

# The OECD Global Minimum Tax Proposal under Pillar 2: Will it achieve the desired policy goal?

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## 1. Introduction

The OECD Pillar 2 (also known as Global Anti-Base Erosion or hereinafter “GloBE” proposal)<sup>1</sup> is based on the premise that capital importing countries provide favourable tax positions, both in terms of tax rate and tax base, to attract investments and businesses.

The last couple of decades witnessed fierce tax competition amongst countries, especially through cuts in their corporate tax rates<sup>2</sup> and the provision of tax reliefs such as accelerated depreciation and super deductions, with the aim of attracting foreign investments. This has originated direct issues in two fundamental dimensions of tax design: efficiency and neutrality<sup>3</sup>. When businesses are located primarily for tax reasons, economic distortions may arise, leading to inefficiencies.<sup>4</sup> Tax systems should provide investment neutrality instead<sup>5</sup>. Under the international tax neutrality principle, the tax consequences should be similar for similar businesses/investments irrespective of places of investment.<sup>6</sup> As tax is a cost to the business, investors and entrepreneurs are naturally incentivized to locate their activities in jurisdictions with lower taxes. The recent phenomena of corporate inversions in the US and other high tax jurisdictions are a fall out of such considerations. When taxpayers change their tax jurisdictions, there is a permanent tax base erosion for that jurisdiction. This undermines the international tax system.<sup>7</sup>

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<sup>1</sup> See OECD (2020), Tax Challenges Arising from Digitalisation-Report on Pillar Two Blueprint: Inclusive framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

<sup>2</sup> See Tax Foundation (2020) “Corporate Tax Rates around the world”, No.735, December 2020.

<sup>3</sup> Devereux, M.P., Auerbach, A.J., Keen, M., Oosterhuis, P., Schön, W., Vella, J. (2021), Taxing Profit in a Global Economy (Oxford: Oxford University Press).

<sup>4</sup> Devereux, M.P. and Vella, J. (2014), ‘Are we heading towards a corporate tax system fit for 21st century’, Fiscal Studies, Vol.35, pp.449-475.

<sup>5</sup> As stated by Adam Smith (1776) in An Inquiry into the Nature and Causes of the Wealth of Nations, as canons of a good tax system: “Every tax ought to be contrived as both to take out and keep out of pockets of the people as little as possible over and above what it brings, into the public treasury of the State”.

<sup>6</sup> For a deeper analysis of international tax neutrality, see Schön, W. (2009), International Tax Coordination for a Second-Best World (Part I), World Tax Journal, 10, 67-114.

<sup>7</sup> Tax Foundation (2020), *op.cit.*, n.2.

Admittedly, the OECD Base Erosion and Profit Shifting (“BEPS”) Action Plans have shown inadequate to tackle tax base erosion fueled by state aid practices and advantageous tax rulings. Therefore, a new GloBE proposal is now being considered to introduce a global minimum tax for businesses irrespective of their place of incorporation or place of activities to combat the issue of tax competition on a global level. The idea is to maintain the tax sovereignty of the jurisdictions,<sup>8</sup> while not undermining the international tax system. The GloBE proposal is intended to be achieved through two interrelated rules.<sup>9</sup> First, an income inclusion rule<sup>10</sup> which would allow the parent company’s jurisdiction to tax on a current basis income earned through its subsidiaries that are subject to a low rate of tax. This proposal, though with some relevant differences, might be considered as a variant of GILTI provisions of the US<sup>11</sup> or CFC rules adopted by various countries to tackle offshore investment income of foreign companies controlled by the parent located in another jurisdiction. Second, an under-taxed payment rule<sup>12</sup> would act as a backstop to the income inclusion rule and allow a jurisdiction to tax for payments made to related parties subject to low tax rates of tax. Additionally, the source countries may also apply withholding tax on certain base eroding payments such as interest or royalty under subject to tax rules if the country of the parent company has a lower rate of taxation.

Despite the popularity that this proposal is gaining in the countries that were mostly hit by tax competition, it seems to encounter significant conceptual and practical difficulties, which will be laid out in this paper.

## **2. OECD Pillar 2 proposal in brief**

The inclusive framework of OECD/G20 unanimously held that the tax competition amongst nations to attract investments and businesses is one of the root causes that contribute to BEPS. The GloBE proposals primarily deal with the issue of tax competition, putting the other ancillary issues relating to BEPS aside. They advocate for the adoption of a global minimum corporate income tax for taxing multinationals.

This idea was introduced by the OECD in its November 2019 *The Policy Note*<sup>13</sup>, released by the OECD on January 30, 2019, focused on two proposals or “pillars” for handling taxation of the digital economy: Pillar One on the allocation of tax rights among jurisdictions and Pillar Two on

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<sup>8</sup> See para.3, OECD (2020), Tax Challenges Arising from Digitalisation-Report on Pillar Two Blueprint: Inclusive framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

<sup>9</sup> See Ibid., para.8

<sup>10</sup> See Ibid., para.9

<sup>11</sup> The United States enacted the Global Intangible Low-Taxed Income (GILTI) regime in 2017 as part of a substantial reform of the US international tax rules. The GILTI regime provides for a minimum level of tax on the foreign income of an MNE Group. While the GILTI and GloBE rules as described in this Blueprint have a similar purpose and over

<sup>12</sup> See Ibid., para.10.

<sup>13</sup> See OECD (2019), “Addressing Tax Challenges of the digitalization of the economy”, Policy Note, Paris: OECD publishing.

remaining BEPS issues.<sup>14</sup> The Public Consultation Document released on Feb. 13, 2019,<sup>15</sup> issued specific proposals for both Pillars, with Pillar Two split into two proposals: an income inclusion rule and a tax on base eroding payments.<sup>16</sup> A detailed outline of Pillar Two is provided in the May 31, 2019 Programme of Work.<sup>17</sup> The *Programme of Work* starts with the clarification that, under Pillar Two, each jurisdiction would be free to choose their own tax system and rates but that other jurisdictions would have the right to apply additional tax rules if that the source jurisdiction taxed that income below some minimum rate.

As mentioned, the GloBE proposal is twofold: an income inclusion rule and a tax on base eroding payments. Under the income inclusion rule, the income of a foreign branch or a controlled entity would be taxed if that income were subject to tax at an effective rate that was below a minimum rate<sup>18</sup>. If the taxation in source jurisdiction is lower than the minimum, the income inclusion rule acts as a top-up to achieve the minimum tax rate. The goal would be to ensure that the MNE is subject to tax on its global income at the minimum rate regardless of where it was incorporated.<sup>19</sup> The global minimum tax rate that is being proposed corresponds to 15%.<sup>20</sup>

There is, however, an exception to the primary rule. First, if the income benefitted from a harmful preferential tax regime, that income would be taxed at a higher rate or to the full domestic rate. Second, the income inclusion rule could be in addition to a jurisdiction's controlled foreign corporation (CFC) rules. A *switch-over rule*<sup>21</sup> is proposed for countries that follow a territorial principle of taxation. Accordingly, the under-taxed income of foreign branches or permanent establishments as well as foreign subsidiaries would be included in the tax base with a foreign tax credit.

The income inclusion rule would be complemented by a tax on base eroding payments<sup>22</sup>. The objective of such a measure would be to enable the source jurisdiction to protect itself from tax base erosion. The tax on base eroding payments would also consist of two parts: an under-taxed payments rule<sup>23</sup> and a subject-to-tax rule<sup>24</sup>. Under the former, a tax deduction would be denied or taxation at source (including withholding tax<sup>25</sup>) would be imposed on payments made to a related party unless the payments were subject to tax at or above a minimum rate. The under-taxed

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<sup>14</sup> Ibid., para.3 and 8.

<sup>15</sup> See OECD (2019), "Addressing Tax Challenges of the digitalization of the economy", Public Consultation documents, Paris: OECD publishing.

<sup>16</sup> Ibid., para.11.

<sup>17</sup> See OECD (2019), "Programme of work to develop a consensus solution to the tax challenges of the digitalization of the economy", Paris: OECD publishing.

<sup>18</sup> Nonetheless, the rate is yet to be agreed on.

<sup>19</sup> See OECD (2019), "Global Anti-Base Erosion Proposal (GloBE) – Pillar Two", Paris: OECD publishing

<sup>20</sup> See OECD (2021), "Statement on a Two-pillar Solution to Address the Tax Challenges Arising from the digitalization of the economy", Paris: OECD publishing, page. 4.

<sup>21</sup> Ibid., para.72.

<sup>22</sup> Ibid., para. 73-77.

<sup>23</sup> Ibid., para. 73-74.

<sup>24</sup> Ibid., para. 73-74.

<sup>25</sup> It is also proposed to make necessary changes to the provisions of double tax treaties.

payments rule would be accompanied by a subject-to-tax rule<sup>26</sup> that could deny eligibility for certain treaty benefits and subject the payment to withholding or other taxes at source, in situations where the payment was not subject to tax at a minimum rate<sup>27</sup>.

While designing the GloBE proposal under OECD Pillar 2, it was emphasized to give priority to simplification. Even though recent statements of OECD<sup>28</sup> have clarified certain attributes such as the minimum tax rate, substance-based carve-outs, etc. several attributes of the proposals are yet to be finalized. These include adjustments on account of the differences emerging from the adoption of accounting standards, coordination among the new rules, thresholds and carve-outs compatibility with international tax treaties, and other obligations.

The determination of a global minimum tax base is a key aspect of the proposal. The use of accounting profit for measuring the tax base,<sup>29</sup> instead of the taxable profit, is mentioned. In principle, the Parent jurisdiction's rules for determining the income of a foreign subsidiary under either CFC rules or domestic tax rules would be used to determine whether the source jurisdiction's rate was above or below the minimum tax rate. Issues such as the appropriate accounting method (Generally Accepted Accounting Principles or GAAP vs International Financial Reporting Standards or IFRS)<sup>30</sup>, treatment of carry-forward losses, the timing of recognition of income and expenses, translation of foreign exchange losses, and so on, would need to be considered.

### **3. Conceptual and practical issues**

#### **3.1 Issues related to the current international tax system: worldwide vs territorial**

The current international tax system allocates different types of income to the country of residence of the owner, the source country where the income is earned or to both jurisdictions. In terms of business profits, both source and residence countries have the right to tax MNE profits. The source (host) country is given "first bite" at taxing MNE profits where earned. The residence country then chooses whether to top up the foreign tax with its own tax (i.e., worldwide taxation) or exempt the foreign source income (FSI) from further taxation (i.e., territorial taxation). If the residence country taxes the MNE's profits on a worldwide basis, the country must provide "tax room" for the source country to avoid double taxation of MNE profits. Normally, a foreign tax credit (FTC) is given for the foreign CIT and any withholding taxes up to the level of the residence country's CIT rate. Foreign subsidiaries are treated as separate entities (stand-alone legal entities) in the host country

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<sup>26</sup> See Ibid., para.73,75-77.

<sup>27</sup> Priority would be given to interest and royalty payments, and possible modifications to Articles 7, 9-13 and 21 of the OECD Model Tax Convention.

<sup>28</sup> See OECD/G20, Statement on a Two-Pillar Solution to address the tax challenges arising from digitalisation of the Economy. 1<sup>st</sup> July 2021.

<sup>29</sup> See Ibid., para. 68-71.

<sup>30</sup> See, for instance, Forgeas, R. (2008) "Is IFRS That Difference from U.S. GAAP?", *CPA Insider*, June 16; Benston, G., Bromwich, M., Wagenhofer, A. (2006) "Principles-Versus Rules Based Accounting Standards: The FASB's Standard Setting Strategy", *Abacus*, 42(2), 165-188.

and separate accounting is used to determine their CIT payments. Foreign branches may also be treated as *de facto* separate entities if they meet the permanent establishment test.

For instance, assume country A (the residence country) has a 30% CIT rate. An MNE resident in country A has a foreign subsidiary in country B where the effective tax rate is 15%. The effective tax rate (T) would be the total sum of the source country's CIT rate and withholding tax rate on dividends remitted to the MNE parent firm. Each foreign subsidiary first pays a foreign CIT on its pre-tax income earned in the source country. The affiliate is then deemed to distribute the full amount of foreign pre-tax earnings to its MNE parent in country A. Country A taxes the grossed-up foreign-sourced income on a worldwide basis annually, assuming no deferral, and then provides tax room to the source countries through an FTC up to Country A's CIT rate. As a result, the foreign subsidiary in B pays the same 30% overall CIT rate. Therefore, as long as the CIT rate of the home country is higher than the effective tax rates of the host country and the home country follows the worldwide income principle, there would be no application of GloBE minimum tax regardless of where they are located. Second, if the CIT rate in the home country is higher than the 15% minimum threshold, there would be no reason for topping up taxation at the level of country A. However, the situation would be different if country A (residence country) lowered its CIT rate so that the effective tax rate declined to below 15%, but not below the effective tax rate of the source country. In such a case, the GloBE may be triggered. For instance, say the CIT of Country A is 14%, whereas the source country's effective tax rate is 10%. In that event, the top-up tax of 4% would be charged in the country of residence A under income inclusion rules. The country of residence of the next level subsidiary may get an additional tax of 1% as country A would fail to top up the tax of the entire 5% because of its CIT rate of 14%. However, this scenario would be extremely rare. Therefore, in very limited circumstances, the residence country may be required to apply the GloBE minimum tax.

The territorial tax systems usually exclude foreign source income except for passive income where a switch-over rule is applied. Accordingly, income in the nature of the interest or royalty arising in the source country is captured in the tax base of the country of residence but with the foreign tax credit. In a simpler way, as far as interest or royalty income is concerned, the territorial tax system is like the worldwide income tax system. Therefore, as shown in the example of the previous paragraph, if the CIT in the home country exceeds 15% and is higher than the effective tax rates of the source country, there will be no application of the global minimum tax. Only when both the CIT in the home country and the effective tax rate of the source country is below 15%, the global minimum tax would be activated. Additionally, as the business income of the source country is not taken into consideration for determining the tax base in the home country in a territorial tax system, top-up of additional taxation at the level of the home country would not arise. However, the jurisdictions of the subsidiaries may apply the global minimum tax if they follow the worldwide income system. The GloBE proposal, nonetheless, also recommends countries that adopt the territorial tax system include a switch-over clause to capture the additional tax under the GloBE proposal.

Therefore, the actual effect of the global minimum tax would not only depend on the tax systems but also the rates, considering both the CIT and the withholding tax, in addition to taxation of repatriated income.

### **3.2 Issues related to the tax base**

#### *3.2.1 Problems of identification of the “correct profit”*

The proposal to adopt a global minimum tax on income is to combat tax competition between countries by use of lucrative tax incentives or reduced tax rates, which results in extremely low effective tax rates. To find a proxy of the minimum tax that businesses should pay, the proposal emphasized the computation of effective tax rates (ETRs) which are based on the ratio between total tax paid and accounting profit in the consolidated financial statements.<sup>31</sup> The accounting profit as per consolidated financial accounts would, therefore, be pivotal in designing the global minimum tax proposal. It is further stated that financial accounting standards for calculating the GloBE tax base are the financial accounting standards used by the parent in the preparation of its consolidated financial accounts.<sup>32</sup> Therefore, measurement of accounting profit would depend on the type of accounting standards the business adopts in its parent’s jurisdiction. Nonetheless, even though many countries have adopted IFRS currently, several bigger economies including the USA, Japan, India, China, etc. have their own GAAP.<sup>33</sup>

As countries adopt different accounting standards to compute accounting profit, to achieve a uniform outcome harmonization at a global level would be needed. The aspect of how easy or difficult is the process of tax base harmonization has been dealt *infra*. Assuming that the accounting tax base is harmonized globally, whether accounting profit reflects the true profit is a matter that needs further deliberation and analysis<sup>34</sup>. The idea of adopting accounting profit instead of taxable profit as the starting point of computation of ETR is that the former is more or less reflects the true profit<sup>35</sup>. On the other hand, the taxable profit may be altered substantially through accelerated depreciation, super deductions etc. The GloBE proposal prescribes IFRS as the preferred accounting standard for the computation of consolidated financial statements.<sup>36</sup> However, not all countries follow uniform accounting standards<sup>37</sup> for computing business profits. For instance, countries like the US, Japan, China, Australia, and New Zealand adopt their own

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<sup>31</sup> See OECD/G20, “Statement on a Two-Pillar Solution to address the tax challenges arising from digitalisation of the Economy”. 1<sup>st</sup> July 2021. para.127.

<sup>32</sup> Ibid., para 3.3.

<sup>33</sup> Ibid., para 3.3.

<sup>34</sup> Freedman, J. (2008), “Financial and Tax Accounting: Transparency and ‘Truth’”, in W. Schon (ed.), Tax and Corporate Governance (Springer Science); Desai, M.A. (2005), “The Degradation of Reported Corporate Profits”, Journal of Economic Perspectives, 19(4), 171-192.

<sup>35</sup> See Devereux, M.P., *et al*, “The OECD Global Anti-Base Erosion (“GloBE”) proposal”, Oxford University Centre for Business Taxation, January 2020.

<sup>36</sup> See *ibid.*, para.3.3.

<sup>37</sup> Even though more than 100 countries follow IFRS, several countries still follow their local GAAP including the US, Japan and India.

GAAP as their accounting standards. Admittedly the IFRS is significantly different from local GAAPs. First, they differ in the valuation of assets/investments. The IFRS follow mainly fair value principles, whereas the US GAAP and other local GAAPs adopt the historical cost method for the evaluation of assets/investments. Therefore, accounting profit under IFRS would report a higher profit in several situations. For instance, in the UK, there has been a serious problem in banking or financial industries as their profits are artificially jacked up due to fair-value evaluations. Similarly, during the financial crises, there would be a reporting of excessive losses. Therefore, the contention that the accounting profit would represent true profit is questionable.

Because of the fair value principle under IFRS, adoption of IFRS would generally increase the reportable profit at least in the short run. As a result, the ETR measured in relation to the accounting profit would be lower than the actual ETR. For example, if the tax paid is 8 and the accounting profit as per IFRS is 100, then the ETR results in 8%. Under the same amount of tax payment if the accounting profit is 80 the ETR will be 10%. Assuming that the global minimum tax rate is 10%, businesses that adopt IFRS will be in disadvantageous situations as the chances of falling under the scope of GloBE tax would be higher for them because of inflated profit. Alternatively, the adoption of IFRS under the GloBE proposal would result in the payment of additional tax even in situations where businesses are already subject to adequate tax.

The objective of adopting accounting profit over taxable profit is to avoid structural differences in the calculation of the tax base between jurisdictions. However, due to several reasons, accounting profit is generally higher than taxable profit. Two of the most common items that create differences between accounting profit and taxable income are depreciation and inventory evaluation.

Depreciation is a non-expense that a company reports on its income statement to account for the wear and tear of plant, property, and equipment. The straight-line method which is adopted under accounting rules spreads the cost of depreciation evenly throughout the life of the asset. For example, if an asset costs \$100,000 and the company estimates that it has a 10-year useful life, the annual depreciation is \$10,000. While companies may use straight-line depreciation to report accounting profit, countries' tax rules allow companies to use an accelerated depreciation method called double-declining balance to record taxable income. Under double-declining depreciation, the same asset depreciates by \$20,000 per year.

Second, inventory also creates a difference between accounting profit and taxable income. Two widely used inventory valuation methods, "last-in, first-out" (LIFO) and "first-in, first-out" (FIFO) affect a company's cost of goods sold, profit and ending inventory balance. LIFO assumes the last goods purchased for inventory are the first ones sold. FIFO assumes the opposite. The tax rule generally allows a company to use LIFO to report taxable income even though it uses FIFO to calculate its accounting profit. Public companies that do this must publish the "LIFO reserve", which basically reconciles the difference between LIFO and FIFO.

The point that is made here is that, even without the tax incentive, there will be a significant difference in the amount of profit reported under the tax code and financial accounts. Therefore, the argument that taxable income does not reflect the true profit is not based on sound reasoning. Without tax incentives, both would reflect correct profit. Therefore, in cases where tax incentives are provided, if the same is added back to taxable income, the same would reflect the correct profit. Therefore, adopting accounting profit based on IFRS might need second thoughts.

### *3.2.2. Issues related to choosing IFRS*

The determination of the effective tax rate is pivotal to the GloBE proposal as it would decide the threshold for the application of global minimum tax. Under the proposal, the ETR is a ratio of tax paid<sup>38</sup> to the tax base.<sup>39</sup> The tax base would be the accounting profit determined in the consolidated financial statement of each constituent entity of the MNE Group, prepared under the financial accounting standards used by the parent entity of the group.<sup>40</sup> Alternatively, it is proposed to use accounting profit just determined under International Financial Reporting Standards (IFRS) for the purposes of GloBE tax base<sup>41</sup>.

The preference of accounting profit over taxable profit as the tax base is basically driven by three reasons. First, the accounting measure of profit is better than taxable profit when the subsidiary is located in a low-tax jurisdiction or a country engaged in tax competition.<sup>42</sup> This is because the Governments of source countries may artificially reduce the tax base by providing tax reliefs such as super deductions, accelerated depreciation and other advantageous tax reductions. Second, as the harmonization of the tax base is essential in the determination of the ETR, profit as per financial accounts would provide an easier way out as compared to taxable profits.<sup>43</sup> Third, it would eliminate the structural differences amongst jurisdictions in calculating the tax base.

However, not all countries use uniform accounting standards or not all multinationals prepare consolidated financial accounts. Even though more than 100 countries now follow IFRS when preparing their financial accounts, there are still many large economies such as the US and Japan that follow their national GAAPs. Two significant problems arise out of this. First, as the US GAAP and IFRS have significant differences, aligning both these standards would be necessary to achieve harmonization. Little work has been done so far on this aspect. Second, if the constituent entities are required to prepare their accounts as per the accounting standard of their parent's

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<sup>38</sup> Tax paid means the “covered tax” as defined in para 3.2 of the GloBE proposal.

<sup>39</sup> See Ibid., para.127, clause 3.1.

<sup>40</sup> See para 164, OECD (2020), Tax Challenges from digitalization –Report on Pillar Two Blueprint: Inclusive framework of BEPS.

<sup>41</sup> Ibid., para 168, clause 3.3.3.

<sup>42</sup> See Devereux, *et al*, *op.cit.*, n.35.

<sup>43</sup> See para.15, Tax Challenges from digitalization –Report on Pillar Two Blueprint: Inclusive framework of BEPS. The OECD's rationale for considering financial accounts is to neutralise the impact of structural differences in the calculation of the tax base.

jurisdiction, which might be different from the ones they use, there would be a relevant increase in compliance costs.

Even if those differences are worked out, there would still be different outcomes as IFRS is a principles-based accounting system, whereas the US GAAP is a rules-based one.<sup>44</sup> Principles-based accounting just provides general rules, leaving much discretion to accountants. As argued, the results in financial accounts would be, thus, far from uncontroversial and straightforward.<sup>45</sup> Financial accounts also serve different objectives than tax accounts. The primary objective of financial accounts is to provide a range of information to the stakeholders. Therefore, when taxation is determined on the basis of accounting rules, there would be pressure on accounting standard boards to accommodate changes to become more prudent.<sup>46</sup> Accordingly, the profits would be deferred while expenses are captured at the earliest. Therefore, there may be a possibility of dilution of accounting standards due to tax considerations.<sup>47</sup> Hence, it is generally argued that convergence of financial accounts with tax accounts are undesirable.<sup>48</sup>

The use of financial accounts for tax purposes also raises constitutional issues.<sup>49</sup> Tax is a sovereign function of a country. Therefore, handing over this important function in the hands of private operators such as the International Accounting standard Board (IASB) or Financial Accounting Standard Board (FASB) would be a real challenge as these bodies, which may be prone to pressure from their users.<sup>50</sup> This is the same issue encountered in the proposal of the EU Common Consolidated Corporate Tax Base (CCCTB), which requires the harmonization of the tax base. Indeed, the EU moved away from adopting the IFRS as a starting point for taxation.<sup>51</sup>

Finally, as differences between the IFRS and US GAAP is inevitable even after the adjustments to be made to take account of permanent and temporary differences, this may lead to forum shopping<sup>52</sup> influenced by the accounting standard of the jurisdiction of parent entity like what is seen in present tax systems. Aligning the GloBE tax base with the computation of taxable income under the rules of the jurisdiction in which the MNE operates remains a critical aspect.<sup>53</sup> Even though the proposal has opted for certain adjustments,<sup>54</sup> both temporary and permanent<sup>55</sup>, to be carried out to the net income, the finer attributes of these adjustments are still to be finalized.

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<sup>44</sup> See *supra*, n.30.

<sup>45</sup> See Quattrone, P., “The forgotten history of accounting words”, FM Magazine 1, December 2019.

<sup>46</sup> See Devereux Devereux, *et al*, *op.cit.*, n.35.

<sup>47</sup> See Freedman, *op.cit.*, n.34.

<sup>48</sup> Ibid. and Devereux, *et al*, *op.cit.*, n.35.

<sup>49</sup> See Freedman, *op.cit.*, n.34.

<sup>50</sup> See Herzfeld, M. (2018), “Warren, the OECD, and Book-Tax Conformity”, Tax Notes, October 2018.

<sup>51</sup> See Freedman, *op.cit.*, n.34.

<sup>52</sup> See page.17, See Devereux, *et al*, *op.cit.*, n.35.

<sup>53</sup> OECD (2020), Tax Challenges Arising from Digitalisation-Report on Pillar Two Blueprint: Inclusive framework on BEPS, para.175.

<sup>54</sup> Ibid., para.175, clause 3.3.4.

<sup>55</sup> Ibid., clause 3.3.4.

### 3.3 Issues related to the scope

The proposal of a global minimum tax is designed to combat the tax competition amongst the nations. However, the proposed tax will only apply to MNEs whose global turnover exceeds € 750 million<sup>56</sup>. The idea of such a threshold is to align it with the requirement of the Country-by-Country Reporting<sup>57</sup> by the MNEs which was brought in to facilitate the alignment of transfer pricing outcomes with economic activities.<sup>58</sup> Therefore, the taxation of around 2,000 large companies globally distributed would be the target of this proposed minimum tax.<sup>59</sup> Additionally, due to substance-based carve-out, the proposal is not intended to apply to active businesses, as it happens in the application of CFC rules or GILTI provisions of the US. The proposal would, in fact, also exclude the income covered under GILTI provisions of the US. The income that is captured under CFC legislation will not be treated in a similar way to the US GILTI, but the taxes paid on such income would be included under covered taxes for the purposes of computation of ETR.<sup>60</sup>

The general argument put forward is that countries are engaging in tax competition by reducing their corporate tax rates to attract investments/businesses. However, the statistics seem to tell a different story. The worldwide average statutory corporate tax rate measured across 177 countries is 23.85%<sup>61</sup>, which is similar to the statutory corporate tax rates of the OECD Countries.<sup>62</sup> The BRICS<sup>63</sup> which are the biggest gainer as far as inflow of investments is concerned have an average corporate tax rate of 27.40 %.<sup>64</sup> This is even higher than the OECD average. Therefore, on a broader level, there seems to be no substantial variation of corporate tax rates between the developed and the developing or emerging economies. The corporate tax rates on a global scale have been in decline for the last couple of decades.<sup>65</sup> In fact, all the big economies in the world in respect of GDP have now statutory corporate income tax within the range of 20%-25%. Therefore, tax competition through favourable tax incentives and reduced tax rates should not be of significant concern as it is projected.

As per the UNCTAD report<sup>66</sup>, out of the top 20 host countries for FDI, the majority are developed countries.<sup>67</sup> Amongst the developing and emerging world, a significant amount of FDI is received

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<sup>56</sup> See 1<sup>st</sup> July report of OECD, “Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy”.

<sup>57</sup> Ibid.

<sup>58</sup> See OECD BEPS action plan final report, 2015.

<sup>59</sup> OECD statistics.

<sup>60</sup> OECD (2020), Tax Challenges Arising from Digitalisation-Report on Pillar Two Blueprint: Inclusive framework on BEPS

<sup>61</sup> See Tax Foundation (2020), *op.cit.*, n.2.

<sup>62</sup> Ibid.

<sup>63</sup> BRICS consists of 5 countries such as Brazil, Russia, India, China, and South Africa which are emerging economies of the world.

<sup>64</sup> Ibid.

<sup>65</sup> Tax Foundation (2020), *op.cit.*, n.2. Also see OECD statistics

<sup>66</sup> See page.no.12, UNCTAD, World Investment Report 2020.

<sup>67</sup> See Ibid., page.no.12.

by China, India, Brazil, Mexico, and Indonesia.<sup>68</sup> The Statutory Corporate tax rate of China is 25% which is at par with many OECD countries. China is not only a top host country for FDI but also significant as far as FDI outflow is concerned.<sup>69</sup> The Corporate tax rate of Brazil is 25%. Similarly, Mexico is also a high tax jurisdiction with a statutory corporate tax rate of 30%. As far as India is concerned, the present corporate tax rate is around 30%.<sup>70</sup> Therefore, on a country-specific analysis of the top FDI recipients, it would reveal that the argument of reduction in the corporate tax rate to attract investments seems not too strong.

Over the last decade, these countries have gone through corporate tax reforms by reducing their corporate tax rate with simultaneous phasing out of the tax incentives to achieve a broader tax base. For instance, in 2015, India made a series of modifications to its tax policy.<sup>71</sup> One of such is to reduce the corporate tax rate from 30 % to 25% with simultaneous phasing out of tax deductions and exemptions. Therefore, when the full effect of such reform would be realized, there will be hardly any difference between the accounting profit and taxable profit. Therefore, ETR would actually be closer to STR for several countries in a near future.

It may be of interest to know that out of the top 500 global companies,<sup>72</sup> around 70% are tax residents of either USA or Western Europe. If the top companies of China are excluded (being an FDI destination country), then it will not be exaggerated to state that almost 99% of top global companies have their tax residence either in the US or Western Europe. Incidentally, almost all of these countries have CFC rules in place, including the US who has recently introduced the GILTI provision to capture similar income the CFC rules intend to capture. The income covered under GILTI is also expressly excluded from the scope of the GloBE proposal.<sup>73</sup> Therefore, in view of the aforesaid discussions, there may not be adequate additional top-up tax collected under GloBE minimum tax.

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<sup>68</sup> See Ibid., page.no.12.

<sup>69</sup> See Ibid., page.no 12.

<sup>70</sup> However, Finance Act 2020 has reduced the corporate tax rates for new corporations to 17%.

<sup>71</sup> See Union budget 2015-16. Available at <https://www.indiabudget.gov.in> budget 2015-16. Indian Finance Minister's budget speech in 2015.

*“ 97. We need to match this transformative piece of legislation in indirect taxation with transformative measures in direct taxation. The basic rate of Corporate Tax in India at 30% is higher than the rates prevalent in the other major Asian economies, making our domestic industry uncompetitive. Moreover, the effective collection of Corporate Tax is about 23%. We lose out on both counts, i.e. we are considered as having a high Corporate Tax regime but we do not get that tax due to excessive exemptions. A regime of exemptions has led to pressure groups, litigation and loss of revenue. It also gives room for avoidable discretion. I, therefore, propose to reduce the rate of Corporate Tax from 30% to 25% over the next 4 years. This will lead to higher level of investment, higher growth and more jobs. This process of reduction has to be necessarily accompanied by rationalisation and removal of various kinds of tax exemptions and incentives for corporate taxpayers, which incidentally account for a large number of tax disputes.*

*98. I wanted to start the phased reduction of corporate tax rate and phased elimination of exemptions right away; but I thought it would be appropriate to give advance notice that these changes will start from the next financial year.”*

<sup>72</sup> See Wikipedia on top companies based on global revenue.

<sup>73</sup> See Ibid., para.

The GloBE proposal excludes from its scope investments in active businesses under a substance-based carve-out proposal<sup>74</sup>. It would exclude a certain percentage of total payroll costs and the carrying value of tangible assets from accounting profit. In a recent statement<sup>75</sup>, the OECD has clarified that a minimum of 5% of the carrying value of tangible assets and payroll costs would be excluded from the income.<sup>76</sup> The objective of such a carve-out is to allow tax benefits for active businesses in the source countries. Therefore, the objective to eliminate tax competition may not be achieved even after the implementation of the GloBE proposal. From a close analysis of the inflow of FDI on a sectorial or industry-specific basis, it is observed that the total global inflow of FDI to manufacturing and service sectors stood at 846 billion USD in 2019<sup>77</sup>, which corresponds to almost 55% of the total global inflow of FDI.<sup>78</sup> This investment would be covered under the substance-based carve-out proposal under GloBE. The balance of 45% may be in the form of passive investments. The FDI outflows data indicates that the top home countries are Japan, the US, and the Netherlands.<sup>79</sup> The low taxed passive income in the form of interest, dividend or capital gains controlled by the US shareholders are anyway captured by US's GILTI provisions. The income covered under GILTI is kept out of the purview of GloBE minimum tax. Japan and Netherlands have CFC rules in place to tax low-income passive income of domestic controlled foreign companies. The taxes paid under CFC rules are to be considered as covered tax<sup>80</sup> for the purposes of ETR computation. Therefore, in a significantly high number of cases, the GloBE proposal would not be operative.

The proposal intends to capture lower or inadequate taxation in the cases of only large MNEs by putting a threshold at 750 million Euros.<sup>81</sup> However, a bright-line test for taxation is simpler and straight forward but it can be avoided as the taxpayer may split the turnover artificially in two or more entities or suppress the turnover to keep it below the taxable threshold. Therefore, it may be debatable as to whether targeting top companies only would bring the desired result.

### **3.4 Interaction with the OECD Pillar 1 proposal**

The initial proposal under GloBE was a global minimum tax at around 10-12%<sup>82</sup>. However, now a consensus has been reached by the Inclusive Framework (IF) of a global minimum tax of

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<sup>74</sup> See Ibid., clause 4.3.

<sup>75</sup> See page.no.4, OECD, Statement on a Two-pillar Solution to address the tax challenges arising from the Digitalisation of the economy, Paris.

<sup>76</sup> However, for the initial 5-year period, the excluded income would be higher which is at 7.5% of the carrying value of tangible assets and payroll cost.

<sup>77</sup> See Page.16, UNCTAD, World Investment Report 2020: International production beyond the pandemic.

<sup>78</sup> As per UNCTAD's world Investment report 2020, the total FDI inflow to both developed and developing economies is in the tune of 1.54 trillion USD.

<sup>79</sup> See Ibid., page.no.15

<sup>80</sup> See Ibid., para.145.

<sup>81</sup> See Ibid., para.41.

<sup>82</sup> See OECD Blueprint.

15%.<sup>83</sup> At this juncture, it may be pertinent to raise that under OECD pillar 1, the market countries are given new taxing rights based on mere sales.<sup>84</sup> As per the new taxing rights proposal, the tax would be a percentage of global profit based on consolidated financial accounts.<sup>85</sup> The MNEs with a global turnover above 20 billion euros with pre-tax profitability of above 10% are considered to fall under its scope.<sup>86</sup> For in-scope MNEs, between 20-30% of residual profit defined as profit above 10% of the revenue will be allocated to market countries with a nexus that considers revenue-based allocation keys.<sup>87</sup> Therefore, no finality has been reached yet on the quantum of taxation.

In the meanwhile, the OECD came out with the GloBE proposal to introduce a global minimum tax for businesses irrespective of their place of legal or economic locations. As both the proposals are taken up simultaneously, one proposal should not outcast the other in the sense that the profit percentage under the OECD Pillar 1 should be such that the same business is not again subject to minimum tax under GloBE. In simpler terms, this presupposes that the tax rate under Pillar 1 should be somewhat higher than the proposed minimum tax. Otherwise, the taxes paid under the new tax regime would all again be subject to additional tax under a global minimum tax regime. This is not the intention of the Inclusive framework. Therefore, the minimum tax rate under the GloBE proposal would depend on the outcome of the tax rate decided in Pillar 1.<sup>88</sup> The consensus to have a global minimum tax rate of 15% would mean that the tax rate under Pillar 1 should be higher than this. However, acceptance of such a high rate under Pillar 1 would be debatable. In view of this, the proposal to have a Global Minimum Tax rate of 15% seems to be premature at this stage.

On pending finality of decision under BEPS Action Plan 1 on taxation of the digital economy, countries have implemented unilateral measures to protect their tax base. For instance, an equalization levy was introduced in India in 2016<sup>89</sup>, a diverted profit tax in the UK<sup>90</sup>, digital services taxes in the EU and other countries<sup>91</sup>. However, taxes paid under these domestic measures are kept outside the scope of covered taxes for the computation of ETR<sup>92</sup>. There may be an argument to back the same as such domestic taxes are not taxes covered under Article 2 under the tax treaties' framework<sup>93</sup>. However, there is no denial of the fact that such domestic measures are

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<sup>83</sup> See 1<sup>st</sup> July report of OECD, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy".

<sup>84</sup> See OECD (2020), Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

<sup>85</sup> Ibid.

<sup>86</sup> Ibid.

<sup>87</sup> Ibid.

<sup>88</sup> See Ibid., para.219 where in it is stated that Pillar One applies before Pillar Two.

<sup>89</sup> See Indian Finance Act 2016, chapter VIII.

<sup>90</sup> UK Finance Bill 2015.

<sup>91</sup> Austria, France, Hungary, Italy, Poland, Spain, and Turkey have a DST.

<sup>92</sup> See OECD Blueprint on pillar 2

<sup>93</sup> See Final report on BEPS Action 1

introduced as a proxy to taxation of business profit<sup>94</sup> which the current international tax rules are unable to tax. In the event of non-consideration of such source taxes, the digitalized businesses would suffer an additional tax burden. One would be the source taxation due to specific legislation, and the second would be the global minimum tax at the level of the parent's or subsidiaries' jurisdiction, as the case may be. Therefore, from a policy perspective, it may not be correct to exclude such alternative business taxes from the covered tax for the purposes of computation of ETR at this stage.

### **3.5 Interaction with Tax Treaties**

Under the GloBE proposal, the businesses or transactions which are not taxed adequately would be subject to the global minimum tax. This would bring under its scope certain base eroding payments like interest and royalty payments that have suffered low or nil tax. Under the tax treaty framework, taxing rights of interest income are shared between residence and source countries. Article 11 of the OECD Model and UN Model deals with the taxation of cross-border interest income.<sup>95</sup> The withholding tax rate on interest payments in source countries varies up to a cap provided therein.<sup>96</sup> Generally, the withholding tax ranges between 0 to 10% in most treaties. Therefore, tax treaties allow applying withholding tax at a rate that is lower than the global minimum tax.<sup>97</sup> Assuming that the country of residence of the parent company taxes interest income at a level of 10%, according to income inclusion rules, the parent's jurisdiction may top up to the extent of the shortfall from the minimum tax. As the tax that is applied in the source country is not unilaterally decided but is bilaterally agreed upon, the application of the global minimum tax would lead to a paradoxical situation.

Another issue may arise in the case of royalty payments. Under the OECD Model, only the residence country has the right to tax royalty income.<sup>98</sup> From the source country perspective, the ETR would be zero as there is no taxation at the level of the source country. Therefore, such a transaction would be brought under the scope of the global minimum tax. As a result, the country of jurisdiction of parent or subsidiaries, as the case may be, may levy additional tax under GloBE minimum tax if their statutory tax rates are below the proposed minimum tax rate. A similar issue may arise in case of business income taxed under Article 8 of the OECD Model and UN Model where the taxing right for income derived from an operation concerning aircraft or ships in international traffic is vested with the residence country only<sup>99</sup>. The income derived from immovable property is taxed only in the country of the situs of the property both under the OECD

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<sup>94</sup> See Final report on BEPS Action 1

<sup>95</sup> See Article 11 of OECD Model and Article 11 of the UN model

<sup>96</sup> See UN and OECD model tax conventions. The language used in most of the Double Tax conventions is as under: "Such interest may also be taxed in the Contracting State in which it arises, and according to the law of that State, but the tax so charged shall not exceed 10% per cent of the gross amount of the interest."

<sup>97</sup> As per the recently released report by OECD dated 1<sup>st</sup> July 2021, the Inclusive Framework has agreed for a global minimum tax of 15%.

<sup>98</sup> See OECD Model Tax Conventions, Article 12.

<sup>99</sup> See OECD Model Tax conventions, Article 8. Also See UN Model, Article 8.

Model<sup>100</sup> and the UN Model<sup>101</sup>. The residence country has no taxing rights in respect of such income. In a situation like this one, if the source country tax is less than 15%, then GloBE minimum tax would be triggered either in the jurisdiction of the parent or in the jurisdictions of the subsidiaries. This issue may be resolved in two ways. First, when the taxation of certain income has already been agreed bilaterally through the application of DTCs, then there is no need to bring the same income under the purview of global minimum tax. Second, it may need to revisit the treaty rules and make necessary modifications to align with the GloBE proposal. This issue needs further deliberation.

### **3.6 Feasibility of source taxation under the GloBE**

As a fallback option, the source country may also be able to apply global minimum tax for undertaxed businesses/payments<sup>102</sup> after the residence countries of parent or subsidiaries exert their options. In the majority of cases, it is doubtful whether the source country can get any pie of the proposed global minimum tax. GloBE minimum tax originates because of low or no taxation at the level of the source country. This may be due to the tax policy of the source country or to administrative incapability.

Assuming that as a policy matter, certain payments/businesses are not adequately taxed in a source country, then it is not understood as to why the same source country could ever get an opportunity to tax such payments/businesses under the GloBE proposal. In any case, even if the source country got a chance to tax such payments/businesses, it is uncertain whether they would exercise this right, as it could be contrary to their policy or policy goals. For instance, if the parent is incorporated in a tax haven and provides debt to a subsidiary situated in a developing country and this country does not tax interest income, as per the GloBE proposal, such income would be covered under its scope as ETR is zero at the level of the source country. The parent jurisdiction does not capture global minimum tax being a tax haven. Therefore, the source country would again get a chance to tax this income under the fallback rule. The policy question is whether the source country would ever tax this income, which it did not intend to tax in the first place, due to their policy objectives. Such issues need reconsideration.

### **3.7 Administrative inconvenience**

The primary taxing rights under the GloBE is given to the country of residence of the parent company. The source country may apply taxation as a fallback provision. Two significant problems stem from this. First, it is provided that in case the parent's jurisdiction does not apply the minimum tax, then the country of residence of the subsidiary would get the chance to tax. In the case of multi-layering structures, several jurisdictions may get the chance to top up tax under the GloBE proposal. This would pose a real administrative challenge. No administrative

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<sup>100</sup> See OECD Model, Article 6.

<sup>101</sup> See UN Model, Article 6.

<sup>102</sup> See Devereux, *et al*, *op.cit.*, n.35.

mechanism and time frame has been designed to pass on taxing rights to next level countries have been clarified.

The only possible mechanism right now, available under the tax treaty framework, is through the Competent Authority (CA) proceedings under Article 25 of the tax treaties. However, the current experience of disposal at the level of competent authorities is not very encouraging. Indeed, a relevant time lag is experienced in passing on information from one CA to another. Therefore, taxation, as proposed under the GloBE, may not achieve the desired objective in the present state.

#### **4. Conclusion**

The objective of the GloBE proposal is that every business should pay a minimum level of tax irrespective of the place they are located. The primary aim is to address ongoing tax competition amongst the nations as businesses tend to locate in low tax countries. However, it suffers from significant conceptual and practical issues. First, the actual effect of the global minimum tax would depend not only on tax systems but the rates, both CIT and withholding tax in addition to taxation of repatriated income. The idea to adopt accounting profit for computation of the ETR on the basis that it is closer to true profit and easier for harmonization of the tax base might be overstated.

Moreover, the process of harmonization seems not only cumbersome but complex. The proposal to apply the global minimum tax only to large companies may lead to tax avoidance by splitting the entities or underreporting. The target companies under GloBE minimum tax are those operating in developing and emerging economies. On a general analysis of corporate tax rates on a global scale, it is seen that there is hardly any difference in statutory corporate tax rates between the OECD countries and that of the developing countries. Moreover, the countries have gone through corporate tax reforms in the last decade with the objective to broaden the tax base by reducing corporate tax rates and phasing out all tax reliefs. Therefore, when the full effect is realized, then there would be no difference between the statutory tax rate and the effective tax rate. Therefore, the tax competition argument might need to be revised and explained more thoroughly.

As per the recent data on foreign direct investment on a global scale, it is seen that a significant amount of investments is made in active businesses and these would not be subject to GloBE minimum tax because of the applicability of substance-based carve-outs. The remaining passive investments may not also fall under the scope of the GloBE tax as return on such investments in the form of dividend, interest, royalty, or capital gains are likely to be captured either under the GILTI provisions or similar CFC legislation of the home countries of investments. The inclusive framework has now agreed to a minimum tax rate of 15%. While a concrete outcome is yet to be reached under the OECD Pillar 1 proposal, this agreement for a minimum tax looks pre-mature as admittedly the outcome of GloBE is effectively dependent on Pillar 1. There would also be a need to revisit tax treaty provisions as GloBE would make several treaty rules ineffective. Last, but not least, the administrative mechanism to carry out the effect of the GloBE proposal is not adequate

at this stage. Therefore, under these circumstances, achieving the policy objective of this proposal is debatable.