Minimum Taxation in the United States in the Context of GloBE

Reuven S. Avi-Yonah  
*University of Michigan Law School*, aviyonah@umich.edu

Mohanad Salaimi  
*University of Michigan Law School*

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The introduction of the minimum tax in Pillar II of the Organization for Economic Cooperation and Development (OECD)/G20/Inclusive Forum (IF) framework was generally seen as a response to the US Tax Cuts and Jobs Act (TCJA) of 2017. The TCJA included both a minimum tax on outbound income (the Global Intangible Low-Taxed Income, or ‘GILTI’) and a minimum tax on inbound income (the Base Erosion Anti-Avoidance Tax, or ‘BEAT’). These were seen as the precursors to the Income Inclusion Rule (IIR) and the Under Tax Payments Rule (UTPR). Thus, unlike Pillar I which was perceived as a device to impose more tax on the US digital giants, Pillar II was seen as more consistent with US tax policy.

This story is true to some extent, but the relationship between the US and Pillar II is more complicated. Pillar II was the culmination of years of efforts to implement the single tax principle (STP), which has its origins in the 1920s but was not the guiding principle of US tax policy for a long period before the TCJA. Moreover, the TCJA does not fully implement Pillar II, and it is unclear whether the US can in fact do so.

In what follows, we will first discuss the relationship between the TCJA and Pillar II, then the possible US responses to Pillar II, and finally what would happen if the US does not implement Pillar II. We will also discuss

**Notes**

1 Irwin I. Cohn Professor of Law, University of Michigan. Email: aviyonah@umich.edu.
2 S.J.D. Candidate, University of Michigan Law School.
the interaction between Pillar II and the recently enacted US corporate alternative minimum tax (CAMT).

The major conclusions of this article are the following:

1. Pillar II is based on the STP, namely that the goal of international taxation should be to prevent both double taxation and double non-taxation;

2. In general, if Pillar II is not implemented in the US, the tax consequences are likely to be increased double taxation as well as a shift in revenues from the US to foreign jurisdictions.

3. Even if the US fails to adopt Pillar II, this does not or should not mean a failure for Pillar II’s prospects: the rest of the world (or those jurisdictions interested in adopting Pillar II) need not wait on or rely on US-Pillar-II-compliance to proceed with meaningful int’l tax reform; to the contrary, some of the pressures that may result from the EU and other major blocks/jurisdictions moving forward with Pillar II may ultimately induce the US to better align itself with Pillar II in the future.

2 THE TCJA AND THE ORIGINS OF PILLAR II

When Pillar II was unveiled, it was generally seen as an attempt to implement on a global basis the two main structural features of the TCJA, GILTI and BEAT, and as therefore reflecting to some extent US interests and influence. But the story is more complicated than that.

The roots of Pillar II go all the way back to the origins of the international tax regime. Pillar II is an implementation of the STP,

which can be found already in the US foreign tax credit (1918)

and the first League of Nations model treaty (1927). In the period between 1961 and 1981, the US took the lead in implementing the STP through its adoption of both Controlled Foreign Corporation (CFC) rules (1961) and treaty rules designed to prevent double non-taxation.

However, in the period between 1981 and the TCJA, the US stopped implementing the STP. It eliminated withholding on interest regardless of whether the interest was taxed at residence or elsewhere (1984) and adopted the check the box rule (1997) which enabled US multinationals to avoid the CFC rules. Thus, it is hard to see Pillar II as consistent with pre-TCJA US tax policy.

The TCJA was driven primarily by domestic concerns, not international consensus. The driving force behind TCJA was the fact that by 2017 US multinationals had accumulated USD 3 trillion in low tax foreign jurisdictions because check the box enabled them to avoid the CFC rules. However, they were unable to bring these profits home to the US without paying a heavy tax at 35%. The Multinational Enterprises (MNEs) therefore lobbied Congress to allow them to bring the profits home free by adopting ‘territoriality’ (i.e., a participation exemption), citing recent similar moves by Japan and the UK. This was not an instance of US leadership in international tax, but rather an explicit attempt to align the US with other countries.

This lobbying campaign was opposed by other large US corporations that earned primarily domestic source income (e.g., Walmart) and were more interested in cutting the corporate tax rate, and by non-corporate interests that were primarily interested in cutting the rate applied to them. In the end, the solution was to give everyone what they wanted: The multinationals got their participation exemption, the corporate rate was cut from 35% to 21%, and a special rate of 29.6% was applied to income from pass-through businesses.

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3 The STP is the idea that the goal of international taxation is to prevent both double taxation and double non-taxation. The IIR reflects the ability of residence countries to implement the STP by taxing their multinationals on a residence basis. Since 97% of large multinationals are resident in G20 countries, this is expected to be highly effective. The UTPR is designed to enable residual source taxation when residence taxation is ineffective. The same idea is the one the first author developed in 1997: ‘When the primary jurisdiction refrains from taxation, however, residual taxation by other (residence or source) jurisdictions is possible, and may be necessary to prevent undertaxation’. See Reuven Avi-Yonah, International Taxation of Electronic Commerce, 72 Tax L. Rev. 507 (1997).

4 See Revenue Act of 1918, Ch. 18, §§ 222(a)(8), 230(d), 240(c), 40 Stat., at 1037, 1073, 1080–1082 (1919).


7 Different treaty provisions provided that the US withholding taxes will not be reduced unless the income was subject to tax in the residence jurisdiction (which is the origin of the STTR in Pillar II). This provision was included in the first US model tax treaty of 1981, and in 1984 the US terminated its treaties with tax havens such as the Netherlands Antilles because they led to double non taxation in violation of the STP.

8 See Amendments to I.R.C. §§871(b) (Pub. L. No. 98-369, §127b(a)(2) and 881(c) (Pub. L. No. 98-369, §127b(b)(3)).


10 Things began to change, however, with the financial crisis of 2008–9. The first important development was the enactment in the US of the Foreign Account Tax Compliance Act of 2010 (FATCA). FATCA was designed to stop the practice of US residents pretending to be foreigners and thereby benefiting from the portfolio interest exemption and other tax breaks for foreign portfolio investments such as the exemption of capital gains. This implements the STP by preventing double non-taxation of portfolio income earned by individuals.

11 For instance, before the TCJA, if a CFC was located in Bermuda where there is a 0% corporate tax rate, every dollar of dividend to the US parent company wou...for 10% owned foreign corporation.

12 The TCJA also introduced additional benefits. These include, e.g., a reduced tax rate imposed on intangible income earned by a domestic corporation when such income is attributable to a foreign market (FDID) (I.R.C. §250).

13 I.R.C. §1599A.
This, however, meant that additional revenues needed to be found, because the legislative process required that the overall revenue loss from the package be limited to USD 1.5 trillion. It was this need for revenue rather than tax policy considerations that led to the enactment of the three international tax reforms included in the TCJA. First, a one-time tax at between 8% and 15% was imposed on the past accumulated profits of the US multinationals (i.e., the USD 3 trillion). Second, GILTI imposed a reduced tax of 10.5% of the global future profits of multinationals that exceed a 10% return on tangible assets. And finally, the BEAT was introduced as a 10% minimum tax on inbound investment on a base that effectively disallows deductions of interest, royalties and other items (but not cost of goods sold) paid to related foreign parties.

Thus, the TCJA was driven primarily by US interests and political concerns, and less by tax policy considerations. Pillar II, on the other hand, was primarily advocated by the Europeans (especially Germany) as an effective way to apply the STP. The STP was already the guiding principle behind many of the actions in the Base Erosion and Profit Shifting (BEPS) Action Plan on Base Erosion and Profit Shifting (BEPS 1.0 (2013–15)) while failing to address the Digital Services Taxes (DSTs) (action 1), it did address hybrids (action 2) which was explicitly designed to prevent double non-taxation through the use of hybrids, in addition to most of the innovations in the MLI. Also, BEPS 1.0 recommended expanding CFC rules (action 3). So, it is hard to see Pillar II as a response to the TCJA.

Moreover, neither GILTI nor BEAT are compatible with Pillar II. The GILTI rate of 10.5% is below the Pillar II minimum rate of 15%, and GILTI is applied on a worldwide basis, not country by country as required by Pillar II. BEAT is very different from the UTPR, because unlike the UTPR it applies regardless of the effective rate in the recipient country. For example, BEAT applies to reinsurance premiums paid by a US affiliate to a German insurance company (with no offset for losses) despite the high German corporate tax rate. Moreover, because BEAT does not allow for foreign tax credits, it can lead to double taxation, which is also inconsistent with the STP as embodied in Pillar II.

3 TWO ALTERNATIVES FOR THE US

The Biden Administration, unlike its predecessor, fully participated in the negotiations leading to the agreement to implement both Pillars in October 2021. Now that Pillar II is about to be implemented, what is the likely US response?

Until recently, there was a big difference in the likely US response to Pillars I and II. Pillar I is highly controversial in the US despite the adjustments made in response to US pressure, such as extending it to all large multinationals and not just the US digital giants. The main problem with Pillar I in the US is that it clearly requires a multilateral treaty to amend Articles 5, 7 and 9 of all the existing treaties, and that is going to be very difficult to pass in the US since treaties require a two thirds majority in the Senate. Even as an executive agreement such a compact would be difficult to enact, especially since it will be delayed until 2023 and the Republicans are likely to control at least one part of Congress by then.

Pillar II, on the other hand, seemed easy because it only required legislation and the Democrats had a bare majority in both houses. And indeed, in the 2021 budget and subsequent legislation (the Build Back Better Act, or ‘BBB’ the Biden administration and Congressional Democrats proposed to align US tax law with Pillar II by (1) raising the GILTI rate to 15%, (2) applying GILTI on a country by country basis, and (3) modifying BEAT to make it compatible with the UTPR by, among other things, providing exception for payments subject to a sufficient level of tax.

Unfortunately, however, BBB failed to pass. This had nothing to do with its tax provisions, which were agreed upon and were not controversial. But no agreement could be reached on the spending side of BBB, and as a result the legislation which passed the House could not make it through the Senate. However, the Senate as well as the House of Representatives did pass and president Biden signed into law the Inflation Reduction Act of 2022, which includes the CAMT. The CAMT is a 15% minimum tax that applies to the largest US multinationals (with average income of over $1 billion per year) if their regular liability falls below 15%. The CAMT is based on book income as reflected in financial statements (with some adjustments) and applies to the entire multinational,
including its controlled foreign corporations. The CAMT does not apply on a country-by-country basis.

There are now two alternatives for the US. The recently released 2023 budget22 assumes that BBB as passed by the House can be enacted, but it also includes other features that are designed to make US tax law Pillar II compatible. First, it raises the corporate rate to 28%, which automatically means that the GILTI rate is raised to 21% (although it is still applied globally, not country by country). Second, it explicitly adopts the UTPR as implemented in the model Pillar II rules. Third, it adopts a domestic top up tax that is designed to shield US companies (and foreign companies operating in the US) from the UTPRs of other countries while retaining US domestic tax credits as much as possible.

If this legislation could be enacted as proposed, the US would be mostly compliant with Pillar II, and any adverse consequences to US multinationals could be averted. However, it seems unlikely that such legislation could be enacted before 2025. Note, however, that it is possible to argue that the recently enacted CAMT satisfies some elements of Pillar II (discussed further below).

Congress passed and President Biden signed into law in August 2022 the Inflation Reduction Act which includes a corporate alternative minimum tax (CAMT) of 15% based on book income. While the CAMT is not technically an IIR under Pillar 2, the US could argue that it is a CFC regime since it includes the income of CFCs of US multinationals. The US could also argue that the domestic portion of the CAMT is a QMDTT. Whether this type of argument is accepted by other relevant parties like the EU or OECD/If remains to be seen.21

If no other additional tax legislation is enacted, GILTI would not be treated as a qualified IIR under the Model Rules, thus the US will not be compliant with Pillar II. Since the US will not have implemented a compliant IIR, the next step under the Model Rules is to check if the IIR applies in the jurisdictions of the holding companies in the group. If there are no holding companies in the structure or if the jurisdictions of the holding companies do not implement a compliant IIR, the UTPR will apply to US multinationals doing business in other countries that follow Pillar II. This will entail a significant shift in tax revenues from the US to other countries and potentially a large disincentive for US companies to do business overseas.

The introduction of the Pillar II rules will also curtail the effectiveness of various domestic US tax credits and incentive regimes such as green/renewable energy credits, low-income housing credits, Foreign Derived Intangible Income (FDII) deductions, R&D credits that reduce the US effective corporate tax rate, because they will be offset by the UTPR if the effective tax rate is below the global minimum tax. As a result, foreign governments will enjoy the incentives and tax benefits offered by the US Congress.24

The main question in this more pessimistic scenario is whether the US will allow foreign tax credits for UTPR taxes. The US Treasury Department has recently published regulations which amended the foreign tax credit rules which, among other things, make it more difficult to get a credit for foreign taxes in the absence of what the US considers adequate nexus to a foreign country (the jurisdictional nexus requirement).25 This change was designed to address DSTs, but it is much broader and may apply to UTPRs which might not be classified as an income tax in the US.26 Under the Model Rules, countries have different options on which adjustments to implement in order to collect the amount of the UTPR, including imputing income or denying deductions (that would have otherwise been provided to the parent company). Imputing income to the parent company might raise transfer pricing differences between the jurisdictions. Also, denying the deductions in this case might prevent the parent company from claiming credits with respect to the tax paid in the foreign jurisdiction under the cost recovery rules of the regulations. If there is no foreign tax credit allowed with respect of the income imputed or deductions denied, the application of Pillar II rules could lead to a significant double taxation as the foreign income of a US multinational will be subject to two different global minimum tax regimes at the same time: the GILTI rules and the Pillar II rules (either through the application of the UTPR or the IIR for holding companies).

Despite all of the above, it should be noted that while the current GILTI would not be treated as a qualified IIR, it constitutes a CFC Tax Regime as such term is defined under the Model Rules.27 The classification of GILTI as a

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23 Republicans have already shown reluctance to the implementation of Pillar II. See e.g., Letter from Mike Crapo, James E. Risch & Pat Toomey, United States Senators, to Janet Yellen, Secretary of Treasury (8 Oct. 2021) expressing concern for any domestication path for Pillar I and II, other than through the formal treaty clause procedure; see also Letter from Mike Crapo et al., United States Senators, to Janet Yellen, Secretary of Treasury (16 Feb. 2022), expressing concerns from a large number of Senate republicans for any implementation of Pillar II.
24 In this case, Congress might consider providing incentives in the form of direct payments to taxpayers in the same amount of the relevant credits, thus reducing significant double taxation as the US would implement the CAMT.
26 The Preamble of the foreign tax credit regulations acknowledges that future changes in US law may necessitate rethinking the rules for determining credits and the effectiveness of foreign tax credits. Thus, the regulations might be modified if Pillar I and Pillar II are implemented, to make the UTPR creditable.
27 CFC Tax Regime is defined in the Model Rules as ‘a set of tax rules (other than an IIR) under which a direct or indirect shareholder of a foreign entity (the controlled foreign company or CFC) is subject to current taxation on its share of part or all of the income earned by the CFC, irrespective of whether that income is distributed currently to the shareholder’. Under that concise definition, current GILTI should constitute a CFC regime.
CFC Tax Regime might lead to an outcome in which the US will be able to claim first priority in taxing rights even if GILTI is not reformed. This is because CFC regimes have priority over other countries’ assertions of the IIR or UTPR under the Model Rules. If GILTI is classified as a CFC Tax Regime, the taxes assessed on income includable from CFCs’ earnings under GILTI would be considered a covered tax allocated to the CFC. Presumably, this outcome was not intended by the drafters of the Model Rules. Therefore, further guidance is required on the interaction between the CFC regimes and the Global Anti-Base Erosion (GloBE) rules, in particular addressing the lack of clarity over whether GILTI would be considered a CFC Tax Regime. Another interesting question is whether the US could argue that the CAMT satisfies Pillar II. The foreign element of the CAMT is not an IIR for the same reason GILTI is not an IIR, namely that it is not applied on a country-by-country basis. However, the US could argue that since the CAMT applies to all the CFCs of the largest US multinationals, it should be treated as a CFC regime, and since its rate is 15%, the UTPR should not apply to these multinationals. In addition, the US could argue that the domestic portion of the CAMT is a QMDTT. If the US is successful in persuading the OECD/G20/IF that these arguments are correct, some of the dire consequences of Pillar II for US multinationals subject to the CAMT could be averted. Whether this is plausible remains to be seen, but if the US is seen as compliant with Pillar II, this could help persuade other countries to implement Pillar II as well.

4 Can Pillar II be implemented without the US?

Some observers have argued that a failure by the US to implement Pillar II (as envisaged in the pessimistic scenario above) could lead to a collapse of the whole enterprise. It seems to us that this fear is exaggerated. First, while the non-implementation of Pillar II in the US might slow down the process, it does not prevent other countries from moving forward with its implementation. The European Commission, for example, published its legislative proposal for an EU Directive to incorporate the Model Rules just a few days after the OECD released the Model Rules. The EU Directive closely follows the Model Rules and aims to implement the IIR and UTPR consistently across the twenty-seven Member States. In addition to the EU, various countries indicated that they would proceed with implementing Pillar II, such as the UK which opened a public consultation on the implementation of Pillar II following the release of the Model Rules.

Moreover, while the whole structure of Pillar II is designed to give priority to the IIR, it also assumes that if for whatever reason a residence country does not apply the IIR, then the UTPR would apply to ensure the minimum tax level is reached.

If the US does not reform GILTI (especially by raising the rate) so that it is not compliant with the IIR, then other countries would apply the UTPR to US companies. If that is the case, there will be a lot of pressure on any US administration to allow foreign tax credits for the resulting UTPR taxes. There will also be pressure to reform GILTI to make it compliant with the IIR and to mitigate the administrative burden associated with compliance with Pillar II. It will also be harder for Republicans to argue that there is a competitive disadvantage for US multinationals when there is a global minimum rate imposed on all companies. We would think that in these circumstances even the Republicans might go along and agree to modifying US tax rules to make them compliant with Pillar II. This would be similar to the US in 2004 responding to a negative outcome in the World Trade Organization (WTO) dispute between the US and the EU by passing legislation that was very favourable to the interests of US multinationals, but also WTO compatible.

5 Conclusion

This note tries to clarify the relationship between US tax law and Pillar II. It argues that Pillar II was not primarily a response to the TCJA, and that while the likelihood of the US enacting legislation this year to make it Pillar II compliant is low, such an outcome need not derail Pillar II.

In general, the US does not lead in international tax matters the way it used to before 1980 (and even as recently as 2010, when the Foreign Account Tax Compliance Act (FATCA) led to the Common Reporting Standards (CRS)). But this is not necessarily a bad outcome. The test for the OECD/G20/IF now will be to show that it can proceed with meaningful international tax reform without the US. This is particularly true given the ambitious timeline that was set out in the October 2021 IF statement for countries to implement Pillar II.

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29 For example, in this scenario some countries might decide to focus on promoting Pillar I given the uncertainty surrounding the GloBE rules and how they will coexist with the current GILTI regime.
32 According to the Oct. 2021 Inclusive Framework statement, IIR is targeted to come into effect in 2023 and the UTPR is targeted to come into effect in 2024.