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The Fine Print on the Global Tax Deal

Domestic Politics Could Prevent Sweeping Reform

By Ruth Mason

The global tax deal endorsed by world leaders at the recent G-20 meeting in Rome reflects the adage "To retain tax sovereignty, a state must relinquish it." This seeming paradox refers to states' increasing inability to collect tax revenue needed to fund domestic policies unless they work together. For example, the Biden administration knows that global competitive pressures have driven down U.S. corporate tax rates and that loopholes in the international tax system have allowed companies to avoid taxes by shifting their profits abroad. To combat these trends, and to secure funding for its "Build Back Better" plan, the Biden administration enlisted international cooperation. The new tax agreement aims to make it harder for companies to escape tax, and it also aims to reduce the global race to the bottom on corporate tax rates.

It does this through two key measures. First, it makes it more difficult for companies to avoid paying taxes in countries where they are making money but have no physical footprint; and second, it introduces a global minimum tax rate of 15 percent. These changes augur a

fundamental shift in how international tax works. Until now, multilateral cooperation involved only a few dozen countries—members of the Organization for Economic Cooperation and Development (OECD)—and only a narrow set of technical issues. The physical presence of a company inside a country determined whether its profits could be taxed there, and the ability to set tax rates was widely viewed as a central aspect of sovereignty that countries should never bargain away. But after nearly a year of intense negotiation, 137 countries representing more than 90 percent of global GDP and almost 75 percent of the world's population agreed to a deal that would both reduce the international tax system's dependence on physical presence and introduce a minimum tax rate.

The agreement has rightly been described as groundbreaking, but its full significance will ultimately depend on future developments. First, the deal will confront the reality of domestic politics. And even if countries manage to implement it, the deal is unlikely to emerge unchanged. Enacting and enforcing the new rules will also require an unprecedented level of international cooperation—and likely a multilateral treaty. Finally, and most important, the significance of the deal depends on what happens next; although the current deal is relatively narrow in scope, it could grow, generating more tax revenue for the countries that need it most.

The impetus for the deal came from fiscal and political woes of the 2008 financial crisis. Revelations of aggressive tax avoidance by tech companies and the COVID-19 pandemic increased pressure on governments. Countries grew frustrated with the century-old tax treaty framework that divides the income of multinationals among states for tax purposes. Increasingly obsolete, the treaties rely too much on where companies are physically located

versus other factors, such as where their customers are. <u>As the digital economy grew, a severe disconnect developed between where companies earn income and where they pay tax</u>.

Targeting Big Tech, three dozen countries, including most prominently France, enacted novel digital taxes to recapture some of the revenue that existing tax treaties prevented them from collecting as the <u>economy digitized</u>. The United States, under the leadership of President Donald Trump, cried foul, arguing that the new taxes violated tax treaties and unfairly targeted U.S. firms. The Office of the U.S. Trade Representative launched an investigation of the French digital tax and concluded that the United States was justified in applying retaliatory tariffs.

The U.S. threat to retaliate with tariffs on French wines and luxury products led to an impasse. <u>France and other treaty partners agreed to remove their digital taxes, but only if the United States would renegotiate tax treaties.</u> After beginning negotiations, the Trump administration used the COVID-19 crisis as an excuse to pause them, perhaps hoping that countries would be too distracted to follow through. But the pandemic's revenue crunch—and Big Tech's outsize COVID-19 profits—ensured that digital taxes remained at the top of countries' agendas. It was not until the Biden administration took office that the United States was truly open to negotiation. Seeking revenue to fund its domestic agenda, the Biden team hoped to tie digital taxes to the larger question of coordinated corporate tax rates.

<u>WHO GETS TO TAX THE WORLD'S MOST PROFITABLE COMPANIES?</u>

The arrangement reached on digital taxes gets less attention than the minimum tax but is no <u>less radical</u>. In a first step, the deal identifies the companies to which it applies—those with global turnover above <u>20 billion euros and profitability of over ten percen</u>t. The idea was to

apply the deal only to the world's biggest and most profitable companies. For these—roughly 100—companies, <u>the deal identified a slice of profits to be reallocated among the countries according to where the company has sales</u>. For example, under current tax treaties, if Facebook had no physical presence in France, then France would not be entitled to tax Facebook on its profits, even though Facebook has over 30 million users in France. In contrast, under the new deal, even without a physical presence, France would be able to tax a certain portion of Facebook's profits. Although details have not been finalized, how much France would be able to tax will depend on the <u>share of Facebook's global sales</u>—for example, its ad sales—that take place in France. For the slice of corporate profits subject to this new rule, the deal completely changes how <u>international taxation</u> of business profits works by <u>severing the connection between tax and physical presence</u>. Because the deal was not meant to result in substantial new taxes for companies, however, it also means that although market countries would gain revenue, other countries—<u>including companies' home countries—would have to give up revenue.</u>

Some countries wanted this proposal—<u>like the digital taxes</u> it would replace—to apply only to <u>Big Tech</u>. Focusing the tax narrowly would, they hoped, limit its burden to the U.S. tech companies that dominated the sector. But negotiators for the United States deftly navigated the process to ensure that the trigger for the new <u>tax was based on profitability, not sector</u>. This policy shift spread the tax hit across more industries and the revenue loss across more countries. Still, the current proposal will affect mostly U.S. and Chinese companies engaged in Big Pharma, Big Tech, and retail.

"Although the deal is narrow in scope, it signals a profound shift in international tax."

Ultimately, the result of the reallocation deal, if implemented, will depend on at least three factors outside the exclusive control of the United States. First is the behavioral response: how much revenue gets reallocated (and where) will depend on how good companies become at manipulating the new rules—which, in turn, will depend on how those rules are written. Second is the stability of the agreement. It will take time to see whether other countries actually repeal—and do not reinstate—popular, easy-to-administer, and revenue-productive digital taxes. Third is the scope. States already plan to widen the deal to include more companies after seven years, and further expansion after that is possible. Right now, the deal would affect only about 100 companies, and the OECD estimates that once enacted, it would reallocate $125 billion in profits.

U.S. officials claim that the revenue effect for the United States will be close to neutral—although the United States would relinquish tax entitlement owing to its status as the home country to many of the affected companies, it would also gain new entitlements to tax owing to its enormous consumer market. But if the scope of this deal were to expand over time, it could ultimately bring a sweeping redistribution of tax entitlements, dramatically increasing revenue for developing countries, especially those with large consumer markets.

France and the United States were the most prominent combatants in the fight over how to tax Big Tech, but framing the dispute exclusively as one between a tech company's home country (often the United States) and a country where many of its users or consumers reside is misleading. <u>Under current law, it is often the case that, through savvy tax-planning techniques, a company can avoid taxes in both its home state</u> and the country where its consumers reside. Instead, profits are reported in tax havens or nowhere at all. Thus, under the current paradigm, France's tax loss does not necessarily amount to a current tax gain

for the United States. Instead, companies park their profits in a low-tax country such as Ireland.

FIGHTING TAX HAVENS

To further weaken the incentive to move profits to low-tax countries, the second part of the deal imposes a 15 percent minimum tax on a small number of extremely high-revenue companies, namely those with annual revenue in excess of 750 million euros. The minimum tax provides for what might be called a "fiscal fail-safe": a set of rules that trigger special additional tax whenever a taxpayer is deemed to have paid an insufficient amount. For example, if a German company did not pay tax of at least 15 percent on its income abroad, the fiscal fail-safe would be triggered, and Germany could top up the tax to reach 15 percent.

The deal makes the minimum tax optional. Countries do not have to adopt it, but those that choose to do so have committed to enact the minimum tax in a coordinated fashion, and even countries that will not themselves implement the fiscal fail-safe have agreed to accommodate the application of the minimum tax by other states. Because the country where a company has its headquarters serves as a kind of tax authority of last resort under the deal, only a few key countries have to adopt the minimum tax for it to apply broadly.

On minimum taxation, the world again moved collectively, and with precision, against a small number of companies perceived to be a prominent source of the tax-dodging problem. But although the deal explicitly targets companies, it also implicitly goes after low-tax countries, seeking to neutralize the allure of tax havens.

The minimum tax rate will be more effective if more states adopt it, and much will depend on the precise rules—yet to be determined—and whether they are stringent enough to

prevent manipulation by tax planners inside affected companies. Most important, the minimum tax involves a gamble. Countries supporting it hope that raising the world's floor rate from today's (implicit) zero percent to 15 percent will afford states the opportunity to raise their national corporate tax rates well above 15 percent if they wish. But as countries compete to attract multinationals, 15 percent may end up serving as a convergence rate, under which lower rates rise until they reach 15 percent but higher rates also decline until they reach 15 percent. This would make 15 percent not only a floor but also effectively a ceiling.

HOW IT PLAYS AT HOME

U.S. Treasury officials used these negotiations to advance purely domestic goals. For example, to fund its spending proposals, the Biden administration planned to dramatically increase U.S. corporate tax rates. The administration actively supported the minimum tax deal with the expectation that it would help convince Congress to agree to large rate increases, including increases well in excess of the agreed global minimum. But Democrats in Congress partially rejected President Joe Biden's rate hikes, citing the need to remain competitive with other countries. Although there are still meaningful corporate tax increases pending before Congress, time will tell whether 15 percent represents the floor the Biden administration hoped it would or whether it effectively represents a convergence rate.

Meanwhile, Republicans have charged the Biden administration with accepting concessions regarding the taxation of U.S. digital companies to secure a higher minimum tax rate. For example, Republicans decried the failure of the United States to secure an immediate cessation of digital taxation upon conclusion of the deal, rather than upon implementation of the deal. As things stand, the United States and several western European countries have

signed a statement of intent that says once the reallocation rules are in place, digital taxes will be refunded to the extent that they exceed what would have been collected under the new reallocation rule. This side deal enables the Biden administration to apply pressure to members of Congress to implement the global tax deal, but unless and until Congress agrees, Big Tech will continue to face digital tax abroad.

"The new deal introduces dizzying complexity into an international system that already had more than its fair share."

European countries also used the OECD forum to secure domestic political objectives. Perceiving themselves as victims of profit shifting by U.S. multinationals and victims of tax poaching by low-tax European states, the high-tax countries of Europe, especially France and Germany, have long pushed for action within Europe. But an EU proposal to tax the digital behemoths failed when low-tax Ireland, among others, voted against it. Likewise, legislative proposals to harmonize corporate taxes within the EU have failed to win consensus. Because every EU member state has a tax veto, the barriers to tax legislation in the EU are especially high. France and Germany hoped that bringing the digital-tax and tax-coordination issues to the larger forum of the OECD's so-called Inclusive Framework of 141 countries would help pressure the smaller EU holdouts.

This strategy worked, at least in part. All of the EU member states signed on to the OECD deal, which presumably means that they will now agree to the EU implementing legislation. Ireland in particular faced pressure from the United States, with Treasury Secretary Janet Yellen visiting the country in the days before the deal was announced. But the need to gain acquiescence by the EU holdouts gave those countries an outsize voice in the negotiations. Ireland agreed to the minimum tax only on the condition that the rate would be no higher

than 15 percent, and on the eve of the deal's announcement, Hungary and Estonia—countries with the lowest tax rates in the EU—negotiated a long extension of a carve-out from the deal. It remains to be seen whether these last minute concessions made to low-tax EU countries translate to yes votes in the EU Council.

WHAT'S IN IT FOR DEVELOPING COUNTRIES?

ENDORSING COOPERATION

Overall, although the deal is narrow in scope, it signals a profound shift in international tax. Over the last decade, international tax diplomacy has become more multilateral and more inclusive. Perhaps ironically, the OECD, an organization long criticized for its exclusivity and rich-country bias, has managed to position itself as a forum serving not just its 38 official members but the 141 members of the Inclusive Framework. The dramatic expansion of the ambit of the OECD—in terms of the types of issues negotiated and, effectively, in membership—as well as its selection as a forum for the current negotiation over, for example, the more inclusive United Nations—reflects not only the opportunism and savvy of the OECD's leadership but the sense among countries that results were urgently needed. Countries' recent experience with large-scale tax cooperation may even embolden the OECD to take on more. Indeed, the next big project is shaping up to be carbon taxation.

The recent negotiations also confirmed a new paradigm in which the United States has less influence over international tax. States have proved themselves willing to depart from international consensus—and arguably to breach their tax treaties with the United States—to enact unilateral rules when the old way of doing things becomes obsolete. Digital taxes are

just one example, and they brought an otherwise reluctant United States to the bargaining table.

Still, working within this new paradigm, U.S. negotiators managed to secure a reallocation deal that is significantly better than what it faced under unilateral digital taxes, as well as an agreement on minimum taxation, a Biden administration priority. More generally, the global tax deal reflects the view that tax cooperation is worthwhile. Only four of the Inclusive Framework countries involved in the negotiations did not sign on: Kenya, Nigeria, Pakistan, and Sri Lanka. To secure the deal, all countries made compromises. For example, to prevent a tit-for-tat trade war on digital tax, countries promised the United States that they would refund digital taxes once the new allocation rule was in place. In turn, the United States agreed to forestall retaliatory tariffs. Likewise, to ensure the collection of a minimum amount of tax, the countries relinquished control—to some extent—over tax rates. In each case, countries can be understood to have ceded national tax sovereignty in an international forum in order to achieve domestic objectives.

Embodying the paradox that to preserve tax sovereignty states must relinquish it, the tax deal represents the hope that by modernizing the international tax system and coordinating corporate rates to dampen tax competition, states can raise the revenue they need for domestic priorities. But international agreements, however well intended, do not by themselves translate to domestic approval or effective implementation. Domestic politics will no doubt change the deal in ways that cannot yet be seen. Countries may find that rather than allowing them to escape the vicissitudes of domestic politics, international cooperation intensifies them.