EU Minimum Corporate Tax Directive and EU Challenges Today

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At the end of 2021, the European Commission (the EC) released a "Proposal for a council directive on ensuring a global minimum level of taxation for multinational groups in the Union."[1] The directive would place a 15 percent minimum effective corporate income tax (CIT) on large-scale company groups. The EC claims that the directive will address tax challenges caused by digitalization and ensure that companies pay "a fair share of tax."

This proposal stems from OECD's "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy,"[2] which aims to limit global corporate income tax competition between countries and to preserve tax revenues in high-tax jurisdictions. According to OECD,[3] there is an increase in tax uncertainty caused by countries that unilaterally address globalization and digitalization pressures, thus a common global approach to taxing capital is required.

Although digitalisation and a growing role of intangible assets in value creation call for overhauling the traditional CIT model, the new directive aims to safeguard revenues from CIT instead of moving towards more efficient forms of taxation. The new rules raise concerns over the sovereignty of Member States to determine the tax rates and the balance between direct and indirect taxation, while their implementation might bring a number of unintended negative consequences.

Summary

This paper suggests that the directive would undermine pro-investment tax policies and inflict the highest competitiveness losses for smaller and less-developed Member States, as they would face more difficulty catching up with the technological and productivity levels of the

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[1] Proposal 2021/0433. *Proposal for a COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union.* European Commission. https://ec.europa.eu/taxation_customs/system/files/2021-12/COM_2021_823_1_EN_ACT_part1_v11.pdf

[2] OECD (2021), *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy.* OECD/G20 Base Erosion and Profit Shifting Project. 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

[3] OECD (2020), *Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/0e3cc2d4-en.

old Member States. In the long run the directive might also result in undermining the free movement of capital.

The new rules involve a dramatic increase in administrative procedures and bureaucracy for tax administrations and businesses, with a particularly disproportionate burden on smaller countries with fewer resources to ensure compliance. The directive is also likely to create legal uncertainties for Member States with preferential CIT regimes applicable to certain types of investment.

The paper argues that EU Member States should be allowed the flexibility to pursue pro-growth CIT models or tax incentives necessary to maintain a sound level of private investment, as well as to adopt a deferred CIT regime without additional discriminatory restrictions.

It is concerning that the directive lacks a comprehensive impact assessment. Without it, the directive's implementation is likely to put national lawmakers, tax administrators, and businesses at risk and create uncertainties that would aggravate the afflictions evolving from the current geopolitical crisis. Moreover, a proper impact assessment is needed to assess the likely effects of the EC's proposed wider scope of the regulation, compared to that agreed by OECD, and potential consequences for the EU if other major economies decide to forego the new OECD rules.

The paper calls for continued inquiry and discussions about the future of business taxation with the goal of promoting efficiency and growth.

The context and the European response

The global economy is becoming more and more digitized – an increased number of people now work remotely, sometimes even in companies based in other countries. Also, more and more purchases of goods and services are made on the internet, meaning that a physical presence in a country is not necessary to do business there. According to the European Union, "there is now consensus that the fundamental concepts of tax residence and source, on which the international tax system has been based for the last century, are outdated,"[4] suggesting that there is a disparity between where the profit should be taxed according to lawmakers and where it is actually taxed. According to the EC, it also "led to new opportunities to manipulate the existing principles through tax planning schemes."[5]

The growing importance of intangible assets in value creation highlights further flaws in the new international CIT rules. Patents, copyrights, and software are hard to value. Their amortization rules hardly have anything in common with physical assets. The latter, when used in production, wear and depreciate. However, software, for example, does not – it only becomes irrelevant when users start finding it invaluable. Additionally, intangible assets are mobile and more convenient to reallocate than tangible assets. Because of this, it is widely claimed that digital companies pay less tax, although this claim is challenged by research

[4] COM (2021) 251. *Business Taxation for the 21st Century.* European Commission. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021DC0251&rid=9
[5] Ibid.

evidence.[6] According to the EC, limiting CIT competition via minimum tax directive will put an end to such tax avoidance by digital companies and ensure a level playing field.

Efforts to limit corporate tax competition by the EU date back to the 1975 EC directive draft, which proposed a minimum statutory tax rate of 45 percent. A 1992 "report of the committee of independent experts on company taxation" recommended putting a minimum CIT rate at 30 percent.[7] Both proposals failed, as tax matters in the EU require unanimity, and not all governments perceived limits to tax competition as serving their best interest.

According to the European Commission's communication "Business taxation for the 21st century",[8] changes in the use of tangible assets in value creation and fears of profit shifting led governments to adopt plenty of new regulations during the last decade, aiming to preserve CIT revenues and leading to an ever-increasing complexity of the rules. Now, the EC proposes even more complex rules to safeguard the current CIT system.

New tax rules bring alarming complexity

The Income Inclusion rule and the Undertaxed Payments (or Profits) rule are the two rules underpinning the minimum corporate income tax proposal as stipulated in the directive.

The first rule is the Income Inclusion rule (IIR). It imposes a top-up tax on a parent entity regarding the income of constituent entities, taxed less than 15 percent based on a jurisdictional basis. It means that the group will have to report the effective tax rate paid in each jurisdiction it operates in.

The second rule is the Undertaxed Payments rule (UTPR), otherwise known as the Undertaxed Profits Rule. It is triggered when there is no possibility to use IIR, for example, in cases when the country of the ultimate parent entity outside the EU does not impose IIR. UTPR allocates a proportion of the top-up tax owed by an undertaxed entity to other jurisdictions in which the group operates. The allocation of additional tax will be based on the carrying value (value reported in financial statements) of tangible assets and the number of employees.

Member States would be allowed to enact a domestic top-up tax. In case the top-up tax liability is triggered and IIR or UTPR is applied, the profit earned in one country could be taxed by a country, in which the headquarters of the firm are located. To avoid this, domestic top-up tax can be used to collect this tax revenue.

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[6] Bauer, M. (2018), *Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions.* ECIPE occasional paper. https://ecipe.org/wp-content/uploads/2018/02/ECI_18_OccasionalPaper_Taxing_3_2018_LY08.pdf

[7] European Commission, DG XV – Internal Market and Financial Services, (1995). *Report of the Committee of independent experts on company taxation*, Publications Office. https://op.europa.eu/en/publication-detail/-/publication/0044caf0-58ff-4be6-bc06-be2af6610870

[8] COM (2021) 251. *Business Taxation for the 21st Century.* European Commission. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021DC0251&rid=9

Notably, Member States would be allowed to introduce a “domestic top-up tax” to avoid other jurisdictions taxing the profits earned in those MSs.

These rules would add even more complexity to the current business tax system and will not bring a sustainable solution, as CIT, with all its computation and regulation complexity, is the least appropriate way to harmonize tax base and to raise public revenue. A sounder and more reliable approach would be a fundamental reform in business taxation that would move the tax base away from financial profits to consumption and pollution, i.e. the alternatives that are less damaging to economic growth. Such a shift would also facilitate the pursuit of the EU's environmental goals and policies.

Corporate income tax and its effects

In a paper “Taxation and Economic Growth”[9] OECD concludes that the corporate income tax is the most damaging tax to economic growth. Another study[10] from OECD, published in 2020, finds that a five percent increase in the effective marginal tax rate is associated with a 0.6 percent decrease in aggregate firm-level investment.

In addition, the corporate tax distorts financing decisions, favouring debt financing over equity, as interest payments are deductible costs that lower the taxes paid. Empirical research suggests that a one percent increase in CIT increases non-financial firms' debt ratio by 0.27 percent: firms have an incentive to borrow, as this leads to a lower CIT paid.[11] A higher debt ratio makes companies more vulnerable in case of economic shocks: the higher the debt, the higher the likelihood of companies not fulfilling their obligations to lenders.

CIT is based on the "ability to pay" rationale. Supposedly, a profitable legal body can pay taxes just like any individual. The problem with this argument is that corporations are legal entities, not real people, and ultimately only people carry the burden of taxes. Thus, CIT is a non-transparent way of taxing individuals – shareholders, workers, and consumers alike. Research suggests that half of the increase in CIT is passed on to workers in a form of lower wages.[12] Lower net profit reduces a firm's ability to invest. Less investment means lower worker productivity.

Maximizing investment returns is an economic rationale for companies, which, under a free movement of capital, means that there is an objective incentive to move business operations to lower tax jurisdictions. For example, empirical estimations in the USA indicate that "an increase of 1 percentage point in the corporate income tax rate of the headquarters state, on

[9] Johansson, Å., et al. (2008), "*Taxation and Economic Growth*", OECD Economics Department Working Papers, No. 620, OECD Publishing, Paris. https://doi.org/10.1787/241216205486

[10] Millot, V., et al. (2020), "Corporate taxation and investment of multinational firms: Evidence from firm-level data", OECD Taxation Working Papers, No. 51, OECD Publishing, Paris https://www.oecd-ilibrary.org/economics/taxation-and-economic-growth_241216205486

[11] Field, Lars P., Jost H. Heckemeyer, and Michael Overesch (2013) “*Capital Structure Choice and Company Taxation: A Meta-Study*.” Journal of Banking and Finance 37(8): 2850–66.

[12] Arulampalam, W. & Devereux, M. & Maffini, G., (2010), The Direct Incidence of Corporate Income Tax on Wages.

average, increases the likelihood of firms relocating their headquarters by 16.8 percent."[13] Conversely, an equivalent decrease in the tax rate of the headquarters state decreases the likelihood of firm relocations by 9.1 percent.[14]

Over the past decades national governments aiming to maintain the levels of economic investment have had to gradually reduce their CIT rates to stand their ground against low-tax jurisdictions. The average global corporate tax rate dropped from 40 percent in 1980 to 24 percent in 2021.[15] The European Union had an even lower average CIT rate in 2021, standing at 20.7 percent.[16] Despite the decrease in rates, tax revenues did not decline.[17] In general, broader CIT bases and moving away from special investment incentives or extra deductions have compensated the lower rates.

Free movement of capital alongside the growing global competition has driven a reduction in the CIT rates and the broadening of the tax base. It has also resulted in improvements in the investment climate and consequently increased public welfare. Despite that, efforts to curb tax competition persist. CIT seems to be an attractive political target, as it allows raising tax revenue from a limited number of taxpayers and is, therefore, more popular in the public eye compared to other taxes.

EU minimum tax directive and its unintended consequences

The European Commission directive proposal aims to "ensure that all corporations pay their fair share of tax on profits generated by their activities in the EU". Yet, measures designed to achieve this objective may cause multiple side effects:

- **The proposed directive would take away the sovereignty of Member States to determine tax rates and balances between direct and indirect taxation.**

In one of its publications on tax competition OECD claims that there is no reason for two countries to have the same taxation system as tax levels and structure are political decisions for national governments.[18] The EU directive proposal will end the sovereignty of countries to offer better CIT conditions for all companies.

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[13] Chow, T. & Huang, S., Klassen, K. & Ng, J. (2021), *The Influence of Corporate Income Taxes on Investment Location Evidence from Corporate Headquarters Relocations,* Cato Institute.
[14] Ibid.
[15] Bray, S. (2021, December 9). *Corporate tax rates around the world*. Tax Foundation. Retrieved March 14, 2022, from https://taxfoundation.org/publications/corporate-tax-rates-around-the-world/#_ftnref1
[16] *European Union corporate tax Rate2021 Data - 2022 forecast - 1996-2020 historical*. European Union Corporate Tax Rate - 2021 Data - 2022 Forecast - 1996-2020 Historical. (n.d.). Retrieved March 14, 2022, from https://tradingeconomics.com/european-union/corporate-tax-rate
[17] Cozmei, C (2015), *Is It any EU Corporate Income Tax Rate-Revenue Paradox?,* https://www.sciencedirect.com/science/article/pii/S221256711500372X
[18] OECD (1998), Harmful Tax Competition: An Emerging Global Issue, OECD Publishing, Paris, https://read.oecd-ilibrary.org/taxation/harmful-tax-competition_9789264162945-en#page1

If tax competition is restricted, it will relieve pressure placed on national budgets and result in less efficient budget spending.

- **The new rules will undermine openness to change and pro-investment tax policies.**

Countries with a modern deferred CIT regime (such as Latvia and Estonia) impose CIT only on profit at distribution, meaning that companies do not have to calculate fiscal profit. More importantly, if they choose to save and invest, they pay no CIT. Under the proposed directive, companies in scope will have to calculate their fiscal profits and pay additional tax on them, so the whole fiscal administration and accounting rules will have to be altered. Private investment of the companies in scope may be reduced.

Furthermore, if a country moves from the traditional to the deferred business taxation model, it will face more extensive restrictions: a minimum effective tax rate would have to be paid every year, not every four years like in countries which adopted the model earlier. For example, in Estonia, which adopted the deferred CIT model years ago, companies in scope will have to pay the additional minimum tax every four years. Yet, if another Member State adopts a deferred CIT model in the future, companies in scope will have to pay the minimum tax every year. It means that Member States using the same CIT model would play by different rules in the single market.

This would also eliminate the benefits of the deferred profit tax model for companies falling under the new rules and would hamper investment in less-developed countries which are striving to catch up with technological advancement and productivity growth. Additionally, this would mean that countries would have to play by different rules, as some would face more restrictions in case they adopted a deferred profit tax model, compared to the countries that already have it. It is essential that member states are allowed the flexibility to adopt deferred profit taxes without being treated unfairly by the rules relative to the status that Estonia and Latvia will enjoy.

- **Smaller countries will incur the highest competitiveness losses on top of sustaining the highest administrative burden.**

Smaller countries cannot attract investors by offering a large market or large governmental subsidies, so the directive will diminish their ability to compete by applying business-friendly CIT rules and a lower CIT rate.

- **The implementation of the minimum tax directive involves a dramatic and hardly manageable expansion of administrative rules, procedures, and bureaucracy.**

The complexity of the rules will challenge lawmakers and tax administrations. Implementing the rules and monitoring compliance in a transparent, accurate, and coherent manner will be an exacting task. This will inflict a particularly onerous burden on small countries with fewer resources and smaller tax administrations. Despite the fact that small countries have fewer firms that will be affected by the new rules and much lower prospects of revenues, they will have to create an extensive legal and administrative infrastructure for companies to comply. The Directive will require more discussion and implementation time to ensure that the challenges related to its adoption and enforcement are properly mitigated.

To comply with the directive, companies will have to calculate their effective tax rates paid in every jurisdiction where they conduct operations. This will require parallel accounting according to the new rules, because eligible costs, revenues, and taxes will differ from national provisions. This parallel accounting means additional time and resources that will reduce the overall productivity of companies and the economy at large.

- **The Directive might create legal uncertainties for countries with preferential CIT regimes applicable to investments of certain types or in specific locations**.

Some countries apply no corporate income tax for investment projects that meet predefined criteria. Such projects depend on a signed contract between an investor and a national government and have a defined timeframe, extending far beyond the planned timeline of the Directive’s implementation. A question remains how the legitimate interests of companies that have made investments and commitments in certain jurisdictions because of a zero-tax rate or other incentives will be protected if those companies fall under the scope of the minimum tax rules.

The directive is predicated on questionable ethical and legal foundations

- **The term “fair share of tax” is not defined in the articles of the directive.**

The directive aims to ensure that multinational corporations pay their “fair share of tax.” The problem is that the Directive does not provide a definition of “fair share of tax.” It can be deduced from the overall rhetoric that a business that shifts part of its operations to a jurisdiction that offers a lower CIT rate in pursuit of a higher return on investment is considered to conduct an "unfair" activity. If the notion of “fair share” is grounded in an approach like this, it may in the long run appear to be at odds with the principle of free movement of capital.

Similarly, if a country has a taxation system that applies a low effective tax rate on business savings, it is held responsible for eroding the tax bases of other countries. Notably, a recent study commissioned by the European Parliament states that "the Member States have a wide leeway to shape their corporate tax rates structure in a way that is exclusively aimed at maximising their own welfare, even if it is to the detriment of other Member States,"[19] suggesting that cooperation, not competition, would maximise the total welfare of member states. It remains unclear why low CIT jurisdictions are held responsible for potentially lower tax revenues in high tax jurisdictions.

[19] Velde, E. & Cannas, F. (2021) *Harmful tax practices within the EU: definition, identification and recommendations,* European Parliament. https://www.europarl.europa.eu/RegData/etudes/STUD/2021/662905/IPOL_STU(2021)662905_EN.pdf

The same argument can be made against countries that impose unfairly high rates on business income: by doing so, they aggravate the investment environment and force businesses to move to countries that apply a lower effective rate of the same tax. This illustrates that putting the blame on low-tax jurisdictions and profit-maximising businesses for an alleged loss of welfare of high-tax countries is disputable and unacceptable as a policy rationale.

- **The directive lacks a proper impact assessment**.

It is troubling that the directive is not supported with any comprehensive impact assessment. Notably, the EC argues that no separate impact assessment is needed because OECD has carried out an impact assessment of the global minimum corporate income tax. However, there are significant differences between the policy stipulated in the OECD impact assessment[20] and the EC's proposal.

Firstly, the OECD impact assessment stipulates a 12.5 percent minimum tax rate, while the directive proposes 15 percent. Secondly, specific tax allowances called substance carve-outs differ in the OECD impact assessment and the EU directive. Specifically, OECD suggests a special allowance for depreciation expenses, while the EU directive allows a carve-out for a particular percentage value of tangible assets.

Furthermore, the EC has not provided any impact assessment for a scenario whereby EU Member States enact the minimum tax while other countries that signed the OECD agreement do not. This scenario would clearly put European businesses at a competitive disadvantage, but the costs are in no way evaluated.

Additionally, the scope of the EU directive extends far beyond what was agreed upon in the OECD given that the directive also includes purely domestic groups. This is very likely to impact aggregate economic activity, but no estimates have been provided to reflect this important change.

It is essential that a comprehensive impact assessment of the directive is carried out, as stipulated by the EU law-making principles and best legislative practices.[21] Notably, impact assessment forms a key part of the EC's better regulation agenda. Importantly, the directive's impact assessment should include a close analysis of the likely effects of the directive on the revenues of Member States and the effective tax rates on businesses in the EU.

[20] *OECD* (2020), *Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing, Paris, https://doi.org/10.1787/0e3cc2d4-en.

[21] *Interinstitutional Agreement Between the European Parliament, The Council of the European Union and the European Commission on Better Law-Making*, 13 April 2016. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.123.01.0001.01.ENG&toc=OJ:L:2016:123:TOC

Conclusions and Recommendations

The EC's proposed minimum tax directive aims to limit corporate income tax competition via international cooperation between governments. The directive would impose a 15 percent minimum effective tax rate requirement via a set of new international rules. Its purpose is to safeguard the revenues from CIT, instead of moving towards more efficient forms of taxation, and to alleviate the pressure on national governments to reduce CIT rates.

The classical CIT hampers economic growth by disincentivizing and reducing investment and, consequently, labour productivity, which means lower wages to workers. Additionally, digitalisation and the growing role of intangible assets in value creation make it more difficult to determine where the value is generated and where the taxes should be paid. Nevertheless, the political will to sustain the traditional form of business taxation persists, even though it may cause a number of negative consequences:

- The proposed directive would take away the sovereignty of Member States to determine tax rates and balances between direct and indirect taxation.

- Smaller countries will incur the highest competitiveness losses. The directive will hurt smaller and less-developed countries by undermining their ability to compete for investment through a business-friendly tax system. Lower corporate tax rates and tax incentives are essential for such countries to compensate for a small market and less-developed infrastructure, but the minimum tax regulation will prevent these alternatives.

- The implementation of the minimum tax directive involves a dramatic and hardly manageable expansion of administrative rules, procedures, and bureaucracy. Additional administration, accounting rules, and reporting requirements would place an onerous bureaucratic burden on businesses and tax administrations, especially in smaller countries that have fewer resources and fewer firms falling in the scope of regulation but will nevertheless have to build an infrastructure to ensure compliance.

- The implementation of the directive would in the long run undermine the fundamental principle of free movement of capital.

- The Directive is likely to create legal uncertainties for countries with preferential CIT regimes applicable to certain types of investment or investments in specific locations.

- It remains unclear why low CIT jurisdictions are held responsible for potentially lower tax revenues in high tax jurisdictions.

- The directive proposal lacks an assessment of its likely impact on the revenues of Member States and the effective tax rates on businesses in the EU. It is equally concerning that there is no impact assessment of a scenario whereby EU Member

States enact the minimum tax while other countries that supported the OECD agreement do not. This scenario would clearly create a competitive disadvantage for the European economy.

- Without a proper impact assessment, the implementation of the directive is likely to put national lawmakers, tax administrators, and businesses at risk and create uncertainties that would aggravate the afflictions evolving from the current geopolitical crisis.

Given the aforesaid, it would be reasonable to continue inquiry and discussions about the future of business taxation with the goal of promoting efficiency and growth.

A sound and reliable approach to ensuring a level playing field for all companies would be a fundamental reform in business taxation that would move the tax base away from profits to consumption and pollution, i.e. the alternatives that are less damaging to economic growth. Such a shift would also facilitate the pursuit of the EU's environmental goals and policies.

Member States should be allowed to retain the flexibility to adopt a deferred CIT model without additional restrictions. Particularly, smaller and less-developed Member States should have the right to pursue pro-growth CIT models or tax incentives necessary to maintain a sound level of private investment.

A comprehensive impact assessment is needed to assess the likely effects of the EC’s proposed wider scope of the regulation, compared to that agreed by OECD, and to evaluate potential consequences for the EU if other major economies decide to forego the new OECD rules.

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