



LEVELLING DOWN

How the global minimum corporate tax undermines the UK

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BRIEFING PAPER

EXECUTIVE SUMMARY

- The UK's decision to rush the implementation of a global minimum corporate tax rate will undermine the levelling-up agenda, hurt the competitiveness of key UK industries, pose unique challenges for the insurance and reinsurance service sector and fail to raise substantial revenue;
- Proposed rules could undermine key areas of UK tax policy including investment zones and freeports, business tax credits, super-deductions for the depreciation of equipment investments, and accelerated cost recovery for new investments in intellectual property, which makes up over one-third of all UK investment;
- Negotiations and technical considerations remain ongoing at the OECD, while the EU is moving forward with their own planned implementation. Moving forward before global rules are finalized risks imposing significant transition costs on UK companies and multiple rounds of transition costs for HM Revenue and Customs, undermining the ability of British businesses to compete on the international stage;
- The insurance and reinsurance service sector — one of the UK's biggest financial services industries — faces unique challenges from the proposed changes, including excess tax liability, the risk of double taxation and high compliance costs;
- Under current plans, implementing the global minimum tax is unlikely to raise substantial revenue — low-tax jurisdictions could continue to compete for out-of-scope enterprises by lowering their corporate tax rates;
- The UK's early implementation of global minimum tax rules is fraught with risk and policymakers should carefully scrutinize current proposals to limit their potential economic damage.

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In the November 17th, 2022 Autumn Statement, HM Treasury confirmed that in the Spring Finance Bill 2023 the government will legislate to impose a global minimum corporate tax rate of 15% for accounting periods beginning on or after 31 December 2023. The legislation constitutes the Treasury's commitment to implement Pillar Two of the 2021 Organisation for Economic Co-operation and Development (OECD) global tax deal.

Leaving aside the broader unsoundness of the deal, in this paper I analyse potential challenges and complications posed by the UK's implementation of the government's proposed multinational top-up tax. Specifically, I find that the proposed rules could undermine domestic tax policy in the areas of investment zones and freeports, business tax credits, super-deductions for the depreciation of equipment investments, and accelerated cost recovery for new investments in intellectual property. I also find that implementation of the proposed rules poses particular problems for insurance and reinsurance companies, which comprise a key industry in the UK's larger financial services sector. I also highlight that early implementation risks imposing substantial first-mover disadvantages on UK businesses, which will have to incur large upfront transition costs to implement rules that have yet to be harmonised at the international level.

Finally, I find that while implementing the global minimum tax will impose large compliance costs and additional complexity on UK firms, with unresolved risks of double taxation, it is unlikely to raise substantial revenue. This is because the Pillar Two framework effectively allows low-tax jurisdictions to continue to compete for out-of-scope companies by lowering their corporate tax rates while also collecting any top-up tax liability for in-scope companies which higher-tax countries like the UK were aspiring, through legislation like this, to collect. Indeed, the global minimum tax may even accelerate lower rates in low-tax jurisdictions, while generating little to no Pillar Two top-up tax revenue for high-tax jurisdictions.

BACKGROUND AND KEY PROVISIONS

The government's legislation to impose a new multinational top-up tax is the UK's attempt to implement Pillar Two of the international tax agreement negotiated and signed at the OECD in December 2021. The rules are designed to impose a minimum effective tax rate of 15% on the corporate profits of multinational enterprises (MNEs) with more than €750 million in total global revenues in at least two of the previous four accounting periods. Companies whose revenues exceed the threshold are within the scope of the new minimum tax regime, while companies below the threshold, as well as certain exempted entities such as qualified investment funds, are outside the scope of the minimum tax. The 15% minimum tax is to then apply in each of the jurisdictions in which the constituent entities of in-scope MNEs operate.

There are two key rules enforcing the 15% minimum tax. The first is an income inclusion rule (IIR), which requires in-scope ultimate parent companies in the UK to pay a top-up tax to HM Revenue and Customs to bring effective marginal tax rates in each of the jurisdictions in which their constituent entities operate up to 15%, with a deduction for certain substantive activities such as payroll costs and investment in tangible assets like buildings and equipment. According to HM Treasury's draft legislation, this rule is set to apply to accounting periods beginning on or after 31 December 2023.

The second rule is an under-taxed payment rule (UTPR). The UTPR is intended to provide a backstop in cases where the effective tax rate in a jurisdiction is below the minimum rate of 15%, but the IIR has not been fully applied. An example of when the UTPR might apply is if the jurisdiction of the ultimate parent company has an effective tax rate below 15% and has not fully complied with the IIR. The UTPR may therefore apply to the subsidiaries of in-scope US parent MNEs if the US Global Intangible Low-Taxed Income tax is not brought into full compliance with the IIR framework. HM Treasury has not yet released details on the design and timing of their implementation of the UTPR, but they have stated their intention to introduce one.

ADVERSE INTERACTIONS OF THE GLOBAL MINIMUM TAX WITH DOMESTIC UK CORPORATE TAX POLICY

One of the challenges to instituting corporate minimum taxes is that companies can have low or even zero corporate tax liability for a variety of legitimate and economically efficient reasons. For example, most tax codes allow businesses that incur net operating losses in one year to carry those losses forward to offset tax liability in future profitable years. This helps to ensure that businesses are taxed on average profitability, making the tax code more neutral with respect to businesses in more versus less cyclical industries.

A second example is the tax deductibility of asset depreciation. Whereas companies can deduct the cost of labor in the year in which the compensation expenses were incurred, they typically have to deduct the cost of acquiring new buildings, machinery, and intellectual property products over multiple years by claiming deductions only for the annual depreciation of those assets. Because of inflation and the time value of money, this means that the present discounted value of deductions for investment in new productive capital is less, and for some assets such as buildings substantially less, than the cost of acquiring them. To address this distortion, many countries, including the UK, allow for accelerated or bonus depreciation, which allows companies to frontload those deductions for depreciation. While the OECD framework attempts to carve out or otherwise exempt such legitimate tax deductions and credits, several key issues remain which could undermine domestic tax policy.

First, countries may wish to provide tax preferences or tax incentives designed to increase investment at certain times, for instance during a recession, or in certain

places, such as distressed or lower-income communities. While tax holidays and place-based tax policy have both pros and cons, the global minimum tax rules can generate problems for countries wishing to introduce such incentives. If profits on investments during a tax holiday or in a zero-tax investment zone are to be liable under the IIR or UTPR anyway, then the desired tax incentive is attenuated or outright neutralized.

Investment zones and freeports in the UK may face such complications. While investment zones and freeports are not exempt from the UK statutory corporate income tax rate, they do offer exemptions from business rates, enhanced tax-free allowances for investment in new plant, machinery, and buildings, as well as exemptions from employer National Insurance contributions and stamp duty land tax. Though carve-outs in the new minimum tax rules for cost recovery on investments in tangible assets should exempt the enhanced allowances for investment in machinery and buildings from minimum tax liability, the same cannot be said of the investment zone exemptions from business rates and stamp duty. Moreover, because the Pillar Two rules permit a carve-out from included income equal to 5% of eligible payroll costs—including payroll taxes paid by the employer—the interaction of the new tax rules with investment zone incentives could perversely result in higher top-up tax liability owing to lower payroll costs in the zones. This would tend to disincentivize investment and employment in investment zones and freeports.

Business tax credits, which countries often elect to increase during periods of recession or slow economic growth to stimulate investment, could also face issues under the new minimum tax regime. Under the proposed rules, refundable tax credits would be counted as increases in income, which would lower effective tax rates and therefore increase the risk companies receiving the credit would be liable under the minimum tax. For example, if the statutory tax rate were 15% and there were refundable tax credits equal to 5% of income, the effective tax rate would be 14.3% and affected entities would be liable for the top-up tax. Nonrefundable tax credits, on the other hand, would directly offset taxes paid under the effective tax rate calculations. Thus, if the tax rate were 15% and there were nonrefundable tax credits equal to 5% of income, the effective tax rate would be 10% and affected entities would be liable for a 5% top-up tax to achieve the 15% minimum. If Parliament ever decided that they wanted to maintain both a low corporate-tax environment with a statutory rate close to but above 15%, then they would likely have to default to a two-tiered tax system in which tax credits effectively only apply to smaller entities not in the scope of the global minimum tax.

An additional challenge for domestic tax policy is with regard to cost recovery for investment in new productive assets. As noted above, following extensive consultations, the Pillar Two rules and the multinational top-up tax do include carve-outs for cost recovery allowances (including accelerated depreciation) for investment in tangible assets, namely, physical equipment and structures. However, the rules as written suggest that bonus depreciation above 100% of the cost of the capital investment, even in tangible assets, may not be exempt from recapture. So items like the

UK's 130% "super"-deduction could be treated as a deferred tax liability subject to recapture if the asset's depreciable life is longer than five years.

More importantly, however, is that with the exception of research and development expenses, the exemption from recapture of deferred tax liability does not apply to intangible assets such as software, entertainment, literary, and artistic originals, and other intellectual property (IP). In addition, there is no substance-based income exclusion for intangible assets, as there are for payroll and tangible assets. As the entire purpose of the minimum tax framework is to impede profit shifting through the location of intangible assets in low-tax jurisdictions, these are design features rather than bugs. It means, though, that accelerated depreciation for intellectual property products with asset lives longer than five years would constitute a deferred tax liability that would be subject to recapture.

Given the importance of IP to the UK economy, this is potentially a significant issue. IP accounts for over a third of overall investment in the UK, and 12% of the total UK capital stock—the latter figure being almost double IP's share of the US capital stock. IP's share of UK investment and the UK capital stock has also been rising over time. Accelerated cost recovery for new IP investment in the UK by in-scope companies could therefore be neutralised if it brings effective tax rates below the minimum tax, thereby triggering top-up liability.

FIRST-MOVER DISADVANTAGES

While an expedited implementation of the Pillar Two rules may permit HM Treasury to begin collecting additional revenue from in-scope enterprises, which they project will ultimately reach £2.3 billion per year by 2027-28, there are also costs to early implementation. Negotiations and technical considerations remain ongoing at the OECD, while the EU is moving forward with their own planned implementation of Pillar Two. Ultimately, the UK will likely have to align the multinational top-up tax with the final rules and guidance agreed to at the OECD and implemented by the EU, or else risk instances of double taxation.

Implementing before global rules are finalized risks imposing initial transition costs on UK companies—which HM Treasury estimate will be £13.2 million, followed by a recurring administrative burden of £8.2 million per year—followed by another round of transition costs to later align with the EU and other participating jurisdictions. Incidentally, it also risks multiple rounds of transition costs for HM Revenue and Customs, which HM Treasury estimate will already face operational costs of £47 million to implement and administer the new rules. In the interim, UK companies will face an additional tax burden not yet applied to parent MNE's in other jurisdictions, placing UK business at a competitive disadvantage during an asynchronous transition.

Moreover, adjustment costs are not limited simply to the compliance costs of investing in the accounting systems and processes for determining whether entities are in-scope and then computing effective tax rates and potential IIR liability by

jurisdiction. There are also organisational costs that may be difficult and costly to reverse if the rules change. To achieve tax efficiency, MNE's may engage in intra-group asset transfers, reorganisations, or changes to tax structure today that generate ongoing Pillar Two consequences tomorrow.

Companies also face the risk of incurring the costs of implementing a global agreement that may yet break down. The reallocation of taxing rights under Pillar One, which would require renegotiation of existing tax treaties, is highly unlikely to pass the United States Senate. Though US Treasury Secretary Janet Yellen acceded to the Inclusive Framework agreement in October 2021, the US Congress is also unlikely to revise the US's Global Intangible Low-Taxed Income (GILTI) regime to align with Pillar Two. While the US did implement a 15% minimum book tax in the 2022 Inflation Reduction Act (IRA), there are substantial differences between the IRA alternative minimum tax on adjusted book income and the Pillar Two IIR, which could result in companies facing liability under both GILTI and/or the 15% minimum book tax, and UTPR liability under Pillar Two. The risk of double taxation could therefore result in substantial frictions between the US and jurisdictions implementing Pillar Two, including over tax treaty violations.

In response to consultations, HM Treasury has noted that even if GILTI is not revised to align with Pillar Two, the UK is prepared to take GILTI payments into account in calculating any future UTPR liability. However, substantial technical challenges would then need to be addressed to incorporate GILTI into the Pillar Two framework, and that will apply not only to the UK multinational top-up tax, but to all jurisdictions implementing the global minimum tax rules. So long as the US remains misaligned with the Inclusive Framework, either the UK and other signatories will have to design a consistent approach to accounting for tax payments made under GILTI and the minimum book tax, or they will have to wholly or partially ignore those payments and assess additional tax liability under the UTPR. The former is complicated and would result in substantially less revenue, the latter risks double taxation, tax treaty violations, and US tariff retaliation. Either way, the whole global process could unravel as a result.

Perhaps most importantly, while HM Treasury may wish to push ahead with early implementation in the hopes of starting to collect those top-up taxes as soon as possible, it is likely they will impose and incur all the costs of transitioning to a highly complex global minimum tax regime only to see low-tax jurisdictions collect the minimum tax revenue instead of HM Revenue and Customs. The reason is the introduction into the Pillar Two framework of the Qualified Domestic Minimum Top-Up Tax (QDMTT). Under the QDMTT rule, low-tax jurisdictions, including those with statutory corporate income tax rates below the 15% minimum, can implement their own top-up taxes to collect revenue from the entities of in-scope MNE's in their jurisdictions. They do not have to raise their corporate tax rate—indeed, they can continue to lower it to attract more out-of-scope companies. They can now just collect additional top-up revenue from in-scope companies, revenue that otherwise would have been collected anyway by other jurisdictions implementing top-up taxes under the IIR or UTPR.

In other words, if a 15% minimum tax is going to be levied on large MNE's anyway, then from the perspective of the low-tax jurisdiction, they might as well collect that top-up tax themselves. If both the low-tax jurisdiction and the higher-tax jurisdiction of the ultimate parent company were to both attempt to tax the low-tax income under some combination of IIR, UTPR, and QDMTT, then we would have a double-taxation problem. This is more likely than not, since to take just one example, even if the US were to make the GILTI regime compliant with Pillar Two, it is still unclear whether they would grant foreign tax credits for QDMTT taxes paid.

Thus, HM Treasury is racing to implement a costly and highly complex global minimum tax regime so that low-tax countries can collect top-up taxes from large MNE's while continuing to entice out-of-scope companies to locate highly profitable intangible assets in their jurisdictions through low rates. Indeed, recent research by scholars at Oxford University's Centre for Business Taxation finds that QDMTT could even increase the incentive for some countries to lower the corporate tax rates, even to zero.¹

POTENTIAL ADVERSE IMPACT ON UK FINANCIAL SERVICES

The UK is home to one of, if not the, largest insurance and reinsurance markets in the world. Pillar Two has posed challenges unique to the insurance and reinsurance service sector, particularly concerning timing issues. In particular, given the time horizons over which insurers transact and the jurisdiction-specific regulatory frameworks within which they operate, substantial differences can emerge between accounting and tax rules. These differences could result in insurance and reinsurance providers facing excess minimum tax liability, and even double taxation, while transitional rules concerning the treatment of loss carry-forwards may be insufficient for the time horizons over which insurers transact. The OECD model rules eventually reflected the need to address deferred tax assets and liabilities, though issues remain concerning certain time limitations and the tax rate at which deferred tax assets and liabilities must be written down.

In addition, the OECD model rules, as replicated by HM Treasury, do not sufficiently reflect the flow-through nature of funds in which many insurers invest. Top-up-tax liability may therefore be triggered because while investment income is sufficiently subject to tax on the investor, the investment vehicles themselves pay little tax. These are just several of the technical complications that are likely to arise for one of the UK's biggest financial services industries in the event that Pillar Two is implemented. It is important to address such technical tax liability issues before rather than after the imposition of large costs of transition and compliance.

¹ Devereux, Michael P. and Vella, John and Wardell-Burrus, Heydon, 'Pillar 2: Rule Order, Incentives, and Tax Competition' (January 14, 2022). Oxford University Centre for Business Taxation Policy Brief 2022. Available at: <https://ssrn.com/abstract=4009002>

Generally speaking, tax competition can be a good thing, nudging tax authorities toward more economically efficient forms of taxation. As mobile as capital and income are across international borders, they are even more mobile across intranational borders. It is therefore striking to observe that more than 200 years of tax competition between US states has resulted in property and sales taxes comprising the number one and two largest sources of tax revenue at the subnational level. Most economists would probably agree that progressive taxes on consumption and immovable property are more economically efficient than taxes on personal or corporate income. There is in fact a large theoretical literature stretching back to the 1970s suggesting that the optimal rate of taxation on capital may be zero. Ironically, international tax competition may have been driving countries toward more efficient forms of taxation.

Instead, signatories to Pillar Two of the Inclusive Framework appear to have elected to try to stop competition and impose an arbitrary floor on corporate income taxation for large multinational enterprises. Not only does this create problems for domestic tax priorities, including but not limited to accelerated depreciation allowances, tax credits, and investment zones, but also, in its current form it patently fails to achieve its objective of preventing a “race to the bottom.” Indeed, under the Qualified Domestic Minimum Top-Up Tax rules, low-tax jurisdictions can continue to compete for out-of-scope enterprises by lowering their corporate tax rates, even all the way to zero. The only difference is that now those low-tax jurisdictions can also collect top-up tax revenue from in-scope enterprises. Countries implementing Pillar Two, like the UK, will therefore merely be imposing considerable new tax complexity and high compliance costs on businesses operating in their jurisdictions, while the additional tax revenue will flow to the very low-tax jurisdictions the pillar was intended to deter.

Considering the costs and distortions involved, the complexities arising from asynchronous implementation by different jurisdictions, the perverse incentives for low-tax jurisdictions that could deny any revenue gains to higher-tax jurisdictions like the UK, and the high probability that the whole agreement may yet break down, forging ahead as an early implementer of Pillar Two is fraught with risk.