Strategic Incentives for Adopting the Global Minimum Tax

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- Hong Kong launched a consultation on implementing the OECD’s global minimum tax (“Pillar Two”) at the end of 2023.

- This talk offers a theory about whether countries have self-interested reasons to adopt Pillar Two.
  - Paper available at https://ssrn.com/abstract=4161375
  - The theory has general application, e.g., to the U.S., China, Canada, Hong Kong, Singapore, etc.

- The Economist (Jan 2022): one of the very few predictions that can be made about Pillar Two is that “a bonanza awaits tax lawyers and accountants.”

- What is driving Pillar Two adoption, *besides* the bonanza promised to tax professionals around the globe?

Main conclusion 1: Even when a significant number of countries initially adopt Pillar Two, it may still unravel, as long as countries act out of national self-interest in the long term.

- Countries from which large multinationals originate bear heavy financial losses from Pillar Two. They should have little incentives to embrace it. In particular, adopting the Income Inclusion Rule is irrational.
  - This applies to China, U.S., Canada, Germany, etc.
- Low-tax countries may temporarily benefit from raising taxes on the MNE subsidiaries they host, by enacting the Qualified Domestic Minimum Top-Up Tax, but this may not last.
  - QDMT adoption is a poor indicator of the long-term viability of Pillar Two.
- Most countries do not have reasons to fear Pillar Two's purported enforcement mechanism, the under-taxed profit rule. The UTPR's enforcement effect is illusory.

Main conclusion 2: There are fundamentally unresolved issues regarding the legality of critical aspects of Pillar Two. They may significantly affect implementation.

- Pillar Two proponents and critics have conflated an *extraterritorial* interpretation and a *non-extraterritorial* interpretation of the UTPR.
- Under current Pillar Two design, the two interpretations have equivalent effects, i.e., failing to enforce Pillar Two.
- But the extraterritorial interpretation implies a new taxing right that poses fundamental challenges to international law.
- The design of QDMT also contains seeds of controversy.

Road Map

1. Schematic example illustrating Pillar Two’s components
2. Why the Income Inclusion Rule is irrational to adopt
3. Why the “enforcement” power of the UTPR is illusory
4. Why the UTPR is dangerous even when it fails to enforce Pillar Two
5. Objections and replies:
    - In particular, do countries act out of self-interest in the sense of maximizing national income (key premise of the paper’s arguments)?
6. Implications for Hong Kong

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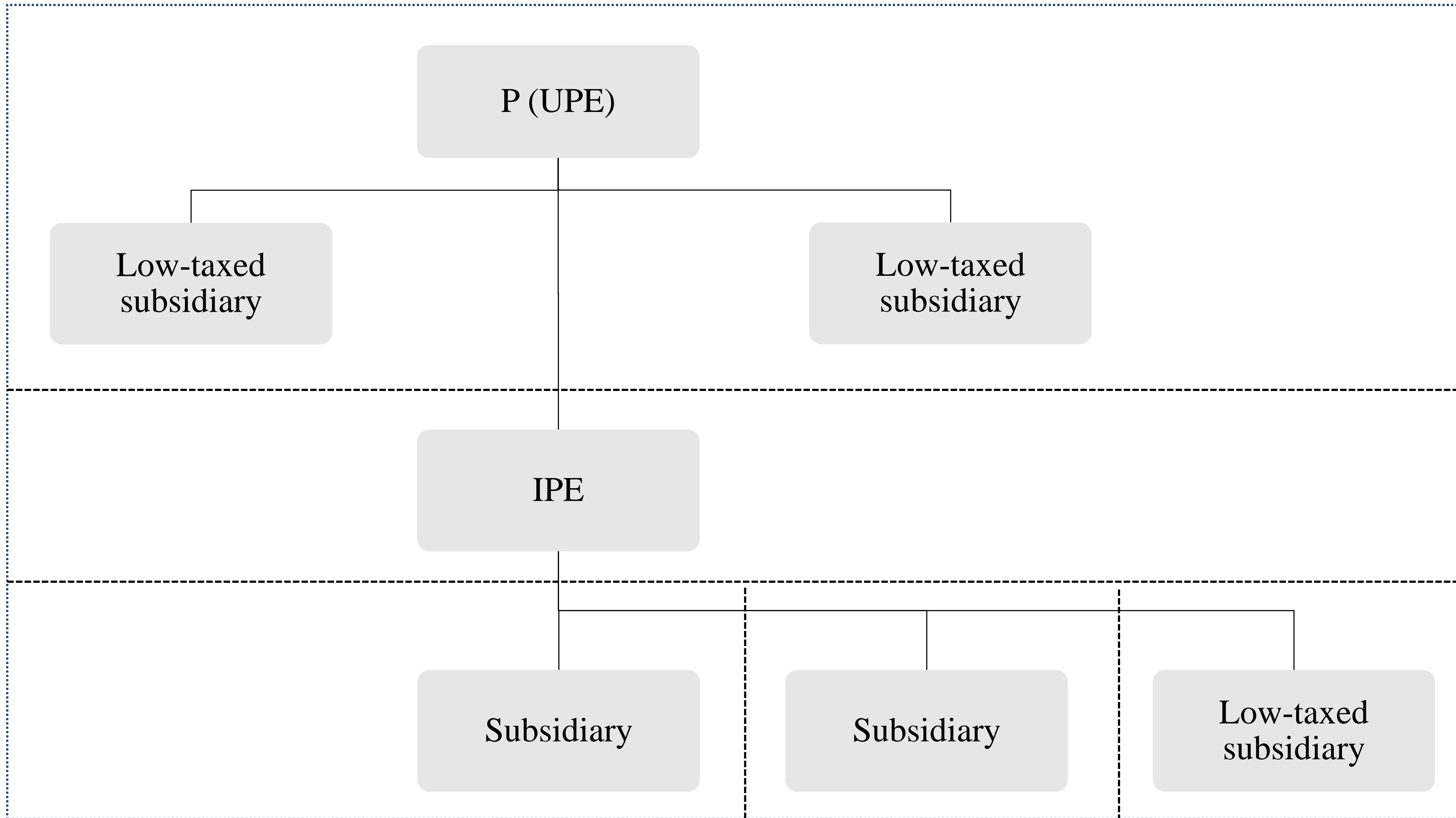
M: Multinational Enterprise Group



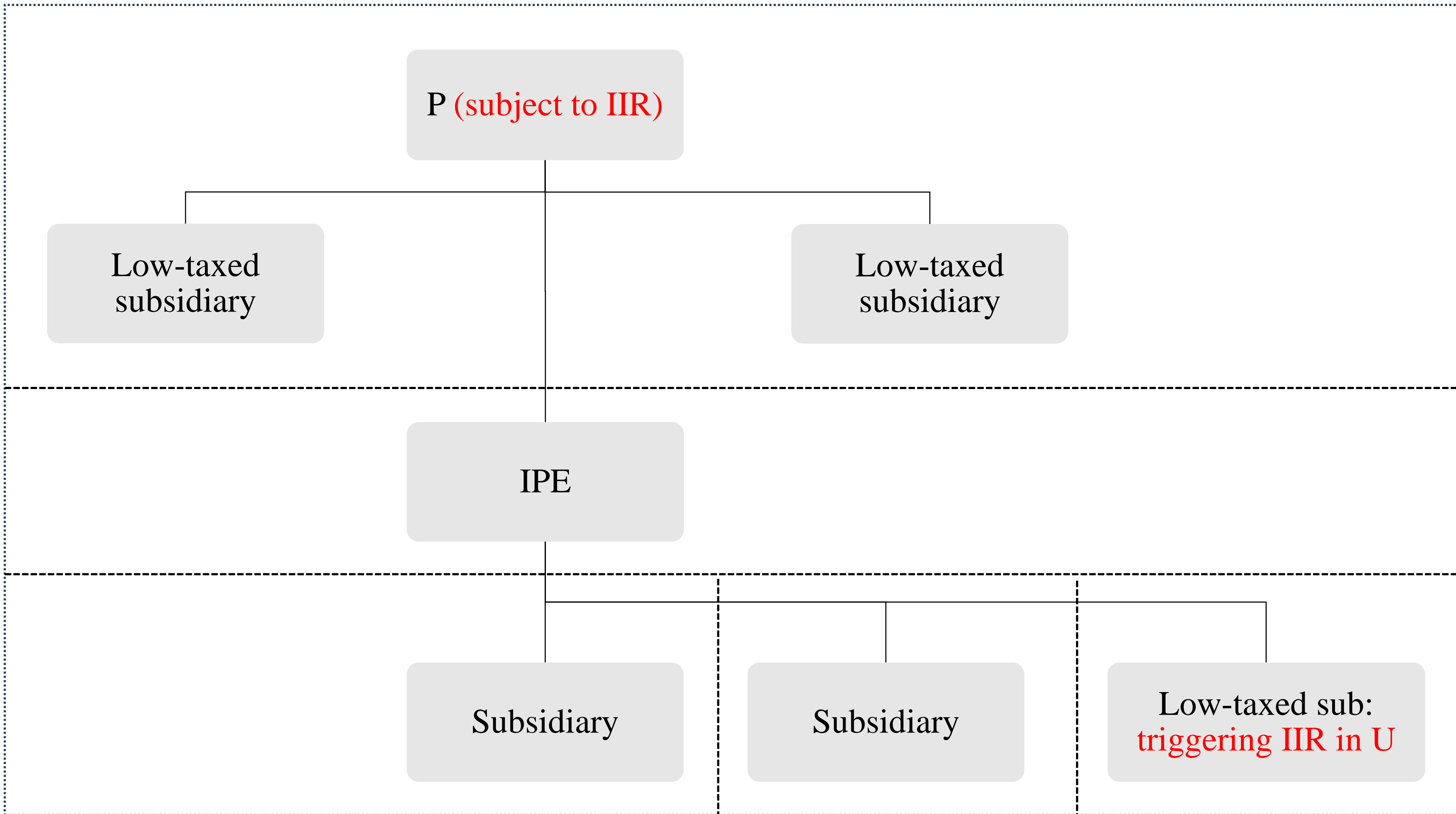
1. U: ultimate parent entity (UPE)
US, China, Canada, India, etc.

4. H: low (zero) tax intermediate parent entity (IPE)
Hong Kong, Luxembourg, etc.

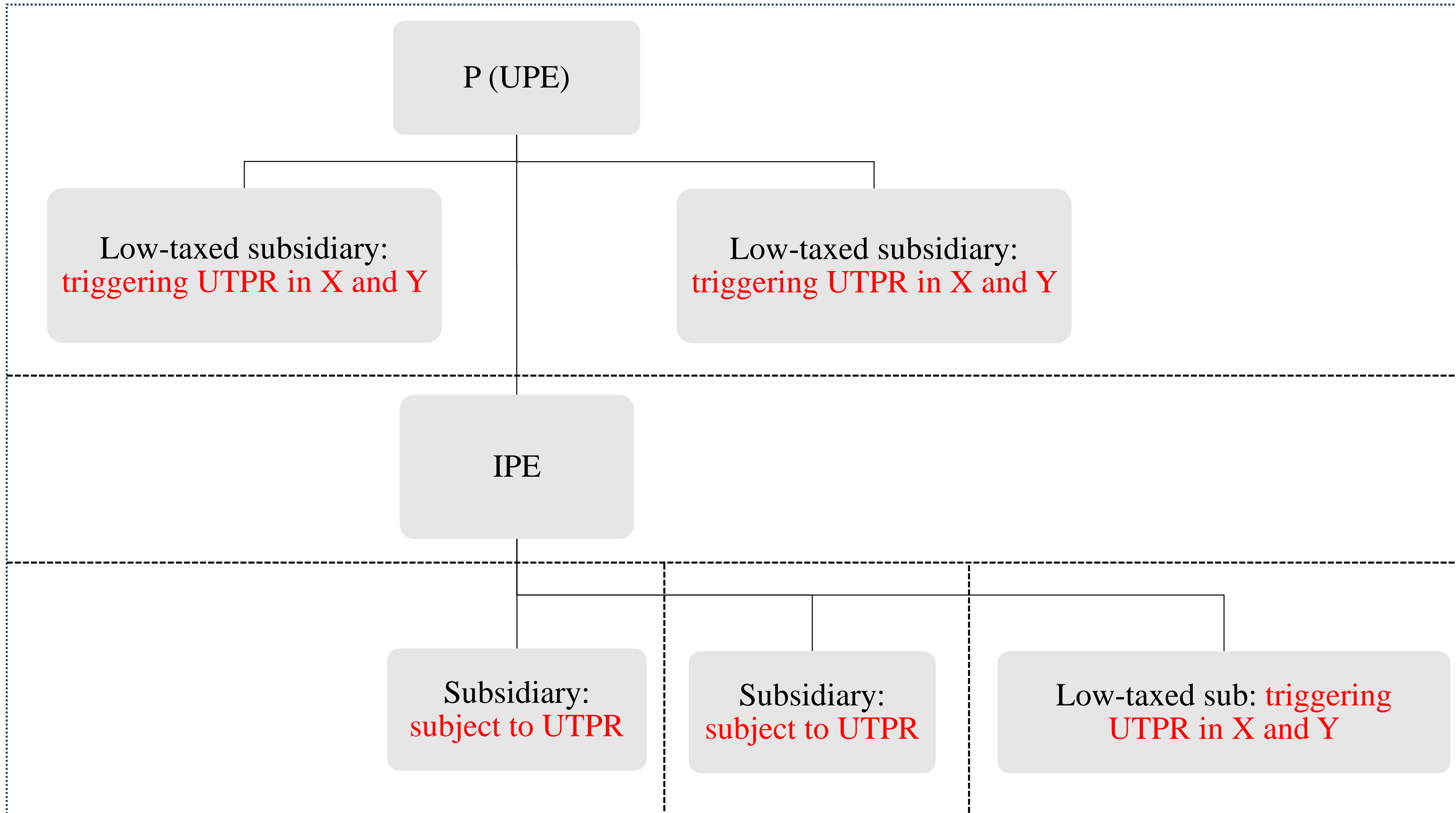
2. X: high-tax host of MNE subsidiaries
France, etc.

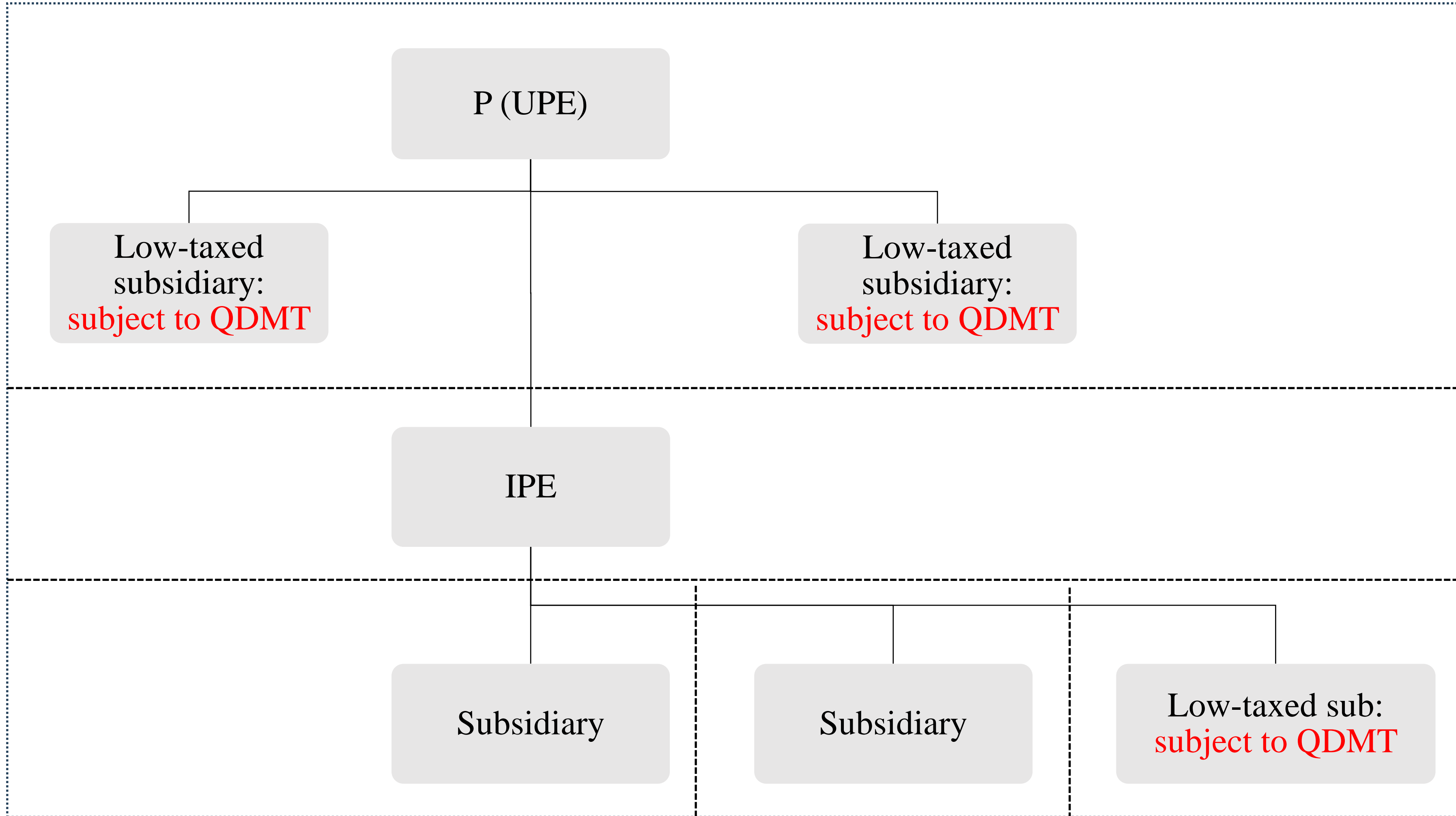
2. Y: high-tax host of MNE subsidiaries
Germany, etc.

3. Z: low tax host of MNE subsidiaries
Switzerland, Hungary, etc.



M: MNE Group
P (subject to IIR)
Low-taxed subsidiary
Low-taxed subsidiary
U: UPE country: potential adopter of the Income Inclusion Rule
IPE
H: low (zero) tax IPE country
Subsidiary
Subsidiary
Low-taxed sub: triggering IIR in U
X: high-tax host of MNE subsidiaries
Y: high-tax host of MNE subsidiaries
Z: low-tax host of MNE subsidiaries


M: MNE Group
P (UPE)
Low-taxed subsidiary: triggering UTPR in X and Y
Low-taxed subsidiary: triggering UTPR in X and Y
U: UPE Country
IPE
H: low (zero) tax IPE country
Subsidiary: subject to UTPR
Subsidiary: subject to UTPR
Low-taxed sub: triggering UTPR in X and Y
X: potential adopter of undertaxed profit rule or UTPR
Y: potential adopter of UTPR
Z: low tax host of MNE subsidiaries


M: MNE Group
P (UPE)
Low-taxed subsidiary: subject to QDMT
Low-taxed subsidiary: subject to QDMT
U: potential adopter of qualified domestic minimum top-up tax (QDMT)
IPE
H: low (zero) tax IPE country
Subsidiary
Subsidiary
Low-taxed sub: subject to QDMT
X: potential UTPR adopter
Y: potential UTPR adopter
Z: potential QDMT adopter

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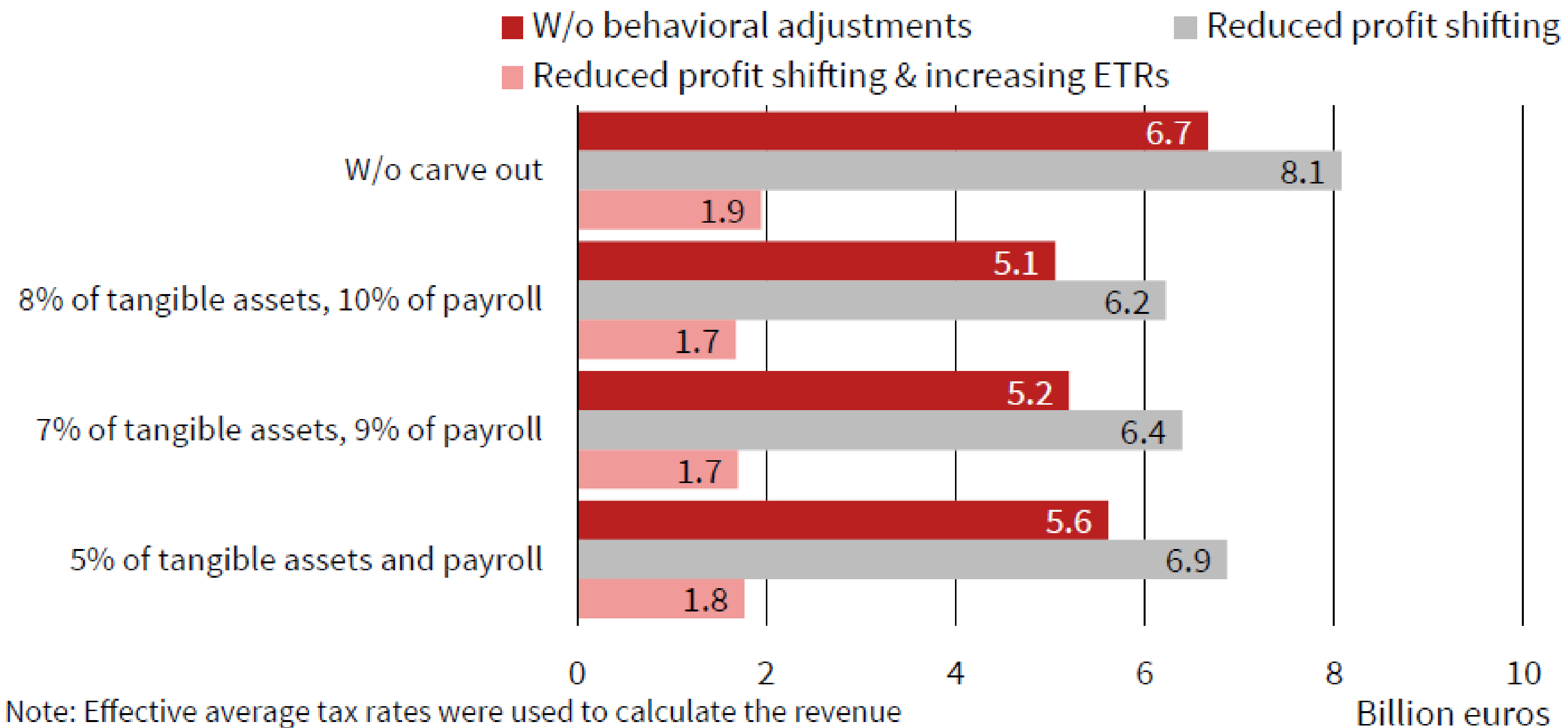
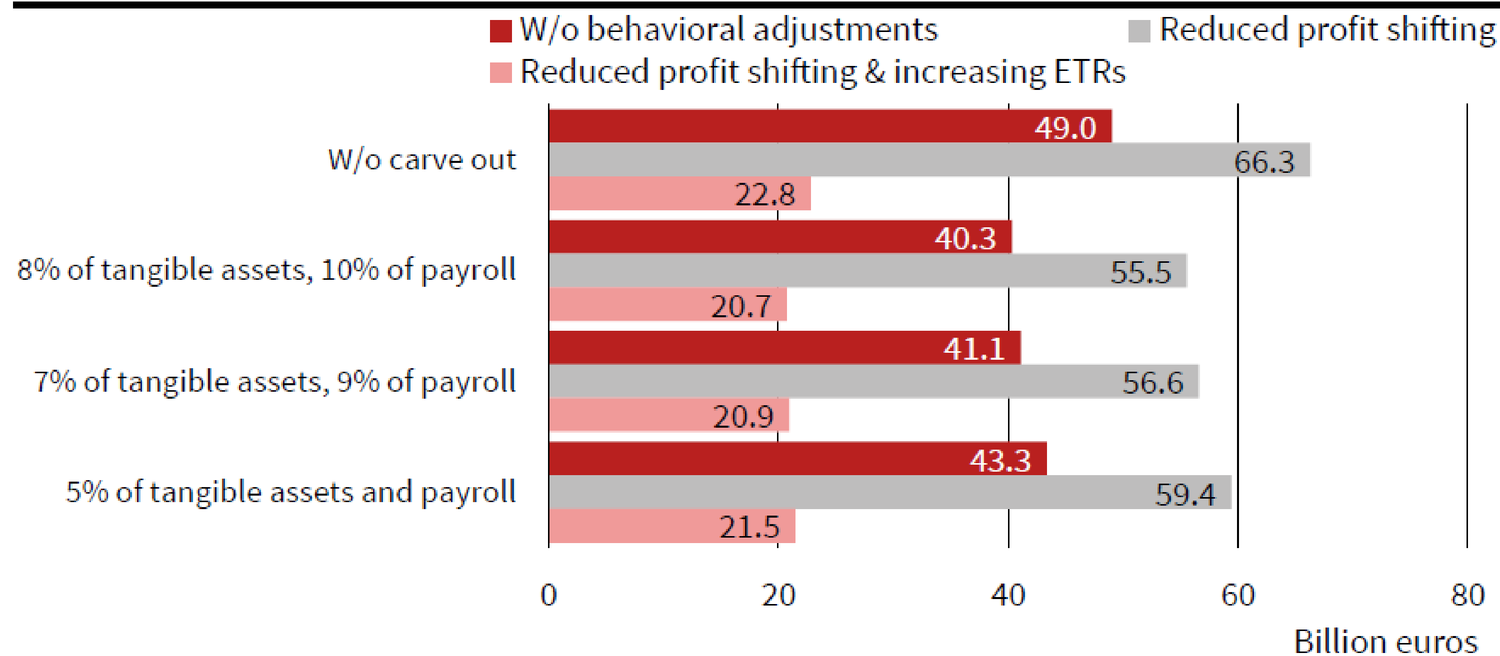
- UPE countries (Germany, Canada, etc.) currently tax their MNEs’ foreign profits lightly, encouraging profit-shifting to low tax jurisdictions.
- The IIR increases tax on such foreign profits, mechanically raising revenue, and reducing profit shifting incentives.
- Such revenue comprises **intra**-nation wealth transfers: the profit of M’s foreign subs represents part of U’s national income, just like U’s tax revenue.
- In contrast, a QDMT imposed by host countries results in **inter**-nation wealth transfers, e.g., from the wealth of shareholders in U to Z.
- Many jurisdictions (e.g., Switzerland, HK) would impose the QDMT only if other countries (i) impose the IIR, but (ii) effectively give a foreign tax credit for the QDMT.
- A UPE country would thus enact IIR **only to enable large transfers of wealth to other countries (i.e., large losses of national income)**

Size of loss of national wealth to UPE countries: very large



Fuest and Neumeier 2022



- Even if one believes that tax competition diminishes the welfare of UPE countries, no theory or evidence has been provided that the magnitude of such welfare loss is as large as the wealth transfer under Pillar Two.

QDMT adoption may not be viable in the long term

- QDMT adoption may be rational conditional on IIR adoption, but if IIR adoption is irrational in the long term, the QDMT may not be sustainable.
  - Indeed, the QDMT deters IIR adoption.

- The viability of QDMT may depend on whether other ways of attracting foreign investment than low taxes, such as business subsidies, can prove effective and internationally less controversial. This is yet to be seen.

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UTPR fails to enforce IIR adoption

- The UTPR either enforces QDMT adoption in countries hosting low-taxed MNE subsidiaries (i.e., those potentially targeted by the IIR) or not.
- If the UTPR (e.g., by Country X or Y) secures QDMT adoption (e.g., by Country Z), then the UPE country (U) gains nothing from IIR adoption, by the preceding arguments.
- If the UTPR (by X or Y) does not secure QDMT adoption (by Z), and
  - the UPE country (U) adopts IIR in response to the UTPR,
  - but the IIR itself triggers QDMT adoption by Z,

U again gains nothing from IIR adoption.

UTPR fails to enforce QDMT adoption by non-UPE countries

- The Pillar Two Model Rules suggest that a UTPR jurisdiction only taxes the profit of an MNE subsidiary located in the UTPR jurisdiction
  - The UTPR, differently interpreted as an extraterritorial tax (see below) but still only within Pillar Two specifications, has the same incentive effects.
- Consider whether a low tax country (Z) will apply QDMT to an MNE's (M) local subsidiary in response to another country's (X) adoption of UTPR.
  - M's projects in X and Z may be marginal or inframarginal (zero v. positive profit)
  - Negative after-tax profit ➔ exit
  - M has other marginal investment opportunities.

- If X project is marginal, X cannot levy UTPR because M will exit.

	Z: marginal with subsidy	Z: inframarginal with subsidy
X: marginal with UTPR	No reason to impose QDMT	No reason to impose QDMT
X: inframarginal with UTPR		

- If X project is marginal, X cannot levy UTPR because M will exit.
- If Z project is marginal only with subsidy, while X project is inframarginal, UTPR imposed by X would prevent M from investing in Z. Therefore *it does not matter whether Z removes the subsidy* (i.e. enacts the QDMT). Z thus has no reason to adopt the QDMT.

	Z: marginal with subsidy	Z: inframarginal with subsidy
X: marginal with UTPR	No reason to impose QDMT	No reason to impose QDMT
X: inframarginal with UTPR	No reason to impose QDMT	

- If Z and X projects are both inframarginal:
  - M is indifferent to being taxed $1 on Z profit or X profit. Should Z tax M profit in Z (with QDMT) to preclude X from taxing M profit in X (with UTPR)?
  - **But wait**: Why aren't Z and X taxing M profit in the first place? Why should Z tax M profits in Z only if X threatens to tax M profit in X?

	Z: marginal with subsidy	Z: inframarginal with subsidy
X: marginal with UTPR	No reason to impose QDMT	No reason to impose QDMT
X: inframarginal with UTPR	No reason to impose QDMT	**???**

- If Z and X projects are both inframarginal:
  - M is indifferent to being taxed $1 on Z profit or X profit. Should Z tax M profit in Z (with QDMT) to preclude X from taxing M profit in X (with UTPR)?
  - **But wait**: Why aren't Z and X taxing M profit in the first place? Why should Z tax M profits in Z only if X threatens to tax M profit in X?
  - This narrative works better if the UPE jurisdiction is considering the QDMT. That is, UTPR is effective only in enforcing QDMT adoption in UPE country.

	Z: marginal with subsidy	Z: inframarginal with subsidy
X: marginal with UTPR	No reason to impose QDMT	No reason to impose QDMT
X: inframarginal with UTPR	No reason to impose QDMT	Reason to impose QDMT in UPE country

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- What if the UTPR is an extraterritorial instrument, i.e., X can tax the profit of the X sub, the Z sub, **and** the U subs?
  - Many write as though the UTPR can be interpreted this way: “If HK does not tax a HK Co’s profit, someone else will tax ‘it’.”
  - This is inconsistent with the text of Pillar Two Model Rules.

- More importantly, it would amount to the creation of a new taxing right.
  - National-income-maximizing governments would use it too much, to the detriment of others.

- On the legality of the UTPR (and QDMT): where positive law is silent, not everything goes!
  - Should countries be allowed to tax profits unconnected with them? Hard to imagine that countries are unconstrained. **Even proponents of the UTPR should reject the ET interpretation**.
  - Should countries be allowed to adopt measures aimed at neutralizing tax incentives in other countries?
  - Is there anything that limits discriminatory applications of the QDMT?

- National governments, though not the OECD, can be challenged in court.

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Should we predict the behavior of countries on the premise that they maximize national income?

- Let's ask the proponents of Pillar Two!
  - EU Tax Commissioner Paolo Gentiloni: Failure to adopt the IIR "will result in an immediate loss of tax revenues."
  - OECD Secretary-General Mathias Cormann: once there's a critical mass of countries on board, "it becomes very hard not to become part of it because essentially, you leave money on the table for other countries to collect if you don't adopt Pillar Two."
  - Pascal Saint-Amans: "if somebody just grabs the tax — your tax — well, you will not let it go. You will act yourself."
  - Former Deputy Assistant Secretary of the Treasury Kimberly Clausing: "countries that enact the agreement's provisions will be able to tax multinational companies based in countries that do not adopt the provisions…This provides a strong incentive for countries…to eventually follow through on their pledge to abide by the agreement."

- Many commentators (including scholars) claim that Pillar Two is “incentive compatible,” displays “diabolical/devilish” logic, or offers “novel enforcement mechanisms”.
  - That is, compatibility with national self-interest is supposed to be essential to Pillar Two design.

- Why else are countries fighting tooth and nail over Pillar One, the Digital Services Tax, etc.?

- The OECD, meanwhile, has promoted the Pillar Two as though governments are revenue-maximizing.
  - Which is more plausible, that governments seek to maximize revenue or that they maximize national income (or welfare)?

- National income maximization is certainly a simplistic predictor of country behavior, but there aren’t many (any?) superior alternatives, and we should not use it only when convenient.

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- HKMTT may be rational for now, but primarily as a response to anticipated IIR (not UTPR) adoption by others.
    - Hong Kong needs to recognize that Pillar Two will come at a large cost for countries like China, the U.S., Canada, and it is unclear that such countries will be willing to bear such costs (or do so indefinitely).
- Adopting the IIR in Hong Kong and subjecting foreign income to Hong Kong taxation *as a response to Pillar Two* is harder to justify.
- Adopting the UTPR is legally and economically risky (reckless?), as it is for other countries.

Thank you and comments welcome!

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Research available at:

https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=633741

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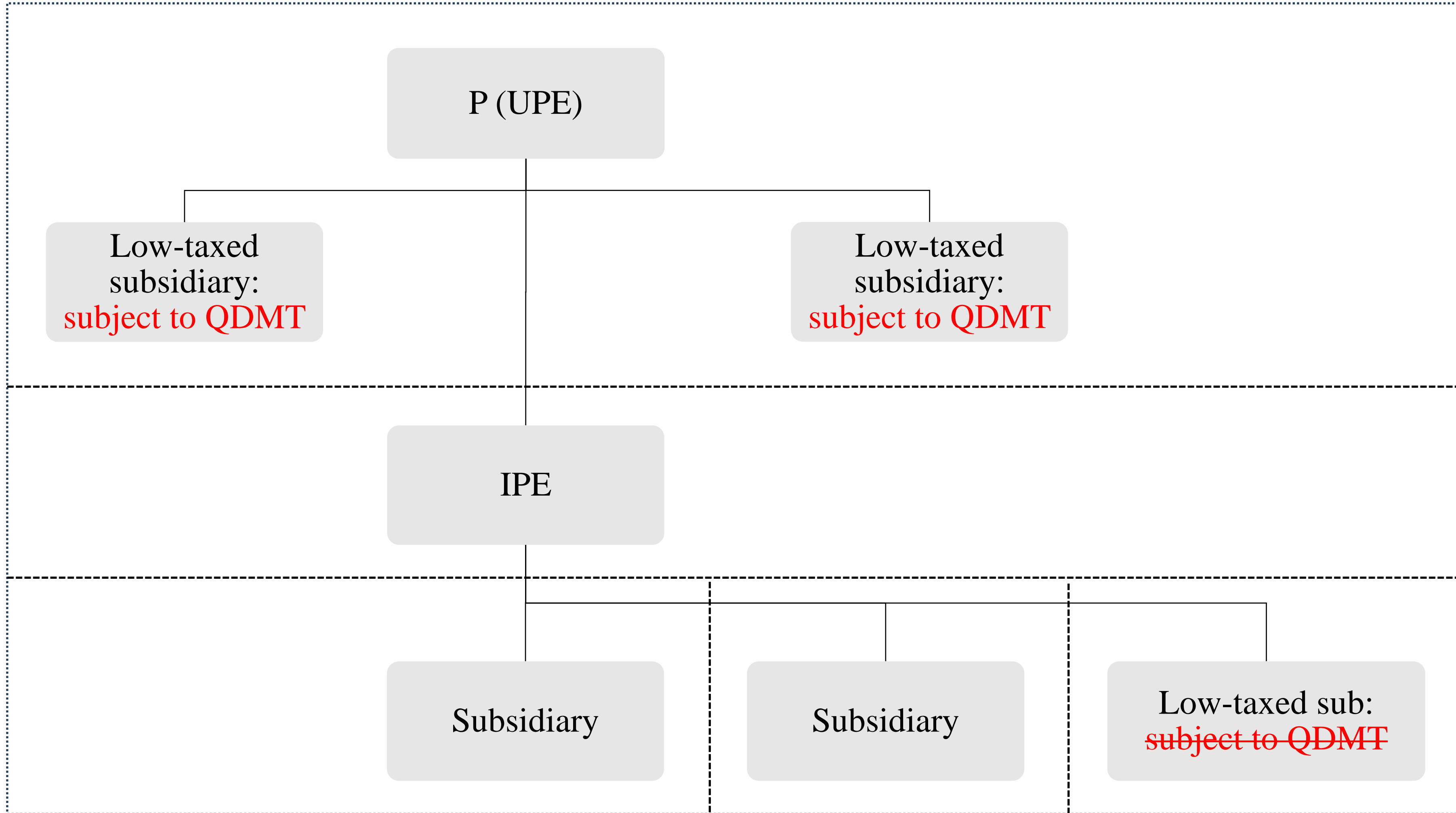

U: Rational to adopt QDMT in response to UTPR

H: low (zero) tax IPE country

X: potential UTPR adopter

Y: potential UTPR adopter

Z: no rational incentives to adopt QDMT in response to UTPR

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	Worldwide taxation by UPE country (e.g., IIR)	Worldwide taxation by subsidiary country (e.g., UTPR)
Bound by profit in taxing jurisdiction?	No	Yes
Separable from foreign tax credit (FTC) feature	Yes	Yes (Pillar Two variant not the only possibility)
National welfare maximizing	Yes without FTC feature	Yes without FTC feature
Compatible with international law (customary or otherwise)	Yes	No!

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