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New International Tax System and Global Investment

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The OECD/G20 Inclusive Framework drives reforms of the international tax system to address tax avoidance issues of multinational enterprises (MNEs) arising in digital economies. Based on the mutual agreement reached in October 2021 by 137 member countries in the Inclusive Framework, two grand schemes will be implemented via the corporate income tax systems of each country by 2023.

This will entail two major changes. First of all, a part of the excess profits earned by the largest and the most profitable MNEs will be reallocated as a tax base to the jurisdiction where revenue is assumed to arise without consideration of permanent establishments. As permanent establishments have been the nexus between earned incomes and corporate income taxes in the extant tax system, companies that are able to sell their services using digital technologies could easily shift their taxable incomes from market countries with high corporate income taxes to other countries with low corporate income taxes, thus reducing their tax burdens by locating permanent establishments such as servers in those jurisdictions. As such, reallocation of taxing rights to market countries will not only ensure the fairness in taxation between countries but also deter the MNEs' incentives of profits-shifting for tax-planning.

Another overhaul of the international tax system suggests setting a minimum level of effective corporate income tax rates for MNEs globally. Specifically speaking, if an affiliate of an MNE pays effective corporate income taxes lower than 15% in one jurisdiction, another company who owns or controls the affiliate in the MNE is obliged to pay "top-up" taxes to fill the gap between the tax rates and 15%. In an ideal situation where all countries cooperate well, this will equalize the tax burdens of MNEs regardless of their locations, thereby reducing profits-shifting of MNEs and mitigating tax competitions between countries to attract foreign investment.

Introducing new rules on international tax systems could shape the global investment environment differently in two dimensions of MNEs' decisions. The former may affect the MNEs' location decisions for production. Given that MNEs invest in some countries to establish conduit companies for tax-planning purpose, reducing the incentives of profit-shifting by reallocating the taxing rights to market countries may allow the MNEs to invest more in other countries even with a high corporate income tax level. This effect will especially be pronounced in countries which are highly competitive in production but with a relatively high level of corporate income taxes.

On the other hand, the latter rule as to the global minimum corporate tax may have an impact on MNEs' R&D decisions. Alleviating tax competitions between countries implies that overall tax burdens of MNEs could increase globally. This would reduce after-tax profits and investment returns of MNEs, leading MNEs to curb their investments in R&D and introduction of new products in the global markets, and as a result, global production and investment could be hampered. This could be followed by export-platform FDIs dwindling if global production becomes sluggish.

For both dimensions, tax uncertainties are another important aspect to consider. Since the new international tax rules feature some interdependences of taxation across countries, information on corporations and imposed taxes should be transparently shared between different tax authorities. Otherwise, facing the risks of excessive tax burden may distort MNEs' efficient decisions.

Against the backdrop of the Covid-19 pandemic, the need for massive government spending to fight with economic downturn has spurred discussions on combatting tax avoidance of MNEs and prompted the members of the Inclusive Framework to reach this agreement on global tax deal. In this regard, the implementation of these new tax rules becomes a prioritized goal to support recovery of the global economy. However, at the same time, it should be noted that the new tax system can have long-term consequences on global investment and competitiveness of the most successful MNEs. KIEP