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The global corporate minimum tax and MNE home countries

by
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In October 2021, over 135 countries reached a political agreement to enact a 15% global minimum corporate tax for MNEs with annual revenues over 750 million Euros. This *Perspective* explores the implications of this tax for the *home countries* of these MNEs. The tax applies to about 8,000 MNEs from both developed and developing countries.

The tax is embodied in Pillar Two of the G20/OECD/Inclusive Forum Base Erosion and Profit Shifting project. MNEs that meet the revenue-threshold are subject to the tax regardless of where they are headquartered or operating. Since almost one-third of global FDI outflows (2022) were from developing countries, a number of these MNEs are headquartered there.

Pillar Two has three components, in order of precedence: the Qualified Domestic Minimum Top-up Tax (Top-up Tax), the Income-Inclusion Rule and the Undertaxed Profits Rule.

- Countries that currently have an effective corporate tax rate below 15% may adopt a Top-up Tax, designed to bring their domestic tax rate up to 15% (calculated based on local accounting rules). For example, Switzerland has recently adopted a Top-up Tax by popular referendum. The Top-up Tax turns off the application of the Income-Inclusion Rule and the Undertaxed Profits Rule for the operations of the MNEs in adopting countries.

- The Income-Inclusion Rule permits MNEs’ home countries to impose a Top-up Tax on their MNEs at a minimum rate of 15% if host countries where foreign affiliates operate do not have a Top-up Tax.

- If there is no Top-up Tax or Income-Inclusion Rule, host countries of MNEs may impose the Undertaxed Profits Rule on their portion of the MNEs’ profits, to increase the overall effective tax rate of the MNEs to 15%. This Rule is the most controversial part of Pillar Two because it has no precedent in existing international tax law (unlike the Top-up Tax (which follows existing law in allowing host countries to tax locally derived income) and the Income-Inclusion Rule (which follows familiar controlled foreign corporation rules such as the US Global Intangible Low-Taxed Income approach)). This has led critics to argue that it violates tax treaties and arguably customary international law. In the US, the Undertaxed Profits Rule has been criticized as taking away Congress' ability to reduce the domestic tax rate of US based MNEs below 15%. The OECD responded recently by adopting a two-year safe harbor that will shield US MNEs' domestic income from the Undertaxed Profits Rule.

- A country could be forced into arbitration under an international investment agreement (IIA) if it applied a Top-Up Tax that eliminates or reduces a preferential tax regime granted to an investor. To avoid this, the host country may grant the investor refundable credits to reduce the Top-Up Tax. However, investors may be reluctant to invoke the IIA if an arbitration award triggers the Income Inclusion Rule or the Undertaxed Profits Rule in a third country.

The most important policy question facing home countries is whether to adopt an Income-Inclusion Rule. The advantage of adopting this Rule is that, to the extent host countries do not adopt a Top-up Tax when they have a tax rate below 15%, home countries gain additional revenue by collecting the difference between the taxes paid in host countries and the 15% global minimum tax.

Since all home countries are subject to the same rules, there is no competitive disadvantage for their MNEs, as all home countries can do the same. Traditionally, the argument against taxing home country MNEs on worldwide income has been that it puts them at a competitive disadvantage compared to MNEs from other home countries that do not tax such income. But if all home countries tax at 15%, there is no competitive disadvantage.

It has been argued that, if all host countries adopt a Top-up Tax, home countries will have no incentive to adopt an Income-Inclusion Rule. But this criticism misunderstands the purpose of Pillar Two, which is not to maximize revenue. The main purpose of Pillar Two is to ensure that every large MNE is subject to at least 15% taxation of its profits, meaning the shareholders of the MNEs are subject to some current taxation without a sale of their shares. Another purpose is to enable home countries to grant tax incentives to their MNEs that reduce the domestic tax rate to 15% (or lower through refundable credits) without worrying that the MNEs will ignore the incentive by shifting profits to other countries.

Pillar Two complements the trend to reduce the negative impact of unfettered globalization on labor, and it protects the ability of home countries to finance a robust social safety net. Home countries should adopt the Income-Inclusion Rule—and that includes the US, which last year failed to adapt its Global Intangible Low-Taxed Income approach to Pillar Two. Consequently, US-based MNEs could be subject to the Undertaxed Profits Rule adopted last year by the EU and other host countries once the temporary safe harbor expires. Perhaps that outcome will induce the US, other developed home countries and developing home countries to adopt the Income-Inclusion Rule.

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