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Deciphering the GloBE in a Low-Tax Jurisdiction

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Deciphering the GloBE in a Low-Tax Jurisdiction**Prepared by Shafik Hebous, Cory Hillier, and Andualem Mengistu**Authorized for distribution by Mario Mansour and Alessandro Gullo
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ABSTRACT Pillar Two rules of the Inclusive Framework agreement on a minimum corporate tax (known as ‘Global Anti-Base Erosion Rules’, for short GloBE) have important implications for the design of the corporate income tax. This chapter discusses these implications particularly from the perspective of low-tax jurisdictions. It argues that it is not possible to design a system that always guarantees generating exactly the bare minimum tax intended by the rules and motivates that this should not be the policy objective anyway. Importantly, if no profit tax already exists, countries need to consider whether to adopt one, and if yes, in what form. There is a case for introducing a general profit tax beyond the GloBE rules, together with a qualifying GloBE domestic minimum top-up tax as a backstop. The familiar alternatives of efficient economic rent tax designs, however, are no longer equivalent under the GloBE. In practice, given the specifics of the rules, an efficient rent tax on in-scope multinationals cannot be combined with a statutory tax rate below a certain cutoff, because the minimum tax becomes always binding. Under the GloBE, immediate expensing particularly maintains the time-value of fully deducting the cost of investment, without impacting the GloBE effective tax rate.

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WORKING PAPERS

Deciphering the GloBE in a Low-Tax Jurisdiction

Shafik Hebous, Cory Hillier, and Andualem Mengistu*

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1. Introduction

The ongoing widespread adoption of a minimum effective rate of corporate tax under the Inclusive Framework agreement is changing the rules of tax competition, to some degree limiting it with important ramifications for zero-tax or low-tax jurisdictions.¹ Questions arise as to whether the minimum corporate tax rate can be set so that all countries, including low-tax jurisdictions, are better off? And what responses (to a binding minimum tax) can these jurisdictions consider given the specificities of the Pillar Two rules?

This paper discusses implications of (and possible reactions to) Pillar Two from the standpoint of a zero- or low-tax jurisdiction. A set of rules for the minimum tax under Pillar Two, known as the GloBE ('Global Anti-Base Erosion Model Rules'), determine which country along the multinational company's chain of ownership can collect the top-up tax. Some observers are tempted to firmly conclude that adopting the qualified domestic minimum top-up tax (QDMTT, one rule of the GloBE) is 'the' best strategic reaction of these jurisdictions, because this rule gives the source country (the low-tax jurisdiction, here) the right to collect any minimum tax. But from a legal design and policy flexibility perspectives, we argue that matters are not that simple, especially if initially there is no corporate income tax (CIT) in place. And importantly, at this juncture, there is an opportunity to endorse a broader tax reform that can be beneficial for low-tax jurisdictions. We discuss here what such a reform can look like, considering design constraints implied by the Pillar Two rules.

Several observations—summarized throughout the paper—are important to consider when a country is contemplating introducing a CIT from scratch. The theme that emerges is that the QDMTT is not the solitary reaction. Ideally, it is rather a backstop rule, as it is intended to be, namely a top-up tax, rather than 'the' tax system of such a country. The general tax system would target only economic rent, but the GloBE have key implications for the choices of the tax rate and base, as we will lay out here.

2. Where We Are Right Now

Profit shifting and tax competition have occupied the top of the policy agenda in the last decade, eventually prompting the Inclusive Framework agreement to address them.

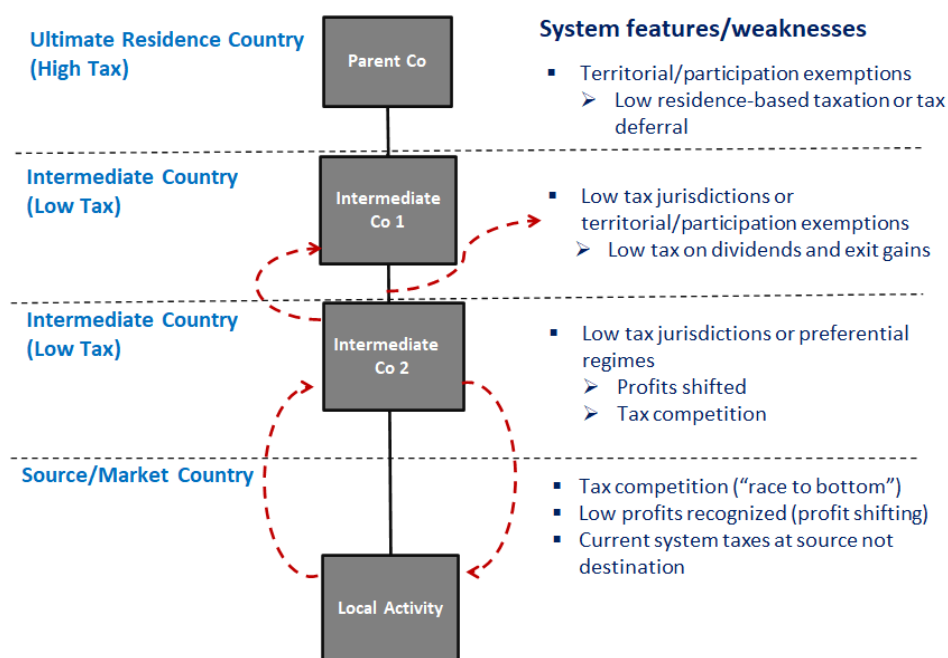
2.1 The Problem

The problems with the existing CIT arrangements are well known and discussed in detail in several papers, including Devereux and Vella (2014) and IMF (2014). In a nutshell, as illustrated in Figure 1, multinational

¹ Whether to introduce a profit tax is relevant for zero-tax jurisdictions, while the design of the tax is relevant for both zero- and low-tax jurisdictions. Note, though, even in a jurisdiction without a corporate income tax, there can be some fees or other light taxes. Such jurisdictions that attract profits from abroad typically tend to be small (Kanbur and Keen, 1993) and exhibit a stable and relatively high institutional quality (Dharmapala and Hines, 2009), among other characteristics (Dharmapala 2023).

affiliates maintain separate accounting and are required to price their intragroup transactions as if they are between unrelated parties (that is, according to the arm's length principle). Tax treaties allocate the taxing rights (and, hence, tax revenues) between two contracting countries.² Broadly, source countries tax income from "production", based on physical presence in the form of a permanent establishment, while residence countries (where "headquarters" are) tax passive income. The application of the arm's length principle has become increasingly complex and difficult to enforce with the rise of the global firm that produces to the global market and the increasing importance of hard-to-value intangibles and intergroup trade in services (Hebous, 2021). Tax treaties opened their own loopholes allowing tax planning (treaty shopping) by exploiting reduced cross-border withholding tax rates in the treaties (Erokhin and Weichenrieder, 2023). The outcomes of these CIT arrangements have been (i) prevalence of shifting of profits by multinationals to low-tax jurisdictions; and (ii) tax competition between countries over profits and investment.

Figure 1. Current CIT Arrangements



Note: A typical MNE profit shifting structure that leverages inter-nation tax competition is where a parent company (Co) that is in a high-tax country establishes intermediate holdings and/or financing affiliates (Co 1 and Co2) which are used as conduits or regional HQs in low tax jurisdictions. Co1 and Co2 transact (for instance, because they hold valuable intellectual property or provide HQ support) with subsidiaries with local business activity in source countries to shift local profits out of that country (for instance, by charging the subsidiaries large royalties or management fees), with those profits ultimately being received by Co (for instance, through intra-group dividends or sale of intermediate shareholdings) with very low overall levels of taxation.

² Some treaties are multilateral. This paper does not address the allocation of new taxing right to market jurisdictions or Pillar One.

CIT arrangements have served low-tax jurisdictions well for a few decades, especially as restrictions to cross border capital mobility and financial transactions decreased during the second half of the last century. Tørsløv et al. (2023) estimate that 36 percent of multinational profits (around \$600 billion) are shifted to low-tax jurisdictions in 2015, but how much of that profit is actually translated into revenue or employment for those jurisdictions is a separate question. The benefits from ‘paper profits’ are challenging to quantify or directly observe, yet they do implicitly manifest themselves in large observed aggregate FDI and established specialized sectors in many low-tax jurisdictions.³

2.2 The Agreement on a Minimum Corporate Tax

Discontent with profit shifting and tax competition triggered unilateral minimum taxes in major capital exporting countries⁴, stricter anti-tax avoidance rules (BEPS 2015 project), and eventually an agreement on the minimum corporate tax agreement (under Pillar Two), with 140 subscribing jurisdictions as of November 2023. Pillar Two minimum tax applies to multinational groups with global revenues above €750 million, with some exceptions (OECD, 2023). Box 1 summarizes the implementation status in selected countries.

The agreement stipulates computing the effective tax rate in a specific way (henceforth the GloBE effective rate). The GloBE effective rate is computed as the ratio of ‘covered taxes’ to GloBE income. The GloBE income is the accounting net income (or loss), adjusted for specific items (for example excluding intra-group dividends). If the GloBE effective rate is below 15 percent, a top-up tax applies. In a zero-CIT country, the GloBE effective rate for any in-scope entity is zero. To determine the *amount* of top-up tax, the resulting 15 percent top-up tax rate is then multiplied by the ‘*excess profit*’ defined as GloBE income minus a substance-based income exclusion (SBIE) in the jurisdiction (set at 5 percent of each of tangible assets and payroll, after a transition period). To illustrate, suppose the covered tax is zero, the GloBE income is 100, and the SBIE is 20. *The resulting top-up tax is 12* (that is, the effective rate *on excess profit* is 15 percent but the average paid tax is 12 percent).

The question becomes who collects the revenue from the minimum tax? Three GloBE rules address this question: The top-up tax will be collected by the source country if it adopts a QDMTT. Otherwise, the headquarters country collects the top-up tax through an income inclusion rule (IIR). If neither rule is implemented or fully captures the top-up tax, then other countries along the chain of affiliates of the multinationals can collect the top-up tax via the undertaxed profits rule (UTPR).

The top-up tax is estimated to raise CIT revenue globally. Earlier estimates put the global impact at 5.7 percent (IMF, 2022) while the OECD (2024) estimates it to be between 6.5 percent and 8.1 percent of the global CIT revenues. The distribution of the global revenue gain across countries depends on country

³ See, for example, De Mooij et al. (2020).

⁴ Prominent examples are the Global Intangible Low-Taxed Income (GILTI) rules in the US and controlled foreign corporation (CFC) rules in many other countries; Overesch et al. (2024).

responses (adopting a minimum tax or not and possible changes to the tax base and rates). The total direct gain can also change depending on the response of multinationals, notably changes to profit shifting and real investment.

3. Can Low-Tax Countries Be Better Off Under a Minimum Corporate Tax? What Theory Predicts

Suppose a binding minimum corporate tax is imposed with a rate set at a level between the initial unconstrained equilibrium rates of the high-tax country and the low-tax country. For the high-tax country, the higher tax abroad serves to protect its tax base, resulting in higher revenues. But the high tax abroad also denies beneficial profit shifting possibilities, which ultimately manifest themselves in lower income in the hands of the shareholders and hence lower consumption (Johannesen, 2022).⁵ The net effect on the high tax country is hence positive if the societal value of the revenue effect dominates. Another potentially offsetting aspect, muting the positive revenue effect, arises if the minimum tax intensifies subsidy competition (Janeba and Schjelderup, 2023). The presumption in the policy arena, however, is that the reduction in profit shifting will dominate and thus high-tax countries will be better off under the minimum tax.

For the low tax country, there are also several key effects:

- *Profit shifting*: Intuitively, forcing the low-tax country to raise its rate to the minimum implies receiving less profits from abroad, and hence less revenue from taxing this profit. It is a negative welfare impact for the low-tax jurisdiction, but it is not the end of the story. The higher rate also means higher revenue from the remaining base, which includes: (i) immobile domestic tax base in the low-tax jurisdiction; and (ii) profit received from abroad (note that the low-tax jurisdiction remains a recipient of foreign profits because of the remaining tax rate differential). To figure out the net revenue effect on the low-tax jurisdiction, the reaction of the high-tax country (to the increase of the low-tax jurisdiction's rate to the minimum) is crucial (Hebous and Keen, 2023).⁶ If the high-tax country raises its rate (by less than one-to-one increase), the fall in profit shifting to the low-tax jurisdiction is muted; that is, increasing the low-tax jurisdiction's rate to the minimum is partially offset by a high rate abroad. Hebous and Keen (2023) show that there is a Pareto-improving efficient minimum rate that makes both the high- and the low-tax country better off: less profit leaves the high-tax country (and hence it collects higher revenue) while the low-tax country collects higher revenues from its immobile base and the remaining incoming profit. Calibration suggests that this Pareto-minimum rate can

⁵ The societal value of the benefits from profit shifting can be lower than that for the avoiders (Hebous and Keen, 2023).

⁶ Theoretically, tax rates can be substitutes or complements. Empirically, the latter possibility is typically supported. For instance, IMF (2022) estimates that a 1-percentage-point change in the average foreign statutory tax rate leads the home rate to change between 0.25-0.4 percentage points in the same direction.

reasonably be in the territory of 17 percent (given an initial Nash equilibrium of 12.5 percent). In this class of models, note though, that a zero-tax is not an equilibrium: that is, there must be some explicit societal benefits for the zero-tax jurisdiction from attracting profits from abroad for the argument here. Otherwise, less profit shifting has no revenue implication for the zero-tax jurisdiction.

- *Investment:* Beyond profit shifting effects, other effects can also arise. If the low-tax jurisdiction is a capital exporter, for instance, then a higher tax rate abroad, could reduce the global demand for capital, which reduces return that it earns on world markets (Keen and Konrad, 2013). In contrast to this negative investment effect, the SBIE can increase the return of investments in the low-tax jurisdictions (Schjelderup and Stähler, 2023). Although as a possibility this latter effect can occur also in high-tax jurisdictions. For example, if existing profit is high and the level of assets and payroll is low (below the SBIE), the firm can increase the after-tax profit by investing more capital and labor in this country up to the SBIE to max out its SBIE deduction.

Recent theoretical contributions highlight further effects of the minimum tax. Clearly, competition over out-of-scope multinationals (and over non-‘excess’ profits and SBIE) continue. Mitigating this competition, by expanding the coverage of in-scope multinationals, is superior to raising the minimum rate (Haufler and Kato, forthcoming). Tax enforcement incentives may change under a minimum corporate tax, for example low-tax countries could reduce their efforts in tax enforcement (Hindriks and Nishimura, 2022).

4. A Low-Tax Jurisdiction Perspective on the GloBE

Overall, the above overview suggests that theoretically the minimum tax can make low-tax jurisdictions better off if they collect more revenue (while remaining hosts of some foreign profits) and safeguard real investment.

4.1 Should Low-Tax Jurisdictions Adopt the GloBE?

While the minimum tax is optional, jurisdictions must accept adoption by others, so what remains for low-tax jurisdictions is to decide whether and how to design their CIT reform in response to the GloBE rules implemented by investment partners. Implementation of the minimum tax is progressing rapidly, entering into effect for some in 2024 in a few important capital exporting countries—notably in the EU and UK—while as at end of 2023 some delay has emerged in adoption in several countries (Box 1). This delay allows many low tax jurisdictions the time to design and implement general CIT reforms, also taking advantage of some of the features of the minimum tax such as the treatment afforded to certain immediate expensing and refundable tax credit regimes, before—or alongside—specific GloBE rules.

Box 1. Implementation of GloBE Rules in Selected Jurisdictions

GloBE adoption plans are ongoing, and the details are still evolving. As summarized below, outside Europe (where the UK and the EU propose to adopt an IIR from 2024; undertaxed profits rule from 2025; with QDMTT adoption dates varying between 2024 and 2025), there is an emerging trend to delay adoption until at least 2025. Many low tax countries and investment hubs announced implementing a general CIT before—or alongside—specific GloBE rules.

Country	Income Inclusion Rule (IIR)	Qualified Domestic Minimum Top-Up Tax (QDMTT)	Undertaxed Profits Rule (UTPR)
<u>Selected countries (with existing CIT regimes)</u>			
<i>Singapore</i>	<i>2025</i>	<i>2025</i>	<i>2025</i>
<i>Cyprus</i>	<i>2024</i>	<i>2025</i>	<i>2025</i>
<i>Netherlands</i>	<i>2024</i>	<i>2024</i>	<i>2025</i>
<i>EU</i>	<i>2024</i>	<i>QDMTT optional</i>	<i>2025</i>
	Must transpose EU Directive end 2023 with IIR and UTPR (but can defer application to end 2029 if no more than 12 ultimate parent entities; elected by Estonia, Latvia, Lithuania, Malta, and Slovakia).		
<i>Switzerland</i>	<i>Delayed</i>	<i>2024</i>	<i>Delayed</i>
<i>United Kingdom</i>	<i>2024</i>	<i>2024</i>	<i>2025</i>
<i>United States</i>	<i>No legislative plans</i>	<i>No legislative plans</i>	<i>No legislative plans</i>
	US GILTI regime qualifies as a Blended CFC Tax Regime under GloBE rules. A domestic corporate alternative minimum tax (at 15%) on the adjusted financial statement income of companies with profits > US\$1 billion adopted.		
<u>Selected low tax jurisdictions (without pre-existing CIT regimes)</u>			
<i>Barbados</i>	<i>No public IIR plans</i>	<i>QDMTT plans (2024, conditional on top-up tax payable elsewhere)</i>	<i>No public UTPR plans</i>
	General CIT: Proposal for a general CIT (at 9%) effective 2024, with QDMTT (at 15%) for multinational groups with revenues of at least €750 million that are subject to an IIR or UTPR elsewhere. A qualified refundable tax credit (QRTC) is also proposed (jobs credit based on payroll plus R&D credit).		
<i>Bermuda</i>	<i>No public IIR plans</i>	<i>No specific QDMTT plans</i>	<i>No public UTPR plans</i>
	General CIT: Adopted general CIT (at 15%) for multinational groups with revenues of €750 million or more (2025). Final law removed credit for U.S. GILTI but has temporary U.S. CFC income exclusion instead. QRTCs also proposed.		
<i>Guernsey</i>	<i>2025</i>	<i>2025</i>	<i>No public UTPR plans</i>
<i>Jersey</i>	<i>2025</i>	<i>2025</i>	<i>No public UTPR plans</i>
<i>Isle of Man</i>	<i>2025</i>	<i>2025</i>	<i>No public UTPR plans</i>
<i>UAE</i>	<i>No public IIR plans</i>	<i>QDMTT delayed (2025)</i>	<i>No public UTPR plans</i>
	General CIT: Adopted CIT (at 9%) on annual taxable profits above AED 375,000 (effective 2023), with delayed adoption of a QDMTT (at 15%).		
<i>Kuwait</i>	<i>No public IIR plans</i>	<i>No public QDMTT plans</i>	<i>No public UTPR plans</i>
	General CIT: Proposal to adopt CIT (at 15%) from 2025, without specific GloBE rules.		

Source: Authors' compilation.

In terms of the GloBE rules themselves, if investment partners are implementing them, there is a case for adopting the QDMTT and IIR rules (although as discussed in Section 4.2, they are not enough):

- *Adopting the QDMTT is a dominant strategy on revenue grounds...* It would put the country at the head of the queue, ensuring that it can collect any top-up tax payable by entities of in-scope multinationals with affiliates in the low-tax country, rather than in another jurisdiction. Importantly, the QDMTT per se would not put a jurisdiction at an investment disadvantage, as wholly owned in-scope companies will in any case be taxed at 15 percent effective tax (if any parent in the chain is in a jurisdiction that implements Pillar Two) and, thus, the QDMTT per se would not drive them away. Moreover, to the extent the existing profit exceeds the SBIE in the country, such a company would even find it beneficial to increase employment and assets in the jurisdiction to benefit from the SBIE exemption as discussed above. Finally, there will be no added compliance costs, as the in-scope multinationals need to undertake the calculations irrespective of the policy of a specific jurisdiction (IMF, 2023).
- *... and so is likely adopting the IIR.* While other jurisdictions will also likely adopt a QDMTT, thereby collecting the top-up tax from the foreign-source income of multinationals based in the low-tax jurisdiction, the IIR: (i) ensures revenue collection if other jurisdictions do not implement a QDMTT; and (ii) renders CFC rules redundant (for in-scope multinationals). If the low-tax jurisdiction is not keen on collecting the revenue, not adopting the IIR can be viewed as a way to attract headquarters. However, for this approach to work, in-scope multinationals need to identify country pairs where neither QDMTT nor IIR has been adopted and the source country is significant enough to relocate their global headquarters (which could also be short lived until a UTPR takes effect – below).
- *The case for implementing the UTPR is weak as of now.* The main argument in favor is that adopting this rule provides an opportunity to collect a share of the global top-up tax payable on low taxed income (abroad) when no IIR or QDMTT applies elsewhere. However, this argument should be qualified and put into the perspectives of a low-tax jurisdiction, which raises doubts about its practical relevance in the near future, because: (i) the UTPR is a provision of last resort (that is, the likelihood of its application in the future is by design expected to be rather low) and the agreed transitional arrangements further weaken the case for its importance in practice at least initially;⁷ (ii) the UTPR still carries implementation risks, which could undermine its legal effectiveness—for example—questions continue to be raised by many legal observers over its consistency with tax treaties, as well as other potential conflicts with international law. Those conflicts arise because offshore undertaxed profits are purportedly becoming subject to tax in local UTPR jurisdictions, *even when those profits have no connection with those UTPR jurisdictions nor accrued to the local constituent entities bearing the local UTPR top-up tax* (Box 2; Figure 2); (iii) the UTPR requires a higher level of administrative co-operation

⁷ For example, transitional arrangements ensure that the UTPR will not apply (top-up tax becomes zero) during the first 2 years of the GloBE implementation if the CIT rate of the parent jurisdiction is at least 20 percent, or to any multinational groups that are within the initial phase of their international activity (applicable during the first 5 years).

when seeking to apply it against a multinational company with subsidiaries in different jurisdictions (that is, it increases administrative and compliance complexities, and risks of cross-border tax disputes); and (iv) the UTPR raises some international trade risks (in the form of possible retaliation) that are yet to be clarified. On balance, from the standpoint of a low-tax jurisdiction, there seems no urgency to prioritize the implementation of the UTPR, sparing time to focus its efforts on more pressing CIT issues. Deprioritizing the implementation of the UTPR is also consistent with the approach signaled by several countries thus far (Box 1).

The strategic considerations in reacting to the GloBE, summarized above, apply to a wider set of countries, but the revenue impact can be particularly relevant for low-tax jurisdictions. Capital exporting countries may react in the same way but as a backstop to their systems, as they tend to already have high taxes above the GloBE minimum. The benefits for them will be from reduced profit shifting (protecting the tax base) and tax competition (less pressures on their rates). For low-tax jurisdictions, however, adopting the QDMTT and the IIR can have a direct sizable revenue impact as long as they still attract some foreign-sourced profits (and imply no revenue loss if they do not). While behavioral response of multinationals in terms of reduced profit shifting lower the revenue potential for low-tax jurisdictions from implementing the GloBE rules, this effect is expected to occur because of the minimum tax (under IIR in the HQ countries), irrespective of the reactions of the zero- and low-tax jurisdictions. It remains to be seen how large such effect will be. To the extent some foreign profits remain in low-tax jurisdictions, the QDMTT generates revenue gains for them.

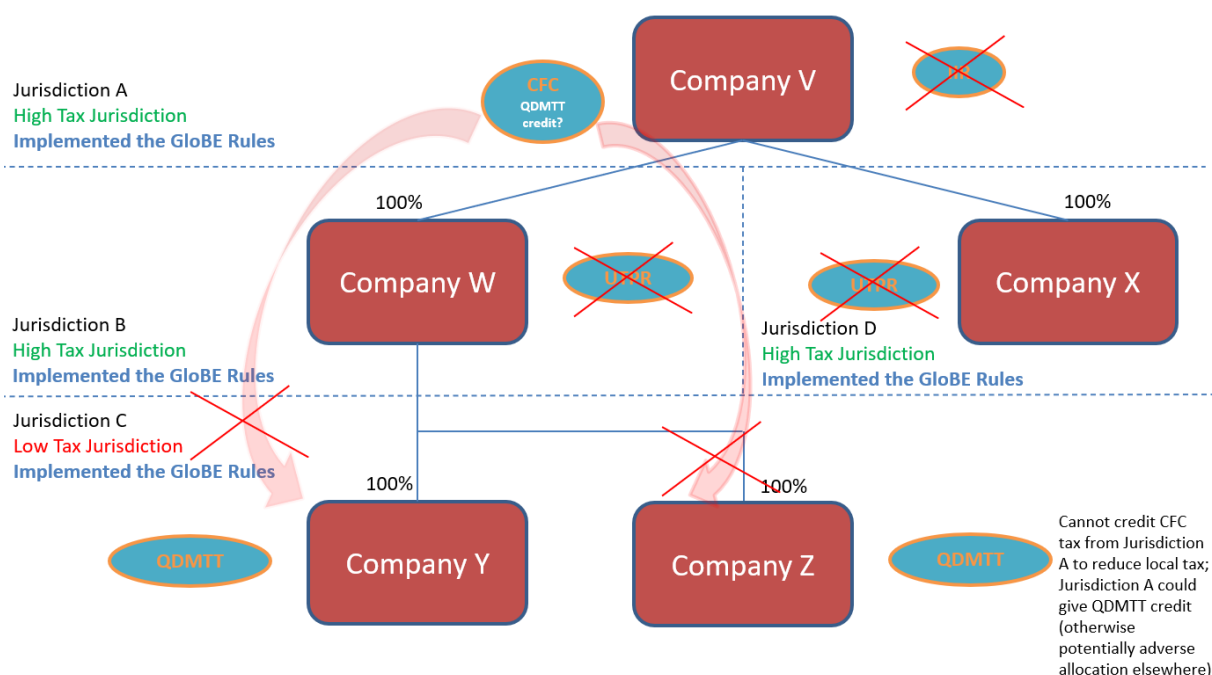
Note that it is rather challenging to calibrate any new domestic taxing instrument to the exact dollar of the top-up tax (whether a GloBE instrument or a general CIT), and countries should not be fixated to do so anyway as discussed later. A general CIT regime at 15 percent on the net GloBE income (say, \$100) will result in slightly more tax (\$15) than would be collected elsewhere under either the IIR or the UTPR (\$12, assuming net GloBE income of the same \$100 less the SBIE of \$20; see example in Section 2.2). Conversely, a general CIT regime at 15 percent on GloBE 'excess profits' (\$12) after considering the SBIE will result in a rate below 15 percent (actually, 12 percent, and, therefore, will still require a top-up tax elsewhere), because of the way the GloBE effective rate and top-up tax are computed (Section 2.2). While a QDMTT would more closely mimic the top-up tax payable elsewhere, it can still imply a different amount given the strict qualifying conditions. Particularly, a QDMTT should be applied to in-scope constituent entities on their entire GloBE 'excess profits' being \$12, *irrespective of whether those in-scope entities are wholly owned or not*. In contrast, the top-up tax payable elsewhere by ultimate parent entity under the IIR in respect of those entities would be adjusted downwards to account for ownership interests that are less than 100 percent. In the example here, it implies only \$9.6 for an 80 percent owned entity.⁸ Thus, even if low-tax countries were to strictly follow and make the GloBE their entire tax system, it is not possible in all cases to exactly impose the bare minimum tax.

⁸ This top-up tax still becomes payable elsewhere even if a QDMTT was limited to wholly-owned in-scope entities.

Box 2. UTPR Operates on an Extraterritorial Basis and CFC Attribution Opens Avenues of Tax Planning

The UTPR provides a mechanism for collecting the GloBE top-up tax when that tax is not charged under another jurisdiction's IIR or QDMTT. It authorizes the implementing UTPR jurisdiction to levy a tax against local constituent entities of a multinational group (for instance, by denying deductions, or imposing an equivalent tax charge under domestic law) equal to that jurisdiction's allocated UTPR top-up tax amount. Importantly, the multinational needs only to have some specified substance (for example, through a local subsidiary) in the implementing UTPR jurisdiction (for instance, with employees and/or tangible assets in that subsidiary) to become subject to a top-up tax through the UTPR in that jurisdiction. Once such substance exists, the implementing UTPR jurisdiction can collect its share of the top-up tax amount from any local constituent entities of the relevant multinational group, which can be sister or lower tier subsidiaries. This can occur even though *entities in the implementing UTPR jurisdiction have no ownership interest in, or control of, the offshore entities* deriving the undertaxed profits in other jurisdictions (Figure 2).

Figure 2. The Mechanism of the GloBE and CFC Rules



Under the GloBE rules, the general CIT (if any) is recognized first (being, a covered tax), followed by the top-up tax (in this order): (i) the QDMTT, and thus Jurisdiction C imposes the top-up tax on both Companies Y and Z before Jurisdiction A (or B); (ii) the IIR, so Jurisdiction A imposes the top-up tax on Companies Y and Z if Jurisdiction C has no QDMTT; and (iii) the UTPR, so Jurisdiction B and Jurisdiction D impose the top-up tax relating to Companies Y and Z (based on a ratio of employees and tangible assets in their respective jurisdictions) if neither A or B has an IIR nor C has a QDMTT. The UTPR also means that Jurisdiction D (despite Company X not having direct control over Companies Y and Z) imposes the top-up tax relating to Companies Y and Z (as explained above). Additionally, interaction with CFC rules opens avenues for tax planning. If C has no CIT (even if it adopts a QDMTT), Company V

can still be subject to CFC in A, and A should give credits for the QDMTT paid in C (but C cannot provide credits for the CFC tax paid in A to offset the QDMTT). Instead, if C has a CIT, it can provide credits for the CFC tax paid in A. The GloBE allows this outcome for blended CFC regimes (notably the U.S. GILTI) by prescribing more favorable CFC allocation rules to (for example, low tax) jurisdictions. For numerical illustration, assume Company Y has profit of 100; Company V's tax (at 21%, before the credit) in A is \$21; and Company V can use credits under a CFC regime with global blending of \$6 relating to another high tax jurisdictions (for example, with a statutory rate above 21%). After credit, the net tax position is \$15, which can be pushed down to Jurisdiction C. This means Jurisdiction C top-up tax is zero, whereas a QDMTT would have yielded additional tax of \$15 in Jurisdiction C on top of the CFC tax in Jurisdiction A (the QDMTT amount might not become fully creditable as an alternative mechanism because of—for example—excess foreign tax credits). As a result of the absence of a QDMTT, Company Y pays no taxes in C, and overcomes the material foreign tax credit risk in A. Company V saves \$6 under a global blending regime by paying \$15 instead of \$21 in A. The total tax paid by Company V would also have increased (i.e., exceeded \$21) if the \$6 foreign tax was otherwise subject to binding credit limitations in A if determined on a country-by-country basis (rather than under global blending).

4.2 Why Go Beyond GloBE?

For a zero-tax jurisdiction, there is a strong case for adopting a broader tax on profit, beyond the backstop of GloBE, considering three broad reasons:

1. *Tax and economic policy perspective:* the changing landscape of taxing multinationals is an opportunity for a low-tax jurisdiction to diversify and raise its revenue, including through taxing economic rent of out-of-scope companies with the appropriate tax design. Rather than adopting the GloBE as the tax system, the country can have its own underlying rent tax system, one that is best suited for the country and more robust to external forces that can change the GloBE in the future. The design of such a tax is discussed below.
2. *Legal design perspective:* The QDMTT and the rest of the GloBE rules are designed to be an 'add-on' to an existing CIT framework—that is, a 'top-up' tax—, requiring an underlying CIT system. A standalone QDMTT would not be a top-up tax but rather a form of CIT with limited scope. Much of the work that would be required in designing and drafting a CIT would need to still be undertaken but without the flexibility that other countries have with existing CITs (which also includes better integration with existing tax treaties, where they exist⁹). Further, a QDMTT which operates as the only tax without an underlying CIT will look different because it will need to be comprehensive, self-executing, and self-administrable. For example, a standalone QDMTT could not rely on existing CIT legal infrastructure such as definitions and collection and enforcement provisions in the general CIT law. Further, rather than simply incorporating OECD guidance and developments, a standalone QDMTT would likely need some ringfenced protection in order to preserve an appropriate level of

⁹ For example, questions could arise as to whether a new standalone minimum tax instrument could be seen as being "identical or substantially similar" to an existing profit tax to be covered by existing tax treaties when compared to the implementation of a broader based CIT system.

tax sovereignty and certainty. This is less of a concern with a defensive top-up tax, because full sovereignty is preserved over the design of the general CIT that can be reformed to minimize the bite of any top-up tax, relegating it to a mere backstop rule (for example, incentives resulting in a GloBE effective tax rate below 15 percent can be removed). Two obvious policy areas where tax sovereignty would need to be preserved over are: (i) the design of tax depreciation rules, where countries tend to deviate from what is recognized for financial accounting purposes, and these deviations are specifically catered for under the GloBE (for example, immediate expensing); (ii) the design of tax credits or other cost-based incentives, which, when refundable, can receive more favorable treatment under the GloBE. Such rules would need to be legislated in a tax law, separately from the GloBE. Divergences in the legal design of a standalone QDMTT to cater for these factors may pose challenges when it is being reviewed for consistency with the GloBE rules. Further, if countries were to simply make the GloBE their entire system, then certain modifications would likely still be required to comply with various other international initiatives.¹⁰ For example, the Model Rules do not themselves contain any economic substance requirements with respect to the exclusion of the specific foreign sourced income relating to dividends and equity gains. Thus, the substance requirements imposed under other international initiatives create a risk that the Model Rules themselves are insufficient to protect a jurisdiction against failing the peer review on harmful tax practices (Action 5 of BEPS) or the European Code of Conduct list of non-cooperative jurisdictions for tax purposes.

3. *Avoiding the application of the subject-to-tax rule (STTR)*: the STTR is a treaty-based rule (under Pillar Two) that enables low-income countries to impose a top-up tax (under the IF's STTR) on specific cross-border payments (including interest, royalties, insurance premiums; financing fees and all intra-group service payments) if the foreign nominal CIT rate is below 9 percent, irrespective of the GloBE rules. This means if the country is keen on circumventing the STTR, it needs some CIT in addition to the GloBE. Some low-tax jurisdictions do not have broad tax treaty networks, but for those that do the STTR has become an important factor. Overall, there is no clear rationale for choosing 9 percent as we will discuss below.

For a low-tax country that already has a general CIT, say with a statutory rate between 9 and 15 percent, adopting the GloBE as a top-up is straightforward, but questions remain as to how to improve this tax system considering Pillar Two by revisiting the CIT rate and base. Zero-tax jurisdictions have the advantage of designing a CIT from scratch that avoids the common distortions that exist in other countries; the debt bias and investment distortions (IFS, 2011; IMF, 2016). In contrast to other jurisdictions, they do not need to deal with transitional challenges and build on an inherently complex and distortive old CIT system.

¹⁰ A country would also still need to adopt other supporting rules such as transfer pricing rules.

There are several observations that shape the response of low- and zero-tax jurisdictions to the GloBE. Before discussing these in the next section, two important points must be also made. The lack of personal income taxes (PITs) is a complication facing any broad taxation of profits in some zero-tax jurisdictions, and particularly for the typical distortive CIT. The tax system should be neutral with respect to (i) the sources of income (across capital incomes—including dividends, interest, and capital gains—and labor income, mainly wages and bonuses); and (ii) the legal form of the business (a corporation or a limited liability company, among others). If, as in most countries, a zero-tax jurisdiction applies a new CIT on every business above the VAT threshold (set at USD 100), without a PIT, the neutrality principle will not be maintained. Then, for instance, a salary of USD 100 will not be taxed whereas a profit of USD 100 will be taxed. The issue is mainly related to the choice of the threshold for any design of the profit tax, but under an efficient economic rent tax, with an appropriately chosen threshold, the tax neutrality in the absence of PIT becomes somewhat less concerning as both the normal return to capital and the equivalence earned by labor are untaxed.¹¹ Still, issues of tax arbitrage and avoidance can arise. The no-PIT concern becomes a question of choosing a sufficiently high threshold (but still below the GloBE one) to capture most of the economic rent.

While “niche responses” can circumvent the GloBE in particular situations, they may not withstand future changes in the GloBE or foreign rules (or different types of businesses that the jurisdiction wishes to attract), to justify falling short of designing a proper underlying CIT. Niche responses would be too focused on a few existing influential companies. The fundamental question is: how beneficial it is to design a tax system that does not collect revenue and leave money for other jurisdictions to collect? For example, in response to the adoption of the GloBE rules, Bermuda announced adopting a new CIT for multinational groups with revenues of €750 million or more (Bermuda CIT). The design was not initially a QDMTT, and appeared to be largely driven by U.S. tax interactions. GloBE gives *blended* CFC regimes (that are not on a country-by-country basis, like the U.S. GILTI) more favorable CFC allocation rules to local jurisdictions (Box 2; Figure 2). The proposed Bermuda CIT seemed to be centered around this point. However, under the final legislation, taxes paid by a U.S. shareholder under U.S. GILTI are now no longer considered creditable foreign taxes, with that feature replaced with a new *temporary* income exclusion for certain Bermuda constituent entities that are treated as CFCs for U.S. tax purposes (which reraises questions as to whether the Bermuda CIT could also eventually constitute a QDMTT). The rate will be 15 percent and the design would credit other foreign taxes paid with respect to Bermuda income (to be applied before qualified refundable tax credits, which are also contemplated). A niche CIT—for example, with generous foreign CFC crediting—should be approached with caution as it could collect little revenue, might be irrelevant for new firms from different countries or sectors, and importantly can lose all their appeal quickly since they hinge on rules of other countries that can change anytime.

¹¹ A question arises as to the taxation of ‘rents’ earned by labor, for which there is no established mechanism.

5. An Efficient Rent Tax: ACE versus Cash-Flow under the GloBE Rules

Economists often argue in favor of an efficient tax targeting only economic rent that implies a zero marginal effective tax rate (METR). There are two broad alternative designs of an efficient profit tax (as summarized in Box 3). The first is a form of cash-flow taxation, under which the entire investment is immediately expensed but (to prevent the cost of investment in effect being deducted twice) no deduction is allowed for interest expense or returns to equity (called ‘R-based’ cash flow tax).¹² Box 3 briefly summarizes various designs under the category of cash-flow taxes. The second design provides a notional deduction for normal return by, for example, providing an allowance for corporate equity (ACE) while maintaining depreciation rules and interest deductions. While both designs are very similar from an economics standpoint (since both do not tax the normal return), they are treated differently under GloBE. The notional deduction of the ACE lowers the covered tax rate under GloBE rules, but immediate expensing is considered a ‘temporary timing measure’ that reverses over time, and thus it would not impact the GloBE effective tax rate.

5.1 The ACE and the QDMTT

The ACE is generally appealing as it covers all (financial and non-financial) companies and is based on familiar accounting standards (including depreciations and interest deductions). However, the ACE will lower the GloBE effective rate of the in-scope companies by more than full expensing does (the latter will be discussed in the next subsection). Although a question remains regarding how exactly the effective rate will be lowered: as a qualified refundable tax credit (QRTC) by increasing the covered income or as a non-qualified refundable tax credit or other tax deduction (NQRTC) by lowering covered taxes. Either way, qualitatively the effect is the same, but the magnitude differs. In this sense, in choosing a form of efficient rent tax, Pillar Two generally tilts the balance toward the R-based cash-flow tax. The implications of GloBE rules for the ACE, as summarized below, comprise a particular concern that arises under a relatively low statutory tax rate close to (but still can be well above) the 15 percent, which is at the upper range of values currently under discussions in the CIT reforms in low-tax jurisdictions.

Implication 1: *The ACE is no longer a tax only on economic rent for sufficiently low statutory CIT rates (still well above the 15 percent). The ACE will imply a top-up tax on in-scope companies even if the investment is just earning the normal return.*

Implication 1, above, can be decomposed into several statements (assuming a QDMTT is in place, the ACE is seen as an NQRTC, and a single period investment model)¹³:

- (i) For investments that earn the normal return (or less), the ACE will result in a zero covered tax (since irrespective of the statutory tax rate, the normal return is untaxed under the ACE). Therefore, only the

¹² Moreover, efficient rent tax designs refund the tax value of losses.

¹³ For formal derivation and multi-period investment, see Hebous and Mengistu (2024). The key insights are similar if the ACE is considered a QRTC.

QDMTT matters. If the ACE is seen as an NQRTC, the top-up rate is the full 15 percent, to be applied on profits minus SBIE.

- (ii) For investments that earn an economic rent, in this case, the ACE always implies a top-up tax on in-scope companies if the statutory CIT rate is sufficiently low (certainly 15 percent or lower; Figure 3). Precisely, this cutoff statutory CIT rate (τ) is given by:

$$\tau = \frac{15\%}{\left(1 - \frac{r \cdot E}{\pi}\right)} \quad (1)$$

where, r is the normal rate (notional deduction rate), E is the value of equity, and π is total profit. For instance, if the notional deduction is 8 percent and the equity-to-profit ratio is 5, a statutory tax rate of 25 percent (or above) is required for preventing the application of the QDMTT.

For projects that earn very high economic rent, the covered tax rate approaches the statutory rate.

And in this case the top-up tax *rate* approaches $15\% - \tau$ (if this difference is positive, otherwise the top-up rate is zero)¹⁴.

- (iii) In terms of total tax paid, for projects that do not earn any economic rent, the average tax rate is a function only of the SBIE. If the SBIE is close to total profit (that is, $SBIE \approx \pi$), the average tax rate is close to zero. In contrast, as the SBIE approaches zero, the average tax rate (even on the normal return) approaches the minimum tax.
- (iv) For projects that earn economic rent, if the top-up tax is zero (that is, the statutory rate is high enough), the normal return will not be taxed, and the resulting average tax rate is implied by the general CIT system (that is, not depending on the SBIE; Panel A of Figure 4). Precisely, it is given by:

$$ATR = \frac{\text{Tax paid}}{\pi} = \tau \times \left(1 - \frac{r \cdot E}{\pi}\right). \quad (2)$$

- (v) For projects that earn economic rent, in the case of a top-up tax (that is, the statutory rate is low enough), the normal return will be taxed, and the resulting average tax rate is a function of the GloBE effective rate, as shown in Panel B of Figure 4 and given by:

$$ATR = \frac{TT}{\pi} = 15\% \times \left(1 - \frac{SBIE}{\pi}\right) + \tau \times \left(1 - \frac{r \cdot E}{\pi}\right) \frac{SBIE}{\pi}. \quad (3)$$

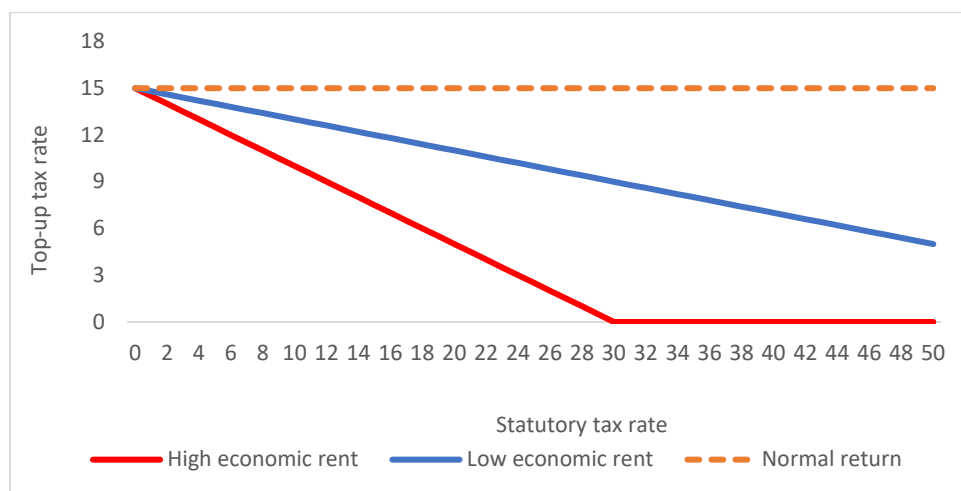
For example, if economic rent is low (shown in Panel B of Figure 4 as allowances of 8 or 10 percent), the average tax rate is close to 15 percent.

To recap, the simple period-by-period illustrative example here gives a sharp result that the ACE+QDMTT system does not guarantee no-taxation of normal returns. The top-up *rate* of a project in this system that yields the normal return will always be 15 percent. The top-up tax amount is positive if SBIE is lower than the normal return, and zero if the SBIE is equal (or larger than) the normal return. The ACE is restored to a tax on economic rent only (for those projects that earn economic rent) for sufficiently high statutory tax

¹⁴ The top-up tax rate is $\max\left(0, 15\% - \max\left(0, \tau \left(1 - \frac{r \cdot E}{\pi}\right)\right)\right)$. When economic rent is very high (i.e., $\frac{r \cdot E}{\pi}$ approaches zero), the top-up tax rate approaches $\max(0, 15\% - \tau)$. Note that in a multiperiod setting, there is no single τ like in equation 1, as such a rate will be time-variant and the treatment of losses becomes critical (Hebous and Mengistu, 2024).

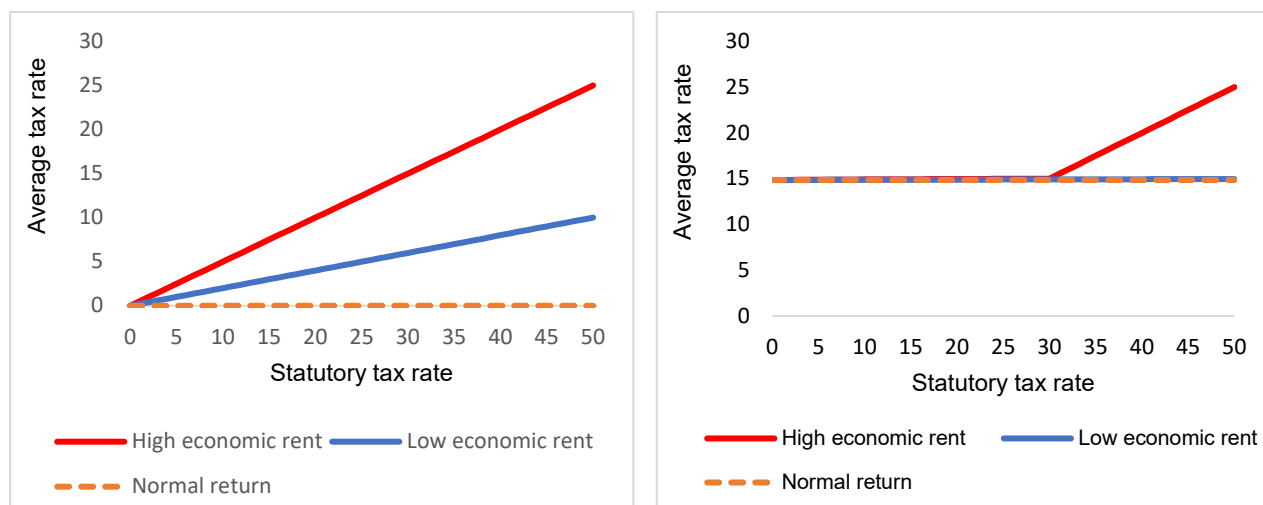
rates, well above the 15 percent, see Equation (1). The results of a broader analysis using effective tax rates (in net present value terms) are somewhat less sharp, depending on the dynamics; but the core mechanism presented here remains valid.

Figure 3. The Relationship Between the Top-Up Tax Rate and the Allowance Under an ACE



Note: Equity-EBIT ratio=10, a single period model, and the ACE is a NQRTC. The project earns a 10% economic return. Whether this is high economic rent, low economic rent, or normal return depends on the notional deduction. For projects that earn just the normal return (if notional deduction is 10%), the covered tax is zero and the top-up tax rate is 15 percent. For projects that earn economic rent (if notional deduction is less than 10%), if τ is < 15% the top-up is $\max\left(15\% - \tau\left(1 - \frac{r^E}{\pi}\right)\right)$ and approached zero if τ is sufficiently high. For projects that earn economic rent, the top-up tax rate is always positive as long as $\tau < 15\%$. Note that the top-up rate only depends on economic rent ($\pi - r \cdot E$) and τ .

Figure 4. Average Tax Rates Under ACE+QDMTT Compared to Only QDMTT



A. No top-up tax due to a large SBIE, assuming SBIE/-EBIT ratio=100%.

B. Top-up tax with a small SBIE, assuming SBIE/EBIT=1%.

Note: The figure assumes an equity-EBIT ratio of 10%, a single period model, and the ACE is a NQDTC.

5.2 Immediate Expensing (vs ACE) and the QDMTT

Immediate expensing does not affect the GloBE effective rate, and thus by itself does not trigger a top-up tax. The METR, as mentioned above, is important for investment decisions. The rules consider immediate expensing a ‘temporary timing measure’ that reverses over time (however, long). Therefore, immediate expensing gives rise to an (upward) adjustment to covered taxes to reflect the temporary difference between the accounting and tax recognition (Article 4.4 of the Model Rules). Thus, immediate expensing does not impact the GloBE effective tax rate, and this has important implications. The METR is larger than zero under a CIT, say with a rate of 15 percent and the typical distorting features (standard depreciation rules and interest deductions, while taxing the normal return). In contrast to such a CIT, a domestic profit tax design can consider a cash-flow tax (where investment is fully deductible as 100 percent depreciation in the first period), and then the same 15 percent statutory rate implies a zero METR (thereby maintaining efficiency).¹⁵ Theoretically, without a minimum tax, the ACE gives the same results as the cash-flow tax. But, as discussed above, under GloBE the ACE lowers the GloBE effective tax rate while immediate expensing of investment does not.

Implication 2: *Given a relatively low statutory tax rate, under the GloBE, immediate expensing (R-based cash-flow tax) tends to result in a lower METR than the ACE, ceteris paribus.*¹⁶

Implication 2 can be organized in three cases (assuming a QDMTT is in place, the ACE is seen as an NQRTC, and on a period-by-period basis):

- (i) *Case 1: No top-up tax (neither under ACE nor under immediate expensing).* This occurs only if the statutory rate is sufficiently high, as given by Equation (1), and the investment yields economic rent (if it yields the normal return, recall under the ACE there will be always a top-up tax and there is no equivalence between the two systems). With economic rent, both the ACE and the cash-flow tax become the familiar economic rent tax design (no investment distortions or financing distortions), and both are equivalent.
- (ii) *Case 2: A top-up tax under the ACE but not under the cash-flow tax.* this is a scenario that occurs for statutory tax rates between 15 percent and an upper level given by Equation (1). Here, the ACE loses its features whereas the cash-flow tax maintains its efficiency (except for banks that would be subject to the QDMTT).
- (iii) *Case 3: Top-up taxes under both systems ($\tau < 15\%$).* In this case, the top-up tax is always higher under ACE than under immediate expensing since $\tau \left(1 - \frac{r-E}{\pi}\right) < \tau$. This implies that the average tax rate is always higher under ACE than under immediate expensing.

¹⁵ The zero METR under immediate expensing holds if tax losses are refundable or carried forward with interest.

¹⁶ Hebous and Mengistu (2024) present formal derivation. Matters are more complex in a dynamic model, as depending on the tax treatment of losses and specific conditions the ACE can result in a lower METR than cash-flow taxes for some investments.

5.3 Why Not Other Forms of Cash-Flow Taxes?

The treatment of banks requires further considerations. Case 2 above does not encompass banks because their interest income is untaxed under an R-based cash-flow tax, and thus will end up subject to the QDMTT. Economic rent in the financial sector can be explicitly captured using other forms of cash-flow taxes, but (as mentioned in Box 3) unfortunately these forms are either insupportable by the GloBE rules (S-base cash-flow) or administratively complex (R+F base cash-flow). One option is to adopt the financial activity tax (described in Box 3) to capture banks and ensure that profits from providing financial services to households and non-taxpayers were taxed. However, this would make sense only if the policy intention is to tax economic rent of out-of-scope banks, and/or possibly tax the in-scope banks by more than what is implied by the QDMTT/IIR. Ultimately, a financial activity tax is a form of an ACE and would require a sufficiently high statutory rate to generate a zero marginal effective tax rate.

Another aspect to note is that the METR can be negative (that is, a subsidy) without prompting a top-up tax. This outcome is possible by providing an income tax credit in the form of a QRTC, for example on top of interest deductions or immediate expensing. However, such a policy is typically motivated by addressing positive externalities (where the societal benefits exceed private benefits), as for example for research and development activities.

6. Conclusion

This paper discusses the interaction between the underlying profit tax design and the GloBE; particularly for countries that initially do not have a CIT in place or have a low CIT. Protection from the top-up tax that could become payable elsewhere should remain one of the tax law design objectives. While this makes the case for adopting the QDMTT (and possibly the IIR), this paper further expands the argument to underscore the importance of adopting the GloBE as a backstop, on top of an underlying well-designed profit tax. The primary goal of this approach is to ensure more flexibility in raising revenues more efficiently, including from out-of-scope companies, and to better preserve tax sovereignty by shielding against dependency on changes in the GloBE or other rules abroad.

In terms of legal implementation, jurisdictions could consider a well-designed profit tax with: (i) foundational legal infrastructure (for example, core definitions, as well as collection and enforcement provisions); and (ii) customary international tax and anti-avoidance provisions (for example, functional transfer pricing rules, and/or economic substance rules for relevant foreign source income exemptions). The GloBE top-up tax rules could be implemented as a backstop, closely following the Model Rules (with few modifications), and possibly enacted through a separate legal instrument (given peer review), leveraging off foundational legal infrastructure embodied in the general profit tax regime so as to be largely self-administrable.

Among the main implications of the GloBE for the general profit tax is that the normal return can be taxed even under an efficient rent tax design especially at relatively low statutory tax rates (possibly above 15 percent), unless the SBIE is equal to (or greater than) the normal return for all marginal investors in any year. Another implication that has, thus far, received little attention is that the equivalence between different economic rent tax designs is not maintained under GloBE. Among the designs of rent taxation familiar to economists, the GloBE rules tilt the balance toward one specific form, namely, the R-based cash-flow tax because immediate expensing does not lower the covered tax, ensuring a zero marginal effective tax rate. In contrast, under an ACE, an in-scope company in any specific year will face a non-zero top-up rate, de facto putting the company under the QDMTT regime, unless the statutory tax rate or the SBIE is sufficiently high (a formula presented here for a single period model implies that it can be easily in the territory of 25 percent). Under this situation of a low statutory rate, the ACE loses its attractive features. Dynamic investment models show, however, that the refundability of tax losses is important for the efficiency of both systems (Hebous and Mengistu, 2024). Also, under the R-based cash-flow banks will end up under the QDMTT under a pure R-based cash-flow tax. New S-based cash-flow regimes are intolerable under GloBE, in the sense they would lead to a lower covered tax.

In conclusion, with the exceptional opportunity to react to the minimum corporate tax agreement, zero- or low-tax jurisdictions can design a profit tax that ensures a zero tax on investment at the margin. Generally, this requires a rate of at least 15 percent. The effective tax on economic rent remains, however, moderate well below 15 percent. To some extent, a decrease in profit shifting to low-tax jurisdictions is expected to occur irrespective of the country-specific response because the agreement generally reduces profit shifting incentives. However, under an efficient rent tax with a rate of around 15 percent, such jurisdictions will likely remain recipients of some foreign profits as they continue to be in the lower range of profit taxation internationally.

Box 3. Summary of Design Options for Efficient Taxation of Economic Rent

Any investment worth undertaking without a tax remains viable under an efficient rent tax. This box summarizes major design options that ensures a zero METR.

R-based cash flow tax

The tax base is net *real* transactions ('R-based'): that is, the net sum of all real (non-financial flows). In essence, it ends the tax-deductibility of interest payments and the taxation of the corresponding interest income in the hands of lenders, typically banks (IFS, 1991). Gross inflows are sales, including sales of capital goods. Gross outflows include all costs, such as labor and purchases of intermediate and capital goods. Financial flows—such as interest payments, net debt issuance, and net dividends—are excluded from the tax base. Losses generate immediate refunds or are carried forward at an appropriate interest rate.

Since the investment cost is immediately expensed, the normal return is untaxed, and thus the R-base cash-flow tax is neutral with respect to investment. Since interest is nondeductible, there is no debt bias (capital expenditures are immediately deductible irrespective of the financing mode). Other forms of cash-flow taxes (discussed below) achieve these objectives too: the (R+F)-based cash-flow tax and the S-based cash-flow tax.

Several countries embraced full expensing in their system, for instance, Hungary (for small businesses only), United Kingdom, and the United States, although (on the contrary to the design) existing full-expensing countries keep some interest deductibility, which means providing a subsidy (negative METR; if losses are carried forward with interest) for debt-financed investment (for example, Adam and Miller, 2023, discuss the case of the UK).

(R+F)-based cash flow tax

The tax base is net real transactions, as above, and net financial transactions (hence, '(R+F)-based'), where the latter comprise received borrowing and interest after deducting interest paid and repayment of debt. For non-financial companies, (R+F)-based cash flow tax is equivalent to R-based cash flow tax since interest paid and debt paid are equal to borrowing in net present value terms. But the R+F based cash-flow tax is difficult to administer. In 2008, Mexico introduced an (R+F)-based cash-flow tax (alongside the CIT) but abolished it in 2014 due to administrative challenges.

S-based cash flow tax (where 'S' stands for share transactions)

The tax base is the net distributions of companies to shareholders; that is, dividends and share buybacks are taxable, while capital increases are deductible. In principle, the S-based cash-flow tax is equivalent to the (R+F)-based cash-flow tax, as total inflows of funds to the company need to be equivalent to the total outflows of funds from the company. The S-based cash flow tax is then:

$$(\text{dividends paid} + \text{repurchases of shares} - \text{new equity issued}) = (\text{sales} + \text{borrowing} + \text{interest received}) - (\text{purchases} + \text{interest paid} + \text{debt paid})$$

Estonia and Latvia, among a handful of countries, have adopted a distribution-based CIT, with similar features to the S-based cash-flow tax.

Pillar Two rules, though, seem not to treat new S-based cash-flow taxes equally to temporary timing measures or existent distribution tax system. The term 'eligible distribution tax system' is used in the Pillar

Two guidance to describe the types of distribution tax systems that are eligible for special treatment under the GloBE rules. An eligible distribution tax system is one that: (i) imposes an income tax on the corporation with the tax generally payable only when the corporation distributes profits to shareholders, is deemed to distribute profits to shareholders, or incurs certain non-business expenses; (ii) imposes tax at a rate equal to or in excess of the minimum rate; and (iii) was in force on or before 1 July 2021.

Allowance for Normal Return

Another family of efficient tax designs is via providing allowances for normal returns. This is also known as efficient excess profit taxation (IFS, 2011; Hebous et al., 2022). One form is an allowance for corporate equity (ACE) that maintains the deductibility of interest expense but permits the deduction of a notional rate as a 'normal' return to equity, broadly expressed as:

$$ACE \text{ Tax Base} = \text{Pretax Profits} - \frac{r \times (\text{Total Equity})}{\text{Allowance}}$$

The allowance rate (r) is in practice predetermined. A few countries adopted such a system in the past (including Belgium and Italy) and linked the allowance to the yields on long-term government bonds (Hebous and Klemm, 2020). The ACE has several desired neutrality features (Keen and King, 2002), importantly (like the cash-flow tax system) *eliminating the investment distortion and the debt bias* (if the notional return is equivalent to the interest rate). The ACE is also neutral with respect to: (i) the *depreciation method* (provided that the notional interest aligns with the firm's time value of money) because an increase in depreciation allowances leads to a lower capital stock, which is in turn offset by a reduced equity allowance; (ii) *Inflation*: Any inflationary uptick adjusts the notional interest rate, accordingly, counteracting the potential tax increase that would occur under a typical CIT. A unilateral ACE can open the door for international tax planning (Hebous and Ruf, 2017).

The Financial Activity Tax

The tax base is the sum of (high) excess profit and (high-level) remuneration of financial institutions. The idea is to approximate a tax on economic rents (the excess of returns over the minimum that investors require) in the financial sector (G20, 2010). As in many countries banks are typically not subject to VAT on their financial intermediation activities, the financial activity tax acts like the VAT (as value-added is profit plus wages), and thus the financial activity tax is on net financial transactions. At a low statutory tax rate (determined by Equation 1), and if remuneration is not considered in the base, then the financial activity tax becomes a form of an ACE, and thus the QDMTT will be binding. Adding remuneration to the tax base of banks raises the covered tax, but it remains the case that at a low tax rate, for the financial activity tax to apply (rather than the QDMTT) the included portions of remuneration and profit should be relatively high (and the remuneration portion should be deemed as a covered tax). If it is the policy intention to tax excess profit in the banking sector, then the financial activity tax could be considered.

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PUBLICATIONS

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