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International Corporate Taxation after Covid-19: Minimum Taxation as the New Normal

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Summary

There are lessons to be learned from the current Covid-19 pandemic. This exceptional situation requires rethinking the provision of sound infrastructures and a functioning health system. National healthcare and other public services, which are currently under increasing pressure, have been underfunded in many countries, an issue that corporate tax avoidance has likely exacerbated. Some multinationals that have been avoiding corporate taxes for years are about to be bailed out by national governments, thus arousing a public sentiment of unfairness. In this Policy Brief, we argue that setting a minimum effective tax rate on the global profit of multinational firms would tackle these concerns.

The ongoing Covid-19 pandemic and the confinement of billions of people are having a tremendous economic impact. States should play a central role in the response to the crisis. In addition to vital sanitary measures, governments are taking a series of actions to battle the economic fallout due to the Covid-19 outbreak, from the "bazooka" measures deployed in Europe and the U.S. to various stimulus packages of unprecedented size. The immediate and most effective economic measures will certainly be those aimed at preserving businesses and jobs, while maintaining liquidity on the financial markets (Ilzetzki, 2020).

The current situation in France, Italy, Spain, the U.S., and elsewhere sheds light on the critical importance of well-staffed and well-funded public services to buffer the impact of extreme events like pandemics. The economic situation brings to mind the taxation of multinational companies for at least two reasons. First, the crisis reveals that some essential public goods, such as the provision of sound infrastructures and a functioning health system, have been underfunded in many countries (Armocida *et al.*, 2020 for instance), an issue that corporate tax avoidance has likely exacerbated. Second, some multinationals that have been avoiding corporate taxes for years are about to receive massive financial help from governments, which many find unacceptable (Turner, 2020). In this post, we argue that setting a minimum effective tax rate on the global profit of multinational firms would tackle both concerns.

we propose a minimum effective tax rate on the global profit of multinational firms

1 Economic policy, firms, and profit shifting

This crisis shows that rare events like pandemics, natural disasters, or terrorism hit individuals and businesses irrespective of their financial health or their contributions to the tax system (De Vito and Gomez, 2020; Bloom *et al.*, 2020). In France, Emmanuel Macron has announced that "No business, whatever its size, will be left at risk of bankruptcy." (16 March 2020). Other countries have adopted a similar approach: many will pay a large share of furloughed employees' wages, and provide tax deferrals or state-granted credit lines.[1]

These budgetary measures are essential but as a result, large businesses that have implemented aggressive tax planning strategies over the last years will also receive financial help, and might even be bailed out. Such ambiguity raises legitimate concerns about the social acceptability of these rescue plans.

1.1. Evidence from specific sectors

The Covid-19 outbreak has hit many sectors, and governments will have to step in through loans and guarantees to support the economy. The airline industry has been greatly affected, with the shock inevitably spreading across all companies operating along the value chain.[2] The International Air Transport Association estimates that the industry will require a cash infusion of up to $200 billion, as well as loan guarantees to weather this economic buffeting. Other industries such as the cruise industry have also been strongly impacted by the crisis. The automotive industry will also be hit hard according to the first projections.[3]

Using data from Compustat, we report the average effective tax rate (ETR) for these 3 industries in Figure 1. The information is for publicly listed companies either incorporated in the U.S. or in one of the E.U. countries. These firms are large corporations, most of them being multinational firms. The ETR has been shown to move closely with aggressive tax planning strategies, and a low average ETR is an indication of tax avoidance (Dyreng *et al.*, 2019). The ETR is computed as the sum of cash tax paid over a long time period of 5 or 10 years divided by the sum of pre-tax income over the same period. Long-run ETRs reduce the volatility of annual ETR measures (Dyreng et al., 2008).

The figure clearly shows that air transportation, automotive manufacturing, and cruise lines have very low effective tax rates, both in the U.S. and the E.U., which indicates a modest contribution to the funding of public services. Despite low effective tax rates, these firms will receive financial help from governments all over the world.

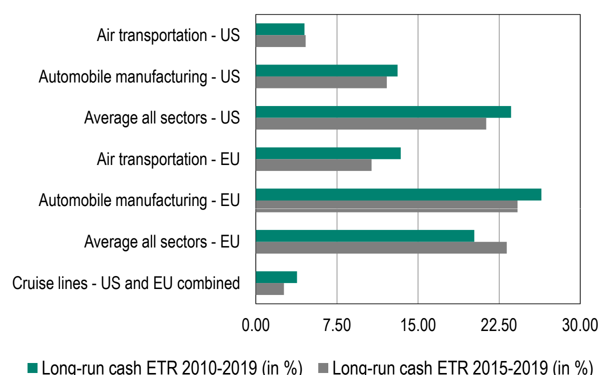
The data show that the effective tax rate in these industries is far below what the statutory tax rate

(1) The IMF policy tracker (https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19) illustrates the exceptional policy responses to the crisis.

(2) In the U.S., $50 billion of the $2 trillion stimulus package passed by the Senate will help the airline sector, with a $17 billion aid given to Boeing alone. Similar plans are on the table in Europe. The Italian government re-nationalized Alitalia with a €600 million cash injection, Denmark and Sweden have offered $302 million credit guarantees to SAS, and the French government assured that it would support Air France-KLM. Airports Council International Europe, a trade organization representing most European airports, sent a letter to the European Commission to urge it to introduce "comprehensive, inclusive and non-discriminatory support to the entire aviation ecosystem."

(3) According to the European Automobile Manufacturers' Association, at least 1.1 million European workers are being affected by factory shutdowns as a result of the Covid-19 crisis. https://www.acea.be/press-releases/article/covid-19-jobs-of-over-1.1-million-eu-automobile-workers-affected-so-far-dat.

Figure 1 – Long-run cash effective tax rates (ETR) by 4-digit SIC sector



Notes: This figure shows the long-run cash effective tax rates for some 4-digit SIC sectors, defined as the ratio of cash income taxes paid to pre-tax income. "Air transportation" refers to industry 4512, "automobile manufacturing" refers to industry 3711, and "cruise lines" refers to industry 4400. The data used to calculate these ratios come from Compustat North America and Compustat Global. "US" and "EU" refer to the state of incorporation. "EU" excludes Ireland, Luxembourg, Malta, and Cyprus.

Source: Compustat North America and Compustat Global, calculations of the authors.

should be in the E.U. (21.7% on average in 2019) or in the U.S. (35% until the end of 2017, 21% thereafter). These industries have a low effective tax rate but are no exception: the average effective tax rate across industries in the U.S. and the E.U. is below 25%.

1.2. Global evidence

While these observations hold for the sectors that are immediately at risk, the phenomenon of tax avoidance is widespread among sectors. Large corporations – and not only digital firms – use various strategies to avoid paying taxes in countries where they do much of their business. Anecdotal and systematic evidence shows that multinational corporations exploit their global network of affiliates to relocate profits to foreign entities within the group in low-tax jurisdictions (see Beer et al., 2019 for a review). The growing economic literature that estimates revenue losses from profit shifting points at sizeable impacts. In the U.S., Clausing (2019) finds that profit shifting was likely costing the U.S. government between €79 and €125 billion in corporate tax revenue by 2017, and that these revenue losses have increased substantially in recent years. The corresponding losses in France are between €5 and €10 billion each year according to three recent studies (Laffitte *et al.*, 2019; Tørsløv *et al.*, 2019, Vicard, 2019). To put these figures into perspective, the French government has proposed an €8.5 billion plan to extend French unemployment benefits as a response to the current crisis.

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Many of these firms will undoubtedly benefit from direct or indirect financial help from governments. To ensure the social acceptability of the emergency measures for these firms and to foster tax revenues in normal times, we believe the Covid-19 crisis provides momentum to implement a minimum effective tax rate levied on the global profits of multinational firms.

2 Reform of the international tax system

2.1. Current negotiations

Since 2018, the OECD has been negotiating a large-scale reform of the international tax system with 130 countries. The negotiations were set to end in December 2020. Different scenarios have been discussed, including minimum taxation. However, this is not the only possible reform that is currently under discussion. Whereas most other reforms propose to redistribute taxing rights (in the vein of the so-called Pillar 1 under negotiation at the OECD), they remain silent about the rate at which multinationals should be taxed. Specifically, they rely on the argument that allocating taxing rights to destination markets will, de facto, reduce tax avoidance. Besides, the complexity entailed by more sophisticated allocation rules, paired with the need for the tax authorities to collect new information, is likely to give more room for multinationals to circumvent corporate taxation, especially in low-income countries.

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By contrast, the principle of minimum taxation is a simple one. The legal contours of its implementation are already known by the tax authorities and it has the merit of tackling corporate tax avoidance directly. Indeed, it can be viewed as an extension of the existing Controlled Foreign Corporation (CFC) rules applied to a broader tax base. Furthermore, its principle relies on the observation that the incentives for profit shifting arise mostly from tax differentials across jurisdictions. Minimum taxation implies that no foreign affiliate can escape a minimum rate of taxation by declaring its operations in a tax haven. Should its

effective tax rate fall below this minimum, the countries where the real economic activity takes place would have the right to tax the difference. Minimum taxation thereby eliminates the incentive to conduct aggressive tax planning.

Importantly enough, this minimum tax rate is not a minimum statutory corporate tax rate but an effective one: the accumulation of tax breaks including loopholes, deductions, exemptions, or credits is permitted up to a tax threshold at which a firm's taxes contribute to the public good sufficiently. It allows countries to put a floor to tax competition for real economic activities, and gives low-tax countries a strong incentive to raise their corporate tax rates.

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2.2. Momentum for the minimum tax

The minimum effective tax rate ensures that the few firms that made profits during the crises do not avoid paying taxes this year and in forthcoming years, a boon for governments.[4] The short-term benefit of the minimum tax could be paired with an exceptional contribution by companies which generate excess profits thanks to the crisis, as proposed by several experts (Amazon, 3M, Gilead, and Zoom are only a few of the many corporations that stand to benefit from the crisis; see *The New York Times*, 2020).[5] Not only is the minimum tax useful to strengthen the social acceptability of some pro-business reforms and to collect corporate taxes in the short run, but this fiscal policy is also pertinent in the medium to long run.

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As the economic situation reverts to normal, multinational firms will contribute to the financing of publicly and locally provided goods. These goods serve as inputs to production and create the basic conditions required for successful corporate activity. They are also crucial to buffer the economic consequences of future large-scale disasters.

Under a minimum corporate tax, the profits realized offshore end up taxed at a minimum effective rate. If the profits are not taxed in offshore jurisdictions, the taxation is implemented by redistributing the taxing rights to the countries where the value was created (but not reported). With minimum taxation, there is no longer an incentive to set up an affiliate for tax reasons only. In a recent policy note, Fuest, Parenti, and Toubal (2019) show that the implementation of a minimum effective tax rate reduces profit shifting and generates substantial gains in tax revenues.

The change to the minimum effective tax rate system should minimize the room for both double taxation and non-taxation (for technical details, see Fuest, Parenti, & Toubal, 2019 and Becker and Englisch, 2019). If a consensus is not reached at the OECD, the reform could be implemented unilaterally. This has been the case of the U.S. since 2018. The U.S. impose a minimum tax on the income that U.S.-based multinationals earn in low-tax foreign countries, with a credit for 80 percent of the foreign income taxes they have paid. Because the Tax Cut and Jobs Act uses a global minimum tax, tax obligations in higher-tax countries can offset the minimum tax due for the activity in low- or no-tax countries. Therefore, firms can blend their foreign income from low-tax and high-tax jurisdictions, reducing their payments of the U.S. minimum tax, and achieving a lower tax rate than the U.S. rate. Thus, while the case of the U.S. shows that a unilateral implementation is possible, its design remains largely unsatisfactory and a country-by-country minimum tax system should be mostly preferred.

A crucial aspect of such a reform is the level of the effective tax rate. For instance, the U.S. global minimum effective average tax rate is between 10.5 and 13.125 percent on an annual basis. While there is no economic consensus on the optimal level, it is our personal opinion that a 20% minimum effective tax rate should be implemented. Indeed, a rate below 20% might legitimize aggressive tax planning, potentially leading even more companies to engage

(4) The minimum tax will not harm firms that underwent losses during the crisis as the tax is only levied on firms running positive profits.

(5) In a recent post, Reuven Avi-Yonah (2020) proposes to revive the wartime excess profits taxes that the U.S. instituted in World War I and World War II. Excess profits taxes are designed to tax the proportion of profits that derives from some external event not of the company's making. During Word War I, for instance, both Britain and the U.S. imposed an 80% tax rate on excess corporate profits (above an 8% annual return on tangible assets). A similar tax was set at 95% during World War II. Various methods may be used to calculate the level of excess profits. One proposal by Avi-Yonah is of particular interest: "The resulting tax (on exceptional profits) can be reduced by credits for wages of additional employees hired in 2020 to encourage the winners to hire and pay well during the recession."

in tax avoidance. Still, a 20% effective average tax rate (EATR) for multinationals' foreign profits is very ambitious already. As a benchmark, it is worth noting that 25 OECD countries have an EATR below 20%, while half of all countries worldwide have an EATR below 11%.[6] Moreover, even within countries with a high EATR, many multinationals report an EATR below the 20% threshold: a recent study for France by the IPP (Bach *et al.*, 2019) reports an average EATR of 17.8% for large companies, and we find an average long-run cash ETR of 18.7% for the French firms listed in Compustat.

(6) These EATRs are computed for the year 2015 in Tørsløv *et al.* (2019).

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A minimum tax of 20% on multinationals' foreign profits would dampen fiscal competition across countries by reducing the incentive of low- or no-tax jurisdictions whose effective tax rate is below this rate. A 20% minimum tax should also reduce the incentive of firms to locate in these countries as long as profit shifting implies positive costs.

All in all, corporate taxes will not only reflect firms' contributions to tax revenues where real economic activity takes place but also help legitimate future rescue plans.

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