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Global Minimum Tax: Is This the End of Tax Havens?

Corporate tax rates have trended down for years on a global scale. US Treasury Secretary Janet Yellen called this development a *'race to the bottom.'* Since 1980, average corporate tax rates have dropped from 40 to now 24 percent as a result of international cut-throat tax competition. Corporate taxes in the EU have eroded from 35 percent in 1995 to 21 percent at present. Game theory describes this socioeconomic phenomenon as the '*race to the bottom'* aspect of the prisoners' dilemma. That means all countries are facing the dilemma that they can only raise corporate taxes if all other countries are guaranteed to do the same. If a country presumes that one or more of the other ones may not cooperate it is preferable not to raise taxes. This will accelerate tax cutting competition until tax rates bottom out, which is the worst-case scenario for the countries involved.

It is obvious that increasing globalization has intensified international competition for multi-national tax dollars. Especially small countries are reinventing themselves as tax havens vying for global players to settle on their shores. However, the socioeconomic detriments from tax income losses in higher taxing countries far outweigh any benefits to the country that lures the capitalist heavyweights to their low-tax lands.

So, how exactly do multi-nationals shuffle their profits around? Taxes typically accrue in the country where a company is generating its value added. In an increasingly digital economy value-added and profit generation often happen in different places. This is particularly the case among the major US tech companies whose value-added stems from intellectual property rights or patents that they register in low-tax countries and thus also pay taxes on their profits there. Google parent Alphabet, for instance, transferred its digital property in the Google search engine to its Bermuda subsidiary. The subsidiary then licences the technology to other Google subsidiaries, for example, in Germany at high fees. These fees offset taxable income in the high-tax country. Google Bermuda, however, pays the much lower tax haven rate on its licencing income.

The above example illustrates that current international tax law is not sufficiently suited to the realities of an information economy. As a result, real-estate holdings represent a disproportionate tax base share of some countries putting local industry at a disadvantage with correspondingly negative effects on wealth gaps and employment.

This is where the OECD initiative *Base Erosion and Profit Shifting* (BEPS) is trying to effect change. Over 130 countries representing some 90 percent of global GDP are cooperating under the OECD umbrella to build a two-pillar model for fighting tax base erosion and international profit shuffling. The objective is to expand the international taxable profit base and distribute tax income more fairly. According to OECD calculations, introducing a worldwide minimum tax would raise global corporate tax volume by up to USD 100 billion per annum. The OECD plans for a fairer distribution of tax income would add another USD 100 billion.

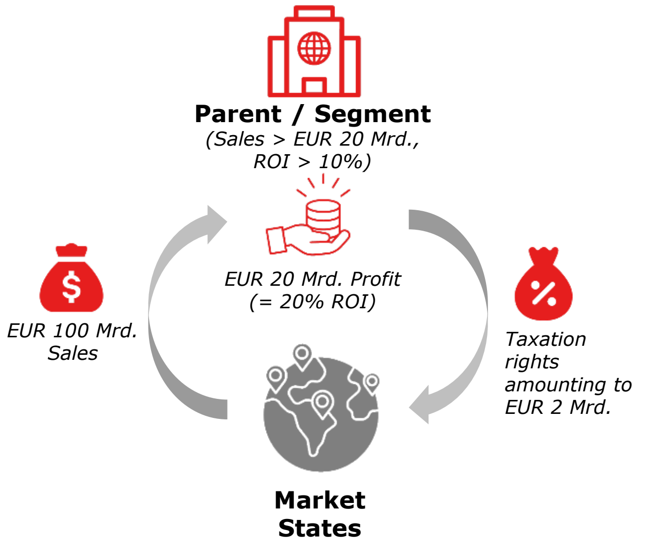

Fig. 1: Simplified representation of the Pillar 1 mechanism

Pillar I concerns the distribution fairness between countries with taxation rights shifting from place of production to place of marketing. This means that at least 20 percent of a company's residual profits in excess of a 10 percent return on sales may then be taxable in the countries where the sales have been realized. The focus will be on so-called 'globalization profiteers' meaning highly profitable groups with return on sales of 10 percent or more and sales volume of at least EUR 20 billion per year but lacking physical presence in their respective sales countries. This currently applies to some 100 groups worldwide. In Germany, this affects DAX groups like SAP, Bayer, Deutsche Bank, Linde, and Henkel. [1] The current interpretation furthermore provides for applying the Pillar I mechanism even if only individual group segments exceed the profitability threshold values whilst the group as a whole might not. One example for this would be Amazon whose cloud segment Amazon Web Services (AWS) may be taxable under Pillar I although the group as a whole does not exceed the profitability threshold.

Pillar II is to secure a globally effective minimum taxation. The idea is to levy 15 percent global minimum tax on a company's sales in all countries where it generates revenue if the company's sales volume exceeds EUR 750 million per annum. If one foreign subsidiary pays less than 15 percent in taxes the Company's headquarter domicile country shall be entitled to tax the company for the difference until the 15 percent total tax have been met. Simultaneously, high tax countries will no longer recognize for tax purposes any intra-group payments from group segments in high-tax countries to other group segments in low-tax countries (for instance, as interest payments or licensing fees). This provision alone would affect 7,000 to 8,000 companies worldwide. This, too, serves to ensure effective minimum taxation.

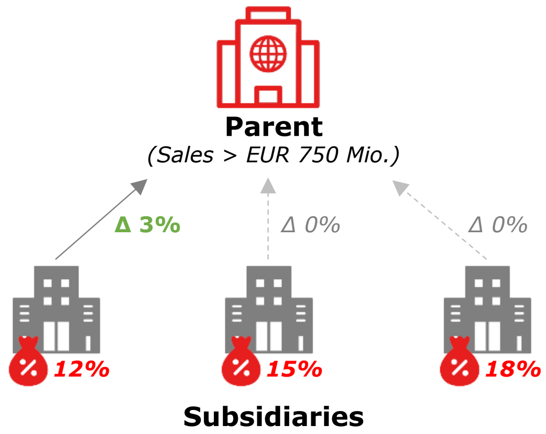

Fig. 2: Simplified representation of the Pillar II mechanism

Who finally stands to lose or gain from such a global tax reform? Pillar I predominantly benefits countries where groups realize high sales but pay little or no taxes. These are not just industrialized countries but also – to a considerable extent – emerging economies. The Pillar I mechanism generally supports countries that suffer most from increasing corporate tax competition. The current domicile countries of big multi-nationals stand to lose the most primary tax income. However, these tend to be high-tax countries and benefit from the globally effective minimum tax under Pillar II. The objective of the global minimum tax is to blockade tax havens that have been the destinations of the great profit shuffle. It should thus come as no surprise that amongst the EU countries particularly Ireland (proud domicile of Apple, Facebook, etc.) reacted with rather curbed enthusiasm to the initiative. Moreover, weaker economies are ever harder pressed to balance location problems with tax perks as they used to.

Multi-nationals that will probably have to pay up under the planned tax reform actually take a generally positive view of the initiative. They appreciate the greater transparency, simplicity, and elimination of double taxation. However, this appreciation may simply be due to the fact that a 15 percent global minimum tax represented a compromise at the lower end of expectations and could have been far more substantial.

[1] Quelle: Refinitiv Datastream [12m Forward Sales & 12m Forward Net Income for DAX & MDAX Constituents]

Estimates of how much this will impact German tax coffers vary widely. The Ifo Institute, for instance, assumes that Germany loses EUR 5.7 billion in tax revenue per year to global profit shifting but would only gain about EUR 2 billion per annum from introducing a worldwide minimum tax. There will be a strong focus on shifting taxation rights abroad, which raises the possibility of losing effective tax income to the fine points in the final agreements. The German Ministry of Finance agrees with and supports the OECD Initiative and expects higher tax revenue under the planned reform. The Leibniz Centre for European Economic Research, by contrast, assumes that the additional bureaucratic costs would render the extra tax income negligible. The auditing firm Deloitte expects Germany to generate additional tax revenue of some EUR 1 billion.

After confirming the fundamental bases of the two pillars at the July 2021 G20 meeting in Venice, the member countries now have their work cut out in negotiating the details. The benchmark figures will include sales and profit thresholds, the share of allotted residual profits, and the minimum tax rate. The October 2021 G20 meeting should define the details and formulate an implementation plan. Then the tax reform can take effect in 2023 as planned.

The success of a global minimum tax depends on whether all countries agree. If some countries decide to charge tax rates other than the agreed minimum rate or offset the taxes with non-tax subsidies, this would open up new negotiation room for companies. So far, 132 of 139 member countries of the OECD Inclusive Framework support the initiative. Of the EU countries, Ireland, Estonia, and Hungary are still on the fence. A ‘no go’ from Brussels would bring the entire project down. It is also not at all clear whether the bill will pass the US senate. The global minimum tax is a key piece of President Joe Biden’s corporate tax plan that is set to increase the US corporate tax rate to 28% in an effort to finance his extensive infrastructure program.

Ultimately, introducing a global minimum tax may make sense in principle and is a solution to problems arising from the game-theory prisoners’ dilemma outlined above but it is a primarily political project. The actual additional tax income after additional bureaucratic expenses should be quite limited in major industrialized countries. Smaller countries and weaker economies have also no longer the option of generating advantages through tax competition. Moreover, any additional tax burden on multi-national corporations is so marginal as to be not really relevant for capital markets. As such, this global tax reform – if it ever came to fruition – would only serve political high ground and philosophical purposes, which may well be important in these spheres and probably justifies the additional costs. This may also explain the fact that Germany’s federal government is convinced that there will be additional tax revenue although this is rather doubtful. That means this is primarily a vehicle for political virtue signaling and less a matter of actual tax income generation. Real economic and financial-market relevant effects will likewise be minimal. The whole discussion and posturing around the subject may be best summed up with the title of William Shakespeare’s comedic masterpiece Much Ado About (Almost) Nothing.

We would like to thank our colleague Tobias Cramer for his extensive support in creating this article.

Market data

Stock marktes	As of 30.07.2021 09:52	Change versus 23.07.2021 -1 week	29.06.2021 -1 month	29.04.2021 -3 months	29.07.2020 -1 year	31.12.2020 YTD
Dow Jones	35085	0,1%	2,3%	3,0%	32,2%	14,6%
S&P 500	4419	0,2%	3,0%	4,9%	35,6%	17,7%
Nasdaq	14778	-0,4%	1,7%	4,9%	40,2%	14,7%
DAX	15465	-1,3%	-1,4%	2,1%	20,6%	12,7%
MDAX	34954	-0,6%	1,9%	6,7%	30,3%	13,5%
TecDAX	3652	-0,4%	1,3%	4,7%	18,8%	13,7%
EuroStoxx 50	4081	-0,7%	-0,6%	2,1%	23,7%	14,9%
Stoxx 50	3540	-0,5%	0,0%	4,5%	17,6%	13,9%
SMI (Swiss Market Index)	12024	-0,9%	0,0%	8,5%	17,1%	12,3%
Nikkei 225	27284	-1,0%	-5,3%	-6,1%	21,8%	-0,6%
Brasilien BOVESPA	125675	0,5%	-1,3%	4,7%	19,0%	5,6%
Russland RTS	1626	1,9%	-0,9%	7,6%	28,4%	17,2%
Indien BSE 30	52719	-0,5%	0,3%	5,9%	38,5%	10,4%
China CSI 300	4811	-5,5%	-7,3%	-6,8%	2,8%	-7,7%
MSCI Welt (in €)	3090	-0,5%	2,1%	6,4%	31,4%	18,5%
MSCI Emerging Markets (in €)	1295	-2,2%	-6,0%	-3,2%	17,6%	3,5%
Bond markets						
Bund-Future	176,44	63	437	656	-51	-120
Bobl-Future	135,34	25	134	69	33	16
Schatz-Future	112,36	7	23	29	26	8
3 Monats Euribor	-0,55	2	2	2	-9	4
3M Euribor Future, Dec 2017	-0,54	-1	-1	-1	-6	0
3 Monats $ Libor	0,13	0	-2	-5	-13	-11
Fed Funds Future, Dec 2017	0,08	0	-1	-2	9	0
10 year US Treasuries	1,25	-4	-23	-39	67	34
10 year Bunds	-0,45	1	-24	-21	8	13
10 year JGB	0,02	2	-4	-7	0	0
10 year Swiss Government	-0,37	0	-18	-18	15	13
US Treas 10Y Performance	705,17	0,2%	2,0%	3,9%	-4,1%	-1,5%
Bund 10Y Performance	681,27	0,4%	2,7%	2,9%	0,1%	-0,5%
REX Performance Index	498,87	0,2%	1,1%	1,3%	0,1%	-0,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,10	-3	-19	-17	-11	8
IBOXX BBB, €	0,46	-4	-22	-23	-58	-9
ML US High Yield	4,57	-1	3	-15	-147	-40
Convertible Bonds, Exane 25	8349	0,0%	-0,2%	0,1%	8,5%	0,3%
Commodities						
MG Base Metal Index	443,34	2,5%	4,5%	2,5%	46,9%	25,0%
Crude oil Brent	75,61	1,8%	0,8%	10,2%	72,6%	45,7%
Gold	1828,92	1,7%	4,0%	3,4%	-6,5%	-3,6%
Silver	25,77	2,1%	-0,1%	-0,7%	6,7%	-2,3%
Aluminium	2609,15	4,7%	2,8%	7,8%	54,8%	32,2%
Copper	9799,50	3,2%	5,2%	-0,9%	51,2%	26,5%
Iron ore	213,52	-1,2%	-0,4%	19,1%	97,9%	37,0%
Freight rates Baltic Dry Index	3214	0,5%	-6,0%	6,9%	144,0%	135,3%
Currencies						
EUR/ USD	1,1890	1,0%	0,0%	-2,0%	1,4%	-3,1%
EUR/ GBP	0,8512	-0,5%	-1,1%	-2,0%	-6,3%	-4,9%
EUR/ JPY	130,24	0,1%	-1,0%	-1,5%	5,6%	3,0%
EUR/ CHF	1,0774	-0,6%	-1,7%	-2,2%	0,1%	-0,3%
USD/ CNY	6,4573	-0,4%	-0,1%	-0,2%	-7,8%	-1,1%
USD/ JPY	109,48	-1,0%	-0,9%	0,5%	4,3%	6,0%
USD/ GBP	0,72	-1,5%	-0,9%	-0,1%	-7,2%	-2,1%

Source: Refinitiv Datastream

Carsten Klude
+49 40 3282-2572
cklude@mmwarburg.com

Dr. Rebekka Haller
+49 40 3282-2452
rhaller@mmwarburg.com

Martin Hasse
+49 40 3282-2411
mhasse@mmwarburg.com

Dr. Christian Jasperneite
+49 40 3282-2439
cjasperneite@mmwarburg.com