GENERALI INVESTMENTS

Core Matters

Bumpy road to modernisation of international taxation

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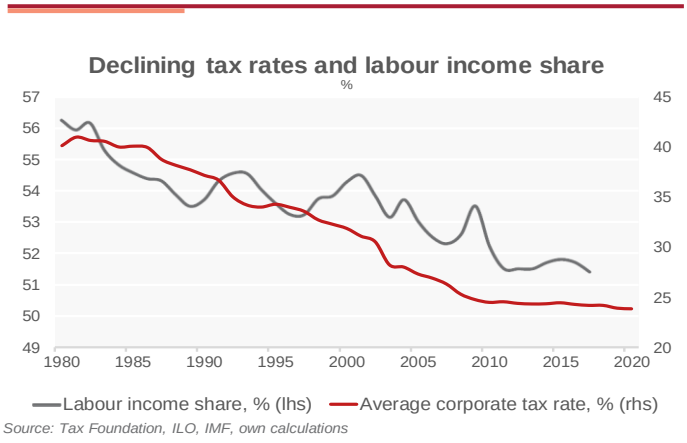
Our Core Matters series provides thematic research on macro, investment and insurance topics

- In early July 2021, over 130 countries agreed to reform international tax rules: Pillar One gives new taxing rights to market jurisdictions. Pillar Two introduces a minimum 15% global tax rate on corporate profits.
- The "overhaul" of taxing rights became necessary to deal with the digitalisation of trade that allows large multi-national enterprises (MNEs) to engage in tax optimisation by shifting profits to low-tax jurisdictions. This raised questions about the fairness of taxation, amplified by tax competition and cherry-picking of tax havens. Moreover, the declining share of labour income spurred concerns about inequality. The proposed new tax order is a sign of renewed multilateralism.



Source: Tax Foundation, ILO, IMF, own calculations

- The tax deal still faces political headwinds from key players. Thus, the current time schedule looks challenging. In the US, Senate Republications have strong reservations and within the EU tax havens like Ireland, Hungary and Estonia are opposing the agreement. That said, a failure to implement the deal would lead to the undesirable proliferation of unilateral digital service taxes, which could easily end up in a global trade conflict.
- The new rules under Pillar One will only affect taxation of about one hundred of the biggest and most profitable multinational enterprises (MNEs). The OECD estimates that total corporate tax revenue could increase by 2.3%-4% while the detrimental impact on investment activity and economic growth is likely to be small.
- With respect to countries, it is obvious that tax havens will lose, while high-tax countries with a big market for digital services will probably benefit. For the US, the net effect is ambiguous as it will lose profit taxing rights to market jurisdictions while the exact co-existence with US tax laws (GILTI) still needs to be clarified.
- The high weight of tech giants in the S&P500 makes it more vulnerable than the MSCI EMU. That said, the short-term impact is likely to be small. Looking ahead, however, a shift in the willingness towards capital and profit taxation might exert more lasting negative effects on equity markets.

CONTENT

In early July 2021, over 130 countries joined the "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy". In a nutshell, Pillar One gives market jurisdictions (where products are marketed) new profit taxing rights while Pillar Two introduces a minimum corporate tax rate of at least 15%. In this report we summarize the points of the agreement most relevant to investors and sketch the likely impact on the economy and financial markets. We first show why digitalisation of trade and profit optimisation has made an "update" of the international order necessary. We also shed some light on political issues like the international tax competition and socially fair taxation. Pillar One and Two contain some complicated technical details but we limit ourselves to giving insight into the basic mechanisms, also by the help of examples. Finally, we discuss headwinds to the implementation, followed by some impacts on tax income, investment and the stock market.

1. New tax rules for the digital age needed

The current international taxation framework dates back about 100 years and was designed for trade mainly in physical goods. Accordingly, the primary right to tax profits from these activities was awarded to the "source" country. i.e. where the production takes place and the company has a physical presence. In case of supply chains, several countries have taxation rights according to the profits accruing to their own jurisdictions. To ensure fairness of the system, it is accompanied by the so-called "arm's length principle". It specifies that "all individual transactions between related entities [are valued] as if they were taking place between unrelated entities in competitive markets". The right to tax passive income (dividends, royalties and interest) was given to the "residence" country, i.e. where the company's headquarters are located. By contrast, the country where the products are marketed (without a physical presence) has no right to tax profits. However, the country can apply a sales tax or VAT. These traditional principles are today enshrined in a global network of estimated 3,000 bilateral tax treaties.

Digitalization: The rise of digital trade undermines the efficiency and fairness of these taxing principles. Digitisation has allowed companies to conduct business in markets without having a physical/production presence there. E-commerce platforms (e.g. Amazon, Alibaba, Mercadolibre, eBay and Etsy) are cases in point. Generally, products are increasingly delivered electronically (e.g. movies via Netflix or music via Spotify), and the features of many of them blur the borders between goods and services. Large network services which come for free for end-users (e.g. Google) nevertheless provide the data on which large profits are made in the advertising sector. Consequently, MNEs may realise large profits in countries without a physical presence. Traditional taxation rights exclude the marketing jurisdictions from participating in profit taxation. This issue also motivated some countries to unilaterally (threaten to) introduce digital service taxes (see below) and is tackled in Pillar One.

Profit shifting: Profit shifting can occur via several channels. It generally involves some manipulation of the "arm's length principle". The emergence of global supply chains has made this process easier. Moreover, in the "digital" age, the importance of intangibles, like brands, copyrights, designs and patents have gained much importance. By their very nature, these assets do not carry a competitive price. By manipulating transfer prices and structuring production, MNEs can thus shift profits to jurisdictions that impose little or no corporate tax. Taxation rights for royalties are awarded to MNEs residence countries. However, to avoid double taxation most countries assume that foreign business profits have already been taxed abroad and provide tax credits. A recent study (see table above) for instance estimates global profit

Global proft shifting and tax losses

	Shifted profits bn USD	Corporate tax loss % tax collected
Euro area	**136**	
Austria	4	11%
Estonia	0	10%
Finland	3	11%
France	32	21%
Germany	55	28%
Greece	1	7%
Italy	23	19%
Latvia	0	7%
Portugal	3	9%
Slovakia	1	5%
Slovenia	0	6%
Spain	14	14%
US	**143**	**14%**
UK	**62**	**18%**
Non-tax haven total	**616**	**9%**

Note: Among the remaining EMU economies, Lithuania is not in the dataset while Belgium, Luxemburg, Ireland, the Netherlands, Malta and Cyprus are classified as tax havens

Source: Torslov, Wier, Zucam (2021)

shifting at US$616 bn in 2015 implying a 9% loss in global corporate taxes. Pillar Two will allow to end this practise, by introducing a global at least 15% minimum tax.

International tax competition and tax havens: Many jurisdictions engage in tax competition by offering MNEs reduced taxation, sometimes to zero. Countries have competed to attract foreign direct investment. Rounds of international tax competition resulted in a "ruinous race to the bottom", undermining the fiscal capacity of states to respond to national as well global challenges. In 1980, the worldwide average statutory corporate tax rate was around 40%, as compared to around 24% in 2020. While corporate tax rates among OECD countries typically vary between about 20% and 32%, a few countries deviate strongly to the bottom. Even the EU countries like Hungary and Ireland have corporate tax rates below the 15% threshold. The cherry-picking of tax havens induces substantial tax losses to the detriment of non-tax haven countries.

Corporate tax rates among OECD economies

central government and sub-central government combined corporate income tax rates, %, in 2020

Source: OECD

Avoiding 'tax wars': In the absence of an international solution and the dismissal of multilateralism by former US President Trump, several countries introduced or threatened to introduce a national digital services tax (DST). In Europe, these were mainly France and the UK. The EU Commission also proposed implementing an EU-wide 3% digital tax. The US responded with a series of trade investigations on national tax legislations (Section 301 of the Trade Act), seeing discrimination against US tech companies in seven cases (France, India, Italy, Turkey, Austria, Spain and the UK). It levied additional 25% tariffs on US$3.4 bn worth of imports from these countries. However, the tariffs have not yet taken effect. The US put the investigations on hold or terminated them recently. As part of the deal, countries also agreed to remove (or put on hold) their DSTs.

Social justice: Tax avoidance is often deemed unfair as government tax incomes provide the basis to provide public goods and mitigate income inequality. Globalization has benefited the mobile factors of production at the expense of the immobile ones, like labour. Post Covid-19, the importance of the digital economy will rise further. This is likely to lower public tolerance for often highly profitable MNEs "not paying their fair share of taxes".

What has been achieved so far: The Two-Pillar Solution had not been possible without efforts and preparations from the OECD. Discussions about a new international taxing framework already started in the 1990s (see box). In 2012, all OECD countries and a number of EMs combined efforts in the so-called "Base Erosion and Profit Shifting (BEPS)" project. This resulted in 2015 in a 15 points action plan, to which the recent agreement still makes reference regarding

Box 1: The long way towards a global tax agreement

1996 – G7 makes the problems of tax evasion and avoidance a priority

1998 – OECD report: *Harmful Tax Competition: An Emerging Global Issue*

2000 – 2007 – Development of international standards on tax transparency and securing commitments to a global level playing field

2008-2009 – Global Financial Crisis – G20 pledge to end bank secrecy and establish the Global Forum on Transparency and Exchange of Information for Tax Purposes

July 2013 – G20 identifies tax avoidance as a priority

October 2015 – Adoption of the **Base Erosion and Profit Shifting (BEPS)** package of 15 Actions to counter tax avoidance – Action 1 deals with the digitalisation of the economy

June 2016 – Establishment of the **OECD/G20 Inclusive Framework on BEPS, now counts 139 members**

2017-2020 – Active discussions in the Inclusive Framework on how to address the tax challenges of the digitalisation of the economy culminating with the release of "blueprints" for a two-pillar solution in October 2020.

July 2021 – Over 130 countries and jurisdictions join a new **two-pillar plan to reform international taxation rules**.

October 2021 – Further report to the G20 Finance Ministers on the finalisation of the agreement and resolution of technical details.

2022 – Development of model legislation, a multilateral instrument and detailed guidance for the implementation of the digital agreement.

2023 – Expected implementation

Source: OECD

certain criteria and co-operations. For the action plan's implementation and surveillance, the so-called OECD/G20 Inclusive Framework (IF) was established.

The IF now counts 139 members of which 132 supported the two pillar solution. Agreeing IF members comprise more than 90% of global GDP, including the US and China. The two interlocking domestic Pillar Two rules are dubbed the "Global anti-Base Erosion" (GloBE) rules (see GILTI below). The OECD provided extensive research on Pillar One, Pillar Two, the economic impact as well as several introductory brochures.

2. New taxing rights of market jurisdictions (Pillar One)

Pillar 1 gives profit taxing rights to market jurisdictions, where the MNE has no physical presence. The approach consists of three elements (Amount A, Amount B, and Tax Certainty) with eleven building blocks. In what follows we cover only the most important ones.

Structure of Pillar 1

Amount A		Amount B	Tax Certainty
Scope	Nexus	Scope	Dispute prevention and resolution for Amount A
Revenue sourcing	Tax base determination	Quantum	Dispute prevention and resolution beyond Amount A
Profit allocation	Elimination of double taxation		
Implementation and Administration			

Source: Adapted from OECD

Amount A specifies the new taxing right of market jurisdictions over a share of residual profits calculated at the MNE group (or segment) level. This amount is computed using a range of criteria:

First, the Scope of the measures are only multinational enterprises (MNEs) with global turnover above €20 bn and a profitability above 10% (i.e. profit before tax to revenue). Within several years the turnover threshold will be reduced to €10 billion, to give tax authorities time to set up data collection. Oil and mining companies and "Regulated Financial Services" are excluded.

Second, a market jurisdiction will participate in a share of Amount A if the MNE under consideration derives at least €1 m in revenue from that jurisdiction (the exact criteria under which a market jurisdiction qualifies for a share of amount A are called the nexus rule). For smaller jurisdictions with GDP lower than €40 bn, the nexus will be set at €250 000.

Third, above this threshold, market jurisdictions will be able to tax MNEs between 20-30% of the residual profit, defined as profit in excess of 10% of revenue. Box 2 may shed more light on how this tax share might be calculated.

Of course, calculations quickly become complex with the number of countries involved, different tax rates and thresholds applied. More examples can be found in the OECD Pillar One blueprint (p.221f).

Box 2: Example for taxation through reallocation

A simplified example (adopted from Tax Foundation website, Author: Daniel Bunn) may shed additional light on the reallocation process. A company C sells products in country A and B, but has a physical presence only in A. Total revenues of $100 stem equally (A = $50/B=$50) from each of these countries. Profits are $20, the profit margin accordingly 20%. In the current situation, in which only the physical presence counts for taxing rights, Country A may apply a corporate tax of 21%, resulting in ($20*21%=) $4.20 tax paid. Country B has no profit taxing right. Under the new proposal, country B can tax 20%-30% (assumed 20%) of the residual profit in excess of 10% (i.e. $10) in line with its revenue share as the nexus (50%), i.e. $10*0.2*0.5=$1. The country B may apply a slightly higher corporate tax as country A of 25%. The tax then amounts to $1*25%=$0.25. Country A gives a tax credit of $1, so that its tax base reduces to $19 and the tax to ($19*21%=) $3.99. Overall, the tax income of country B is small. The total tax paid by company C increases from $4.20 to $4.24.

The base for the calculation of MNEs' profits will be determined by reference to their own financial accounting income, with a small number of adjustments. Moreover, MNE losses can be carried forward. Segmentation (different business lines within a MNE) will occur only in exceptional circumstances where (based on the segments disclosed in the financial accounts) a segment meets the scope rules. Double taxation will be avoided.

Amount B concerns the distribution of subsidiaries that perform "baseline marketing and distribution activities" in the market jurisdiction. Many firms sell their goods only via such subsidiaries while production, design and other features are located elsewhere. The goal of amount B is to simplify things in two respects:

- First, it is intended to streamline the enforcement of transfer pricing rules for tax administrations, reducing the compliance costs for taxpayers.
- Second, it aims at enhancing tax certainty and reduce controversy between tax administrations and taxpayers.

The IF statement remains vague on that point. It states that "the application of the arm's length principle to in-country baseline marketing and distribution activities will be simplified and streamlined, with a particular focus on the needs of low capacity countries. This work will be completed by the end of 2022." The discussions suggest that Amount B will ascribe a fixed taxable return to the marketing and distribution activities. Then the national tax authority can simply tax this amount, without going into details of transfer pricing problems. The challenge with such a "pre-defined" return is that it might vary strongly between industries. In the future differentiation among industries or regions may be introduced.

Tax Certainty: The IF also agreed to put in place dispute prevention and resolution mechanisms for MNEs and all related parties. This will cover double taxation for Amount A as well as related issues concerning transfer pricing and business profits disputes. Disputes shall be solved in a mandatory and binding manner, which may have form of mandatory binding arbitration enshrined in bilateral tax treaties (like in action point 14 of the 2015 plan).

3. A 15% minimum tax (Pillar Two)

The so-called Pillar 2 introduces an at least 15% global minimum, effective corporate tax rate. This is intended to put a floor on tax competition and prevent companies from shifting their profits to low-tax countries.

The centrepiece of the IF agreement is to combat profit shifting by a "top-up" tax in the country where the headquarters are located. Its government can apply an additional tax to profits recorded in another, low-tax country in order to lift it to the minimum of 15%. Thus, while the agreement does not touch each country's sovereignty on setting its own taxes, it undermines the firm's incentives for profit optimisation.

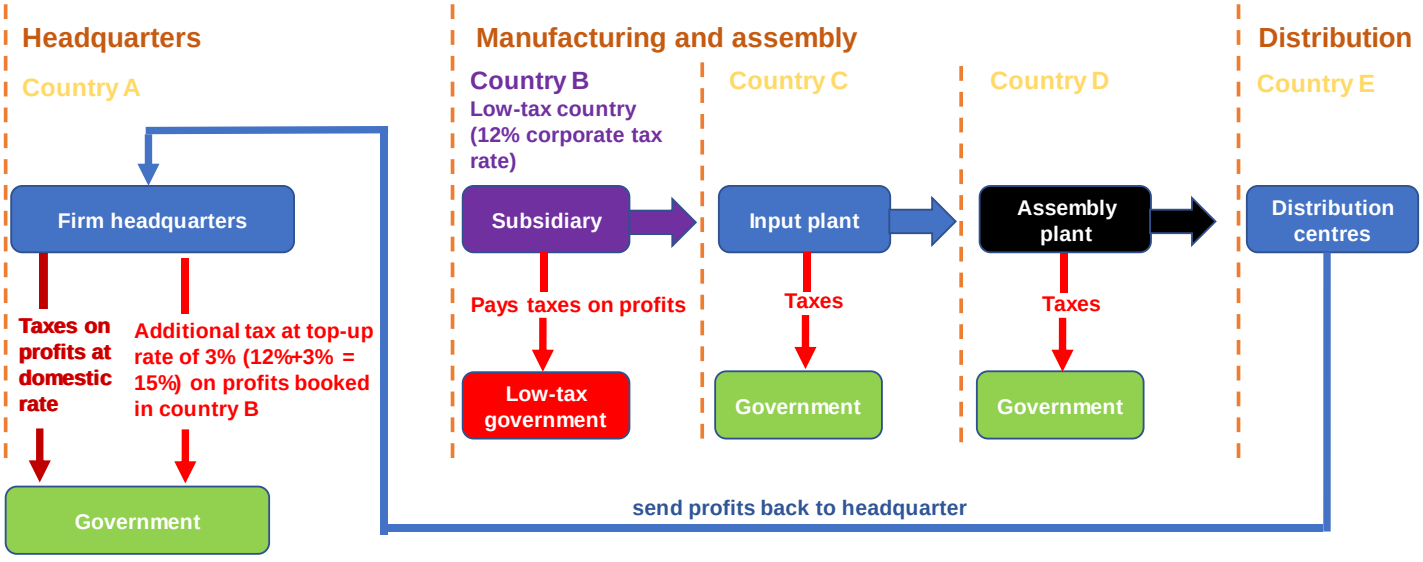
As an example, consider a subsidiary of an MNE in a low-tax jurisdiction with a corporate tax rate of 12%. The government in the firm's country of residence can apply a top-up tax on profits stemming from this low-tax jurisdiction of 3 pp which brings the total tax on these profits to 15%. At the same time, it can tax the domestic profits of the firm in accordance with its own tax rate (e.g. 21%).

This mechanism is called "Income Inclusion Rule" (IIR). It is accompanied by several other rules aiming at the avoidance of loopholes.

- First, the "Undertaxed Payments rule" (UTPR) addresses base erosion through deductible intra-group payments to low-taxed subsidiaries (not controlled by a parent company which is subject to the IIR). If such a payment was not subject to the minimum tax, the deduction of the payment would be denied.
- Secondly, a "Subject to Tax Rule" (STTR) acknowledges that barring the deduction of certain intra-group payments (subject to no or low rates of nominal taxation) may help countries, especially those with lower administrative capacities, to protect their tax base.

While the basic principle looks straightforward, the additional rules already give a preview on how complicated matters become (compare below for implementation risks). Tax authorities need to clarify a huge number of technicalities, ranging from determining the "Group" structure amid complicated ownership problems, profits and the effective tax rates on each stage of production, thresholds, carve-outs and avoiding double taxation.

How the proposed 15% minimum tax would deter profit shifting



Source: adapted from PIIE

GILTI co-existence: The recently introduced US "Global Intangible Low-Taxed Income" (GILTI) resembles in important aspects Pillar Two. Therefore, the agreement specifies that "consideration will be given to the conditions under which the US GILTI regime will co-exist with the GloBE rules, to ensure a level playing field.". The GILTI tax applies to income from intangible assets of US controlled foreign co-operations (CFCs). The tax rates range from 10.5% to 13.125%, well below the regular 21% US corporate tax rate. Like Pillar Two, it discourages MNEs to shift their profits to low tax countries.

4. Political headwinds and key details still missing

The deal is scheduled to be finalised in October 2021, which also then includes an implementation plan. However, despite the agreement of 134 countries, the Two Pillar statement contains some details on which Inclusive Framework (IF) members have yet to agree. This concerns for example, the exact profit to be re-allocated (20%-30%) and the precise global minimum tax rate (will be "at least" 15%). Moreover, not all members of the IF have agreed. Ireland, Hungary and Estonia joined a small group of six countries, including two Caribbean tax havens, to oppose the OECD deal. Overall, this deadline looks challenging.

Once an agreement is found, Pillar One is likely to be implemented by a multilateral (international) instrument which then will be open for signature in 2022 and come into effect in 2023. For Pillar Two the outlook is vaguer: "(…) *members will agree and release an implementation plan*." However, the time frame is identical.

There are also a range of political hurdles. For example, in the US, tax laws must be passed by the Congress. Currently it looks unlikely that Pillar One and Two will be presented as one bill. Pillar Two changes domestic legislation and could possibly be passed using the so-called reconciliation process, for which the one seat majority the administration enjoy in the Senate is enough. However, Pillar One likely involves international tax treaty changes, which would require a two thirds majority in the Senate. If that cannot be secured (which looks likely, given the opposition by the Republicans) the administration could resort to legalistic arguments known as "last in time" rule which allows new US legislation to override existing treaties. The deal could even be blocked if in the 2022 mid-term elections the Republicans would get the majority in Congress.

Similarly, within the EU Ireland, Hungary and Estonia have so far refused to support the deal. While Ireland's stance looks more compromising, Hungary and Estonia see the minimum tax as contradicting the current EU law. However, EU officials insist that it was compatible. Nevertheless. a clash among EU member countries cannot be excluded. Taxing issues still require unanimity by EU law and attempts by the EC to move to qualified majority voting failed due to stiff resistance from low-tax countries. A coalition of the willing could implement the 15% minimum tax rate through the enhanced co-operation procedure whereby a minority of states can pursue a policy without the others. But this raises legal risks as some states would deprive their firms from lower tax rates available elsewhere. The reallocation of taxing rights implies a change of a huge number of international tax treaties that definitely need unanimity. We expect cumbersome arm twisting and horse trading until the new tax order is put into EU law. Therefore, even in case of a global consensus the implementation into EU law by 2023 might be ambitious.

Thus, while here are a lot of political hurdles involved, the alternative without a deal is the proliferation of DSTs and similar measures. The Pillar One agreement explicitly states that the "*package will provide for appropriate coordination between the application of the new international tax rules and the removal of all Digital Service Taxes (…)*". While this statement is vague, failure to agree on the deal opens up the possibility of severe trade frictions. As in the past, the introduction of DSTs could lead to retaliation by tariffs which could prompt counterretaliation and so on. These arguments will also be considered by the US Senate as well as tax haven countries.

5. Global tax revenues to increase by up to 4%

The IF mandated the OECD to carry out an economic impact assessment of the Pillar One and Pillar Two proposals on tax revenues, investment and economic activity. It was carried out in 2020 before the full agreement was signed and assumes a minimum tax of 12.5% instead of 15%. Moreover, due to publication lags, the data used predate the 2017 US tax reform, the implementation of some aspects of the OECD/G20 Base Erosion and Profit Shifting (BEPS) package and the Covid-19 crisis.

Keeping these caveats in mind, the OECD estimates a 2.3% to 4% (US$56-102 bn) increase in global corporate income tax (CIT) revenue (total global CIT is estimated at about US$ 2.5 tr in 2019), including the US GILTI. As could be expected from the discussion of Pillar One (compare example in Box 2), the revenues it raises are rather small with 0.2%-0.5%. Amount A reallocated taxing rights to market jurisdictions could sum up to US$ 100 bn.

By contrast, the global revenue gains from Pillar Two could be much more significant at 1.7%-2.8% of global CIT. As the minimum tax reduces the differences in effective tax rates across jurisdictions, this will also diminish MNEs' incentives to shift profit to low-tax countries. Some MNEs could consider the gains no longer worth the costs (e.g. in terms of outsourcing consultancy and reputational costs, etc.). However, the exact scale of the reduction in profit shifting is difficult to ascertain.

Finally, regarding the geographical distribution, on average, the OECD study reckons that **low, middle- and high-income jurisdictions would all benefit from revenue gains**. "These would be relatively small under Pillar One and larger under Pillar Two. The combined revenue gains from both pillars are estimated to be broadly similar – as a share of current CIT revenues – across low, middle and high in-come jurisdictions." The impact of Pillar Two gains tends to be relatively larger among high income jurisdictions which are predominantly hosting most ultimate parents of MNE groups. However, countries considered "investment hubs" (defined as jurisdictions with a total inward FDI position above 150% of GDP) would lose tax base from reduced profit shifting under Pillar Two.

Global tax revenue effects from the proposals

Estimated global tax revenue gain		% of global CIT revenues	bn USD
Pillar One		0.2%-0.5%	5-12
Pillar Two	Direct revenue gains	0.9%-1.7%	23-42
	Additional gains from reduced profit shifting	0.8%-1.1%	19-28
	Total Pillar Two	1.7%-2.8%	42-70
Total Pillar One and Pillar Two		1.9%-3.2%	47-81
US GILTI regime		0.4%-0.8%	9-12
Total, including GILTI		2.3%-4.0%	56-102

Source: OECD

6. Only a muted impact on investment and growth

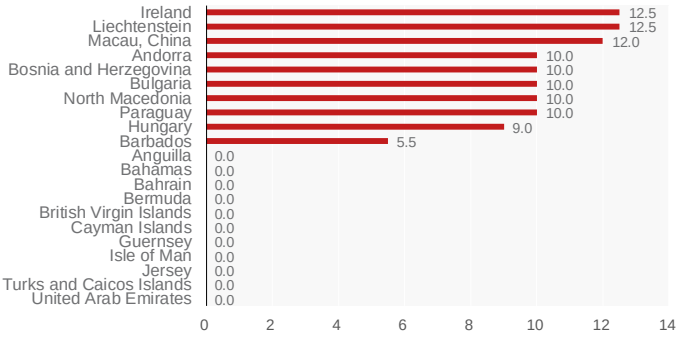
The additional profit tax on large MNEs reduces the after-tax investment rate of return. However, the impact should be minimal: the OECD estimates "that the effective average tax rate (EATR, i.e. the average tax rate on the profit derived from a new investment project) on a typical investment project by an MNE would be increased by around 0.3 pp", compared to an average EATR level of about 24% currently. Consequently, the negative impact on economic activity is estimated to be very modest: less than 0.1% of GDP over the medium to long term. On top of higher taxes, the measures will also increase the compliance costs for MNEs and administration costs for governments. To minimise the impact, both pillars try to reduce costs by simplifying measures as well as by providing large tax certainty and mechanisms to settle tax disputes. Theoretically, the reduced tax advantage large MNEs enjoy could make smaller MNEs or locally operating firms more competitive and thus work against further market concentration. Finally, the IF-measures must also be compared with a scenario of no multilateral agreement, i.e. a situation where national DSTs would increase, potentially resulting in trade disputes and retaliatory duties. Given a broader DST implementation, the OECD estimates the damage to global GDP could reach 0.4% to 1.2%.

7. Winners and losers

It is obvious that the introduction of a minimum international tax rate of 15% (Pillar Two) might induce capital flows benefitting some countries at the expense of others. Countries with corporate tax rates below this threshold will tend to suffer from reduced competitiveness, capital outflows, receding corporate tax receipts and deteriorating public debt metrics. Additionally, capital repatriation may produce a negative productivity shock. In case countries suffer from significant capital repatriation it will also reduce their capacities of production and therefore increase their dependency on imports (terms of trade-effect). A negative impact on competitiveness could also induce lower public investment spending. However, the balance between crowding-in and crowding-out effects from public investments is ex ante unclear; hence the effect is ambiguous and unlikely to prove significant in our view. Countries with corporate tax rates below the 15% threshold are likely to experience on average capital outflows (see graph below). Apart from Ireland and Hungary these are only non-OECD economies comprising the classical tax havens.

Corporate tax rates below 15% threshold

central government and sub-central government combined corporate income tax rates, %, in 2020



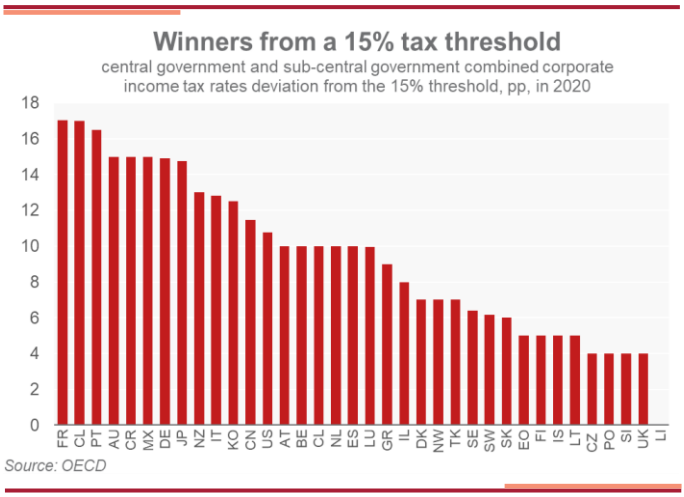
Source: OECD

While it is obvious which countries will lose from the intro-duction of international taxation, it is less clear which ones will benefit from capital inflows. It need not necessarily be the home country of an MNE but might also be another country with a more attractive business and tax environment (i.e. closer to the 15% threshold). According to the tax metric (only) the three least attractive countries for the repatriation of capital are France, Chile and Portugal while Lithuania, the UK and Slovenia have the highest attractiveness.

The new taxing rights by market jurisdictions (Pillar One) also needs to be considered for identifying winners and losers from the new tax regime. This is much harder to quantify as it needs to consider for each country the profits taxed relative to the revenues made there. A study exploring firm data for Europe finds that in 2018 over one third of MNE's profits were booked in Ireland, the Netherlands and Luxemburg while the

combined share of ecommerce revenues from these countries was only around 15%. In the case of Facebook these countries even amount to less than 5% of user and ecommerce revenues. According to the above quoted study, Germany, France, Italy and Spain stand out to be the main beneficiaries. Their combined national share of profits booked here was 7.6% in 2018 while user and ecommerce revenues for US MNEs in Europe were above 40% and the combined share of Facebook users is around one third.

The effects from new taxing rights and capital repatriation determine the overall effect of the new tax regime for a country. The complexity of the underlying analysis makes it hard to reach clear conclusions on a country basis. The Netherlands for instance exhibit a corporate tax rate of 25%



thereby potentially benefitting from a minimum tax rate. But for MNEs located there the tax benefit they currently enjoy (which would be curtailed) is disproportionate relative to the revenues from the Dutch domestic market. A reduced attractiveness of the Netherlands might then induce MNEs to relocate away. That said, it is relatively clear to us that high-tax economies with a big market tend to benefit. However, the magnitude is still subject to uncertainties from the final agreement on technical details (with the revenue threshold for taxing being key). There is also the need to consider potential tax losses from domestic firms now being taxed abroad. With respect to Germany for instance the ifo institute still expects positive net effects on tax revenues. It foresees an average tax increase in the 2022-2027 period of € 1.9 bn per year. But in a less ambitious scenario (with the revenue threshold being lifted) this tax increase could come down to € 0.8 to 1.0 bn.

8. Market impact mostly on Tech and Pharma

Higher corporate taxes usually eat into companies' earnings, lowering valuations. Yet, capital markets were so far unimpressed by the introduction of the new global tax regime. This probably has to do with implementation risks (see section 4). Nations have their own tax laws, which will take years for lawmakers to draft, negotiate, and pass — and might in the end look very different from the G7's proposals.

But even if the current plans were fully implemented the overall impact on equity markets is likely to be moderate. Even under relatively strong assumptions on revenue generation we find that the impact on MSCI EMU as well as S&P500 is only moderately negative (see box). The expected impact on the S&P500 is higher than on the MSCI EMU. A high share of firms fulfilling the criteria for being taxed internationally (13% vs 6%) as well the big tech firms (Apple, Google, …) are all listed in the S&P500. But put into perspective that's not much compared with other corporate tax hikes currently being envisioned by policy makers in the US. For individual companies, however, the results might be different. Companies with significant revenues attributable to intangible assets will be most impacted. These are big internet and pharmaceutical companies in the first place. Hence, the Tech and Health sectors might be impacted more negatively.

Box 3: Limited impact on equity markets

The bar for a company to fall under the new international tax regime is quite high. The revenue threshold as well as the required profitability of at least 10% already reduce the number of potential firms significantly (see table below).

A further narrowing of the firm base comes from the requirement **that the turnover needs to be generated abroad even without a physical presence** (according to current international tax law a physical presence already allows for profit taxation). Data on the turnover generated abroad without a dependency are hard to get. As an approximation we only consider the firms covered also by the OECD Analytical Database on Individual Multinationals and Affiliates (ADIMA) for 2019 (latest available). This is a conservative assumption and tends to exaggerate the base for international taxation. For instance, within the MSCI EMU a clear candidate for the new digital tax could be SAP. However, according to the OECD it has a physical presence in 75 jurisdictions, probably limiting the tax base.

Moreover, under the extreme assumption that 30% of the 2020 profit (EBITA) exceeding 10% is generated abroad and taxed at a rate of 20%, the absolute amount of taxes generated, while high, has only a **small negative impact on** the **valuation** of the S&P500 and the MSCI EMU.

The proposed new international tax rules are anything but an earthquake in quantitative terms. It needs to be kept in mind

that the proposed measures cover only a relatively small part of the economy. It is only one aspect of the entire BEPS programme. Affected firms can easily digest it. Still, the agreement itself would be an important signal that multilateralism is still alive and able to tackle key global challenges. The political hurdles to finally implement the new tax order are still high and there is a non-negligible risk that a shift towards populism derails the deal.

That said, a successful global tax deal could pave the way towards more impacting action. We conjecture that longer term the dispersion of tax rates among countries is likely to decrease thereby also reducing international tax competition. At international organizations like the OECD the work on the taxation of virtual currencies and exchange of information about VAT relevant sales is ongoing. Also, the general attitude towards taxation is likely to change as inequality becomes a more pressing issue. Recently researchers for instance proposed a wealth tax on stocks in the G20 which would be even more far reaching. In the future, this might result in additional tax burdens for MNEs.

Effect of international taxation on markets

	S&P500	MSCI EMU
Number of firms		
- total index	504	237
- after € 20 bn revenue threshold	113	64
- after 10% profit threshold	82	22
MNE by OECD (ADIMA)	64	14
Taxation (20% on extra-profits with 30% of profits made abroad)	43.8 (bn USD)	4.2 (bn EUR)
effect on fair market value (by means of the Gordon growth model)	-2%	-0.5%
share of MNEs taxable	13%	6%

IMPRINT

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