Tax Foundation Response to OECD Public Consultation Document: Global Anti-Base Erosion Proposal ("GloBE") (Pillar Two)

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The Tax Foundation appreciates the opportunity to respond to the public consultation document on Global Anti-Base Erosion Proposal ("GloBE") (Pillar Two).

General Comments

The significant overhaul of U.S. international tax rules and the recently adopted anti-tax avoidance provisions in Europe and other parts of the world have reshaped international tax policy in a variety of ways. Policymakers should cautiously approach new international standards before the impacts of the recent tax changes in the U.S., Europe, and elsewhere have unfolded.

The magnitude of the problem[1] created by base erosion and profit shifting (BEPS) raises serious questions, and it is worth considering whether that problem has been sufficiently addressed by recent policy changes.[2] In 2016, economists Ernesto Crivelli, Ruud de Mooij, and Michael Keen found that profit shifting amounted to an estimated revenue loss of 1.3 percent of GDP for non-OECD countries and 1 percent of GDP for OECD countries.3 The Inclusive Framework should assess how much of that has already been addressed by BEPS-related policies before pursuing a new set of anti-BEPS proposals.

With respect to the Secretariat's proposal on Pillar 2, though, this response makes four main points covering the design of the income-inclusion rule and the under-taxed payments rule:

1. The tax base for the income-inclusion rule should be neutral toward business investment decisions; a minimum tax base paired with a minimum rate may be most appropriate.
2. The income-inclusion rule could have impacts like controlled foreign corporation (CFC) rules which can cause bunching around minimum rate thresholds, raise the cost of capital, and change real business investment patterns.
3. The level of blending that policymakers choose has implications for how a minimum tax will affect business decision-making.
4. The under-taxed payments rule could lead to double taxation if it is not clearly limited to instances where the income-inclusion rule does not apply and where the effective rate of the beneficiary of the payment is taken into account.

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[1] For a recent review of estimates and methodologies, see Nadine Riedel, "Quantifying International Tax Avoidance: A Review of the Academic Literature," *Review of Economics* 69:2 (2018), https://www.degruyter.com/downloadpdf/j/roe.2018.69.issue-2/roe-2018-0004/roe-2018-0004.pdf.
[2] In 2014, economist James Hines raised several key questions regarding BEPS, many of which are relevant to the discussion of the GloBE proposal. See James R. Hines Jr., "Policy Forum: How Serious is the Problem of Base Erosion and Profit Shifting?" *Canadian Tax Journal* 62:2 (2014), https://repository.law.umich.edu/cgi/viewcontent.cgi?article=2378&context=articles.
[3] Ernesto Crivelli, Ruud de Mooij, and Michael Keen, "Base Erosion, Profit Shifting and Developing Countries," *Public Finance Analysis* 72 (2016), https://www.mohrsiebeck.com/artikel/base-erosion-profit-shifting-and-developing-countries-101628001522116x14646834385460.

Tax Base for the Income-inclusion Rule

A global minimum tax is just like any other tax in that it needs to have a clearly defined tax base alongside a tax rate. Many countries have various policies that result in businesses paying a low or zero effective tax rate. This could be because the country has a policy to subsidize certain business activities through the tax code, or because the country has a well-designed tax base.

In the first instance, whether it is through patent boxes and various tax credits and super deductions, some countries like France have domestic policies which can lead to very low effective tax rates for some businesses.[4] Certain businesses in countries with similar preferential policies can see very low effective tax rates. In some cases, these policies can even take the form of full tax abatements.

On the other hand, Estonia, Latvia, and Georgia have cash flow taxes which are neutral toward business investment and result in a zero marginal tax rate on reinvested business profits.[5] Due to their cash flow systems, these countries effectively allow unlimited loss carryforwards, carrybacks, and deductions for business investment. Though other countries do not have cash flow taxes, loss and investment deductions are featured in many corporate income tax systems throughout the world. Businesses that invest heavily or run heavy losses can see very low effective tax rates in some years due to these common policies.

The income-inclusion rule should differentiate between effective tax rate results driven by preferential policies and neutral policies. One approach the Inclusive Framework should consider would be to apply the minimum tax to a minimum tax base, mirroring at the global level a cash-flow tax base that allows for unlimited loss carryforwards, carrybacks, and deductions for business investment.

Minimum Taxes and CFC Legislation

The income-inclusion rule can be thought of as a large CFC rule, and the Inclusive Framework should consider recent research on the economic impacts of such rules and the ways that they can influence business behavior. As the 2015 OECD report on CFC rules points out, "CFC rules can run the risk of restricting or distorting real economic activity."[6] Recent research has attempted to measure where and how serious those distortions are when they arise.

In a recent paper in the *Journal of Public Economics*, economist Sarah Clifford identifies specific mechanisms in CFC rules that influence business responses.[7] Clifford uses the variation of CFC rules across countries and the variation of other tax reforms to measure how businesses react to the rules and study the revenue effects.

Many countries have effective rate thresholds in their CFC legislation that work like a minimum tax, and Clifford shows that companies respond to those thresholds by bunching their subsidiary income in tax jurisdictions just above the threshold to avoid having income taxed under CFC rules. Clifford estimates that one impact from a reform that moves a foreign subsidiary below the

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[4] Daniel Bunn, "France's Digital Services Tax: Facts and Analysis," Tax Foundation, Mar. 11, 2019, https://taxfoundation.org/france-digital-services-tax/.
[5] Daniel Bunn, "Better than the Rest," Tax Foundation, Oct. 9, 2019, https://taxfoundation.org/estonia-tax-system-latvia-tax-system/.
[6] OECD, "Designing Effective Controlled Foreign Company Rules, Action 3 Final Report," Oct. 5, 2015, https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1575081719&id=id&accname=guest&checksum=ACF8AD14FD9B4EA9002E0363037BEB6E.
[7] Sarah Clifford, "Taxing Multinationals Beyond Boarders: Financial and Locational Responses to CFC Rules," *Journal of Public Economics* 173 (May 2019), https://www.sciencedirect.com/science/article/abs/pii/S0047272719300088.

effective tax rate threshold is a 13 percent reduction in financial profit in that subsidiary. By shifting financial income to countries with tax rates just above the CFC threshold, companies can work within the rules to minimize their tax burdens under the new regime.

Clifford finds this effect results in higher tax revenue not only for the countries where the financial profit is shifted to but also for the country enforcing the CFC rules.

Shifting of financial income around the effective rate threshold is not the only result from research on CFC rules, however.

A 2015 paper by economists Peter Egger and Georg Wamser in the *Journal of Public Economics* estimates the impact of CFC rules on foreign real investment by German firms.[8] According to their work, the incentives embedded in German CFC legislation led to an estimated €7 million reduction in investments on average in fixed foreign assets (like property, plants, and equipment) by German multinational corporations.

So if, prior to the adoption of the German CFC rules, German firms were investing in assets like factories and distribution centers outside of Germany, the CFC rules led to a reduction in those investments, other things being equal. The authors note, "This suggests that the CFC rule brings about a sharp increase in the cost of capital."

A third study, by economist James Albertus, examines how foreign multinational companies with a presence in the United States change their behavior when their home countries enact CFC rules.[9] Albertus estimates that when the U.S. subsidiary of a foreign company becomes subject to a CFC regime the subsidiary reduces investment by 12 percent and employment by 16 percent. Additionally, U.S. subsidiaries subject to foreign CFC regimes reduce their wages for employees by 11 percent.

The Inclusive Framework should consider ways to minimize such distortive effects resulting from the adoption of an income-inclusion rule. An overly broad rule could further distort business investment behavior, raise the cost of capital, and impact real business investment. Each of these outcomes will in turn impact wages, employment, and economic growth in countries around the world.

Blending Considerations: GloBe and GILTI

The design of the income-inclusion rule draws some inspiration from the U.S. international rule on Global Intangible Low Tax Income (GILTI).

GILTI was designed to subject foreign income of U.S. companies to a minimum tax rate. However, because GILTI was layered on top of existing U.S. international tax rules, it has created various policy challenges,[10] among them a question of what high-taxed foreign income should be excluded from the policy. This is relevant not just to the U.S. policy debate but also to the designs being considered by the Inclusive Framework: the level of blending that policymakers choose has implications for how a minimum tax will affect business decision-making. Specifically,

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[8] https://www.sciencedirect.com/science/article/abs/pii/S0047272715001243.

[9] James F. Albertus, "The Real Effects of US Tax Arbitrage by Foreign Multinational Firms," Carnegie Mellon University - David A. Tepper School of Business, Oct. 27, 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2691065.

[10] Mindy Herzfeld, "What the OECD Can Learn from the GILTI Regime," *TaxNotes*, Jan. 14, 2019, https://www.taxnotes.com/featured-analysis/what-oecd-can-learn-gilti-regime/2019/01/11/291qz.

the more granular the level of blending, the higher the associated compliance costs and the impact on decisions related to expanding overseas business operations.

If the Inclusive Framework desires to minimize the impact that the income-inclusion rule has on business location decisions, then a broader approach to blending will be necessary.

At the global level, a business will consider how a new investment in a country will impact its average foreign effective tax rate, which, in the short term, may not be very much. However, with jurisdictional-level blending, or entity-level blending, each new investment could be influenced by the income-inclusion rule. As mentioned previously, CFC legislation can lead to bunching behavior around effective tax rate thresholds. A narrow blending approach will likely lead to similar behavior, with countries just above the threshold gaining investment and countries below the threshold losing out.

Worldwide blending not only allows for high- and low-tax income to be mixed, but, as pointed out in the consultation document, it could help minimize volatility that comes from some foreign entities facing losses in some years. Worldwide blending would allow losses in some entities/jurisdictions to offset income in other jurisdictions, allowing for the taxation of average foreign profitability.

Jurisdiction-level blending would require businesses to calculate their overall tax rate on a country-by-country basis, which could create significant compliance costs. The global minimum tax would then apply to income from countries where a business's foreign income is taxed at a rate that is below the global minimum tax rate. Jurisdiction-level blending minimizes the tax benefits of locating operations in low-tax jurisdictions.

If the minimum rate is in the low teens, businesses would know the minimum possible rate they could face on any new investment. Countries with low statutory corporate rates like Hungary (9 percent), Bulgaria (10 percent), Ireland (12.5 percent), and many others would lose the relative attractiveness for investment that their current tax rates provide.

Subsidiary-level blending, specifically at the CFC level, would allow blending of entity-level income and taxes at the CFC level before determining whether and to what extent the global minimum tax applies. CFCs can cross country borders, though. Blending at the CFC level would therefore allow businesses to blend high-tax income in some jurisdictions with lower-tax income in other jurisdictions. This means that businesses could arrange their business units within their CFCs so that the overall tax rate faced by the CFC would be just above the threshold for not being subject to the global minimum tax. This could allow both the low- and high-tax income in a CFC to be excluded from the global minimum tax.

An **entity-level** global minimum tax would effectively allow zero blending and increase the role that taxes play in each decision to set up a new foreign entity. To ensure the taxation of average profitability, allowing the carrying back and carrying forward of losses alongside deductions for business investment would be essential. In general, an entity-level approach could create immense compliance burdens, particularly for businesses with many entities.

The Inclusive Framework should consider how the choice of blending works to achieve the goals of the current project without creating new distortions and heavy compliance burdens.

Avoiding Double Taxation under the GloBE

The income-inclusion rule by itself could result in double taxation if countries do not adjust their current anti-avoidance legislation including CFC rules to ensure that foreign-sourced income is only taxed once, if at all, by home jurisdictions.

When paired with the under-taxed payments rule, though, the question of double taxation immediately arises. Transactions could occur where income would be subject to the income-inclusion rule by the home country and the payment would be subject to the under-taxed payments rule by another jurisdiction. In such instances, it will be critical to know which rule should apply. The Inclusive Framework should set clear standards for rule priority to avoid double taxation.

Separately, the under-taxed payments rule runs the risk of creating frictions in the global economy by taxing payments that are part of the same transaction more than once. The rule has the potential to become a withholding tax that applies every time a payment crosses jurisdictional boarders without enough tax being paid. To avoid this outcome, the Inclusive Framework should work to design the rule so that taxes paid by the beneficiary of a payment are accounted for even if the payment does not face taxes when it crosses into a jurisdiction.

Conclusion

The design questions behind the GloBE have serious ramifications for business decision-making and for countries' own policies.

The tax base for the income-inclusion rule will be just as important as determining the rate, and both the base and the rate will likely impact business decisions. Additionally, policymakers need to determine how the choice for blending fits with the overarching goal of the policy. And as the example of GILTI shows, it is essential to assess how current international tax regulations would interact with a global minimum tax.

All of the options will have consequences for compliance costs and business decisions to invest in different countries. In turn, this will impact economic outcomes and the profitability of the affected companies. Policymakers should work toward solutions that meet their policy objectives while minimizing negative consequences.

The economic impacts will be important. The Inclusive Framework should recognize that higher tax burdens on businesses (along with high compliance costs) could create various economic ripples throughout the international economy.