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International Tax Proposals Addressing Profit Shifting: Pillars 1 and 2

On June 5, 2021, finance ministers of the G7 countries, including the United States, agreed in a communiqué to two proposals addressing global profit shifting. They agreed to Pillar 1, allocating rights of taxation of residual profits to market countries of at least 20% for certain digital services for large profitable multinationals while eliminating digital services taxes. They also agreed to Pillar 2, imposing a global minimum tax of at least 15%.

These proposals were developed in OECD/G20 blueprints for addressing profit shifting and base erosion, which involved participation by 139 countries. The G7 agreement is a general agreement and does not address the detail in these blueprints. This G7 communiqué is a first step in the process of reaching a multilateral agreement and is not binding. On July 10, the G20 endorsed the plan. Some aspects might require legislative changes. The OECD reported on October 8 that 136 out of 140 countries participating have joined the framework.

The agreement does not mention a specific revenue threshold, but the OECD in another initiative had proposed a threshold for country-by-country reporting of €750 million. The next two sections discuss the two pillars as outlined in the OECD/G20 blueprints.

Pillar 1

The standard international agreements historically have allocated the first right of taxation of profits to the country where the asset is located. This location may be where the asset is created (e.g., from investment in buildings, equipment, or research) or where the rights to the asset have been purchased, which may happen easily with intangible assets, such as drug formulas or search algorithms. Many U.S. multinationals have sold the rights to intangible assets to affiliates in other countries to serve the foreign market. This system allocates profits between related parties on the basis of arm's-length prices (i.e., the price upon which a willing buyer and a willing unrelated seller would agree to transact), although true arms-length prices often are difficult to determine.

With the advent of companies providing digital services that are often free services to consumers (such as search engines, online market places, and sites for social networking), an argument has been made that the country where the users reside should have a right to tax some of the profits of these companies because the users create value. Advocates also argue that these companies escape taxes on some of their profits by locating assets in tax havens. Several countries have imposed digital services taxes, although generally in the form of excise taxes (such as taxes on advertising revenues, digital sales of goods and services, or sales of data), while proposed changes in the taxation of profits are being discussed. The United Kingdom (UK) enacted a diverted profits tax with a similar objective. The United States has decided to impose tariffs against seven countries that imposed digital excise taxes: France, Austria, India, Italy, Spain, Turkey, and the UK, although these tariffs were temporarily suspended until November 29, 2021, to allow time for further negotiations.

Pillar 1 would allocate some rights to market countries to tax profits of digitalized firms (and countries would eliminate their digital services taxes). In 2020, then-Secretary of the Treasury Steven Mnuchin signaled the U.S. position that negotiations over Pillar 1 were at an impasse. The G7 agreement reversed that position.

The Pillar 1 blueprint would allow market countries a share of 25% of the *residual profits* (defined as profits after a 10% margin for marketing and distribution services) of large multinational companies. It would apply to companies with global revenue turnover of more than $20 billion and apply to market countries that provide at least $1 million in revenue. As noted earlier, this agreement does not have force of law and is viewed as a first step. The proposal would allocate the residual share based on revenues (such as sales of advertising) and the location of the user or viewer for an array of digital services and split the residual share 50:50 between the location of the purchaser and seller for online markets. The OECD/G20 blueprint provides a positive list of the businesses covered: "sale or other alienation of user data; online search engines; social media platforms; online intermediation platforms; digital content services; online gaming; standardized online teaching services; and cloud computing services," as well as online market places.

This agreement is viewed as a fundamental departure from the traditional allocation of the first right of taxation to the owner of the asset, which is consistent with the economic concept of profits as a return to the investor and not to the consumer.

Although the Pillar 1 proposal does not conform to the traditional framework, it could serve the purpose—if agreement is reached—of heading off unilateral action, as has developed with the digital services taxes. From the viewpoint of the United States, which has large multinational digital firms (e.g., Google and Facebook), the arrangement could be costly. The excise taxes that would be eliminated are borne largely by the customers; that is, an advertising tax decreases the net price from sales and would lead to higher prices to advertisers, which would in turn be reflected in higher product prices to customers who are largely in the country imposing the excise tax. Were countries unilaterally to impose taxes that are tied to profits without an agreement, under proposed regulations, U.S. multinationals would not receive a U.S. foreign tax credit, and the burden would fall largely on the profits of these firms. With a multinational agreement such as in Pillar 1, the U.S. foreign tax credit presumably would be allowed for these taxes (unless Congress intervenes), which would reduce revenues for the U.S. government, and the burden would fall on U.S. persons in general.

U.S. companies may prefer this substitution of Pillar 1 for the digital services taxes, as they likely would not see a tax effect (since the taxes collected by the market countries would be largely offset by foreign tax credits), and they would be freed from the uncertainty and complexity of digital services taxes.

Also, the United States may have an interest in maintaining harmonious relationships with the rest of the world, which may justify the loss of revenues. The acceptance of Pillar 1 also has been tied to establishing a global minimum tax under Pillar 2, which would discourage the so-called "race-to-the-bottom" as countries lower tax rates to attract capital.

Pillar 1 probably can be adopted without changing the tax code, although it could require changes in treaties.

Pillar 2

Pillar 2 would impose a global minimum income tax to address base erosion, or GLoBE. It includes an income inclusion rule (IIR) to raise the effective tax rate on a country-by-country basis to 15% on profits in excess of a fixed return for substantive activities (including tangible assets and payroll). This rule is termed a *top-up tax*. The income base is financial profits. These taxes would be imposed by the parent company. In cases where the IIR does not apply, there is a subsidiary rule to tax payments to low-tax countries (the undertaxed payment rule, or UTPR) at 9%.

Most countries do not tax profits earned by their firms' foreign subsidiaries in other countries (or tax them in a limited way under anti-abuse rules). The United States currently has a minimum tax on foreign source income of subsidiaries of U.S. multinationals, the tax on global intangible low-taxed income, or GILTI. (See CRS Report R45186, *Issues in International Corporate Taxation: The 2017 Revision (P.L. 115-97)*, by Jane G. Gravelle and Donald J. Marples for a discussion of GILTI and other tax provisions enacted in 2017.)

GILTI is similar in some ways to the minimum tax that would be imposed by GLoBE under the IIR. It imposes a tax at a lower rate (currently half the U.S. rate, or 10.5 %) to income in excess of a deemed return of 10% of tangible assets. The rate is scheduled to rise to 13.125% after 2025. In addition to the lower rate, three other features of GILTI differ from the IIR. First, GLoBE would allow an exclusion for a broader range of spending that includes payroll as well as tangible assets, although at a lower rate of 5%. (During a transition period the percentage would be 8% for tangible assets and 10% of payroll, phased out over 10 years.) Second, GILTI achieves the "top-up" tax by imposing the full tax and then allowing credits against the GILTI tax for 80% of foreign taxes paid, up to the amount of U.S. tax due. This limit is imposed on a global basis so that unused credits in high-tax countries can offset U.S. tax due in low-tax countries; the IIR would apply on a country-by-country basis. Finally, the IIR would allow carryforwards of losses and excess taxes, which is not allowed under GILTI.

The Administration budget proposals and several congressional proposals, including the Build Back Better Act (H.R. 5376), would raise the GILTI rate, eliminate or reduce the deduction for tangible assets, limit the credit on a country-by-country basis, and increase the share of taxes credited in some cases. (See CRS In Focus IF11809, *Trends and Proposals for Corporate Tax Revenue*, by Donald J. Marples and Jane G. Gravelle for a summary.)

The OECD blueprint recognizes the coexistence of GILTI and certain problems that may arise and concerns if GILTI were to be limited by future legislation.

An advantage of a global minimum tax is that it could reduce the race-to-the bottom as countries lower their taxes to attract capital investment. A global minimum tax would allow countries with higher tax rates to attract more capital.

Adoption of the GLoBE provisions to replace GILTI, or modifying GILTI to be more consistent with GLoBE, would require legislative action to change the tax code as well as revising treaties.

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