



## Insight

# The Outlook on the G20 Agreement on Pillars One and Two

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## Executive Summary

- Considerable international momentum is gathering behind the adoption of new global taxing rules for large multinational firms.
- At present, 132 of 139 countries participating in negotiating the new rules have signed on to a high-level agreement on major parameters for the new tax rules.
- The new rules would reallocate profits for large international firms for the purposes of taxation and would establish a new global minimum tax.
- Notwithstanding the gathering steam behind the adoption of these policies, considerable policy, process, and political challenges remain.

## Introduction

Over July 9-10, the finance ministers and central bank governors of the G20 met in Venice to address a number of multilateral issues of interest to the 20 most significant economies on the planet. As was expected, these cabinet-level officials endorsed a framework that would substantially alter the international tax landscape. Representatives from all 20 nations joined in the official communique issued at the conclusion of the meeting, which stated that the group had “achieved historic agreement” on the key elements of ongoing international tax negotiations. Specifically, the body endorsed policies grouped under two policy initiatives: Pillar One and Pillar Two. Pillar One is a policy regime that would reallocate taxing rights over certain portions of major multinational firms’ global profits. Pillar Two is a policy initiative that would establish a global minimum corporate tax. The current international tax reform efforts have been substantially underway since 2019 and have seen increased momentum since the Biden Administration assumed office. Notwithstanding the support of the G20, agreement and full implementation of any international agreement will require substantive refinement, consensus, and congressional support over the next year and more.

## The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project

In 2015, the OECD (Organisation for Economic Co-operation and Development), a supranational forum for the world's 38 major developed economies, released its Action Plan on Base Erosion and Profit Shifting (BEPS), a [15-point plan](#) for identifying and addressing concerns among member nations over tax avoidance by major multinational firms. Action item 1 of the BEPS project was to address tax challenges posed by the digitalization of the economy. In 2018 and 2019, renewed effort and attention was devoted to this concern, and in May of 2019 the G20 and other nations agreed to a [work plan](#) to develop policies responsive to these concerns. The work plan divided the policy response into two pillars: Pillar One would address taxing rights, essentially to what extent firms can be taxed when they do not have a physical presence in a tax jurisdiction; and Pillar Two

would establish a global minimum corporate tax. These policy pillars were further developed over the next year. The key parameters and concepts that would inform these policies were developed and articulated in blueprints for [Pillar One](#) and [Pillar Two](#), which were released in October of 2020. While the blueprints do not represent a consensus product, they were endorsed as the foundation for finalized multilateral policy initiatives.

The broadest forum for negotiating and refining these policy initiatives is known as the [inclusive framework](#) and includes 139 nations that have been convened under the aegis of the OECD and the G20. Critical recent advances in this effort have necessarily been among the world's most developed economies. Since the Biden Administration took office, U.S. participation in this process has been more accommodating. Indeed, the United States joined the 6 other nations of the G7 in [endorsing](#) in broad terms Pillars One and Two in early June. The G20 communique and agreement of [132 of the 139](#) members of the inclusive framework reflect broader agreement among a more diverse set of economies – perhaps most conspicuously China – and underscore gathering momentum for broader agreement. The absence, however, of three EU members – Ireland, Estonia, and Hungary – and four African nations including Nigeria, a larger economy than the three EU holdouts, underscores the reality that there is a long road to full implementation of the policies.

### **High-Level Consensus on Pillars One and Two**

The fine points for Pillars One and Two have not been fully developed and agreed upon. Rather, at present there is high-level agreement among 132 nations on major parameters for Pillars One and Two, which is articulated in a [5-page memo](#). These are very distinct policy regimes that will have very different tax consequences for multinationals and tax jurisdictions but are nevertheless traveling together through the OECD/G20/Inclusive Framework process. To the extent the process ends in agreement by the key participants – potentially when the heads of state of the G20 meet in October – they will require different paths to implementation.

#### *Pillar One*

The G20 statement signaled agreement on the broad architecture of the Pillars. Pillar One would establish a novel mechanism for reapportioning a share of profits (known as “Amount A”) earned by multinational firms with revenue above 20 billion euros and with profit margins above 10 percent. Under Pillar One, 20 to 30 percent (the exact amount remains unspecified) of residual profits, which are defined as profits in excess of 10 percent of a firm's revenue, could be reapportioned to and taxed in jurisdictions even if the firm has no physical presence in that jurisdiction. This new regime departs from prevailing norms in international taxation, which typically precludes taxing foreign firms without a [permanent presence](#) or “nexus” in a given tax authority's jurisdiction. The rules that would source revenue to these market jurisdictions have not been fully specified. Financial services and extractive firms (oil, gas, mining, etc.) are exempted from Pillar One under this agreement.

While clearly designed to capture profitable technology companies, in substance it really just captures multinationals that “look” like profitable technology companies. Indeed, Amazon, among the most conspicuous global technology companies, is not, it turns out, wildly profitable. Its [6.3 percent profit margin](#) would not, all else equal, place it within the scope of Pillar One. The recent agreement, however, allows for segmentation, whereby Pillar One could apply to specific divisions of firms – such as Amazon's Web Services. Further, the agreement contemplates reducing the revenue threshold for the application of Pillar One to 10 billion euros after it has been in place for at least 7 years.

Observers could be forgiven for concluding that Pillar One appears to be an attempt to seize a share of the U.S.

corporate tax base. It is important to recognize that unilateral assaults on the U.S. tax base are already underway in the form of [Digital Services Taxes \(DST\)](#), which tax firms with a digital footprint in jurisdictions even without a physical presence. These policies openly defy international tax conventions, double-tax firms, and invite retaliatory tariffs. Under the agreement, the reallocated profits could be credited or exempted to avoid double taxation, an international dispute mechanism would be established, and unilateral taxes such as DSTs are expected to be removed. While Pillar One may be a more orderly approach to an alternative tax and trade landscape characterized by DSTs and tariffs, neither outlook is particularly favorable to U.S. interests.

### *Pillar Two*

The G20 and the Inclusive Framework members agreed to key parameters of a new global minimum tax under Pillar Two. Pillar Two as articulated in the memo, and generally consistent with previous public documents, would establish three new rules, two domestic rules and one treaty-based rule that would establish a minimum tax for firms with revenue in excess of 750 million euros. The domestic rules combined are known as Global anti-Base Erosion (GloBE) rules. The first rule is the Income Inclusion Rule, which would apply additional tax to any foreign income of firm that is taxed at an effective tax rate below the rate ultimately agreed to by the members of the Inclusive Framework. At present, that rate has been agreed to be at least 15 percent. The second component of the GloBE rules is the Undertaxed Payments rule, which would allow jurisdictions to deny deductions or otherwise apply tax up to the minimum rate on low-tax income. This provision is designed to tax income that would otherwise face tax in a foreign jurisdiction at a rate below the agreed-upon minimum, such as deductible interest payments from a subsidiary to a parent in a low-tax country. The third rule is a treaty-based rule that would allow countries to tax certain related-party payments at a rate of between 7.5 and 9 percent.

Much of the attention on Pillar Two relates to the rate – at least 15 percent – that would apply to taxable income under this proposal. Just as if not more critical is the determination of the tax base. The tax base of a country is very much a function of its sovereign taxing power. In the United States for example, investment in plants and equipment is currently fully deductible; it is not in the U.S. tax base as a result, nor is the expense of research and development. These exemptions reflect the deliberate policy choices of a representative democracy. They are also not universal features of other nations' tax bases. In determining the tax base for Pillar Two, the agreement begins with financial reporting and provides for some limited adjustments. Income for financial reporting purposes is substantially different from taxable income, and conflating the two concepts can be [highly misleading](#). The determination of a global corporate tax base will require substantial refinement and clarification between now and October.

Of note, the OECD memo describing the key agreed-upon parameters for Pillar Two includes a substance-based carveout for at least 5 percent (and at least 7.5 percent for the first 5 years) of the value of tangible investment and payroll. This provision is quite similar to the qualified business asset investment (QBAI) threshold in the [U.S. GILTI \(global intangible low-tax income\) regime](#). The effect of this proposal is to exclude the normal returns to overseas tangible investment and labor.

### **Next Steps and U.S. Considerations**

While there is high-level agreement among a substantial majority of the Inclusive Framework membership, there is a long way between high-level agreement and implementation. Pillar One as proposed requires implementation through a multilateral instrument, essentially a global treaty. The agreement states that the instrument will be developed and collect signatories in 2022 for implementation in 2023. Ratification of the terms of the instrument would generally require 67 votes in the U.S. Senate.

For Pillar Two, the agreement calls for enactment in 2022 for implementation in 2023. In contrast to Pillar One, implementation of Pillar Two could be accomplished through the budget reconciliation process, which requires only a simple majority in the U.S. Senate. Indeed, the U.S. GILTI regime, which closely resembles proposed GloBE regime, was enacted through reconciliation, and the Biden Administration’s proposed increases to GILTI and elimination of QBAI are expected to be considered under reconciliation. The interaction between GILTI and Pillar Two is a critical consideration for U.S. policymakers. The agreement states that “consideration will be given to the conditions under which the U.S. GILTI regime will co-exist with the GloBE rules.”

Implementation of Pillars One and Two also faces international challenges. As noted, three EU members have not agreed to the framework. Adoption of taxation measures in the EU typically requires unanimity. The agreement also notes that excluding multinational firms, “in the initial phase of their international activity” from Pillar Two will be “explored.” This note appears to suggest the potential for exempting Chinese firms. An agreement that would see U.S. firms face new taxation abroad but holds China harmless would be difficult to rationalize. Last, there remains significant technical refinement, policy development, and consultation to do before a final agreement could be meaningful.

## **Conclusion**

Successive announcements of agreement among ever-broader groups of nations to new international taxing rules suggests a high likelihood of broader adoption of new taxing rights on portions of the largest global firms, and a new global minimum tax. These new rules reflect the interests of participating members to raise taxes on multinational firms and reduce tax competition. Not every nation shares this interest, however, and it remains uncertain if the high-level agreements of the summer lead to global agreement on the fine print.