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The Pillar 2 Global Minimum Tax: Implications for U.S. Tax Policy

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SUMMARY

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The Pillar 2 Global Minimum Tax: Implications for U.S. Tax Policy

In response to concerns about multinational corporations shifting profits to low-tax countries, the Organisation for Economic Co-operation and Development (OECD) and the G20, through an inclusive framework of 141 countries, developed a proposed global minimum tax (GLoBE) of 15%. The United States had considered tax policy changes to conform domestic rules more closely with GLoBE, but these changes were not adopted. On December 15, 2022, the European Union (composed of 27 countries) adopted the Pillar 2 minimum tax.

The overarching goal of GLoBE is to address profit shifting, where multinational enterprises (MNEs) use techniques such as transfer pricing and location of debt to reduce income in high-tax countries and increase income in low-tax countries. About 69% of the foreign profits of U.S. multinationals are located in eight identified tax haven jurisdictions and in "stateless entities and other countries" generally subject to low or no local taxes.

GLoBE would impose a rate of at least 15% on the earnings of large MNEs in each country they operate in via an additional, or top-up, tax. The minimum tax would be imposed on all constituent entities (parents, subsidiaries, branches, or permanent establishments) in each country with lower taxes, so that the overall effective tax rate on earnings of the MNE in that country is increased to 15%. GLoBE is based on financial income but, to target intangible income in each country of operation, would apply the additional tax to income after a deduction for a share of the book value of tangible assets and for a share of payroll costs. The allowance for these deductions is referred to as the *substance carve-out*, and would begin at 8% for tangible assets and 10% for payroll before eventually equaling 5% after a 10-year phase-down period.

The right to tax income goes first to the source country through a qualified domestic minimum top-up tax (QDMTT). If the source country does not impose a top-up tax on income earned in the country, the home country of the parent company can collect the tax through the income inclusion rule (IIR) by increasing the income of the parent subject to tax. If neither of these taxes apply, then countries where other constituent entities (such as subsidiaries and branches) are located can collect the tax by denying deductions for those constituent entities through the undertaxed payments rule (UTPR).

Tax credits would reduce taxes, but refundable credits (and grants) increase income. Other tax deductions would reduce taxes, but there is a provision to deal with timing differences for items such as accelerated depreciation. GLoBE applies to entities that are consolidated in the MNE accounts and excludes income and losses included under the equity method of accounting.

The United States currently has its own minimum tax on foreign-source income—the tax on global intangible low-taxed income (GILTI)—that is similar to the IIR. The Build Back Better Act (H.R. 5376) would have increased the GILTI tax rate and imposed it on a country-by-country basis, along with other changes, to more closely align the GILTI rules with GLoBE. The Administration's FY2023 budget proposals would repeal the current base erosion and antiabuse tax (BEAT), an alternative tax on a base that includes certain payments to foreign affiliates, and impose a domestic top-up tax and an undertaxed payments rule. The final version of the bill, the Inflation Reduction Act (P.L. 117-169) did not adopt these changes, although it adopted an alternative minimum tax on large corporations.

GLoBE could increase taxes on multinationals' operations in the United States, even absent U.S. action with respect to the GLoBE proposal. Other countries could impose taxes on U.S. earnings of multinational firms triggered by a low U.S. effective tax rate through the UTPR or IIR. Thus, GLoBE could reduce the benefit of domestic tax incentives such as tax credits. The major tax credits include the research credit, the low-income housing tax credit, and credits for renewable energy.

At the same time, several aspects of the GLoBE proposal would limit its effect on domestic tax policy and incentives to encourage certain types of investment. These include the carve-out for payroll and tangible assets, adjustments for timing differences between financial and tax accounting, and the exclusion for investments accounted for under the equity method. Outside of the research credit, it appears other credits would generally not be affected because they fall under the equity method exclusion. Additional taxes could be triggered by other provisions as well, although some highly aggregated tax-rate

calculations suggest the effect would be limited or perhaps concentrated in certain industries. The potential effect on the research credit, or any other affected credit, could be reduced by making it refundable.

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Introduction

Following the 2007-2009 financial crisis, policymakers were increasingly concerned that the tax planning strategies used by multinational corporations were leading to profits being shifted to low- or no-tax jurisdictions. While profit shifting has been a long-standing policy concern,[1] the more developed economies appeared particularly concerned that the practice was eroding their respective corporate tax bases and resulting in substantial tax revenue losses. Governments around the world had incurred large budget deficits to address the severe economic downturn caused by the financial crisis, and they began to look toward curbing profit shifting as a method to raise revenue to address fiscal imbalances. Additionally, portions of the public and some policymakers perceived that multinational corporations were not paying their fair share of taxes.

In 2012, the Organisation for Economic Co-operation and Development (OECD), at the request of the G20, launched its Base Erosion and Profit Shifting (BEPS) project. The project laid out 15 steps (or actions) that would be compiled into an overarching Action Plan countries could use to coordinate a modernization of the international tax system.[2] In October 2015, the OECD published its final Action Plan, which was endorsed by the finance ministers of all G20 countries, including the United States.[3] The release of the final Action Plan was followed by the creation of the OECD/G20 Inclusive Framework on BEPS, with the goal of bringing together OECD/G20 member countries and nonmember countries to collaborate on equal footing in implementing the proposals contained in the BEPS Action Plan. As of November 2021, 141 countries are members of the Inclusive Framework.[4]

In October 2021, the Inclusive Framework announced that nearly all of its members, including the United States, had agreed to a two-pillar solution to Action 1 of the Action Plan, which calls for addressing tax challenges of the digital economy.[5] Pillar 1 proposes to allocate corporate profits above a threshold (i.e., residual profits) to market jurisdictions (i.e., to countries where customers and users are located) in exchange for repealing existing and halting new digital services taxes (DSTs). Thus, Pillar 1 deals primarily with *nexus*, or determining which countries have the right to tax corporate profits. Pillar 2, which is the focus of this report and discussed in more detail below, proposes a coordinated global 15% minimum tax regime under a set of global base erosion (GLoBE) rules.

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[1] See CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle.

[2] Organisation for Economic Co-operation and Development (OECD), *BEPS 2015 Final Reports*, 2015, https://www.oecd.org/tax/beps-2015-final-reports.htm. Also see CRS Report R44900, *Base Erosion and Profit Shifting (BEPS): OECD/G20 Tax Proposals*, by Jane G. Gravelle.

[3] OECD, "G20's ownership and support to BEPS deliverables," press release, October 9, 2015, https://www.oecd.org/tax/g20-ownership-and-support-to-beps-deliverables.htm; and G20, "G20 Leaders' Communiqué, Antalya Summit, 15-16 November 2015," press release, November 16, 2015, http://www.g20.utoronto.ca/2015/151116-communique.pdf.

[4] OECD, *Members of the OECD/G20 Inclusive Framework on BEPS*, updated November 2021, https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf.

[5] OECD, "International community strikes a ground-breaking tax deal for the digital age," press release, October 10, 2021, https://www.oecd.org/tax/beps/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm. For a summary of the two-pillar solution, see OECD, *Two-Pillar Solution to Address the Tax Challenges Arising from Digitalization of the Economy*, October 2021, https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf.

On December 15, 2022, the European Union (composed of 27 countries including major trading partners such as Germany and France, and Ireland where many multinational firms have subsidiaries) adopted Pillar 2.[6]

Profit Shifting: Methods and Evidence

Methods

Corporations shift profits to low- or no-tax jurisdictions using two primary methods: (1) transfer pricing, and (2) the location of debt.[7] Transfer pricing refers to the pricing of transactions involving the exchange of goods, services, and assets between firms under the same ownership umbrella (parent company). To properly reflect income, the prices of goods, services, and assets exchanged by companies under the same ownership umbrella, also referred to as *related firms*, should be the same as those that would be agreed upon by two unrelated firms in the market. If transactions between related firms are in fact occurring at such prices, then they are referred to as being made at *arms length*. For example, transfer pricing would apply when a U.S. firm that has developed intellectual property (IP) sells the rights to use the IP in a particular geographic location to a subsidiary in a low-tax country. Examples of IP, also known as intangible assets, are algorithms, copyrights, design plans, drug formulas, patents, trademarks, and the like. The growing importance of intangible assets is part of the motivation behind the two-pillar solution to Action 1.[8]

Profits can be shifted from high-tax to low- or no-tax jurisdictions if transactions between related firms are not priced in accordance with the arms-length principle. Continuing with the example above, if the U.S. firm charges an artificially low price to the subsidiary, profits reported in the low-tax country will be artificially high (because the subsidiary has a lower cost), while profits in the United States will be artificially low (because the U.S. firm receives less income). With a greater share of profits being reported in the low-tax country, the company's overall tax is reduced.

Debt-location concerns are related to where a multinational corporation borrows. One straightforward way a corporation can use debt to reduce taxes is to borrow in relatively high-tax countries and deduct the associated interest payments. Deductions reduce taxes in proportion to the applicable tax rates, which results in the deduction of interest payments reducing taxes the most in higher-tax jurisdictions. Another approach, known as *earnings stripping*, involves a subsidiary in a low-tax jurisdiction lending to another subsidiary or parent in a high-tax jurisdiction. The related firm in the high-tax jurisdiction will then make interest payments on the loan, and those interest payments will be deductible in the high-tax country, thus reducing taxes. Action 4 of the BEPS Action Plan specifically addresses limiting interest deductions to curb profit

[6] Council of the European Union, General Secretariat, Communication, December 15, 2022, https://data.consilium.europa.eu/doc/document/CM-5860-2022-INIT/en/pdf. For further discussion, see Ernst and Young, EU Member States unanimously adopt Directive implementing Pillar Two Global Minimum Tax rules, December 15, 2022, https://globaltaxnews.ey.com/news/2022-6224-eu-member-states-unanimously-adopt-directive-implementing-pillar-two-global-minimum-tax-rules.

[7] For more information on profit shifting, see CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle.

[8] For more on the growing importance of intangible assets, see CRS Report R47003, *Corporate Income Taxation in a Global Economy*, by Jane G. Gravelle, Mark P. Keightley, and Donald J. Marples.

shifting. The United States and around half of the 141 Inclusive Framework members already have rules in place to limit interest deductions.[9]

A recent estimate suggests that transfer pricing accounts for the majority (72%) of profit shifting.[10] It is important to note that decisions about transfer pricing and the location of debt do not solely reflect the desire to shift profits; they can also be made to support real economic business activity. Additionally, international corporate tax planning strategies are extremely complex and require navigating not only U.S. tax law, but also the laws of each jurisdiction in which a corporation has subsidiaries. Corporations must also factor in bilateral international tax treaties between countries.[11]

Evidence

U.S. companies reported earning profits of $1.2 trillion abroad in tax year 2019, according to Internal Revenue Service (IRS) data.[12] **Table 1** shows that the 10 most popular places to report profits were responsible for 54% (or $639.2 billion) of the total $1.2 trillion in overseas earnings. Eight of the 10 reporting jurisdictions (i.e., excluding Canada and the U.K.) are generally considered by international tax experts to be "tax havens" or "tax preferred."[13] Canada and the U.K. are major industrialized countries with close trading ties to the United States, which explains their inclusion in **Table 1**.

Table 1. Most Popular Places to Report Profits for U.S. Companies, 2019

Rank	Jurisdiction	Profits (millions)	Profits as % of Overseas Total
1	United Kingdom[a]	$104,797	8.8%
2	Netherlands	$99,467	8.4%
3	Switzerland	$71,994	6.1%
4	Cayman Islands	$70,203	5.9%
5	Ireland	$69,142	5.8%
6	Singapore	$65,347	5.5%
7	Luxembourg	$46,477	3.9%
8	Bermuda	$44,595	3.8%
9	Puerto Rico[b]	$34,755	2.9%

[9] For more information on Action 4, see Organisation for Economic Co-operation and Development, *Action 4 Limitation on Interest Deductions*, https://www.oecd.org/tax/beps/beps-actions/action4/. For more information on U.S. rules on deducting interest payments and earnings stripping, see CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle.

[10] Jost H. Heckemeyer and Michael Overesch, *Multinationals' Profit Response to Tax Differentials: Effect Size and Shifting Channels*, Center for European Economic Research, Discussion Paper 13-045, 2013, https://ftp.zew.de/pub/zew-docs/dp/dp13045.pdf.

[11] For more on profit shifting methods, see CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle.

[12] U.S. Internal Revenue Service, *Statistics of Income Tax Stats, International Business Tax Statistics, Country-by-Country Report: Major Geographic Region and Selected Tax Jurisdiction with Positive Profit Before Income Tax*, 2019.

[13] For more information on tax havens, see CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle.

Rank	Jurisdiction	Profits (millions)	Profits as % of Overseas Total
10	Canada	$32,435	2.7%
Top 10		**$639,210**	**54.0%**
Stateless entities and other countries not separately specified[c]		**$195,431**	**16.5%**
All Foreign Jurisdictions		**$1,184,313**	**100.0%**

Source: U.S. Internal Revenue Service, *Statistics of Income Tax Stats, International Business Tax Statistics, Country-by-Country Report: Major Geographic Region and Selected Tax Jurisdiction with Positive Profit Before Income Tax*, 2019.

Notes:

a. The United Kingdom includes England, Northern Ireland, Scotland, and Wales.

b. Puerto Rico enacts and administers a tax code that is distinct from the federal tax code.

c. The IRS defines stateless entities as those "that are not residents of any tax jurisdiction." The IRS also does not indicate the countries in its "other countries" category.

Table 1 indicates that a significant share of overseas profits (16.5%) were reported by stateless entities and in "other countries" outside the approximately 100 countries the IRS provides information on. The IRS defines stateless entities as those "that are not residents of any tax jurisdiction," but warns that researchers are "strongly cautioned against inferring that income reflected on the stateless line is not subject to tax."[14] The IRS also does not indicate the countries in its "other countries" category. While the profits reported by stateless entities and companies with operations in "other countries" may not be subject to zero tax, the cash tax paid by this group in the aggregate was 0.7%. A number of notable tax havens are not individually identified in the IRS data and are likely included in the stateless entity and other country category, including, for example, the Bahamas, British Virgin Islands, Jersey, Isle of Man, Guernsey, Malta, and Seychelles. The IRS data do capture the larger tax havens (as seen in **Table 1**) and all major developed countries.

The OECD/G20 Pillar 2 Proposal

Overview of the Minimum Tax

Pillar 2 proposes a coordinated global 15% minimum tax targeted at the intangible income of *multinational enterprise* (MNE) groups under a set of global base erosion rules. The tax would be levied on financial income after a deduction for substantive activities, and would apply to MNE groups with revenues exceeding €750 million (equivalent to approximately $780 million as of June 15, 2022) in two of the past four years.[15] The proposed tax is similar in some ways to the

[14] Internal Revenue Service, *Tax Year 2019 Country-by-Country Report Data Sources and Limitations*, https://www.irs.gov/pub/irs-soi/19itdocumentationcbc.pdf.

[15] Pillar 2 also includes two treaty-based rules. One is a provision called the subject to tax rule (STTR), which is not part of GLoBE and would be implemented separately. It provides for a top-up tax on payments between related parties where the source country has ceded taxing rights through a treaty and the recipient country is a low- or no-tax jurisdiction. These payments generally involve interest and royalties. The rate is 7.5% to 9%. See OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges Arising from the Digitalisation of the Economy*,

current U.S. tax on global intangible low-taxed income (GILTI), but also differs in important aspects, as discussed in the next section. Most notably, the GLoBE tax would apply separately to the operations of *constituent entities* (e.g., subsidiaries and branches) in each country, rather than applying on an overall basis to all foreign-source income, as is the case with GILTI. A constituent entity with operations in a country that are generating less than €10 million of revenues or less than €1 million in losses would be excluded from the 15% minimum tax for those specific operations.

Key Terms

- Multinational Enterprise (MNE) Group—a company consisting of an ultimate parent entity that owns or controls at least one other business entity with operations in a different jurisdiction.
- Ultimate Parent Entity—a business entity with a direct or indirect controlling ownership interest in another business entity and that is not owned by another entity.
- Constituent Entity—a business entity (including an ultimate parent entity, subsidiary, permanent establishment, or branch) that is included in the consolidated financial statement of a MNE group.
- Excluded Entity—a business entity that is not considered a constituent entity, including government entities, international organizations, nonprofits, pension funds, investment funds, and real estate investment vehicles that are ultimate parent entities. Excluded entities are exempt from the GLoBE regime.

Source: OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from the Digitalisation of the Economy: Global Anti-Base Erosion Model Rules (Pillar Two)*, 2021, at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf. The OECD has also provided a Commentary with additional information. See Article 10 Definitions, at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf.

Under the GLoBE rules, an effective tax rate would be calculated for all constituent entities of a MNE group located in each country. Income from interests accounted for under the equity method in financial accounting, where a share of after-tax income is included in profits, is excluded. The equity method applies when there is a significant, but not controlling, interest in the entity, typically where the ownership share is between 20% and 50% in corporations and certain partnerships, although it depends on the circumstances and entity structure. For example, in a limited partnership, limited partners are not considered controlling if the general partner controls the investment, even if a limited partner owns a large share of the investment. For purposes of GLoBE, the income and tax items attributable to these entities would be excluded from the calculation. International shipping income would also be excluded from coverage, as would investment funds and tax-exempt organizations, such as charities and pension funds.

To target *intangible* income in each country of operation, the minimum tax would apply to income after a deduction for a share of the book value of a constituent entity's *tangible* assets and

July 2021, https://www.oecd.org/tax/beps/brochure-addressing-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf. These payments are subject to a lower rate but are taken into account in determining the overall effective rate; SSTR would apply before the income inclusion rule (IIR). It is expected that STTR would be requested largely by developing countries. The other provision is the switch-over rule, which allows jurisdictions that have agreed in treaties to exempt income of foreign branches to overturn those agreements and move to a foreign tax credit to address double taxation. The United States taxes income of foreign branches and allows foreign tax credits to prevent double taxation. For the rules, see OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from the Digitalisation of the Economy: Global Anti-Base Erosion Model Rules (Pillar Two)*, at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf. The OECD has also provided a Commentary with additional information, at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf.

for a share of the value of payroll. The allowance for these deductions is often referred to as the *substance carve-out*, and would eventually equal 5% after a 10-year phase-in period. The deductible share of tangible assets would initially equal 8% and decline by 0.2 percentage points per year for the first five years, and then decline by 0.4 percentage points per year over the next five years to reach 5%. The deductible share of payroll would begin at 10% and decline by 0.2 percentage points per year for the first five years, and then by 0.8 percentage points per year over the next five years to reach 5%. According to the OECD, the substance carve-out is intended to allow tax incentives for routine activities without triggering the top-up tax. The OECD also claims that the carve-out will cover a broad range of industries because it includes a deduction for payroll as well as tangible assets.[16]

The Top-Up Tax

Under the GLoBE rules, a *top-up*, or additional, tax would be levied to increase a constituent entity's effective tax rate (ETR) to 15% if the entity's tax was below the 15% minimum rate in its country of operation. The calculation to determine whether a constituent entity's effective tax rate was below 15% would be made *before* deducting the substance carve-out. The top-up tax would then be applied to income *after* deducting the substance carve-out. For example, assume a constituent entity has an effective tax rate of 10% before deducting the substance carve-out. Also assume that the entity has a carve-out equal to 20% of income. Then the top-up tax would be 4% (5% times [100% minus 20%]).

The top-up tax would be achieved in one of three ways according to the following order:

- First, the country in which the entity is operating can impose its own top-up tax, known as a qualified domestic minimum top-up tax (QDMTT), to bring the entity's ETR up to 15%. This would preserve the first right of taxation to the source country, which would benefit from the tax revenue.[17]
- Second, if the source country does not impose a QDMTT, the country in which the ultimate parent entity is located can impose a top-up tax on the parent entity under the income inclusion rule (IIR). This rule would include the income of the foreign constituent entity that has an ETR of less than 15% in the income of the ultimate parent entity sufficient to raise the rate on the foreign constituent entity's income to 15%. If the parent entity owns less than 80% of the entity (called a *partially owned parent entity*, or POPE), then the POPE would be responsible for the top-up tax. In either case, the tax revenue would accrue to the country in which the parent (or POPE) is located, and not the low-taxed entity's country of operation. The IIR is proposed to be effective in 2023.
- Third, if the ultimate or partially owned parent entity's home country does not adopt an IIR, then all other countries in which the MNE group has constituent entities could increase the effective tax rate on the constituent entities operating within their borders by invoking the undertaxed payments rule (UTPR). The UTPR would allow the denial of deductions in an amount to produce an additional tax liability equal to the needed top-up tax in the low-tax jurisdiction such that the 15% minimum tax is achieved. Deductions could be denied for

[16] See OECD, *Global Anti-Base Erosion Model Rules, Frequently Asked Questions*, Question 7, https://www.oecd.org/tax/beps/pillar-two-model-GloBE-rules-faqs.pdf.

[17] Although there is no set way to structure this tax, it presumably would be imposed on the parent if a U.S.-parented firm and its other domestic constituent entities pay low taxes, since this is the entity that pays taxes, and on the U.S. subsidiary if its parent firm is foreign.

payments to group companies and third-party entities, and for other items as determined by local law, including depreciation and interest. An additional tax could also be applied. The right to the top-up tax increase would be allocated to countries imposing the UTPR based on 50% of their share of total tangible assets in the entities imposing the UTPR group plus 50% of their share of employees in the entities imposing the UTPR. The UTPR would, therefore, be imposed by countries on constituent entities that are neither in the source nor headquarters country, and all revenue would accrue to the countries imposing the tax. It would serve as a backstop to ensure that the minimum tax is imposed. If adjustments could not be made to collect the full top-up tax, any uncollected tax would be passed forward to be collected in the future. The UTPR is proposed to be effective in 2024.

Treatment of Credits, Grants, Deductions, and Losses

Under GLoBE rules, refundable credits (to be received within four years) and grants would be counted as increases in income (but not taxable) rather than reductions in taxes. Thus, for example, if the tax rate is 20% before credits and there is a refundable credit equal to 15% of income, the effective tax rate would be reduced to 17.4% (0.20/1.15) and no top-up tax would apply. If, however, the credit were nonrefundable, the tax rate would be reduced to 5%, and a 10% top-up tax would apply to achieve the 15% minimum rate unless there was an applicable exception. One exception would pertain to tax credits that accrue to operations that are treated under the equity method of accounting.[18] The equity method is used when a company must account for the profits or loss of another entity it has a substantial, but not controlling, ownership interest in. Under GLoBE rules, the income attributable to these entities is not included in the consolidation of earnings and would therefore be excluded from the effective tax rate calculation for purposes of the minimum GLoBE tax. Thus, tax credits attributable to such operations would not be affected by GLoBE.

The GLoBE calculation of the tax allows for temporary timing differences in the financial and tax accounting treatment of deductions (such as depreciation), so lower taxes for this reason (e.g., tax depreciation occurs before book depreciation) would not trigger a top-up tax. (This tax benefit can be recaptured, however, if not resolved in five years for certain items, although this five-year rule does not apply to cost recovery.) Any losses are valued at the minimum tax rate and carried forward as credits to offset future taxes.

The U.S. Tax Proposals

Several proposals have been made to conform the U.S. tax system to the Pillar 2 proposals, including the revisions to GILTI in the Build Back Better Act that were not enacted and the proposed replacement of the base erosion and anti-abuse tax (BEAT) with the undertaxed payments rule (UTPR) in the FY2023 budget proposals. An Administration official has indicated the need to undertake reforms in light of the adoption of Pillar 2 by the European Union and the

[18] The equity method generally applies when the firm has a substantial interest but does not have control. For an investment in a corporation, control is generally based on more than 50% ownership, but it varies for other types of investments depending on context and structure. For example, for passive investments in limited partnerships, the equity method would apply when the general partner (who may own a negligible share) has control.

consideration of Pillar 2 now taking place in Australia, Japan, Switzerland, and the United Kingdom.[19]

Changes to GILTI in the Build Back Better Act

As noted in the previous section, the United States has a minimum tax on global intangible low-taxed income, which is similar in some ways to GLoBE, but different in important respects. GILTI only corresponds to the income inclusion rule and thus does not address low tax rates on the parent company. The Build Back Better Act (BBBA; H.R. 5376) proposed revisions to GILTI. **Table 2** compares the GLoBE provisions with GILTI as it currently stands and as proposed under the BBBA. As can be seen, the proposed changes in the BBBA would bring GILTI rules closer to GLoBE, including a similar tax rate and a per-country application. These changes were not adopted in the final version of H.R. 5376, the Inflation Reduction Act (P.L. 117-169). That act adopted an alternative minimum tax based on adjusted financial statement income that would increase taxation of some large multinational corporations, although it is uncertain how this tax would be taken into account under GLoBE.[20]

[19] Stephanie Soong, U.S. Must Reform GILTI in Line With OECD Pillar 2, Grinberg Says, Tax Notes Today Federal, December 19, 2022.

[20] See CRS Report R47328, *The 15% Corporate Alternative Minimum Tax*, by Jane G. Gravelle for a discussion of the new alternative minimum tax, including how it might relate to GLoBE.

Table 2. Comparison of Basic Features of GLoBE and GILTI

	GLoBE	GILTI (Current Law)	GILTI as Proposed in the BBBA
Tax Rate	15.0%	10.5% (13.125% after 2025) with some tax applying to income earned in countries with tax rates of 13.125% or less (16.4% after 2025) if the foreign tax credit limit applies	15.015% with some tax applying to income earned in countries with tax rates of 15.8% or less if the foreign tax credit limit applies
How Tax is Applied	Per Country	Overall	Per Country
Tax Base	Financial Income	Taxable Income	Taxable Income
Substance Carve-Out (deduction)	5% of tangible assets, 5% of payroll costs after a10-year phase-down (rates start at 8% of tangible assets and 10% of payroll)	10% of tangible assets	5% of tangible assets
Avoiding Double Taxation	Add-on or top-up tax, applied based on priority	Foreign tax credit allowed, but limited to 80% of foreign taxes	Foreign tax credit allowed, but limited to 95% of foreign taxes
Losses	15% of losses carried forward as future credits	No loss carryforward	One-year loss carryforward
Other features	Credits for deferred income and deductions to address timing differences between tax and financial income		
Excluded Industries	International shipping income	International shipping income and foreign oil and gas extraction income	International shipping income

Source: Congressional Research Service.

An important difference between current-law GILTI and GLoBE is the overall treatment of foreign income and foreign tax credits. Income, losses, and foreign tax credits are measured on an overall basis for all foreign countries under GILTI. As a result, losses in one jurisdiction can offset income in another, and credits in excess of U.S. taxes in a high-tax jurisdiction can offset U.S. taxes in low-tax jurisdictions. GLoBE would apply separately to each country, and the BBBA would apply this per-country treatment under GILTI.

The GILTI base is taxable income, whereas the base under GLOBE is financial income. Presumably, GLoBE proposes using financial income because financial accounting rules are more standardized across countries, whereas computing taxable income depends on the structure of each individual country's tax system. The GLoBE rules include provisions to address timing differences based on when income and expense are recognized under tax accounting and financial accounting principles. GLoBE also allows for tax rules regarding deferred compensation, such as stock options.

Tax rates are also lower under the current GILTI regime than under GLoBE. Although the current GILTI tax rate is 10.5%, the GILTI tax actually applies if the foreign tax rate is slightly higher due to the limitation on foreign tax credits. Specifically, GILTI taxes will apply as long as the

foreign tax rate is below the U.S. tax rate divided by the share of foreign tax credits allowed, which is 80%. Thus, the 10.5% tax applies to income earned in foreign tax jurisdictions with rates less than 13.125% (0.105/0.8) under current law. After 2025, when the GILTI tax rate increases to 13.125%, GILTI taxes will apply to income earned in foreign tax jurisdictions with rates less than 16.4% (0.13125/0.8).

GLoBE and GILTI take different approaches to reducing double taxation. The method of avoiding double taxation under GLoBE is to apply the minimum tax as a top-up tax with the right to tax first belonging to the source country, via a QDMTT, then belonging to the home country of the parent company (or partially owned parent entity) through the IIR, then finally to the countries where other constituent entities operate through the UTPR. The method of avoiding double taxation under GILTI is allowing a credit against U.S. taxes for up to 80% of foreign taxes paid.

A study by the Penn Wharton Budget Model computed effective tax rates for 51 countries under the OECD proposal, the current GILTI rules, and the rules in the BBBA.[21] All of the countries in **Table 1** except Canada and the U.K. would experience increased taxes under GLoBE compared to present law, suggesting that, without change, other countries could collect additional taxes on U.S. foreign operations. With the changes proposed in the BBBA, the U.S. tax rate would be higher than the GLoBE rate except in Canada, so the United States would collect the residual taxes. The study also indicated the importance of the per-country rule in producing tax rates higher than the GLoBE rate. Overall, under current law, U.S. multinationals are estimated to collect a residual tax of 2.1% with the combined U.S. and foreign tax rate of 12.7%. GLoBE would increase the residual tax to 6.1% for a total of 16.7%. That is, other countries would collect revenues of 4% of income. With the changes in the BBBA, the U.S. residual tax would rise to 7.4% and the total tax to 18.1%, with the United States collecting those additional revenues.

FY2023 Budget Proposals

The Administration's FY2023 budget proposals contain some additional provisions to conform the U.S. tax system with GLoBE and to ensure that the United States exercises its rights to taxation.[22]

Under current law, the base erosion and anti-abuse tax provides for an alternative calculation of tax by adding certain payments to related foreign parties (such as interest and royalties) and taxing this income at 10%. Payments for the cost of goods sold are not included. BEAT does not allow tax credits, including the foreign tax credit, except for a temporary allowance of the research credit along with 80% of the low-income housing tax credit and two energy credits. After 2025, the BEAT rate will rise to 12.5% and no credits will be allowed.

The Administration's proposal would replace BEAT with a UTPR similar to the proposal in GLoBE that would apply to multinational firms with $850 million in revenues in two of the past four years. As with GLoBE, it would be applied to financial income and allocated based on the share of employees and tangible assets. The proposal would also apply a QMDTT to ensure that the United States collects the top-up tax on U.S.-source income. This measure is projected to raise $239 billion over 10 years, although there is no separate estimate for the QMDTT, which would apply to domestic operations. The proposal states that it will ensure that taxpayers benefit from

[21] Penn Wharton Budget Model, *Effective Tax Rates on U.S. Multinationals' Foreign Income Under Proposed Changes by the House Ways and Means and the OECD*, September 28, 2021, https://budgetmodel.wharton.upenn.edu/issues/2021/9/28/effective-tax-rates-multinationals-ways-and-means-and-oecd#:~:text=In%20aggregate%2C%20PWBM%20estimates%20that,the%20statutory%20rate%20of%2035%25.

[22] U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals*, March 2022, https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf.

tax credits and other tax incentives encouraging U.S. jobs and investments, though specifics of how this will be accomplished are not provided.

The Administration also proposes raising the corporate tax rate to 28%, while maintaining the proposed treatment of GILTI in the BBBA. Under GILTI, the 15.015% rate results from a 28.5% deduction of income under a 21% corporate tax rate (i.e., 1-0.285) multiplied by 21% equals 15.0155. Leaving the deduction of 28.5% raises the GILTI rate to 20% with a 28% tax rate (i.e., (1-0.285) x 0.28).

Implications for Revenues and Incentives

GLoBE has a broader scope than GILTI. GILTI and its proposed revisions focus on U.S. taxation of its own multinationals' operations abroad. GLoBE could affect U.S. multinationals' operations in the United States as well as abroad through the UTPR, even absent U.S. action with respect to the GLoBE proposal. This is because the UTPR could be imposed by a foreign country on a foreign constituent entity of U.S. multinationals (e.g., foreign subsidiary of a U.S. parent) by disallowing deductions or making equivalent changes. The UTPR would be equivalent to raising the tax in the United States, since it is triggered by the tax rate in the United States, even though it is collected by a foreign government. Similarly, a domestic U.S. investment made by a foreign multinational could be subject to taxes in the country where the foreign parent is located through an IIR or in the country where another constituent entity of the MNE group is located through the UTPR.

Thus, if GLoBE is widely adopted (and it has already been adopted by the European Union), changes in U.S. taxes as proposed in the BBBA or by the Administration (increasing GILTI and adopting the UTPR and the domestic top-up tax) might shift the receipt of revenue to the United States, but higher taxes will apply to both foreign entities and domestic operations. This issue has led to concerns about the effects on domestic investment.

At the same time, several aspects of the GLoBE proposal would limit its effect on domestic tax policy and incentives that have been provided to encourage certain types of investment. First, the carve-out for payroll and tangible assets will reduce any top-up tax. Second, incentives that involve only timing differences, such as accelerated depreciation, should not be affected by GLoBE because the proposal contains adjustments for temporary timing differences between financial and tax accounting. Bonus depreciation is the most significant tax incentive in the current U.S. code and allows investment in equipment to be deducted immediately rather than over a period of time. Bonus depreciation is scheduled to be phased out over five years beginning in 2023, although tangible assets will still have accelerated depreciation. Similarly, GLoBE would allow deductions for stock options, which often reduce effective tax rates for financial purposes, to be treated as under the tax law, so they would not be affected.

The third aspect is the treatment of provisions in the form of credits. The major U.S. business tax credits include the research and experimentation (R&E) tax credit, the low-income housing tax credit (LIHTC), and credits for renewable energy; there are also smaller credits programs, such as the new markets tax credit (NMTC) and the historic rehabilitation tax credit (HTC). None of these credits are refundable and, without an exception, they could trigger a top-up tax and potentially reduced investment in the activities that generate these credits.[23] Community development interest and advocacy groups expressed this concern to Treasury Secretary Yellen in

[23] The BBBA proposed making the energy credits refundable, which would significantly reduce any impact of GLoBE.

an April 5, 2022, letter.[24] However, outside the R&E tax credit, most of the investments using these credits are accounted for using the equity method and appear not to be affected by GLoBE.[25] The R&E credit would lower the effective tax rates, which would introduce the potential for a top-up tax to apply and for the credit's incentive to be diminished. One option to preserve the R&E credit's incentive under the GLoBE framework would be to make it refundable. This change would cause the credit to increase income rather than reduce taxes, significantly reducing its impact on effective tax rates.

Like the research credit, the deduction for foreign-derived intangible income (FDII) could also lead to a top-up tax. FDII allows a deduction for income associated with foreign-derived income of intangible assets held in the United States. It was enacted to equalize the treatment of intangible assets held in the United States with those held abroad that benefit from the lower tax rates imposed by GILTI. Tax-exempt interest income is another tax preference that could lower effective tax rates.

Aggregated data from the IRS's Country-by-Country report can be used to examine industry-level effective tax rates under GLoBE, and the effect of substance carve-outs (**Table 3**).[26] Effective tax rates were calculated as U.S. taxes accrued (to capture timing differences) divided by profits from the United States. This table relates to the permanent effects, since the carve-outs are larger during a 10-year transition period.

Table 3. Effective Tax Rates in the United States by Major Industry Group, 2019, and the Permanent OECD Carve-Outs

Industry	Effective Tax Rate	Percentage Reduction in Tax Base Due to Wage Carve-Outs	Percentage Reduction in Tax Base Due to Capital Carve-Outs	Total Percentage Reduction in Base Due to Carve-Outs
Agriculture, Fishing, Forestry, Mining, Oil and Gas Construction, Utilities, Construction	-0.9%	7.3%	159.2%	166.5%
Manufacturing	12.8%	4.4%	18.3%	22.7%
Wholesale and Retail Trade, Transportation, Warehousing	7.9%	9.8%	25.8%	35.6%
Information	20.8%	4.1%	19.3%	23.4%

[24] Letter to Janet Yellen, U.S. Secretary of the Treasury, April 5, 2022, https://cdn.ymaws.com/www.nalhfa.org/resource/resmgr/alert_files/Community_Development_Financ.pdf.

[25] Most of the investment financing raised through LIHTC and renewable energy credits is from banks and financial institutions. The interest from banks and financial institutions in LIHTC is partly motived by the Community Reinvestment Act, though both LIHTC and the renewable tax credits are attractive to banks because they typically expect to have tax liabilities to offset with the credits. A review of recent 10K reports of three of the largest banks indicated use of this method as well as significant low-income housing credits. For more information on the LIHTC investor landscape, see CohnReznick, LLP, *Housing Tax Credits Investments: Investment and Operational Performance*, November 18, 2019. For more information on the renewable tax credits investor landscape, see Oliver Metcalfe and Tara Narayanan, "U.S. Clean Energy Boom Strains Tax Equity Supply," *BloombergNEF*, August 12, 2021.

[26] Effective tax rates for specific companies or more specific industries are not available. These data generally cover the firms that would be subject to GLoBE. Inclusion in IRS data is triggered by revenues in the previous year, while inclusion in GLoBE is triggered by two out of the past four years. GloBE revenue triggers are measured in euros, while IRS reporting is based on dollars.

Finance, Insurance, Real Estate	11.1%	2.6%	17.0%	19.6%
Professional, Scientific, and Technical Services	16.9%	13.7%	13.7%	27.4%
Management of Companies, Other Services	18.2%	9.4%	18.1%	27.6%

Source: CRS calculations from Internal Revenue Service, *Statistics of Income, International, Country-by-Country Report: Tax Jurisdiction Information, Major Industry Group, Geographic Region, and Selected Tax Jurisdiction*, https://www.irs.gov/statistics/soi-tax-stats-country-by-country-report.

Notes: Taxes accrued in the United States divided by profit in the United States. Profit is reduced by 5% of employees multiplied by $67,000 plus 5% of tangible assets when incorporating carve-outs. Average wages are from Statista, https://www.statista.com/statistics/243842/annual-mean-wages-and-salary-per-employee-in-the-us/#:~:text=Annual%20mean%20wages%20and%20salary%20per%20employee%20in%20the%20U.S.%202000%2D2020&text=In%202020%2C%20the%20average%20wage,and%20payments%2Din%2Dkind.

Although the high degree of aggregation makes the numbers in **Table 3** less informative, there are differences in tax rates. Some are well above 15%. In cases where the top-up tax applies, it will typically be reduced by the deduction of carve-outs. In addition, compensation relating to stock options and similar forms of compensation would be allowed as deductible items, raising the effective tax rate compared to financial income. Thus, it seems unlikely that GLoBE would have a significant impact on domestic tax incentives, especially in the near term.

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