Intelligence MEMOS

From: Angelo Nikolakakis

To: Finance Minister Chrystia Freeland

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Re: **Global Tax Deal: Who Wins and Who Loses?**

Headlines abound on recent developments toward the widespread – but not universal – adoption of a new approach to the taxation of large multinational enterprises (MNEs).

Last week, a G20 Communiqué proclaimed an "historic agreement" that "will establish a more stable and fairer international tax system." There are two pillars to the agreement. Pillar I allocates new taxing rights to market countries for about 100 of the largest MNEs, and Pillar II establishes a global minimum tax of 15 percent for MNEs with revenues of €750 million, which includes many Canadian MNEs.

Finance Minister Chrystia Freeland told the CBC that Canada expects at this point to raise additional annual tax revenues of $4.5 billion, of which "about $1 billion" would come from Pillar I, so about $3.5 billion is expected to come from Pillar II. She also stated that "the only losers from this deal are big multinational companies who are currently using globalization and the loopholes it has created to avoid paying taxes."

If Canada raises additional annual tax revenues of $3.5 billion, at a 15-percent rate, that is tax on about $23 billion of profits that Canada must be thinking it would be taxing under Pillar II. However, what happens if relevant foreign countries raise their rates to 15 percent? Will Canada really see any new tax revenues from Pillar II, or will all the tax and the corresponding wealth be lost to other countries?

Consider the following example. A Canadian MNE is owned by a Canadian pension fund. It has in place traditional group financing arrangements – through a finance company (Finco) located in Country X, which makes interest-bearing loans to group operating companies (Opcos) located in high-tax jurisdictions around the world.

For every $1 billion of interest expense paid by the Opcos, let us assume they save $200 million of foreign taxes (i.e., the tax rates in the locations of the Opcos is 20 percent, and the tax rate in Country X is zero percent.) Finco pays dividends of roughly $1 billion to the Canadian MNE, which pays dividends of roughly $1 billion to the pension fund, which pays benefits of roughly $1 billion to millions of Canadian seniors, who pay some personal income taxes and then spend the rest of that that money on Canadian goods and services.

In that scenario, while the Canadian MNE pays no corporate income tax on that $1 billion, all of the money still comes into the Canadian economy, is taxed to some extent in the hands of the pension beneficiaries, and then generates additional Canadian economic activity and taxes (including corporate taxes, personal taxes, and consumption taxes) when it is spent on Canadian goods and services.

In contrast, if Country X increases its corporate income tax rate to 15 percent, there would still be tax deductions for the interest expense and corresponding tax savings of $200 million in the locations of the Opcos, but in Country X there would be tax liability of $150 million.

Back in Canada, there would be no tax liability under Pillar II, since the income would have borne the minimum tax rate of 15 percent. More importantly, the dividends paid by the Canadian MNE to the pension fund, and by the latter to Canadian seniors, would be reduced by $150 million, which means the pensioners would not pay Canadian taxes on it, and they would have less to spend on Canadian goods and services.

In brief, the Canadian economy will have lost real wealth $150 million, will not have raised a penny of additional tax under Pillar II, and will have lost existing tax revenues that would have been generated by the additional Canadian economic activity that would have occurred through spending that lost $150 million.

As a further contrast, if Canada were to lower the rate of corporate income tax on foreign profits to 15 percent, many Canadian MNEs would no longer have a tax incentive to establish group finance and similar entities in foreign jurisdictions, so the 15-percent tax would be paid in Canada; and, more importantly, all the related income would come into the Canadian economy (although the pensioners would still not get it). The US FDII (foreign-derived intangible income) rules represent an important precedent for that approach.

Against that background, it is very difficult to accept the Finance Minister's statement that "the only losers from this deal are big multinational companies who are currently using globalization and the loopholes it has created to avoid paying taxes."

The race to the bottom may be over, but the race to 15 percent has just begun.

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