Skadden

Is Tax Competition Dead?

The G7's support for OECD-backed tax reforms could mark a big step toward a more consistent, revamped global tax scheme — depending on the details and whether it is actually adopted.

- Winners could be higher-tax rate countries seeking to collect more revenue from multinationals.
- Losers could include companies that currently earn substantial income in lower-tax jurisdictions.
- The agreement may put pressure on the Biden administration to align its corporate tax reform proposals with the OECD's, including by reducing planned tax hikes.
- Many significant details remain to be resolved, including the scope of the rules, tax rates and mechanisms to mitigate double taxation.

The G7's unanimous support for a proposed agreement to forge more uniform global corporate tax principles, including a minimum rate, drew wide coverage in the business press when it was announced June 5. The agreement has been billed as heralding a global convergence of corporate tax regimes.

What will it mean for multinational corporations, the U.S. corporate tax system and the Biden administration's proposals to raise corporate tax rates? It is too soon to tell, but here's a quick guide to what the agreement might and might not do and the obstacles to adopting it.

What exactly did the finance ministers agree on?

Despite the fanfare, this was simply an agreement to reach an agreement — with a goal of further agreement at the G20 summit on July 9-10. Many questions, large and small, remain.

While the G7 supported a global minimum tax, its communiqué referenced a minimum rate of "at least" 15%, suggesting continuing disagreement about the precise rate. And little detail was offered about the mechanisms to allocate more income to jurisdictions where products and services are ultimately consumed.

Was the announcement significant?

Yes, in several ways, even though it is incomplete. It signals a move toward a more uniform, global structure for corporate tax, and a consensus that governments should attempt to curb tax competition.

- The U.S. is actively leading the discussion and appeared, for the first time, to fully subscribe to the two-pronged conceptual scheme the Organisation for Economic Co-operation and Development has been discussing for years.

The OECD framework consists of rules to require companies to recognize more income in end markets ("Pillar One") and to pay minimum tax rates ("Pillar Two"). Pillar One addresses the concerns of countries that argue that technology companies are making profits from their citizens without paying enough tax in the jurisdiction. Pillar Two targets tax competition between countries.

- The 15% minimum rate in the G7 statement suggests a consensus for a level higher than the rates in effect today in several jurisdictions (including Ireland), but significantly lower than the Biden administration's proposed 21% minimum rate for foreign income of U.S. companies.
- The minimum rate would be applied on a country-by-country basis, so companies could not offset high taxes in one market with lower taxes in another.

What the G7 Ministers Said

"We strongly support the efforts underway through the G20/OECD Inclusive Framework to address the tax challenges arising from globalisation and the digitalisation of the economy and to adopt a global minimum tax. We commit to reaching an equitable solution on the allocation of taxing rights, with market countries awarded taxing rights on at least 20% of profit exceeding a 10% margin for the largest and most profitable multinational enterprises. We will provide for appropriate coordination between the application of the new international tax rules and the removal of all Digital Services Taxes, and other relevant similar measures, on all companies. We also commit to a global minimum tax of at least 15% on a country by country basis. We agree on the importance of progressing agreement in parallel on both Pillars and look forward to reaching an agreement at the July meeting of G20 Finance Ministers and Central Bank Governors."

– G7 Finance Ministers & Central Bank Governors Communiqué, June 5, paragraph 16

What will this mean for the foreign income of U.S. companies?

That is not yet clear. The 2017 tax reforms that lowered the basic statutory corporate tax rate to 21% added provisions to collect more tax on foreign subsidiary income (primarily through a provision known by its acronym GILTI), albeit at more favorable rates. There is no sign the Biden administration will abandon that structure; to the contrary, it has proposed tightening rules and raising rates for foreign income.

If the U.S. adopts the Pillar One approach, that could cause U.S. companies to recognize more income in higher-tax countries. Absent coordination mechanisms, they could also face double taxation. At the same time, the Biden proposals include new restrictions on foreign tax credits. The bottom line is that many U.S. multinationals may see higher global tax rates.

Will this affect the Biden administration's proposed rate increases?

The administration proposed to raise the basic statutory rate for corporations from 21% to 28% and the minimum tax on foreign income from 10.5% to 21%, as well as to deny deductions for payments made to low-tax affiliates.

If other countries set their rates at or not far above the 15% minimum, a 28%/21% structure could place

U.S. companies at a significant competitive disadvantage. That could put pressure on the White House to compromise on rates. The 28% proposal already faces significant opposition in the U.S. Senate. But coming down from the 28%/21% rates would cut into the revenue increases that the administration has been relying on to fund major spending programs.

Does the G7's scheme have implications for the digital services taxes (DSTs) some countries recently imposed?

Pillar One is supposed to substitute for the DSTs that have been proliferating, and which mainly affect large U.S.-based technology companies. The G7 communique stated that an agreement would "provide for appropriate coordination between the application of the new international tax rules and the removal of all Digital Services Taxes."

The U.S. and the technology companies have complained that the DSTs single out a particular industry and home country. It remains to be seen if the final Pillar One scheme addresses or reinforces these concerns.

What are the odds the G7/OECD structure will be adopted?

Inevitably, there would be winners and losers, both companies and countries. Lower-tax jurisdictions may lose investment and tax revenue as their rate advantage is removed. And shifting the site of income recognition is a zero-sum game that will benefit some countries at the cost of others. Hence, there is likely to be opposition and significant negotiation over the scope of these rules and the relevant applicable rates.

In the U.S., some Republicans have voiced objections to the G7 arrangement, saying it cedes taxing authority to other countries and discourages investment and growth by raising business tax rates.

The EU is a question mark. Any EU-wide directive would require unanimity, which is unlikely. And doubts remain regarding the ability of EU member states to implement these changes unilaterally.

But many believe that unanimity is not needed to make the system work as long as there is agreement among a critical mass of jurisdictions that host enough major multinationals. If those headquarter jurisdictions adopt rules taxing the income earned by low-tax subsidiaries or deny deductions for payments made to low-tax affiliates, those "sticks" could eliminate the advantages of booking income in lower-tax countries.

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