**

The Statement of 8th October now has 136 "signatories".<sup>43</sup> But what have they actually signed up to? While the UK, US, G7, G20 and OECD all issued statements asserting the historic significance of the decisions made at various points in June,

<sup>42</sup> <https://www.finanze.gov.it/export/sites/finanze/.galleries/Documenti/Varie/Assessing-profit-shifting-using-Country-by-Country-Reports-Bratta-Santomartino-Acciarri-2021-19-02.pdf>

<sup>43</sup> <https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-members-joining-statement-on-two-pillar-solution-to-address-tax-challenges-arising-from-digitalisation-october-2021.pdf>

July, and October, the reality is that much of the substance of the two treaties has yet to be developed. And some of the substance that has been agreed was met with such disapproval by several key jurisdictions that they initially refused to sign up.

There are ways to limit the harms imposed by Pillar Two, as noted above, including by: using a global blending method for calculating the effective tax rate; reducing the level of the minimum tax (and introducing a mechanism that prevents it from being ratcheted up); and allowing a much broader range of deductions. But such limits on the harms are unlikely to transform Pillar Two into a net economically beneficial proposition. Given the scale of the undertaking, that is troubling: why are so many governments investing so much effort in a change to the tax system that makes the world, on net, economically worse off?

Now the UK is no longer bound by the EU's rules regarding freedom of establishment and free movement of capital, it is free to enact stricter CFC rules. It could tackle subsidiaries in low-tax jurisdictions. There's really nothing stopping it, except that doing so would probably be counterproductive. Signing a global agreement on a minimum tax doesn't change that reality.

There might be a role for a new international agreement on taxation, but Pillars One and Two as currently constituted are not it.