ICRICT

Independent Commission for the Reform of International Corporate Taxation

ICRICT EVALUATION OF THE OECD/G20 TWO-PILLAR SOLUTION – June 2024

Tax avoidance by multinationals and ICRICT solutions

The current international tax system is broken and skewed towards the richest and most powerful of our societies. This system fosters and perpetuates inequality, not only between countries, but within countries. It does so by allowing tax havens to exist. Tax havens enable the richest in our societies to hide their wealth using highly opaque financial services. Tax havens also are the favored location for booking the profits of the largest and most powerful multinationals in the world. The current system of taxing multinational corporations' global profits based on transfer pricing is outdated and unfair, enabling systemic tax avoidance by large multinational corporations which deprives both developed and developing countries of resources to invest in public services.

The only simple and effective way to prevent this, is to tax MNEs in accordance with the economic reality in which they operate: that is, as unitary enterprises under common ownership and control, and to apportion their total global profits in proportion to their real activities for taxation in each country. To put an end to MNEs' tax avoidance, as an independent Commission we have urged governments to move away from the existing transfer pricing system towards a unitary approach to taxation of multinationals ("MNEs"), based on a system whereby taxable profits would be apportioned to countries based on a formula , together with a global effective minimum tax on a country-by-country basis of 25%. There could be different formulae for such allocation of profits across different sectors (in terms of choice and weight of factors like sales, employment, capital and use of local natural resources) to recognise the principle that different supply and demand factors interact in creating MNEs' global profits.

The Two-Pillar solution

Recognition of widespread and continued tax avoidance by MNEs led G20 leaders in 2013 to ask the OECD to come up with a solution to stop—or at least reduce—this. After years of negotiations, in October 2021, the OECD/G20 Inclusive Framework on BEPS delivered a “Two-Pillar Solution”, which included both the ideas of unitary taxation of MNEs and a global minimum tax.[1]

Pillar One aims to directly curb profit-shifting by introducing a unitary approach to allocating MNE profits to market countries for taxation. Pillar Two seeks to limit the incentives for profit shifting, by introducing a minimum effective tax rate for MNEs’ profits, regardless of where they are declared.

However, Pillar One applies only to the biggest and most profitable MNEs (those with global turnover of at least \$20 billion and a profit margin of at least 10%) and re-allocates 25% of the “residual profit” (i.e. the profit above the 10% margin) to the countries where they sell their products and provide their services and where their consumers are.

Under Pillar Two, a much larger group of MNEs (any company with over EUR 750 million of annual revenue) would now be subject to a global minimum corporate tax of 15%. With the new rules, companies showing their profits in a jurisdiction with an effective tax rate lower than 15%, could still be taxed on those profits at the minimum rate of 15% in another jurisdiction in which they operate.

Our evaluation of the Two-Pillar solution

The mandate for the G20/OECD project on base erosion and profit shifting (BEPS) was to ensure taxation of MNEs ‘where their activities take place’. The Two-Pillar solution is a step in the right direction as it establishes for the first time a global minimum effective corporate tax rate. However, it falls short in terms of comprehensively addressing the challenge of tax avoidance by MNEs.

Pillar One

- Pillar One’s estimation of the taxable profits that can be allocated across countries (Amount A) is indeed a formulaic reallocation of the profits of the largest and most profitable multinationals. But it applies to very few firms, only about 100, and the amount to be redistributed takes only a small portion of profits (25% of the residual profits). There is no economic justification for the narrow scope. The narrow scope means the additional revenue to be redistributed globally is very small (estimated at \$9.8-22.6bn[2] , ￼.
- The failure to come up with a comprehensive solution applicable to all profits of all MNEs means that a large share of the profits of MNEs would continue to be allocated under the OECD’s transactional transfer pricing methods. This reproduces existing distortions in international taxation and adds further complexity to the current system, while generating little additional revenue.
- In a well-designed corporate tax system, the cost of capital is fully costed (with often more than economically justifiable deductions for depreciation and interest), so that there is no disincentive to enterprise investment and sustainable growth. Thus, for practical purposes, only “pure” profits (i.e., economic rents) are taxed, and those economic rents are associated with the global activities of the MNE. Therefore, there

[1] 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.htm
[2] https://www.oecd.org/tax/beps/economic-impact-assessment-amount-a-pillar-one-overview.pdf

is no reason to exclude profits below the 10% rate. Rather, all profits of all MNEs should be apportioned for taxation through a formula. Even if there are administrative reasons for excluding smaller MNE's, the residual profit threshold cannot be justified.

- The OECD formula uses only sales for reallocation of residual profits. This disadvantages countries with relatively small domestic markets, or those with substantial exports. As rich countries consume more, the allocation of profits by sales only is likely to result in an unequitable distribution between countries. There is no economic justification for this particular formula, and in many cases, it is clearly inappropriate.
- Signing and ratifying Pillar One's Amount A multilateral convention requires countries to give up their autonomous taxing rights. They must commit to not implement digital services taxes, and other measures like withholding taxes would be contested. This ties the hands of governments on what taxes they can impose in future, in return for a very limited amount of expected revenue. The taxes forgone, like digital taxes, could be an increasingly important source of revenue, making signing on to Pillar I even less attractive for developing countries.

Pillar Two

- The second pillar introduces a global minimum effective tax rate of 15%. This tax rate is relatively low in a historical and international perspective. Most countries attempt to tax profits at rates higher than 15%--in fact the median corporate tax rate across all countries is estimated to be 25%.[3] There is no clear reason why multinational companies should be allowed to pay less tax than domestic companies.
- The proposed minimum tax also includes a major loophole: carve-outs for substance. Specifically, a certain amount of profit (i.e. a return on the value of tangible assets plus payroll) – can be excluded from the base of the minimum tax. There is no economic justification for these carve-outs. The carve-outs allow firms that have any real economic activity in a low-tax country to keep paying less than 15% in that country, even a 0% effective tax rate. As a result, they create incentives for firms to move production to countries with tax rates below 15%.
- Thus, the minimum global tax rate of 15% will not drastically reduce MNE's financial incentives to shift profits to tax havens. There is a further risk that a minimum tax can become the "maximum tax" because of competitive pressure.
- It is also a missed opportunity to raise more revenues. The current agreement will only bring an estimated $155-192[4] billion additional revenue globally, while a 25% minimum rate such as the one we propose at ICRICT could generate more than $500[5] billion a year of additional revenue globally.

Our advice to countries:

Due to the limitations of the Two-Pillar solution, this is our advice to countries:

[3] https://www.oecd-ilibrary.org/taxation/corporate-tax-statistics-2023_f1f07219-en
[4] https://www.oecd.org/tax/beps/presentation-webinar-economic-impact-assessment-global-minimum-tax-january-2024.pdf
[5] https://www.taxobservatory.eu/publication/2938/

- Do not ratify the Pillar One Amount A multilateral convention. Instead, protect the tax base by considering the introduction of alternatives to Pillar One, such as withholding taxes and digital services taxes.
- Introduce alternative minimum taxes at higher rates than 15%, ideally close to 25% and without carve-outs and exemptions, to ensure all profits within the jurisdiction are taxed at least at the minimum rate and to retain primary taxing rights so that no other country has a right apply a minimum tax on profits made within the jurisdiction.