Pillar Two: A Step Towards Ending Base Erosion?

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Summary

- The background that gave rise to Pillar Two
- The framework for Pillar Two
- The considerations and recommendations set forth in the Report* with respect to Pillar Two
- The future of Pillar Two and combatting BEPS

* "Report on the OECD Global Anti-Base Erosion Model Rules (Pillar Two)," NYSBATS Rep. No. 1465 (July 21, 2022)

Introduction

The Context for Pillar Two

- With an increasingly globalized and digital economy, the ability to shift profits to low-tax or no-tax jurisdictions has prompted countries to seek a multilateral approach to combatting base erosion and profit shifting ("BEPS").
- In early 2020, a group of 135 nations (including the United States) agreed to move forward with a two-pillar approach to address these issues:
  - ***Pillar One*** was designed to address the allocation of taxing rights (nexus and profit allocation) of digital profits.
  - ***Pillar Two*** was designed to ensure that multinational enterprises ("MNEs") pay a minimum tax on profits.

Goals for Pillar Two

- The idea is that Pillar Two will subject the world's largest corporations to a global minimum tax to ensure that they do not shelter income in low-tax or no-tax jurisdictions, particularly in an era where intangible assets associated with the digital economy can be easily moved to such jurisdictions.
- Unlike Pillar One, which reshapes international norms regarding sourcing rules and would therefore likely require a multilateral instrument to be implemented, the OECD argues that Pillar Two can be adopted on a country-by-country basis without all participating countries signing on at once.

The Path Towards Implementation

- In October 2020, the OECD published a report that detailed the current status of the Pillar Two rules, and then in October 2021, the OECD released a set of comprehensive model rules (the "Model Rules") for what a Pillar Two regime would look like.
- Earlier this year, in March, the OECD published commentary to explain the Model Rules and provide examples.
- Currently, Pillar One is not expected to be implemented until 2024, Pillar Two regimes may be implemented as early as 2023, though the European Union has indicated that it may be 2025 before the full suite of rules is implemented.

The Framework for Pillar Two

Key Principles of Pillar Two

- The basic idea A global minimum tax of 15% applies to every multinational enterprise, or MNE, with revenue of €750 million or more.
- A "Top-up Tax" is imposed on a jurisdiction-by-jurisdiction basis to ensure that the MNE and each member of the MNE, or "Constituent Entity," are paying at least a 15% tax in such jurisdiction. Top-up Taxes imposed under the Model Rules are referred to as Global Anti-Base Erosion Taxes, or "GloBE Taxes."
- Income for Pillar Two purposes ("GloBE Income") is calculated based on the consolidated financial statements of the parent entity.

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Calculating the Top-up Tax

- Mathematically, the Top-up Tax is calculated in three steps:
  1. Net GloBE Income in a jurisdiction is reduced by the "Substance-Based Income Exclusion," or a deemed return on tangible assets and local employment expenditures. This figure, or "Excess Profits," is multiplied by the 15% minimum tax rate.
  2. From this amount is subtracted "Adjusted Covered Taxes," but subject to a haircut equal to the fraction of Net GloBE Income that constitutes Excess Profits.
  3. Finally, from this amount is further subtracted any Qualified Domestic Minimum Top-up Taxes, or "QDMTT."

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The Top-up Tax Expressed as a Formula

- Where T_{TUp} is the Top-up Tax, r_M is the minimum rate (15%), I_G is the Net GloBE Income, S is the Substance-based Income Exclusion, T_{AC} is the sum of adjusted covered taxes, and $QDMTT$ is the qualified domestic minimum top-up tax:

$$T_{TUp} = r_M(I_G - S) - T_{AC}\left(\frac{I_G - S}{I_G}\right) - QDMTT$$

- The orange part reflects the minimum tax to be imposed; the blue part reflects an exclusion for covered taxes (subject to a haircut); the green part reflects a further reduction for domestic top-up taxes.

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Adjusted Covered Taxes

- The Model Rules describe four different categories of Adjusted Covered Taxes, including taxes on income or profits of the CE or on the distributive share of income or profits of an entity in which the CE has an ownership interest, taxes in lieu of a generally applicable corporate tax, and taxes imposed by reference to retained earnings.
- For taxes imposed on shareholders of controlled foreign corporations ("CFCs"), the Model Rules generally pushes down such taxes to the CFC such that the taxes are associated with the income with respect to which they are imposed.

Qualified Domestic Minimum Top-up Tax

- To qualify as a qualified domestic minimum top-up tax, or QDMTT, the tax must meet three requirements:
  1. It must calculate excess profits in a manner equivalent to the Model Rules;
  2. It must operate to increase the tax with respect to the excess profits to the minimum rate; and
  3. It must be implemented and administrated in a manner consistent with the Model Rules.

The IRR Regime

- Once we have a GloBE Tax, the allocation of that tax (i.e., which entity has a responsibility for paying it) is made under two different regimes.
- The first regime is the income inclusion rule, or "IRR," which says that the ultimate parent entity, or "UPE," will include the full amount of the GloBE Taxes of members of the MNE if the UPE has an IRR regime in place. Otherwise, generally the highest-tier entity in an MNE with an IRR regime will have the inclusion.

The UPTR Regime

- For CEs that have GloBE Taxes that are not allocated under an IRR, the GloBE Taxes are allocated to countries that have an undertaxed profits (or payments?) rule, or "UTPR," regime in place.
- The UTPR liability is allocated between jurisdictions by looking at the ratio of employees located in a relevant UTPR jurisdiction and the portion of all tangible asset located in such jurisdiction.
- While the IRR regime is an additional tax, the UTPR regime functions by denying deductions such that the cash tax liability in the UTPR jurisdiction equals the amount that it should be.

The NYSBATS Report on Pillar Two

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Considerations and Recommendations

- The first set of considerations in the Report relate to the interaction between the U.S. tax system and the Model Rules.
- The second set of recommendations in the Report involve implementation of the Model Rules in the United States.
- Finally, the Report offers several observations on the Model Rules—i.e., areas where the further clarification and guidance might be warranted.

Pillar Two and the U.S. Tax System

- A CFC Regime is defined in the Model Rules, and it is defined in such a way as to be mutually exclusive from an IRR Regime.
- How do key parts of the U.S. international tax regime fit into the Pillar Two scope?
  - Section 951A (GILTI)
  - Section 951 (Subpart F)
  - Section 59A (BEAT)
  - Section 55 (Corporate Minimum Tax)

Implementing Pillar Two in the United States

- Ensuring that U.S. entities subject to U.S. tax are not subject to a Top-up Tax in another jurisdiction on account of differences between book income and taxable income calculated under U.S. federal income tax principles.
- Should the United States implement a separate QDMTT or Top-up Tax?
- How does the United States balance fair tax administration with goals of simplicity and predictability?

Further Clarification and Guidance

- The Model Rules are based on a conception of an MNE, but likely requires anti-abuse rules to ensure that groups of companies that would otherwise qualify as an MNE do not fragment themselves to avoid the imposition of minimum taxes.
- The Model Rules treat flow-throughs, disregarded entities, permanent establishments, and corporations all as "constituent entities." However, this leads to several issues that don't mesh well with the treatment of these entities under U.S. law.

The Future of Pillar Two and Combating BEPS

Issues with Implementation

- While it *can* be implemented on a one-off basis, it requires a critical mass of countries willing to implement it.
- There is agreement at the conceptual level regarding Pillar Two, but it is not clear whether the Model Rules reflect a broad consensus.
- Timing remains an issue, particularly as the EU does not have unanimity as yet in moving forward.
- Will the United States participate in implementing Pillar Two?

Potential Issues of Administration

- The paradigmatic MNE is one that has a single publicly traded corporation with constituent entities across different jurisdictions. But this is not always the case. Does Pillar Two still work when the MNE is a state-owned oil company? Does it matter?
- While Pillar Two is designed in such a way as to create incentives for countries to join in, does this still work where nations are in a state of hostility with one another? Will developing nations benefit from Pillar Two, or is it only wealthy nations that would benefit?
- The flip side of Pillar Two's incentive structure is that there's no easy way to "get out" if it turns out to be less than successful. How do you unwind it if it's a failure?

The Road Ahead for BEPS

- Base erosion and profit shifting remains a big problem in the modern world, and the two-pillar framework remains one of the largest coordinated efforts to address the issue in recent history. But what happens if it fails?
- Are there alternatives to multilateral coordination to address base erosion and profit shifting?
- Many countries are experimenting with various new taxing regimes, ranging from excise taxes on base erosion payments (e.g., BEAT), digital services taxes, mark-to-market wealth taxes for individuals, etc. Should this process play out first before implementing a multi-state solution?

Questions?

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