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Research Report

QDMTTs leave geographic disparity between increased pillar two costs and revenues

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ZEW policy brief

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QDMTTs Leave Geographic Disparity Between Increased Pillar Two Costs and Revenues

For the better part of the last decade, the global minimum tax, or Pillar Two, has dominated international tax policy discussions. Developing out of the Base Erosion and Profit Shifting (BEPS) Project at the Organisation for Economic Co-operation and Development (OECD), Pillar Two's main objective is to ensure that multinational enterprises (MNEs) with a consolidated group revenue of over EUR 750 million pay an effective tax rate of at least 15 percent in each jurisdiction where they earn profit. Some portion of the Pillar Two model rules have been adopted by several dozen countries around the world, but, importantly, not by other large economies such as the United States, India, or China. This especially puts European MNEs at a competitive disadvantage vis-à-vis jurisdictions without a domestic minimum tax system. Our estimates show that the additional compliance costs for affected European MNEs amount to EUR 1.2 billion (up to EUR 2.0 billion) and total recurring costs amount to EUR 517 million p.a. (up to EUR 865 million p.a.). Due to the incentive for jurisdictions to implement a qualified domestic minimum top-up tax (QDMTT), Pillar Two leaves a geographic asymmetry. Additional tax revenues would predominantly accrue to low-tax jurisdictions, with high-tax jurisdictions receiving little to no increase. At the same time, it is likely that MNEs expense compliance costs in the jurisdictions where they are headquartered, often high-tax jurisdictions. Furthermore, Pillar Two incentivizes jurisdictions to move from competition on tax rates to less transparent subsidies, which could also result in less disposable tax revenue. The combination of losing international competitiveness, increasing compliance costs for firms and tax authorities, and the lack of significantly more revenue is forcing some Member States to reconsider the policy altogether.

KEY MESSAGES

- The global minimum tax will only work if it is truly international. However, the EU remains the only large economy to implement the rules, putting its firms at a competitive disadvantage. Therefore, the EU should suspend the application of the rules and reconsider the policy as part of the Commission's 2026 simplification package.
- Agreeing to a G7 side-by-side agreement with the United States, simplifying the rules through the OECD, and implementing permanent safe harbors should all be seen as second-best options. These solutions are required to reduce the negative impact of Pillar Two on European MNEs; however, there are more efficient options to reduce harmful profit shifting without compounding taxation costs (e.g., relying on existing ATAD regulation).
- The EU should focus on the simplification of its direct tax systems (something it does not currently have a mandate for) to foster European integration and strengthen the Single Market. The EU should focus on measures it can implement without relying on regulatory support by any foreign administration (i.e., outside the EU), to increase democratic legitimacy.

→ To the Discussion Paper: https://ftp.zew.de/pub/zew-docs/dp/dp25053.pdf

THE GLOBAL MINIMUM TAX

Over 130 countries agreed to a global minimum tax within the OECD/G20 Inclusive Framework in 2021

On 8 October 2021, more than 130 countries agreed to a global minimum tax, known as Pillar Two, under the OECD/G20 Inclusive Framework. The stated goal of Pillar Two is to decrease profit shifting by MNEs through low-tax jurisdictions and increase government revenue by ensuring that MNEs with a consolidated group revenue of over EUR 750 million pay an effective tax rate of at least 15 percent in each jurisdiction where they earn profit. There are three main parts to the so-called GloBE model rules: a qualified domestic minimum top-up tax (QDMTT), an income inclusion rule (IIR), and an undertaxed payments rule (UTPR). These rules are structured so that a local jurisdiction may first use a QDMTT to generate revenue from low-tax profits created in its jurisdiction. However, if that government does not, the IIR and UTPR allow other jurisdictions to tax that profit up to the 15 percent effective rate. These ordering rules create an incentive for each jurisdiction to implement a QDMTT. The EU adopted Pillar Two by EU Directive in 2022, and more than 50 countries have adopted at least one piece of Pillar Two; notably, other large economies like the US, China, and India have not.

Compliance costs are key for cost-benefit analysis of Pillar Two

While much of the public discourse on Pillar Two has been around reducing the attractiveness of profit shifting through low-tax jurisdictions and increasing government revenues, the economic effect of increased compliance costs for both MNEs and tax authorities has been understated. Until now, increased compliance costs have either been largely disregarded as insignificant relative to MNE revenue or overstated. However, new findings show that neither is a safe assumption to make.

ESTIMATING COMPLIANCE COSTS

Survey on compliance costs for EU-headquartered MNEs

According to our survey, increased compliance costs for affected European MNEs would amount to EUR 1.2 billion (up to EUR 2.0 billion) in one-time costs and EUR 517 million p.a. (up to EUR 865 million p.a.) in total recurring costs. However, these costs will largely vary according to policy uncertainty from continuing OECD guidance and possible changes to EU law as part of a side-by-side deal with the United States. While these costs may seem small relative to the revenues of large MNEs, policymakers should not confuse the ability to pay a tax with good tax policy design that prioritizes simplicity, transparency, stability, and neutrality.

FIGURE 1: DISTRIBUTION OF ONE-OFF COST TYPES

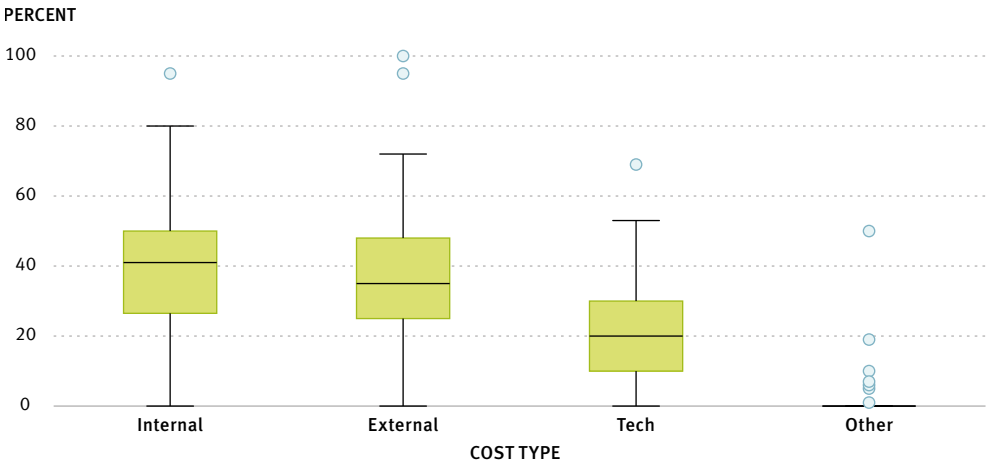
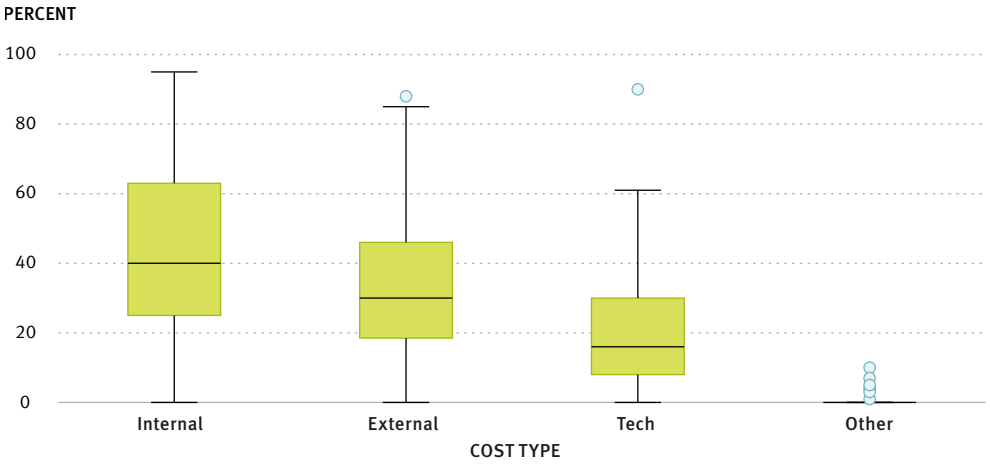


FIGURE 2: DISTRIBUTION OF ONGOING COST TYPES



For example, the EU's Pillar Two Directive calls for each Member State to adopt a QDMTT. This allows local jurisdictions a first top-up taxing right for profit created within their borders that would otherwise be subject to taxes below 15 percent. However, if Pillar Two succeeds in changing policies in formerly low-tax jurisdictions, there will likely be a geographic disparity between where compliance costs are booked (firm headquarters in high-tax jurisdictions) and where the increased revenues are collected (formerly low-tax jurisdictions). This calls into question why high-tax jurisdictions, like the majority of EU Member States, would support a policy with such negative outcomes for the competitiveness of their MNEs and their budget revenue.

Compliance costs and increased revenue are unlikely to occur in the same jurisdiction

CONSEQUENCES OF NON-ADOPTION BY COMPETITORS

Despite Pillar Two's design as a global minimum tax, the EU is the only large economy that has adopted the model rules into law. This leaves European MNEs at both a policy and compliance cost competitive disadvantage relative to Indian or Chinese MNEs that don't have domestic minimum tax systems. Theoretically, this allows those firms to compete with European MNEs around the world at a lower cost. Competition with American MNEs is more nuanced given that, unlike China or India, the US does have a domestic minimum tax system (including CAMT and NCTI, formerly GILTI). While this system does not follow the model rules, it does produce similar outcomes with similar compliance costs. There are ongoing discussions about how to accommodate differences with the US approach. During the first six months of President Trump's second term, the US took a stick and carrot approach by threatening tariffs and retaliatory tax measures against countries that enforced the Pillar Two rules against US firms while Congress worked to adapt the US system to act more like Pillar Two. After the removal of the Section 899 retaliatory tax proposal from the final One Big Beautiful Bill Act, the US and other G7 countries signed a political agreement on a side-by-side solution that would exclude US-parented groups from the IIR and UTPR.

Large economies such as the US, India, and China have not adopted the rules, leaving EU MNEs at a disadvantage

Countries are actively exploring changes to the Pillar Two rules. The potential changes include addressing concerns about differential treatment of tax credits and payable (refundable) credits, and safe harbors that could limit compliance costs with the UTPR. However, even if these frictions are solved, due to the effective tax rate formula, governments are still incentivized to turn to inefficient and less transparent subsidies to compete for investment rather than lower tax rates available to all firms. It is unclear how the EU would win a subsidy race with other economies without a taxing competence that currently lies with the Member States.

Does Pillar Two create more problems than it solves?

Calls to abolish Pillar Two are growing louder

The question for European policymakers now is how to move forward. Even if side-by-side negotiations with the US avoid retaliatory tariffs and taxes, it is unclear how the EU or OECD would handle the lack of adoption by India or China. Furthermore, high-tax jurisdictions are starting to question whether the Commission should pause the applicability of Pillar Two within the EU until international policy uncertainty is resolved. Multiple German federal states and CFE Tax Advisors Europe have already called for such a response to preserve European competitiveness. While policymakers consider their next move, they should not only focus on profit shifting and government revenue, but also on compliance costs.

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Imprint

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