For a Better GLOBE: A Minimum Effective Tax Rate For Multinationals

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In this article, the authors suggest a more equitable, far less complex, and more practical variant on the proposal for a global anti-base-erosion tax, which could be introduced by a coalition of willing states.

International efforts to reform taxation of multinational enterprises have reached a critical turning point. The proposals to stem profit shifting provide elements for a way forward, but the overall package is complex and could only be implemented through a universally adopted multilateral tax convention. This is highly improbable. We propose a variation of the key proposal for a global anti-base-erosion (GLOBE) tax that is more equitable and far less complex, and could be introduced by a coalition of willing states.

Launched after the great financial crash a decade ago and the explosion in profit shifting that took place from the 1990s onward,[1] this initiative is now even more urgent as the world economy is plunged into a crisis sparked by the COVID-19 pandemic. The introduction of MNE country-by-country reporting has given tax authorities unprecedented insights into profit shifting as it affects their tax bases, and the publication of limited, aggregate data has shown that the global scale of the problem exceeds $1 trillion in annual tax losses.[2] But attempts to reform international rules designed a century ago have created a logjam, mainly because of the perceived need to achieve an illusory worldwide consensus.

I. Pillar 2's Prospects and Flaws

The most promising proposal is for a global minimum corporate tax under pillar 2, part of the OECD's approach to updating global tax systems for the digital economy. The technical blueprint[3] published by the OECD secretariat in October 2020 provides key building blocks. However, its

[1] Alex Cobham and Petr Janský, "Measuring Misalignment: The Location of US Multinationals' Economic Activity Versus the Location of Their Profits," 37(1) *Dev. Pol'y Rev.* 91 (2019).

[2] For analysis, see Tax Justice Network, "Watershed Data Indicates More Than a Trillion Dollars of Corporate Profit Smuggled Into Tax Havens" (July 8, 2020).

[3] OECD, "Tax Challenges Arising From Digitalisation — Report on Pillar Two Blueprint" (Oct. 14, 2020).

overall design is excessively complex, and fails to provide a simple method that could be accepted as fair and effective by all states. The blueprint rightly starts from the reality that MNE corporate groups operate as unitary, centrally directed organizations, enabling them to avoid tax by attributing excessive profits to jurisdictions in which they are subject to low or no taxation. However, it proposes separate measures for home (residence) and host (source) countries to apply top-up taxes, with a complex system of rules to manage the interaction of these rights.

It is a major flaw that the home country measure applies first, and that the host country measure will only be applicable if the home country chooses to not apply taxation. This grant of superior rights to MNEs' home countries particularly disadvantages low-income countries, which are generally only hosts to MNEs. To remedy this, the blueprint proposes a third rule allowing host-country taxation; but this would require these tax havens to accept disadvantageous revisions to their tax treaties. It would give them an effective veto over these treaty revisions, so that this third rule has little chance of success.

The GLOBE must be reformulated so that it can be both effective and widely accepted. It should enable states to tax MNEs on both inbound and outbound investment to place them on a more equal footing with domestic firms. Such a tax could command support from a strong coalition of both richer and poorer countries. We propose a revision of the GLOBE that builds on its components. We call it a minimum effective tax rate (METR) for multinationals.

II. The METR

The METR looks to ensure that all MNEs pay a level of tax commensurate with their activities in each country by targeting misallocated profits that are undertaxed. Like the GLOBE, the METR's starting point is the constituent entity-level financial information used in preparing an MNE's global consolidated accounts. The METR follows the GLOBE's procedure for calculating the effective tax rate (ETR) by jurisdiction. It diverges from the GLOBE, however, in allocating the rights to tax undertaxed profits by applying a substance-based allocation rule, thereby resolving the contentious priority issue.

The METR calculates an MNE's share of noneffectively taxed profits (NETs) and allocates them among all countries in which the MNE has a taxable presence. This allows each country to apply taxation under its own rules and rates. To compute NETs, an MNE's profits reported in any country with an ETR below the set minimum are multiplied by:

(i) the difference between the minimum ETR and the actual ETR, divided by

(ii) the minimum ETR.

This method identifies on a jurisdictional basis the portion of profits that have not been economically taxed after determining the portion of profits that have been taxed at the set minimum rate. The MNE-wide aggregate of these country NETs (MNE NETs) is allocated across all countries in which the MNE has a taxable presence by applying factors reflecting its real activities in each country (see table). The allocation uses a substance test, similar to the substance-based carveout proposed in the GLOBE blueprint, as the rule for allocating taxing rights over the MNE NETs. A throwback rule applies to any factor in a country in which an MNE maintains no taxable presence.

Applying a single substance rule for the allocation of MNE NETs would greatly simplify the tax. It removes the need for the complex rules on linking and priority, and the associated procedures for monitoring implementation of the interlocking rules proposed in the current GLOBE blueprint. Instead of a series of interlocking rules, rights to tax MNE NETs are allocated by a single combined rule that integrates the income inclusion rule (IIR) and the undertaxed payments rule (UTPR) of the GLOBE into a formulaic apportionment rule (FAR).

IIR and UTPR are main elements of the GLOBE and premised on participating states applying a top-up tax to profits that are not effectively taxed in another jurisdiction. The IIR does this by requiring a parent to pay top-up tax on its share of the profits of its foreign subsidiaries or branches, while the UTPR adjusts accounts relating to intragroup transactions or makes other adjustments to achieve the same objective. Under

Application of the Substance Rule

	RUP	FOM	OTB	CSB	FMM	Totals
Declared taxable profit	100	300	500	4	96	1,000
Applicable tax rate	20	12.5	0	25	30	
Cash tax paid (covered taxes)	20	37.5	0	1	29	87
ETR by jurisdiction	20	12.5	0	25	30	
Minimum ETR	25	25	25	25	25	
Undertaxed profits	100	300	500	0	0	900
Profits that have not been effectively taxed (for allocation)	20	150	500	0	0	670
Allocation percentage based on objective location-specific factors (FAR)	37	30	5	5	23	100
Allocated NETs	248	201	33.5	33.5	154	670
Top-up tax payable (at country's standard rate)	49.6	25.1	0	8.4	46.2	129.3

RUP = residence of ultimate parent

FOM = foreign operations + some marketing

OTB = offshore tax base

CSB = conduit services base

FMM = foreign mainly marketing

Note: FOM and CSB are countries in which the MNE has some operations, but that allow it to reduce its global ETR by attributing profits to OTB, because of preferential regimes. RUP, FOM, and OTB all apply a tax rate below the minimum ETR, while CSB and FMM's tax rates are equal or higher. For the sake of simplification, this table assumes that each country's nominal tax rate is also its ETR. Countries with an ETR at or above the minimum, as well as losses, have no undertaxed profits.

FAR, the same mechanisms are used, but they can be applied simultaneously by all countries in which the MNE has real activities that create a taxable presence. This ensures that their respective shares of the undertaxed profits are taxed at an appropriate rate.

Because METR integrates the IIR and the UTPR, which the OECD has found could be applied under national tax rules, the METR could also be implemented without the need for treaty changes. Combining the IIR and the UTPR would ensure that the measures are nondiscriminatory and therefore valid under trade and investment treaties, as well as EU rules. The same test of substance would be applied by each country to both its local and foreign-based MNEs, thereby ensuring fairness and nondiscrimination.

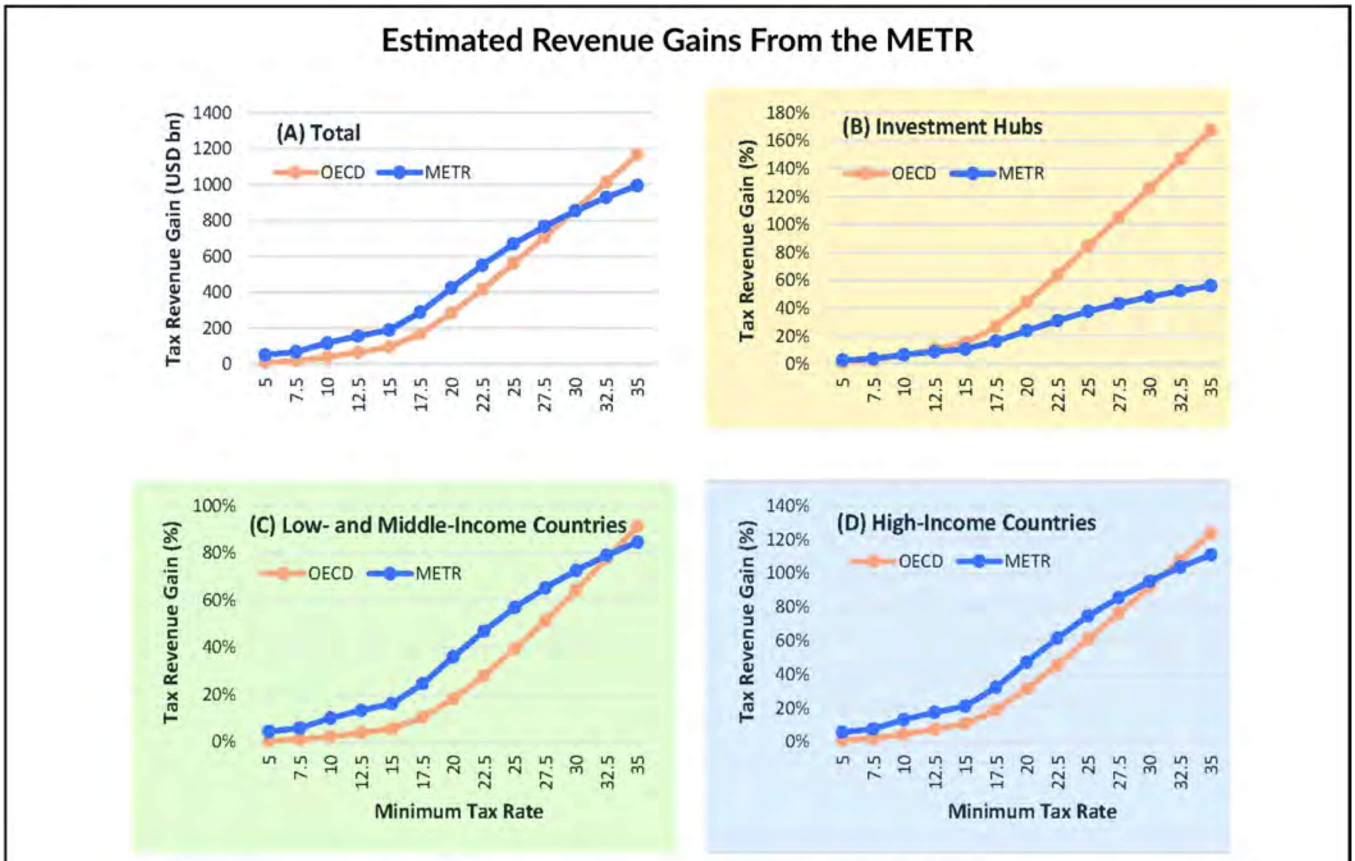
III. Applying the METR

Our proposed FAR would apply a multifactor allocation of profits based on:

- capital (physical assets);
- personnel; and
- sales revenues (by location of customers and users).

Detailed allocation keys and weightings would be needed for common business models and sectors.

This will be the same whether from the perspective of the MNE's host (source) or home (residence) countries. The substance test is similar to the formulaic substance-based carveout proposed in the GLOBE, but with the inclusion of sales revenue, to provide a balance of supply-side and demand-side factors. The need to allocate a proportion of profits to countries in which sales



Note: (A) Total tax revenue gains. Relative tax revenue gain for (B) investment hubs, (C) low- and middle-income countries, and (D) high-income countries. Relative gains are calculated as an increase from current tax revenue. The METR proposal is in blue, and the GLOBE proposal is in orange.

are made has been recognized in the OECD's pillar 1 blueprint,[4] which provides detailed sourcing rules for sales revenue based on the location of customers and users. This allocation of taxing rights based on their real activities in each country would place MNEs on a more equal footing with purely national businesses, which have all their activities, and hence their costs and revenue, in the same jurisdiction.

The METR approach is designed to halt the general decline in corporate tax rates and encourage convergence toward an optimum rate. The GLOBE is based on the U.S. global intangible low-taxed income regime of 2017, which set the minimum at 10.5 percent, due to rise to 13.125 percent in 2026. Recognizing that this is too low, the Biden administration is committed to increasing it to 21 percent. In our view, the minimum ETR should be set at approximately the weighted global average nominal corporate rate, which is 25 percent.[5]

Under the METR, the rights to apply a top-up tax would be allocated to all countries in which the MNE has a taxable presence, regardless of their tax rates, in proportion to the MNE's real activities in the country. Each country would be free to maintain its own corporate tax rate, even if this is below the minimum, and apply any top-up tax accordingly. This would remove the incentive for MNEs to design structures to enable attribution of high levels of profit to countries in which they are taxed at lower rates. The tax rate

[4] OECD, "Tax Challenges Arising From Digitalisation — Report on Pillar 1 Blueprint," at ch. 4 (Oct. 14, 2020).

[5] Elke Asen, "Corporate Tax Rates Around the World, 2020," Tax Foundation (Dec. 9, 2020).

would still be taken into account by MNEs in deciding where to locate investments, but because these would need to involve real activities, the predominant consideration would be suitability of the location (infrastructure, skilled workforce, and so forth). Including sales in the formula would discourage the choice of countries that offer only a platform for exports.

The METR would not on its own provide a complete solution. There is clearly an urgent need for the adoption of a wider definition of taxable presence, to ensure that all countries in which an MNE has a significant economic presence can tax their fair share of its profits. We believe adopting the METR would provide an impetus for countries finally to come together to agree on the principles and details of a fairer system for allocation of MNE profits based on formulary apportionment as a long-term solution. Our analysis also strongly suggests that the widespread, unilateral adoption of the METR approach would itself provide a sustainable solution with greatly preferable characteristics to either the status quo or the pillar 2 blueprint.

IV. Modeling the METR

To ensure that our findings are as closely comparable as possible, our modeling is based on the OECD's economic impact assessment of the blueprint.[6] The OECD has used a sophisticated method to create a database on four matrices — profit, turnover, tangible assets, and payroll — by a combination of, and extrapolation from, data from these four sources. There remain significant limitations in the data because of the way that data have been aggregated into country groups before publication. We have nevertheless used the same data for comparability, with the strong caveat that the modeling can only provide broad estimates that are necessarily inexact but still provide adequate comparisons of alternatives.

In comparison with GLOBE, the METR is estimated to generate higher overall revenue gains at all levels of minimum tax rate up to 30 percent, ranging from $50 billion to $140 billion in additional revenue gains (see Box A of the figure). This is because the METR allows each country to which undertaxed profits are allocated to apply its own tax rate, while the GLOBE allocates a top-up tax to bring the rate on undertaxed profits up to only the set minimum ETR.

Even more significant are the distributional differences. Despite the distortions from the aggregation of the OECD data at the level of country groups, the METR provides investment hubs with smaller increases in revenues than other countries (see Box B of the figure). Importantly, the additional revenue gains are relatively higher for low- and middle-income countries (see Box C of the figure) than for high-income countries (see Box D of the figure), and would bring them more absolute revenue gains than GLOBE. The more equitable reallocation of taxing rights in the METR proposal is especially relevant if profit shifting is not eliminated by the minimum tax rate — that is, if the minimum tax rate is too low.

V. Conclusions

The revision of the GLOBE design proposed by the METR would offer key advantages that could unblock remaining obstacles to progress on international corporate tax reform. It would:

- resolve the key problem with the GLOBE by eliminating the need for priority rules;
- greatly simplify the proposal, making it easier to apply;
- be capable of rapid implementation by all willing countries, using a common method, without any tax treaty changes;
- allow states to apply their own tax rules and rates, without discrimination between national companies and MNEs, or between inbound and outbound investment;
- result in greater as well as more fairly distributed revenue gains than the GLOBE; and
- point the way forward to more effective comprehensive reforms.

This would still not be a complete solution. Changes would be needed to tax treaties to ensure a taxable nexus for significant economic presence and to allow a switchover rule. However, progress on ensuring a minimum effective tax rate should not depend on securing signature and ratification by all states of a multilateral treaty, as

[6] OECD, "Tax Challenges Arising From Digitalisation — Economic Impact Assessment," Annex 5D (Oct. 12, 2020).

is necessary for the pillar 2 proposal. Such a ratification process would in practice give all states a veto on implementation, which would be fatal. The METR provides a practical and pragmatic basis for a feasible consensus of willing states to create a critical mass for progress toward effective reforms. ■