Tax Management International Forum

Pillar Two: A Country by Country Perspective

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Content

Executive Summary

In a comprehensive effort to tackle the taxation challenges arising from the digitalization of the economy and the imbalances this has created in the current international tax system, the OECD/G-20 Inclusive Framework on Base Erosion and Profits Shifting (OECD IF) has agreed on a Two Pillar Approach. While some countries within the OECD IF have already started to address these challenges through unilateral measures (e.g., through the creation of digital taxes), there is a large degree of international consensus for taking a global approach to avoid potential conflicts inherent in an array of uncoordinated independent domestic measures, such as double taxation.

The 2022 International Forum presents an overview of the current situation in some of the main jurisdictions regarding the implementation of Pillar Two and the challenges those countries are facing, particularly in relation to the impact of Pillar Two on their domestic legislations and the changes needed to prevent overlaps between the former and the latter.

Unlike previous editions, the 2022 International Forum will be continuously updated. This will allow the Forum to monitor the latest implementation, policy and technical considerations as they evolve and to explore the potential implications of the Two Pillar approach for the way multinational enterprises will do business going forward.

Australia

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Craig Silverwood (Partner), Mark Konza (Tax Controversy Consultant), Gwen Young (Associate) and Keren Stuk (Associate) of MinterEllison Australia provide insight into the implementation of Pillar Two in Australia and what is expected in the foreseeable future in this regard.

Introduction

Australia has been at the forefront of support for the adoption of the Base Erosion and Profit Shifting (BEPS) Actions for many years. In 2014, Australia was president of the G-20 and championed the introduction of the initial BEPS Action Plans. Arguably, it went even further than those plans required, supplementing measures from the BEPS plans with unilateral measures, including the diverted profits tax (DPT) and the multinational anti-avoidance law (MAAL). Prominent past members of the Australian parliament are now fulfilling key roles at the Organisation for Economic Co-operation and Development (OECD).

In May 2022, the OECD Secretary-General and former Australian Finance Minister, Mathias Cormann, cast doubt on Pillar One's implementation next year, instead anticipating a 2024 start date. Accordingly, the focus has seemingly shifted to the implementation of Pillar Two.

Concurrently, Australia's political landscape changed in late May, with a Labor government being elected for the first time in nine years. The Labor government will not only engage with Mathias Cormann, but also with former Labor member of parliament David Bradbury, who is currently Head of the Tax Policy and Statistics Division of the Centre for Tax Policy and Administration at the OECD. High on the new government's policy agenda is BEPS 2.0, with the government confirming its commitment to swiftly implementing both pillars. While Pillar One will almost certainly be delayed, Pillar Two is likely to be implemented at the earliest opportunity, probably in 2023.

This article considers the potential implications of Pillar Two from an Australian perspective rather than delving into a detailed description of the Pillar Two rules.

Implications for Australian Headquartered Multinational Enterprises

Pillar Two applies to multinational enterprises (MNEs) with an annual turnover of 750 million euros ($790 million) or more (called "Significant Global Entities" under Australian law). Despite Australia's comparatively high nominal corporate tax rate of 30%, Pillar Two has major implications for an estimated 160 Significant Global Entities headquartered in Australia.

Ostensibly, it would appear that most Australian headquartered MNEs would not fall within the remit of Pillar Two's Income Inclusion Rule (IIR) as Australia's corporate tax rate is higher than the 15% minimum rate required by Pillar Two. However, the calculation mechanism for Pillar Two's Global Anti-Base Erosion (GloBE) Income is not based on nominal corporate tax rates. Rather, it refers to a MNE's effective tax rate (ETR), which is an objective measure of taxable profit based on an entity's financial accounts. Accordingly, the cumulative effect of available tax concessions (for instance, the patent box regime) in Australia may reduce a company's ETR below the 15% minimum in some circumstances and therefore trigger Pillar Two.

Recent Australian Tax Office (ATO) corporate tax transparency data on Australia's largest taxpayers for the financial year ended June 30, 2020, disclosed that about 3.4% of Australian entities have an indicative ETR of less than 15%. In relation to Pillar Two, this figure will almost certainly decrease, as not all of those entities meet the 750-million-euro turnover threshold. While this number is proportionally low, the scope of Pillar Two enables a country to apply the IIR to MNEs headquartered in its jurisdiction even where such entities fall short of the annual turnover threshold. The implementation of Pillar Two's IIR will also create an obligation for Australian headquartered MNEs to monitor any potential exposure to the measure, report liabilities to the ATO, and calculate and pay any "top-up tax" for its international subsidiaries whose ETR is below 15%.

Pillar Two is designed to encourage jurisdictions to implement the IIR. In the unlikely event that Australia does not implement the IIR and the ETR of an Australian headquartered MNE is below 15%, international revenue authorities could apply the Undertaxed Payments Rule (UTPR) under Pillar Two to effectively collect the tax on Australian-sourced profit that should have been collected and paid in Australia—the top up tax. The UTPR operates to collect the top-up tax that has not been charged under the IIR to the relevant international subsidiary by denying deductions that the subsidiary might otherwise claim to reduce its taxable income.

The scope of Pillar Two's IIR has parallels with Australia's existing controlled foreign company (CFC) rules; however, the GloBE rules are much broader in application than the CFC rules. The IIR will operate globally in the first instance and as noted, the UTPR provides a safety net to ensure that non-implementing IIR jurisdictions will still be captured. Subject to how the Pillar Two rules are enacted and interact with Australian domestic tax law, this may mean that listed countries under the Australian CFC regime (Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States) transacting with Australia may not be afforded the leniency previously afforded under the CFC rules. Other interactions between Pillar Two and Australian domestic law will need to be carefully considered on implementation.

Rethinking Centralized Supply Chains

Centralized hubs in historically low-tax jurisdictions can still coexist with the implementation of Pillar Two, albeit likely not as we currently know them. On the face of it, under the Pillar Two rules, nothing below an ETR of 15% can be accepted. MNEs may, therefore, need to carefully consider and potentially restructure their supply chains and placement of development, enhancement, maintenance, protection and exploitation (DEMPE) functions to ensure that the DEMPE activities correspond with the location of their experienced employees and where the valuable tangible assets are held.

As the UTPR amount assigned to a jurisdiction is calculated based on the economic substance of operations in the relevant international jurisdictions, an assessment of DEMPE functions will be relevant for the UTPR calculations. Specifically, the UTPR calculation method distributes any additional top-up tax to the applicable jurisdictions in proportion to the costs of employees and the value of the tangible assets present in those jurisdictions.

In the lead up to the implementation of Pillar Two, the authors expect the ATO to maintain a strong focus on the assessment of the DEMPE functions of MNEs. This approach is currently observed in the broader Australian transfer pricing and DPT context when the ATO is assessing economic substance in global value chains.

The authors also anticipate the proliferation of alternative incentive programs being offered by countries not captured by Pillar Two in an effort to remain competitive and continue attracting business. Jurisdictions that have been offering regional headquarters and marketing hubs incentive schemes will be challenged by these changes and may seek to negotiate and offer alternative incentives to entities that have historically sought to establish centralized operations in Asia. Incentives that involve the effective repayment of tax will not be permitted under Pillar Two, but other types of incentives may be considered. In the absence of these alternative incentives being implemented, it is likely that the volume of cross-border dealings between Australia and lower-tax jurisdictions may reduce over time.

International Tax Controversy

The application of the UTPR and the restructuring of global supply chains could foreseeably result in an increase in international tax controversy and disputes between jurisdictions. The lack of any guidance on dispute resolution mechanisms to remedy such international tax controversy between jurisdictions has been a glaring omission to date. The OECD has received substantial commentary regarding safe harbor protections, including the issuance of guidance and rulings, dispute resolution, binding mechanisms through the OECD and the overlay of domestic dispute resolution.

Since the IIR and UTPR measures are not applications of the general division of taxing rights agreed to under tax treaties, for example, under the Business Profits and Permanent Establishment (PE) articles, multilateral instruments (MLIs) will be essential to their operational administration – particularly in light of the length of time it takes to negotiate tax treaties and the absence of tax treaties between many jurisdictions. In Australia, a MLI has previously been utilized to adopt the OECD/G-20 BEPS 1.0 project. The authors would expect any future MLI to provide for dispute resolution mechanisms to address potential disputes between jurisdictions.

Compliance Burden

MNEs will need to consider and swiftly address the significant compliance burden that will ensue following the implementation of Pillar Two. The parent entity of a MNE is responsible for filing GloBE information returns for all jurisdictions in which it has entities or PEs. In practical terms, the GloBE reports will be significantly more detailed than country-by-country (CbC) reporting. While CbC reporting provides an indicative ETR, several adjustments are required to effectively apply GloBE methodologies. For instance, in calculating income, generally accepted accounting principles vary between global and domestic income. Additionally, while the ATO is accommodating of substituted accounting periods, some revenue authorities do not offer this flexibility and financial data may have to be reconciled across different accounting years. Nonetheless, the authors expect CbC reporting to remain in place and GloBE reporting to form an ancillary administrative burden for the parent entity of a MNE.

At a domestic level, the authors anticipate that the ATO will request a relevant entity to state whether its ETR is above the minimum 15% in its income tax return or international dealings schedule. The ATO would otherwise have to wait for the GloBE report to be issued by the competent authority of the headquartered MNE.

Concluding Remarks

In short, there is a long way to go before the technical mechanics required to implement and apply Pillar Two are finalized. The authors anticipate that Australia will fully endorse Pillar Two's enactment into its domestic legislation as soon as is practicable, particularly as the Australian treasury and the ATO are understood to have deployed resources to monitor and implement Pillar Two. Impacted MNEs are strongly encouraged to consider the application of Pillar Two and proactively bolster their internal governance systems to ensure they are adequately resourced and functionally able to manage the additional compliance obligations arising from Pillar Two's operation.

European Union

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Pascal Faes of Antaxius Advocaten CVBA considers the European Commission's proposed Pillar Two Directive. The proposed Directive is designed to provide a common framework for the implementation into the EU member states' domestic laws of the OECD Model Rules, as modified to meet the particular requirements of EU law.

Introduction

Building on the Communication from the Commission to the European Parliament and the Council Business Taxation for the 21st Century presented on May 18, 2021, on December 22, 2021, the Commission launched a proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the EU (the "Proposed Pillar Two Directive").[1]

The objective of the Proposed Pillar Two Directive is to provide a common framework for implementing the Organisation for Economic Cooperation and Development (OECD) Model Rules into EU member states' national laws in a coordinated manner and adjusted for EU law requirements. Specifically, the Proposed Pillar Two Directive is aimed at laying down rules to ensure a minimum level of effective corporate taxation of large multinational groups and large-scale purely domestic groups operating in the single market. The rules are intended to be consistent with the Pillar Two agreement reached by the OECD/G-20 Inclusive Framework (IF) on Base Erosion and Profit Shifting (BEPS) on October 8, 2021, and to follow closely the OECD Model Rules agreed by the IF and published on December 20, 2021.

By way of a reminder, within the context of an extension to the 2015 OECD BEPS project, the IF worked on a solution to address the tax challenges arising from the digitalization of the economy. The discussions focused on two work streams: Pillar One, which proposes a partial re-allocation of taxing rights towards market jurisdictions and Pillar Two, which proposes to introduce minimum effective taxation for large multinational groups. Specifically, Pillar Two consists of two rules intended for introduction in national domestic tax laws, and a treaty-based rule. The two domestic tax rules are the Income Inclusion Rule (IIR) and its backstop, the Undertaxed Payments Rule (UTPR), together known as the Global anti-Base Erosion (GloBE) rules. The Subject to Tax Rule (STTR) is a treaty-based rule that allows source jurisdictions to impose limited source taxation on certain related-party payments that are subject to tax at less than a minimum rate in the

[1] {SWD(2021) 580 final}; COM(2021) 823 final; 2021/0433 (CNS).

jurisdiction of the recipient. The OECD Model Rules contain provisions with respect to the GloBE Model Rules only.[2]

The Commission mirrors that approach in considering that the STTR is naturally suited to being addressed in bilateral tax treaties, implying that the Proposed Pillar Two Directive is merely aimed at implementing the GloBE Model Rules. As indicated, the Proposed Pillar Two Directive has been designed to reflect the global OECD Pillar Two agreement, albeit with some necessary adjustments to ensure conformity with EU law.

The Commission also points out that the implementation of the GloBE Model Rules in the EU could have implications for existing provisions of the Anti-tax Avoidance Directive (ATAD) and specifically for the Controlled Foreign Company (CFC) rules, which could interact with the primary rule of Pillar Two, i.e., the IIR. The Commission has explored how best to accommodate the interaction between the CFC rules of the ATAD and the IIR and concluded that it is not necessary to amend the ATAD in this regard. Moreover, it is consistent with the OECD Model Rules to continue the application of the ATAD CFC rules in parallel with the GloBE Model Rules. In practice, the ATAD CFC rules will apply first and any additional taxes paid by a parent company under a CFC regime in a given fiscal year will be taken into consideration in the GloBE Model Rules by attributing them to the relevant low-taxed entity for purposes of computing its jurisdictional effective tax rate.

[2] The general OECD Pillar Two architecture may be summarized as follows. Pillar Two applies to groups of multinational enterprises (MNEs) and large-scale domestic groups that have a combined annual group turnover of at least 750 million euros, based on consolidated financial statements. This threshold was decided by the IF to ensure consistency with existing international corporate tax policies such as the rules on Country-by-Country Reporting (CbCR). Government entities, international organizations, non-profit organizations, pension funds and investment funds that are Ultimate Parent Entities (UPEs) of an MNE Group are not subject to the GloBE Model Rules. The IIR works by imposing a top-up tax on a parent entity with respect to the low-taxed income of group entities (which are referred to as "constituent entities"). The IIR applies on a top-down basis, which means that it is applied by the entity that is at, or near, the top of the ownership chain in the MNE Group, which is normally the UPE. However, in case where the UPE does not apply the IIR, one or more intermediate parent entities (IPEs) will have to apply the IIR to their low-taxed constituent entities. The IIR is subject to a split-ownership rule for shareholdings below 80%. This means IIR will be applied by a partially-owned parent entity (POPE) to its controlled subsidiaries of a subset of the MNE Group in priority to the UPE when the POPE is more than 20% owned by shareholders outside the MNE group. If there are a number of POPEs in an MNE group, the IIR will be applied by the POPE closest in the chain of ownership to the low-taxed constituent entity. The UTPR acts as a backstop to the IIR and applies in situations where there is no qualifying IIR in the jurisdiction of the UPE or where a low level of taxation arises in the jurisdiction of the UPE. The UTPR works by allocating top-up tax to a jurisdiction to the extent the low-taxed income of a constituent entity is not subject to tax under an IIR. The UTPR allocates top-up tax to jurisdictions based on a two-factor formula – the carrying value of tangible assets in the jurisdiction and the number of employees in the jurisdiction. While the global agreement aspires to having the IIR operational from January 1, 2023, the UTPR is required to be implemented one year later. The GloBE Model Rules operate by imposing the top-up tax on a jurisdictional basis utilizing an Effective Tax Rate (ETR) test. If the ETR of an MNE group's constituent entities computed together as one in a jurisdiction falls below the minimum tax rate of 15%, top-up tax is due with respect to each of the constituent entities in the jurisdiction to bring the ETR of that jurisdiction up to the minimum rate. The ETR for a period is computed by dividing corporate and equivalent taxes attributable to that period for that jurisdiction (known as "adjusted covered taxes") by the adjusted income of the MNE Group for the jurisdiction. The ETR test is both a trigger for the application of the Pillar Two rules and also a measure of how much additional tax is payable by the MNE Group. The GloBE Model Rules also provide for a substance carve-out based on a formula that aims to reduce the impact of Pillar Two on MNE groups in a jurisdiction where they are carrying on real economic activities.

Secondly, according to the Commission, the transposition of the GloBE Model Rules in the EU should pave the way for agreeing the pending proposal for recasting the Interest and Royalties Directive, which has been in the Council since 2011. The aim of the recast was to make the benefits of the Interest and Royalties Directive (which eliminates withholding tax obstacles to cross-border interest and royalty payments within a group of companies) conditional on the interest or royalties being subject to tax in the destination state. Some member states held the view that the Interest and Royalties Directive should go further and set a minimum level of tax in the destination state as a condition for benefiting from the absence of withholding tax. In the Commission's opinion, the implementation of the GloBE Model Rules in the EU should resolve the issue under discussion for recasting the Interest and Royalties Directive.

While the Proposed Pillar Two Directive generally closely follows the OECD Model Rules, it extends its scope to large-scale purely domestic groups in an effort to ensure compliance with the fundamental freedoms, in particular the freedom of establishment. This means that a parent company established in an EU member state that has a subsidiary in the same state with an effective tax rate of less than 15% would have to pay a top-up tax. In addition, the Proposed Pillar Two Directive makes use of an option offered in the Commentary on the OECD Model Rules whereby the member state of a constituent entity applying the IIR, which is usually the jurisdiction of the UPE, is required to ensure effective taxation at the minimum agreed level not only of foreign subsidiaries but also of all constituent entities resident in that member state and permanent establishments (PEs) of an MNE group established in that member state. The OECD Model Rules provide that the jurisdiction that applies the IIR takes into account the ETR of only foreign constituent entities.

Scope

The scope of the Proposed Pillar Two Directive is defined by reference to constituent entities located in the EU that are part of MNE groups or large-scale domestic groups (whose members are Constituent Entities) with a consolidated group revenue of at least 750 million euros ($790 million) in at least two of the four preceding years.

For various policy reasons, such as the desire to preserve the tax neutrality principle, and in line with the OECD Model Rules, the following entities are excluded from the scope of the Proposed Pillar Two Directive: governmental entities, international organizations, non-profit organizations, pension funds and, provided that they are at the top of the group structure, investment entities and real estate investment vehicles. Entities that are owned at least 95% by excluded entities are also out of scope.

As regards the location of a constituent entity, the Proposed Pillar Two Directive deems a constituent entity, other than a PE or flow-through entity, to be located in the jurisdiction of which it is considered to be a resident for tax purposes. Where the location of a constituent entity cannot be ascertained based on this rule, the entity is deemed to be located in the jurisdiction in which it was created. The Proposed Pillar Two Directive also determines the location of a constituent entity that is a PE and includes tie-breaker clauses for specific situations.

Application of the Income Inclusion Rule and the Undertaxed Payments Rule

Chapter II of the Proposed Pillar Two Directive sets out the rules for the application of the IIR and the UTPR by EU member states.

Income Inclusion Rule

Under the Proposed Pillar Two Directive rules, the IIR applies in the following situations:

(i) UPE in the EU: if the UPE is located in the EU, it will be subject to the top-up tax with respect to its low-taxed constituent entities in the same and other EU member states, as well as in third-country jurisdictions.

(ii) IPE/POPE in the EU with UPE outside the EU: if there is no UPE in the EU, the low-taxed constituent entities of the MNE group in the EU would effectively be taken into account by the third-country UPE of the group if it applies the IIR. However, if there is at least one POPE or one IPE (if the jurisdiction where the UPE is located does not apply an IIR) in the EU, then the IPE/POPE will be subject to the top-up tax with respect to its low-taxed directly- or indirectly-owned constituent entities in the EU and third-country jurisdictions.

(iii) POPE in the EU with UPE in the EU: although a UPE located in the EU is normally charged the top-up tax with respect to its low-taxed constituent entities (see (i)), there is also a possibility that the primary taxing right may lie with the member state of a POPE. In these cases, a "bottom- up" method must be followed to identify the POPE that is liable to tax. It is necessary to start from the lowest-tier wholly-owned constituent entities and move up to the first POPE, which will be liable to top-up tax under the IIR with respect to its low-taxed constituent entities. The other POPEs up to the UPE will also be subject to the IIR but with a right to receive a credit for top-up tax payable by another POPE lower in the chain.

The Proposed Pillar Two Directive determines how much of a constituent entity's top-up tax a parent entity is entitled to collect through the IIR. This allocable share is, in general, based on the proportion of the parent entity's interest in the income of the low-taxed constituent entity. Furthermore, in the case of a large-scale domestic group, a UPE located in an EU member state is subject to the IIR top-up tax with respect to its low-taxed constituent entities.

To preserve the sovereignty of EU member states, the Proposed Pillar Two Directive provides that a member state can opt to apply the top-up tax domestically to constituent entities located in its territory (domestic top-up tax). This election allows the top-up tax to be charged and collected in a jurisdiction in which a low-level of taxation occurred, instead of all the additional tax being collected at the level of the UPE. When the election is exercised, the parent entity applying the IIR will be obliged to give credit for qualified domestic top-up tax in calculating the top-up tax with respect to the relevant jurisdiction.

Undertaxed Payments Rule

The Proposed Pillar Two Directive provides that in circumstances where the UPE is located outside the EU in a jurisdiction that does not apply a qualifying IIR, all its constituent entities in jurisdictions with an appropriate UTPR framework will be subject to the UTPR. In this circumstance, an apportionment will be made among the constituent entities of such an MNE group that are located in an EU member state, and those entities will have to pay, in their respective member states, a share of the top-up tax linked to the low-taxed subsidiaries in the MNE group.

The Proposed Pillar Two Directive further provides that the UTPR will also apply to situations in which the jurisdiction of the UPE operates a qualifying IIR but the UPE, together with its subsidiaries located in that same jurisdiction, are low-taxed. The top-up tax corresponding to the low-taxed UPE and its domestic subsidiaries will be charged through the UTPR to all the eligible entities across the MNE Group, including to entities that are located in an EU member state. This should only happen when the UPE is located outside the EU because an EU-located UPE either applies the IIR principles to itself and to its domestic subsidiaries or acknowledges that top-up was locally charged via the domestic top-up tax. No top-up tax should therefore be allocated under the UTPR when the UPE is located in the EU.

In line with the OECD Model Rules, the calculation and allocation of the UTPR top-up tax in the Proposed Pillar Two Directive is based on two factors—the number of employees and the carrying value of tangible assets.

Calculation of the Qualifying Income or Loss

Chapter III of the Proposed Pillar Two Directive contains rules for determining "qualifying income," i.e., the adjusted income that is to be taken into account for purposes of computing the effective tax rate. The starting point for the computation of this income is the financial accounting net income or loss of the constituent entity for the fiscal year, as determined for purposes of preparing consolidated financial statements. Certain adjustments are then to be made to the financial accounting net income or loss of a constituent entity to determine its qualifying income or loss – these adjustments include adjustments for: (i) net taxes expenses; (ii) excluded dividends; (iii) excluded equity gains or losses; (iv) included revaluation method gains or losses; (v) certain excluded gains or losses from the disposal of assets and liabilities; (vi) asymmetric foreign currency gains and losses; (vii) policy disallowed expenses; (viii) prior period errors and changes in accounting principles; and (ix) accrued pension expenses (all as defined in Article 15(1) of the Proposed Pillar Two Directive).

In line with the OECD Model Rules, the Proposed Pillar Two Directive excludes international shipping income and partly ancillary international shipping income from the application of the GloBE Model Rules. This exclusion follows the principle in accordance with which, in national tax systems, income from shipping is often taxed pursuant to a separate set of rules from those of the mainstream corporate tax system.

Chapter III of the Proposed Pillar Two Directive also includes rules specific to constituent entities that are PEs or flow-through entities.

Computation of Adjusted Covered Taxes

Chapter IV of the Proposed Pillar Two Directive defines "covered taxes of a constituent entity." These include: (i) taxes accrued in the financial accounts of a constituent entity with respect to its income or profits, or its share of the income or profits of a constituent entity in which it holds an ownership interest; (ii) taxes on distributed profits, deemed profit distributions and non-business expenses imposed under an eligible distribution tax system; (iii) taxes imposed in lieu of a generally applicable corporate income tax; and (iv) taxes levied by reference to retained earnings and corporate equity, including taxes on multiple components based on income and equity. "Covered taxes of a constituent entity" do not include: (i) the top-up tax accrued by a parent entity under a qualified income inclusion rule; (ii) the top-up tax accrued by a constituent entity under a qualified domestic top-up tax; (iii) taxes attributable to an adjustment made by a constituent entity as a result of the application of a qualified UTPR; (iv) disqualified refundable imputation tax; and (v) taxes paid by an insurance company with respect to returns to policyholders. At the option of a constituent entity, covered taxes with respect to any net gain or loss arising from the disposal of immovable property in the fiscal year in which the election is made are to be excluded from the computation of the adjusted covered taxes.

Chapter IV subsequently outlines the rules for the calculation of "adjusted covered taxes" of a constituent entity for a fiscal year. The prime principle in allocating covered taxes is to assign them to the jurisdiction in which the underlying profits subject to these taxes were earned. To ensure adherence to this principle, the Proposed Pillar Two Directive also provides special rules with respect to cross-border taxes on income streams in the case of a PE, transparent entity, controlled foreign company or hybrid entity, and taxes on dividends.

Calculation of the Effective Tax Rate and the Top-up Tax

Chapter V of the Proposed Pillar Two Directive contains rules for the calculation of the effective tax rate of an MNE group in a jurisdiction for a fiscal year. The effective rate is computed by dividing the adjusted covered taxes of the group by the adjusted income earned by the group in a specific jurisdiction for the fiscal year. In line with the global OECD agreement, the minimum effective tax rate for purposes of the GloBE Model Rules is set at 15%. In other words, if the effective tax rate for the entities in a particular jurisdiction is below the 15% minimum, the Pillar Two rules are triggered, and the group must pay a top-up tax to bring its rate up to 15%. This top-up tax applies irrespective of whether the subsidiary is located in a country that has signed up to the international OECD/G-20 agreement.

Chapter V also deals with the calculation and allocation of the top-up tax. First, the top-up tax percentage is computed for a jurisdiction as the difference between the minimum effective tax rate of 15% and the ETR for the jurisdiction. This top-up tax percentage is then multiplied by the income for GloBE purposes for that jurisdiction for the year in question.

In line with the GloBE Model Rules, the Proposed Pillar Two Directive provides for a substance-based income exclusion based on payroll costs and tangible assets. The filing entity of an MNE group can elect not to apply the substance-based income exclusion for a jurisdiction. The amount to be excluded under the substance-based income exclusion (if any) is deducted from the amount of income for GloBE purposes for the jurisdiction concerned in arriving at the jurisdictional top-up tax.

Finally, the top-up tax for each constituent entity in a jurisdiction is obtained by apportioning the jurisdictional top-up tax among the constituent entities in that jurisdiction based on the income for GloBE purposes of each constituent entity in that jurisdiction.

The Proposed Pillar Two Directive further specifies that when, as a result of an adjustment made to covered taxes or qualifying income or loss for a prior fiscal year, there is additional top-up tax to be collected, such top-up tax should be treated as additional top-up tax for the fiscal year under review.

To reduce compliance burdens in low-risk situations, an exclusion applies to minimal amounts of profit, i.e., the de minimis income exclusion. This applies when the profits of an MNE group's constituent entities in a jurisdiction are less than one million euros and revenues are less than 10 million euros. In such circumstances and provided an election for the de minimis income exclusion is made, the top-up tax of the constituent entities in this jurisdiction is deemed to be zero for GloBE purposes.

Special Rules for Mergers and Acquisitions

Chapter VI of the Proposed Pillar Two Directive contains special rules with respect to mergers, acquisitions, joint ventures and multi-parented MNE groups. It provides for the application of a consolidated revenue threshold to group members in a merger or demerger situation. When a constituent entity is acquired or sold by an MNE group within the scope of the rules, the entity should be treated as part of both the selling and the acquiring group during the year, with certain adjustments being made to the values of the attributes used for the operation of the GloBE Model Rules (covered taxes, eligible payroll, eligible tangible assets, GloBE deferred tax assets). There are rules for the recognition of a gain or loss and carrying values in a transfer of assets and liabilities, including a reorganization. There is a special provision to include joint ventures that would otherwise not be included in the definition of an MNE group for GloBE purposes. Finally, there is a specific rule for multi-parented MNE groups to the effect that group entities are treated as part of a single MNE group.

Tax Neutrality and Distribution Regimes

Chapter VII of the Proposed Pillar Two Directive contains rules with respect to tax neutrality regimes and distribution tax systems.

With a view to avoiding unintended outcomes, such as a disproportionate UTPR top-up tax liability in an MNE Group, special rules apply for the computation of the income of a UPE, where the UPE is a flow-through or subject to a deductible dividend regime.

With respect to investment entities, there are specific rules for the determination of the ETR and the top-up tax. An election to treat such entities as tax transparent entities is available, as is an election to apply the taxable distribution method.

In relation to distribution-based corporate tax systems (i.e., systems under which the taxation of profits is postponed until the profits are distributed by way of dividends or otherwise) the Directive provides that, on an annual election being made by the filing entity with respect to constituent entities that are subject to an eligible distribution tax system, a deemed distribution tax is included in the calculation of the adjusted covered taxes of the relevant constituent entities. This involves maintaining a deemed distribution tax recapture account for each fiscal year for which the election is made. If, in a four-year period, no tax is paid at the minimum rate on deemed distributions, and the constituent entity has not incurred an allowable loss, the top-up tax is payable based on the outstanding balance of the recapture account for the year in question.

Administrative Provisions

Chapter VIII of the Proposed Pillar Two Directive contains administrative provisions, including provisions addressing filing obligations.

The Proposed Pillar Two Directive obliges a constituent entity of an MNE group located in an EU member state to file a top-up tax information return, unless the return is filed by the MNE group in another jurisdiction with which the member state has an exchange of information agreement. The required return may be filed by either the constituent entity or another designated local entity located in the member state on its behalf. A constituent entity that is relieved of having to file the return must nevertheless notify its tax administration of the identity and location of the constituent entity filing the return for the MNE group. The return must be filed within 15 months after the end of the fiscal year to which it relates.

Penalties apply for failure on the part of an MNE group to comply with the obligations set out above. A constituent entity that does not comply with the requirement to file a top-up tax information return for a tax year within the prescribed deadline or makes a false declaration would be charged an administrative pecuniary penalty amounting to 5% of its turnover in the relevant fiscal year. This penalty would apply only after the constituent entity had not provided the top-up tax information return, following any issue of a reminder, within a period of six months.

Specific Application of the Income Inclusion Rule to Large-scale Domestic Groups

Chapter X of the Proposed Pillar Two Directive extends the application of the IIR to purely domestic groups located in an EU member state if they meet the 750-million-euro threshold. This particular aspect of the EU rules is designed to avoid any risk of discrimination in a member state between an entity that belongs to a group with cross-border activities and a group with purely domestic activities. These large-scale domestic groups will compute their ETR and, where relevant, be charged any top-up tax due under the IIR.

To maintain equal treatment with regard to MNE groups that are in the first stages of their international activities, Chapter X also grants to large-scale domestic groups a five-year transitional period during which their low-taxed domestic activities will be excluded from the application of the rules.

Assessment of Third-Country Income Inclusion Rule Systems

Chapter XI of the Proposed Pillar Two Directive sets out conditions that will enable the Commission to assess whether third-country systems (for example, the U.S. Global Intangible Low-Taxed Income (GILTI) Regime[3]) are equivalent to the content of the OECD GloBE Model Rules (and in particular to the IIR) and to include the jurisdictions that fulfil the relevant conditions in a list annexed to the Directive. This is important because whether a jurisdiction has a "qualifying IIR" plays a key role in determining how the "top-up tax" is allocated under the IIR or the UTPR. The Proposed Pillar Two Directive also assigns to the Commission the function of modifying the annexed list as a result of a subsequent assessment after a third-country jurisdiction modifies its legal framework. Amendment of the Annex will have to be carried out in conformity with the rules on delegated acts.[4]

Transposition

Chapter XI refers to the beginning of the application of the Proposed Pillar Two Directive rules, which is set for January 1, 2023, with the exception of the UTPR the application of which is deferred until January 1, 2024.

Flow Chart

The Explanatory Memorandum to the Proposed Pillar Two Directive contains a flow chart illustrating the operation of the rules in the EU.

Further Developments

At the ECOFIN meeting of January 18, 2022, the EU Finance Ministers held a public policy debate on the Proposed Pillar Two Directive. Overall, EU member states expressed their support and confirmed the priority nature of this initiative and the urgent need to transpose the agreed rules of international corporate taxation as soon as possible. However, eight member states also expressed concerns related to the tight

[3] The September 27, 2021 Build Back Better Bill (BBBB) contained a number of changes to the U.S. international tax regime, including applying the global intangible low-taxed income (GILTI) rules on a country-by-country basis and increasing the GILTI effective tax rate from 10.5%/13.125% to 15.01%/15.80%. These changes were thought to bring the GILTI regime in conformity with OECD Pillar Two and its 15% global minimum tax. Although the BBBB passed on November 19, 2021 in the House of Representatives (220–213), it stalled in the Senate. However, on March 28, 2022, the U.S. Treasury proposed a new mechanism to comply with and enforce the OECD Pillar Two 15% global minimum tax rate. Under the proposed mechanism, the base erosion and anti-avoidance tax (BEAT) would be replaced with the OECD Pillar Two's UTPR for tax years beginning in 2024. A U.S. domestic minimum top-up tax (at a 15% rate) would be part of the rules to protect U.S. revenues from the imposition of UTPR by other countries. The UTPR would not apply to income subject to the U.S. GILTI regime. The new regime would apply to U.S. corporations and U.S. branches of foreign corporations that are members of any financial reporting group with annual consolidated global revenues of $850 million or more. It is noteworthy that the March 14, 2022 Commentary on the OECD Model Rules remains silent on guidance around the compatibility of GILTI with the GloBE rules.

[4] A "delegated act" gives the Commission power to adopt the technical, non-essential elements of existing legislation.

implementation timeline, the complexity of the rules, the link between Pillar One and Pillar Two and the application of the rules to domestic groups.

In response to these concerns a restated version of the Proposed Pillar Two Directive was presented on March 12, 2022, in anticipation of the March 15, 2022, at the Economic and Financial Affairs Council (ECOFIN) meeting. The main changes in this "compromise" version concern: (i) an extension of the deadline for transposing the rules into domestic law to December 31, 2023–the IIR would then enter into effect for fiscal years commencing after December 31, 2023 and the UTPR for fiscal years commencing after December 31, 2024; (ii) the possibility for an EU member state in which there are fewer than 10 parented groups within the scope of Pillar Two to elect not to adopt the IIR and UTPR until 2025; and (iii) unanimous determination of the equivalence assessment of the IIR of third countries by the Council via an implementing act after a proposal by the Commission (rather than by the Commission alone, see above). Also, the 5% of turnover penalty (see 'Administrative Provisions' section, above) has been removed in the "compromise" version. Regarding the concern of some member states on the link between Pillar One and Pillar Two, the French Council Presidency announced its plans to issue a statement, along with the agreement on the Proposed Pillar Two Directive, confirming the commitment of all member states to the ongoing process on Pillar One in the IF.

At the March 15, 2022 ECOFIN meeting, four EU member states (Estonia, Malta, Poland and Sweden) still expressed some reservations and did not agree with the adoption of the "compromise" version of the Proposed Pillar Two Directive, with the result that the required unanimous consent for its adoption was not achieved.

A new compromise text of the Proposed Pillar Two Directive was presented on March 28, 2022, with a view to removing these reservations. The March 28, 2022 compromise version provides that EU member states in which no more than 12 (previously 10) UPEs of in-scope groups are located may elect not to apply the IIR and the UTPR for six (previously five) consecutive fiscal years. It also maintains the delay in the application of the new rules from January 1, 2023 to December 31, 2023. According to a new recital, member states that opt to defer the application of the IIR and the UTPR should transpose the Proposed Pillar Two Directive (once adopted as a Directive) in a manner that allows the application of the UTPR in other member states and third-country jurisdictions. To facilitate the application of the UTPR, those member states opting for deferral are to require domestic constituent entities to share the relevant information within the MNE Group. As regards reporting obligations in situations in which the UPE of an MNE Group is located in a member state that opts for the IIR and UTPR deferral, the new compromise version states that the UPE will be exempted from the GloBE filing obligation but would be asked to nominate a designated filing entity in another member state (that has not made use of the deferral election) or in a third-country jurisdiction (that has a qualifying competent authority agreement in effect with the UPE jurisdiction). The UPE would also be required to provide the designated filing entity with information necessary to file the GloBE returns on its behalf. Finally, the proposal that the equivalence assessment of the IIR of third countries be determined unanimously by the Council (as proposed in the first comprise text, see above) was removed, meaning that it is again left to the Commission to assess whether third-country systems are equivalent to the content of the OECD GloBE Model Rules (and in particular the IIR) and to include the jurisdictions that fulfil the relevant conditions in a list annexed to the Directive.

However, despite these changes, at the April 5, 2022 ECOFIN meeting it was still not possible to reach a consensus. Poland reserved its position on the grounds that the new compromise version of the Proposed

Pillar Two Directive did not constitute "a legally binding solution" for ensuring that both Pillar One and Pillar Two enter into force at a similar point in time. The French presidency of ECOFIN responded that such a legal link would not be possible as EU law does not allow making the Pillar Two Directive contingent on the entry into force of the (contemplated) multilateral convention implementing Pillar One—an international instrument—since this would undermine European sovereignty. It further regretted Poland's position as all the other 26 EU member states had agreed on the current draft. As no unanimity was reached, the Proposed Pillar Two Directive (as amended) was not approved. At the subsequent press conference, the French presidency stated that the draft directive will remain on the ECOFIN agenda until unanimity is reached.

At the ECOFIN meeting of June 17, 2022, held by way of public session, Poland dropped its reservations on the adoption of the Pillar Two Directive. Hungary, however, while it had supported the Directive in the April 5, 2022 ECOFIN meeting, changed its position and formally objected on the grounds that Europe is currently facing major challenges due to the ongoing war in the region and the current economic crisis (for example, increasing interest rates and inflation), adding that required technical work on Pillar Two is still ongoing. In other words, again no unanimity could be reached.

It is important to note that the uncertainty as to whether the Proposed Pillar 2 Directive will eventually obtain the consent of all EU Member States does not mean that Member States will not implement the Pillar Two rules into their domestic legislation as they have agreed to the OECD texts and committed themselves to such implementation. In addition, if it continues to prove impossible to reach unanimity on the Proposed Pillar Two Directive, there is at least a theoretical possibility that the Proposed Pillar Two Directive could be implemented under the "enhanced cooperation procedure" in Article 20 of the Treaty on the Functioning of the European Union, which would allow the 26 participating member states to proceed, without the need for the approval of the last dissenting member state.[5] Obviously, all of this would fall foul of the Commission's objective of achieving "full harmonized" implementation of the OECD rules throughout the European Union. Also, in light of the timetable, there is currently no guarantee that the ongoing OECD work and the Proposed Pillar 2 Directive (once adopted as a Directive), including the Member States' implementation of that Directive, will be fully convergent.

[5] Under the Treaty, enhanced cooperation may only be adopted as a last resort when the Council has established that the objectives of the cooperation cannot be achieved by the European Union as a whole within a reasonable time. Enhanced cooperation must be intended to further the objectives of the Union, protect its interests and reinforce its integration process. At least nine EU Member States must participate. Others may join at a later stage. Enhanced cooperation must not undermine the internal market or the economic, social and territorial cohesion of the European Union. It must not constitute a barrier to, or discrimination in, trade between Member States, nor may it distort competition between them. It must respect the competencies, rights and obligations of nonparticipating Member States. Although legislation adopted by enhanced cooperation only binds participating Member States, it does form part of the EU *acquis* and can have a knock-on effect on nonparticipating Member States.

Mexico

Terri Grosselin, Koen van´t Hek and Fernando Gallegos
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Terri Grosselin, Koen van ´t Hek and Fernando Gallegos of Ernst & Young discuss the Mexican approach to Pillar Two to date and some practicalities and potential implications for Mexico's domestic tax legislation.

General Background

Mexico is a member of the Organisation for Economic Co-operation and Development (OECD)/G-20 Inclusive Framework on Base Erosion and Profit Shifting Actions (BEPS) and joined the October 2021 statement on a two-pillar solution to address the tax challenges arising from the digitalization of the economy. It also took part in the discussions on the Pillar One and Two initiatives. The Global Anti-Base Erosion (GloBE) model rules and the respective commentaries resulting from the Pillar One and Two initiatives were published by the OECD in December 2021 and March 2022, respectively.

In line with this project, the Mexican government has expressed its intention to work during 2022 on the adjustments required to align Mexico's domestic tax laws with the GloBE rules for large multinational enterprise (MNE) groups. (This intention was expressed in the context of the income policies under the "General criteria of economic policy for the initiative of the income law and the budget of expenditures of the federation for fiscal year 2022.")

The incorporation of the GloBE rules into Mexican tax law will be a challenging process that will require significant effort -- not only on the part of the Mexican legislators, but also on the part of Mexican MNE groups and, certainly, on the part of the Mexican tax authorities -- to ensure the rules are complied with. It should be noted that, in 2020, Mexico underwent a significant tax reform as a result of which several BEPS 1.0 recommendations were incorporated into Mexico's tax law.

One would expect the GloBE rules to be incorporated promptly into Mexico's tax law, since this will allow the Mexican tax authorities to increase tax revenue. However, not all multilateral OECD efforts have been immediately supported by the Mexican legislature. This is exemplified by the significant amount of time that the Mexican Senate is taking to ratify the Multilateral Instrument (MLI) to implement BEPS measures.

Qualified Domestic Minimum Top-up Tax

The GloBE rules allow countries to collect top-up tax from their own resident MNEs, in cases where subsidiaries (constituent entities) have an effective tax rate (ETR) that is lower than 15% ("Qualified Domestic Minimum Top-up Tax") calculated according to the GloBe rules. This is not likely to occur very often in Mexico, because of Mexico's 30% corporate income tax rate and the lack of tax incentives. Nevertheless, in certain specific situations the GloBE ETR of a Mexican constituent entity may potentially be less than 15%, for instance, under the maquiladora regime or where there are inflationary losses on monetary liabilities.

Income Inclusion Rule

There are probably over 100 Mexican based MNEs that have revenues in excess of the 750 million euro ($790 million) threshold, a few of which have significant international footprints. These MNE groups will be subject to the Income Inclusion Rule (IIR) as soon as Mexico incorporates the GloBE rules into its domestic law.

Mexico's current controlled foreign company (CFC) rules are quite strict—much stricter than the rules proposed in the BEPS Action 3 recommendations—and provide for a 22.5% threshold rather than a 15% minimum tax rate. It is, therefore, not entirely clear whether the IIR will significantly affect Mexican MNEs.

Under the "top-down" approach, if Mexico does not introduce the GloBE rules or delays their introduction, other jurisdictions may collect the top-up tax (for instance, where a Mexican MNE has a sub-holding company that is resident of a jurisdiction that has introduced the IIR).

Undertaxed Payments Rule

One of the changes incorporated in the 2020 tax reform referred to above was the introduction of a rule that disallows a tax deduction for payments made to related parties that are not sufficiently taxed (i.e., rate taxed at a rate that equates to less than 75% of the Mexican income tax rate). This rule is substantially similar to the first draft of the Undertaxed Payments Rule (UTPR) outlined in some of the earlier versions of the global minimum tax proposal in 2019.

Specifically, the rule denies a deduction for payments made to foreign related parties located in low-tax jurisdictions (LTJs), i.e., where the tax payable is less than 75% of Mexican income tax payable. The rule provides for an exemption when a direct or indirect recipient located in a LTJ has the personnel and assets necessary for conducting its business activities (i.e., a substance test). However, the substance test does not apply to payments regarded as derived from a "hybrid mechanism" for tax purposes. The rule seems to combine features of the BEPS 1.0 project and BEPS 2.0 (i.e., the GloBE rules).

The Mexican tax authorities have not provided any insight into how the UTPR will interact with this existing deductibility limitation; however, the payments to LTJs rules in combination with the top-up tax payable as a result of the recipient of the payments concerned having an ETR lower than 15% may well result in cumulative non-deductibility.

Subject-to-Tax Rule

The Pillar Two Blueprint and the 2021 statements establish an additional rule, the Subject-to-Tax Rule (STTR), which imposes a minimum tax rate of 9% on certain payments (most likely interest, service fees and royalties, as well as other payments on a defined list). It is important to keep in mind that the STTR is a treaty-based rule and, therefore, would have to be implemented via the renegotiation and amendment of the relevant tax treaties with a view to limiting or denying treaty benefits when the income of a receiving entity is taxed at a rate lower than 9% in its residence country. Developing countries, such as Mexico, are incentivized to adopt the STTR because it allows them to tax the income not being taxed (or not being sufficiently taxed) abroad.

In this context, it should be noted that Mexico has over 60 tax treaties in force. Since, in most cases, these treaties provide for reduced withholding tax rates of 10% to 15% on interest and royalty payments, the STTR will probably have only a minor impact in Mexico. Nevertheless, certain service payments made by Mexican residents to nonresidents are not subject to withholding tax -- in such cases, the STTR would apply when the relevant income is taxed in the residence country at an adjusted nominal tax rate lower than 9%.

The Mexican tax authorities have not indicated their view regarding the appetite and effort that it will take to renegotiate Mexico's existing tax treaty network to accommodate the STTR, and it is worth pointing out that many of Mexico's treaties have already recently been renegotiated to include other provisions such as the principal purpose test.

Conclusion

Although Mexico has indicated its inclination to adopt the Pillar Two model rules, it is likely that these will have only a minimal impact in Mexico, particularly in light of the country's 30% statutory income tax rate, the lack of tax incentives, the limited number of Mexican MNEs and the existing treaty network standards.

Also, given the prior experience with the implementation of BEPS 1.0 into domestic law, it will be important to monitor closely whether Mexican tax law will be aligned with the GloBE rules.

Switzerland

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Jonas Sigrist and Pascale Schwizer of Pestalozzi Attorneys at Law Ltd, Zurich, discuss the status of the implementation of Pillar Two in Switzerland to date, and the divergence of the GloBE income rule from the income subject to Swiss corporate income tax.

Background

BEPS Action 1 on the Taxation of the Digital Economy

In 2015, the Organisation for Economic Co-operation and Development (OECD) released its final report on Base Erosion and Profit Shifting (BEPS).[1] The BEPS project is a package of measures with 15 specific actions that tackle tax avoidance and aim to ensure the taxation of profits where economic activities and value creation take place.[2] Action 1, which addresses the tax challenges arising from digitalization and is commonly known as the Taxation of the Digital Economy, is based on a Two Pillar concept.[3] On October 14, 2020, the OECD/G-20 Inclusive Framework on BEPS published a report on the Pillar Two Blueprint. On October 8, 2021, the Inclusive Framework issued its Statement on a Two Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, which was agreed by 137 member jurisdictions, including Switzerland, by November 4, 2021.[4]

The Two Pillar concept for the Taxation of the Digital Economy is generally referred to as "BEPS 2.0." In a nutshell, Pillar One provides for a shifting of taxing rights to market jurisdictions and affects entities with more than 20 billion euros ($21.4 billion) in consolidated annual revenue and a profit margin of more than 10%. Pillar Two provides for a global minimum 15% rate of taxation for multinationals with consolidated annual revenues of more than 750 million euros.

[1] BEPS 2015 Final Reports, published on https://www.oecd.org/ctp/beps-2015-final-reports.htm, last visited May 27, 2022.
[2] For further reference, visit: https://www.oecd.org/tax/beps/beps-actions/, last visited May 25, 2022.
[3] Website of the OECD regarding Action 1, https://www.oecd.org/tax/beps/beps-actions/action1/, last visited May 23, 2022.
[4] Statement on a Two Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, published on https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm, last visited May 27, 2022.

Impact of BEPS 2.0 on Switzerland

While Pillar One is expected to affect only a handful of large multinationals, Pillar Two is of particular interest for Switzerland, because some 200 multinationals headquartered in Switzerland and a multitude of Swiss subsidiaries of foreign multinationals will be affected by the global minimum taxation rules.[5]

Switzerland is well known for its competitive corporate tax rates. As of January 1, 2020, a corporate tax reform became effective in Switzerland that abolished the previously existing special tax regimes, including the regimes for holding and international trading companies. At the same time, this reform introduced tax reliefs that are widely accepted as being in compliance with the OECD modified nexus approach, including a patent box and a super deduction for research and development (R&D Super-Deduction).[6] The corporate tax reform was designed to improve Switzerland's compliance with international tax standards while at the same time maintaining and further expanding its tax competitiveness. The reform provided the Swiss cantons with additional financial latitude, allowing them to reduce their ordinary corporate tax rates.

Against this background, many cantons have significantly reduced their ordinary corporate income tax rates over the last few years. In 2021, the aggregate ordinary corporate income tax rates on profit before taxes ranged from around 11.8% to 22.8%.[7] The average aggregate rate of corporate income taxes (including federal income tax) on profit before taxes across the Swiss cantons is slightly below 15%.[8] A company with its registered office and place of effective management in Switzerland that is subject to a higher corporate income tax rate may, however, still be affected by Pillar Two because of:

- A potentially lower tax basis under Swiss statutory accounting and corporate tax rules as compared to the Global Anti-Base Erosion income relevant for Pillar Two (for more details see below);
- A lower tax basis resulting from preferential taxation, for example, in connection with the patent box, the R&D Super-Deduction, or the deductibility of amortization following a tax neutral basis step-up; and/or
- A lower tax rate resulting from the allocation of a portion of the company's profit to another Swiss canton with a lower tax rate under inter-cantonal tax allocation rules.

Switzerland is a relatively small country in terms of geographical size and population,[9] but has a considerable economy in terms of both size (its gross domestic product (GDP) of some $750 billion is larger than that of the smallest of the G-20 countries) and innovation (Switzerland leads the Global Innovation Index). While

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[5] Press release from the Federal Department of Finance dated July 1, 2021, https://www.efd.admin.ch/efd/en/home/the-fdf/nsb-news_list.msg-id-84315.html, last visited May 25, 2022.

[6] Press release from the Swiss Federal Council on the implementation of November 13, 2019, https://www.admin.ch/gov/en/start/documentation/media-releases/media-releases-federal-council.msg-id-77046.html, last visited May 27, 2022.

[7] Pascal Hinny, Steuerrecht 2022, Zurich 2022, Steuerbelastung in den Kantonen p. 2484-2485.

[8] Average corporate income tax rates in Switzerland between 2012-2022, Schweiz - https://de.statista.com/statistik/daten/studie/513550/umfrage/gewinnsteuersatz-in-der-schweiz, last visited May 20, 2022.

[9] Switzerland has a total surface of 41,285 square kilometers and had some 8.6 million inhabitants per the end of 2020 according to the Swiss Federal Statistical Office.

there are widely shared concerns in Switzerland about the potential negative impact of the Pillar Two concept on tax competition and innovation, there is also broad agreement that Switzerland cannot isolate itself from international norms. Recently, there has also been some feeling of relief in view of the fact that BEPS 2.0 entails only a limited shift in taxing rights to market jurisdictions and a rather modest global minimum tax rate of 15%. Against this background, Switzerland joined the Inclusive Framework Statement while explicitly maintaining its reservations. "Switzerland is committed to rules that foster innovation and prosperity, that are applied uniformly worldwide and that are subject to a dispute settlement mechanism."[10]

Switzerland aims to provide multinationals with legal certainty and plans to implement the Pillar Two rules in its domestic legislation as soon as possible. In compliance with Switzerland's legislative process, however, the implementation of the Pillar Two rules cannot be expected before 2024 (for more details, see below). The implementation of Pillar Two in Swiss domestic law will prevent multinationals from being exposed to additional tax procedures abroad, which would also result in additional costs and tied resources. Besides that, if Switzerland were not to implement the Pillar Two rules in its domestic law, multinationals could be subject to a top-up tax abroad, which would ultimately result in tax revenues bypassing Switzerland and flowing to foreign jurisdictions.

Pillar Two — Global Minimum Tax

Overview

The details of the Pillar Two rules are outlined in the Global Anti-Base Erosion Model Rules, which were published by the OECD on December 20, 2021 (the Model Rules)[11] and in the commentary on the Model Rules, which were published by the OECD on March 11, 2022 (the Commentary on the Model Rules).[12] The 15% global minimum taxation is to be achieved based on:

- The Income Inclusion Rule (IIR), which imposes a top-up tax on a parent entity of a multinational group with respect to low taxed-income of a group subsidiary or permanent establishment (PE) (a Constituent Entity);[13]
- The Undertaxed Payments Rule (UTPR), which denies deductions or requires an adjustment to the extent low-taxed income of a Constituent Entity is not taxed under the IIR;

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[10] Press release from the Federal Department of Finance dated October 8, 2021, https://www.admin.ch/gov/de/start/dokumentation/medienmitteilungen.msg-id-85410.html, last viewed May 27, 2022.

[11] Tax Challenges Arising from the Digitalization of the Economy Global Anti-Base Erosion Model Rules (Pillar Two), Inclusive Framework on BEPS, OECD/G20 Base erosion and Profit Shifting Project (Model Rules), approved by the OECD/G20 on December 14, 2021, https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf, last visited May 25, 2022.

[12] Tax Challenges Arising from the Digitalization of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), Inclusive Framework on BEPS,, approved by the OECD/G20 on March 11, 2022, https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf, last visited May 25, 2022.

[13] As defined in art. 1.3 of the Model Rules.

- The Subject to Tax Rule (STTR), which is an overriding treaty-based rule that allows source jurisdictions to impose limited source taxation on certain payments from affiliates subject to low (or no) taxation; and
- The Switch-Over Rule (SoR), which is a treaty-based rule that permits a residence jurisdiction to switch from an exemption to a credit method of relieving double taxation.

Essentially, Pillar Two aims to ensure that all participating jurisdictions impose a global minimum tax of 15% on Constituent Entities of multinational groups. If a jurisdiction does not tax a relevant Constituent Entity at a rate of at least 15% (for example, by way of an ordinary income tax or a domestic top-up tax), the IIR or the UTPR will allow other jurisdictions to levy taxes to ensure a minimum global 15% taxation. The IIR provides for a "Top-Down" approach to determine the jurisdiction that has the right to levy such taxes.[14] This means that, if the jurisdiction of tax residence of a Constituent Entity does not ensure the minimum taxation, the jurisdiction of the Ultimate Parent Entity (or of the next Intermediate Parent Entity) generally has the right to levy the additional taxes.[15] The UTPR, which allows any jurisdiction in which one or more Constituent Entities are tax resident to levy additional taxes or deny deductions on a pro rata basis, applies only if the IIR does not apply.[16]

The IIR and the UTPR are commonly referred to as the GloBE Rules. The GloBE Rules have to be implemented in Switzerland's domestic law based on the Model Rules, whereas the STTR and the SoR may be introduced through Switzerland's many tax treaties with other jurisdictions.

Scope of Minimum Taxation

Multinational enterprise groups fall within the scope of the Pillar Two rules if they have consolidated annual revenues of at least 750 million euros in at least two of the four preceding fiscal years (MNE Groups).[17] Unlike Pillar One, Pillar Two generally does not provide for industry specific exemptions, except with respect to income deriving from international shipping. (Entities generating income from the transportation of passengers or cargo by ships via inland waterways within the same jurisdiction are, however, not excluded from the Pillar Two measures.[18]) Nor does Pillar Two apply to governmental entities, international organizations, non-profit organizations, pension funds and investment funds or real estate investment vehicles that are Ultimate Parent Entities (Excluded Entities).[19] However, the revenue of Excluded Entities is still taken into consideration in calculating the revenue threshold of an MNE Group.[20] Furthermore, a de

[14] Model Rules, p. 9 and pp. 24 et seq.; Overview of the Key Operating Provisions of the Globe Rules ("Fact Sheet Model Rules"), https://www.oecd.org/tax/beps/pillar-two-GloBE-rules-fact-sheets.pdf, last visited May 25, 2022, p. 6/6.

[15] Regarding the detailed rules, reference is made to art. 2.1 -2.3. Model Rules.

[16] Model Rules, art. 2.4.

[17] Model Rules, art. 1.1.1.

[18] Model Rules, art. 3.3.2.

[19] Model Rules, art. 1.5.

[20] Fact Sheet Model Rules, p. 2/6.

minimis exemption applies to jurisdictions in which an MNE Group has less than 10 million euros of (average GloBE) revenue and less than 1 million euros of (average GloBE) income.[21]

Basis for the Calculation of the Top-up Tax

To determine if the income of a Constituent Entity within a jurisdiction is subject to a minimum rate of 15%, the Global Anti-Base Erosion income (GloBE Income) as well as the current tax expense accrued in the annual financials (Covered Taxes) must be determined for each jurisdiction in which an MNE Group has a Constituent Entity. If the percentage arrived at by dividing the Covered Taxes by the GloBE Income is less than 15% in a relevant jurisdiction, that jurisdiction may levy a top-up tax. If the jurisdiction does not impose such a top-up tax, other jurisdictions may levy taxes under the IIR or the UTPR.

GloBE Income and its Divergence from the Income Subject to Swiss Corporate Income Tax

The relevant GloBE Income is to be determined based on an Acceptable Financial Accounting Standard,[22] in particular IFRS or U.S. GAAP. The Swiss Accounting and Reporting Recommendations (Swiss GAAP FER)[23] should also be considered an Acceptable Financial Accounting Standard.[24] Swiss GAAP FER, which is based on a true and fair view approach, is not to be confused with the Swiss statutory accounting rules under the Swiss Code of Obligations.[25]

The Swiss statutory accounting rules focus on creditor rather than on investor protection and do not adhere to the true and fair view principle. Specifically, subject to certain limitations, the Swiss statutory accounting rules allow assets to be understated and liabilities to be overstated, and to provide for excessive depreciation and amortization, resulting in hidden reserves. It is, therefore, possible that financial reporting in accordance with the Swiss statutory accounting rules will often result in a Material Competitive Distortion,[26] requiring an adjustment to achieve alignment with the corresponding IFRS principle or procedure for purposes of determining GloBE Income.

Subject to a few specific adjustment rules, a Swiss company's standalone financial statements drawn-up in accordance with Swiss statutory accounting rules (rather than an Acceptable Financial Accounting Standard) are relevant to the determination of the profit subject to corporate income taxation in Switzerland.[27] Determining the GloBE income or loss of a Swiss resident Constituent Entity therefore requires specific knowledge of the Acceptable Financial Accounting Standards and where they conflict with Swiss statutory accounting rules. This may represent a significant challenge for Swiss Constituent Entities and an even greater challenge for the cantonal tax authorities who will be responsible for assessing or reviewing

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[21] Model Rules, art. 5.5.1

[22] As defined in art. 10.1 nos. 3 et seq. on p. 193 of the Model Rules.

[23] Available on https://www.fer.ch/en/, last viewed May 27, 2022.

[24] Cf. Daniel Gentsch/Alain Horat, Principles of Calculation of the Globe Tax Rate, ExpertFocus April 2022, p. 132.

[25] Swiss Federal Act on the Amendment of the Swiss Civil Code (Part Five: The Code of Obligations) of March 30, 1911, arts. 957 et seq.

[26] As defined in art. 10.1 nos. 58 et seq. on p. 203 of the Model Rules.

[27] Swiss Federal Direct Tax Act of Dec. 14, 1990 ("DBG"), arts. 58 et seq.; Federal Act on the Harmonization of the Direct Taxes of the Cantons and Municipalities of Dec. 14, 1990 (StHG), arts. 24 et seq.

GloBE International Returns but may well not have the requisite knowledge or resources. This is particularly true for the rural cantons in which there may be only a few taxpayers that are required to file GloBE International Returns.

The Model Rules also provide for a number of adjustments to the financial results computed in accordance with an Acceptable Financial Accounting Standard for purposes of determining the GloBE income.[28] However, these adjustments are often not consistent with Swiss domestic tax rules, resulting in a tax burden for GloBE purposes different from the tax burden under Swiss corporate tax law. For example:

- Swiss tax law provides for a relief with respect to income from qualifying shareholdings that, on the one hand, also applies to short-term and portfolio shareholdings with a fair market value of at least 1 million Swiss francs ($1.02 million) and, on the other, is limited to "net" income after the deduction of financing and administration costs.[29] On the contrary, under the Model Rules, Excluded Dividends do not include dividends from portfolio shareholdings with a holding period of less than one year but do include the entire gross dividend amount in the case of other dividends.[30]
- Recaptures and revaluation gains in the context of the alienation of qualifying shareholdings are taxable for Swiss federal corporate income tax purposes, while capital losses and depreciation with respect to qualifying shareholdings are classified as tax-deductible expenses.[31] This will result in a deviation from the GloBE income calculation rules where such items are classified as, respectively, Excluded Equity Gains or Losses under the Model Rules.[32]
- It is generally possible to make a tax-neutral transfer of a fixed business asset or an entire business unit between Swiss Constituent Entities in the same MNE Group by maintaining the asset's existing tax basis.[33] If such a tax neutral transfer results in a loss for the transferring Swiss Constituent Entity, that entity would be required to adjust its income for GloBE purposes under the arm's length principle.[34]

Covered Taxes

Covered Taxes for purposes of the calculation of the minimum taxation include all types of taxes levied on the income or profits of a Constituent Entity. It is expected that, in addition to the ordinary corporate income taxes, the following Swiss taxes will be regarded as giving rise to relevant tax expenses: capital taxes on net equity; church taxes; real estate capital gains taxes; and foreign withholding taxes that are final and for which a refund cannot be claimed. Swiss top-up taxes, stamp duties and other transaction taxes, value-added taxes,

[28] Model Rules, art. 3.2.

[29] DBG, arts. 69 et seq., StHG, art. 28(1).

[30] Commentary to the Model Rules, art. 3.2.1(b).

[31] DBG, arts. 62(4) and 70(2)(c).

[32] Commentary to the Model Rules, art. 3.2.1(c)

[33] DBG, art. 61.

[34] Commentary to the Model Rules, art. 3.2.3., no. 107.

customs duties, and social security contributions are, however, not considered Covered Taxes under Pillar Two and will therefore not be included in the minimum taxation calculation.[35]

GloBE Tax Return

Constituent Entities are generally required to file separate tax returns (GloBE Information Returns) in the jurisdictions that have implemented Pillar Two.[36] However, the obligation to file in all relevant jurisdictions does not apply if it is possible to file the GloBE Information Return in a jurisdiction that will provide the other jurisdictions with the relevant information based on an automatic exchange of information agreement ("Qualified Competent Authority Agreement").[37] Switzerland plans to implement Qualified Competent Authority Agreements with all other participating jurisdictions, so that Constituent Entities will not be required to file additional GloBE Information Returns in Switzerland.

The GloBE Information Return will have to be filed within 18 months after the last day of the reporting fiscal year in a standard template and will have to include the requisite information for all relevant jurisdictions to enable an assessment to be made as to whether the minimum taxation standard is met.[38] If the filing obligation is not complied with and the appropriate share of taxes is not paid, the penalties and sanctions of the relevant jurisdiction will apply.[39] While the sanctions for noncompliance have not yet been specified, sanctions will certainly be introduced in Switzerland in parallel with the implementation of Pillar Two.

Implementation of Pillar Two in Switzerland

The Model Rules provide for the implementation of the IIR with effect from January 1, 2023, and the UTPR with effect from January 1, 2024.[40] Most EU member states have indicated that they aim to implement the minimum taxation rules in accordance with the OECD timeline, i.e., starting January 1, 2023.

Switzerland has also been consistently working towards the implementation of the Model Rules in its domestic jurisdiction. However, the Swiss legislative process is slow in comparison to that of other jurisdictions. The implementation of Pillar Two is complicated by the fact that it entails an amendment to the Swiss federal constitution with regard to the competences of the federation and tax harmonization between the Swiss cantons, as well the principles of universality and uniformity of taxation and taxation that respects the taxpayer's ability to pay. There are still numerous uncertainties and outstanding questions regarding the technicalities of the Model Rules, which are not expected to be fully resolved before the end of 2022. Many aspects of the rules are subject to interpretation and will probably only be clarified once a practice has been established. Moreover, discussions are ongoing in Switzerland over whether all tax revenues deriving from

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[35] Erläuternder Bericht zum Bundesbeschluss über eine besondere Besteuerung grosser Unternehmensgruppen (Umsetzung des OECD/G20-Projekts zur Besteuerung der digitalen Wirtschaft), dated March 11, 2022, ("Erläuternder Bericht"), p.26/59, last visited May 25, 2022; Daniel Gentsch/Alain Horat, loc. cit., p. 135.

[36] Model Rules, art. 8.1.1.

[37] Model Rules, art. 8.1.2.

[38] Model Rules, art. 8.1.4.

[39] Model Rules, art. 8.1.8.

[40] Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, dated October 8, 2022, p.5.

the top-up taxes should be for the benefit of the cantons, how the intercantonal tax allocation should be made, and how the costs resulting from the implementation of Pillar Two should be allocated.

Against this background, the OECD's published timeline is too ambitious for the Swiss legislative process to accommodate and Pillar Two cannot be expected to be implemented in Swiss domestic law before January 1, 2024.[41] To address timing constraints and uncertainties, Switzerland is planning to implement the Model Rules in two steps.[42] In the first step, Switzerland will amend its federal constitution and empower the Federal Council to implement Pillar Two based on a federal ordinance, which will remain valid until the enactment of a formal federal act by Swiss Federal Parliament. In the second, later step, the provisions of this initial ordinance will be updated and converted into a formal federal act. This two-step approach will allow Switzerland to deal with the time pressure and incorporate already gained experience into the subsequent federal act.

The Swiss Federal Council initiated the legislative consultation procedure on March 11, 2022.[43] Professional organizations and the cantons have submitted a number of statements that broadly agree with the suggested two-step approach. The Federal Council intends to adopt its dispatch on the constitutional amendment still in summer 2022 for the attention of the Federal Parliament. The mandatory referendum for the amendment of the federal constitution is expected in summer 2023. Provided the amendment of the constitution passes the referendum, both the constitutional amendment and the Swiss Federal Council's temporary ordinance on the implementation of Pillar Two should enter into force on January 1, 2024. There are currently no plans to introduce Pillar Two measures in Switzerland with retroactive effect in view of the rule of law that prevents measures being introduced retroactively.[44]

From a Swiss tax perspective, Swiss-headquartered MNE Groups are not expected to face any changes as a result of the GloBE rules prior to 2024, because implementation of the rules in Switzerland will not occur before that date and the UTPR will not apply before 2024 according to the timeline published by the OECD. However, because many other jurisdictions are expected to implement the IIR as soon as January 1, 2023, foreign MNE Groups with Constituent Entities in Switzerland may already be subject to Pillar Two taxation in other countries in 2023. If the jurisdiction in which a parent company is domiciled has already introduced the IIR in 2023, this jurisdiction may impose taxes on the GloBE Income of Swiss Constituent Entities that are not yet taxed at the 15% global minimum tax rate (the Top-Down approach).

In the short term, the top-up tax is expected to result in additional tax revenues in the range of some 1-2.5 billion Swiss francs in Switzerland.[45] In the long term, however, there are fears that Switzerland may lose its tax attractiveness for MNE Groups. Discussions are therefore underway as to how Switzerland's tax attractiveness may be further enhanced (for example, by introducing a tonnage tax or by reducing fiscal

[41] Erläuternder Bericht, p.19/59.

[42] Erläuternder Bericht, p. 18-19/59.

[43] Press Release of March 3, 2022, *https://www.sif.admin.ch/sif/de/home/dokumentation/medienmitteilungen/medienmitteilungen.msg-id-87569.html*, last viewed May 27, 2022.

[44] Erläuternder Bericht, p. 18-19/59.

[45] Erläuternder Bericht, p. 36.

burdens that are not Covered Taxes), as well as to how Switzerland's general competitive appeal may be promoted by other means (for example, by increasing funding for R&D and other innovative activities).

United Kingdom

James Ross
McDermott Will & Emery UK LLP

James Ross of McDermott Will & Emery UK LLP discusses the U.K. approach to Pillar Two to date, including comments on the consultation document issued by the government on the transposition of the OECD proposals into U.K. law and some draft legislation.

Throughout the Base Erosion and Profit Shifting (BEPS) project, the U.K. has been one of the first countries to implement the recommendations of the Organisation for Economic Development and Co-operation (OECD), and this appears likely to be the case again with respect to Pillar Two. On January 11, 2022, the government issued a consultation document on the transposition of the proposals into U.K. law—only a few weeks after the publication of the model rules by the OECD, and before the publication of the OECD official commentary. Following the conclusion of the consultation, the government envisages publishing draft legislation during the summer of 2022. This, in turn, would be included in the 2022/23 Finance Bill, which would be published after the budget in the autumn of 2022, and would be expected to pass into law in the spring of 2023.

The government is intending to bring the income inclusion rule (IIR) into force from April 1, 2023 (in line with the OECD proposals) and, as it currently has a comfortable parliamentary majority, there is no reason to believe that it will not be able to do so.

The consultation document indicates that the government will cleave closely to the OECD proposals and does not anticipate going significantly beyond them. The IIR would, therefore, only apply to groups with consolidated annual revenues in excess of 750 million euros ($780 million). Accordingly, multinationals whose revenues are below the 750 million euros threshold will be unaffected by the new rules. The government's intention appears to be to implement the IIR as a free-standing tax charge, rather than as an extension to the existing corporation tax or Controlled Foreign Companies (CFC) charge. Accordingly, it does seem to be minded to amend any existing reliefs that might otherwise enable multinationals to achieve an effective tax rate of less than 15%. However, it does not intend to introduce any incentives or tax reductions that might compensate for any increased tax liability resulting from the introduction of the IIR.

The U.K. has an "above the line" research and development expenditure credit, the rate of which was increased to 13% in 2020, and which is payable to the taxpayer to the extent it exceeds the company's liability to HM Revenue & Customs across all taxes. The consultation document confirms that, in line with the OECD Model Rules, this should constitute an increase to the claimant company's income, rather than a reduction to its tax liability. This is likely to ensure that the credit remains of benefit to groups that are within the scope of the IIR.

The consultation document strongly suggests that the government is minded to introduce a domestic minimum tax in line with the OECD proposals. The government's primary justification for doing this appears to be a recognition that if Pillar Two is widely adopted, groups within the scope of such a charge will be paying a minimum 15% tax on their U.K. profits somewhere, and the government should ensure that those revenues flow to it rather than to any other governments. It does also suggest that a domestic minimum tax would spare larger groups from complex undertaxed profits rule (UTPR) calculations that would otherwise be necessary.

The domestic minimum tax would be introduced from April 1, 2024, at the same time as the UTPR. The practical effect in the short term is likely to be limited, however, as the U.K.'s main rate of corporation tax is scheduled to increase from 15% to 25% a year before that.

The government's thinking on the UTPR appears less developed. It remains open-minded as to whether this should be implemented by denying corporation tax deductions, or by way of a free-standing charge capped by reference to payments made by U.K.-constituent entities, though it "sees some attraction" in the latter approach. The government also asked for views on a number of broader issues relating to the implementation of Pillar Two, and whether implementation provides scope to simplify or reform existing rules without unduly exposing the tax base to material risks.

A response to the consultation is likely to be published later in the year alongside draft legislation.

United States

Peter Glicklich and Heath Martin
Davies

Peter Glicklich and Heath Martin of Davies cover the status of Pillar Two in the U.S., and how the economy could be impacted if the government decided not to follow the OECD recommendations on Pillar Two. They also discuss some proposed tax law changes that could affect both the Base Erosion and Anti-Abuse Tax (BEAT) and the Global Intangible Low-Taxed Income (GILTI) rules.

Introduction

In the U.S., the future of the Organisation for Economic Co-operation and Development (OECD)'s Pillars depends on national politics. Historically, the U.S. has not shown much openness to the OECD's Base Erosion and Profit Shifting (BEPS) proposals and has declined to sign on to measures like the Multilateral Instrument and the Common Reporting Standard.

In a break from this history, the current presidential administration has taken steps to adopt policies and legislation that, in principle, would pave the way for the U.S. to implement the Pillars. However, if the balance of power in Washington shifts after the mid-term elections this year, these efforts to harmonize the U.S. federal tax law with the Pillars may turn out to be short-lived.

Unlike in the case of earlier OECD tax policy proposals, the U.S. would face some difficult economic consequences if it fails to implement the Pillars. In the last few years, many countries have adopted unilateral digital services taxes, which are widely seen as a form of "self-help" for countries to access the untaxed profits of large digital companies. Since many of these companies are based in the U.S., these digital services taxes are thought to be targeted against U.S. business interests.

The tax changes in the Pillars would provide a multilateral solution that would render these digital services taxes superfluous. In fact, the U.S., and some other countries that have adopted digital services taxes, have made an explicit agreement to roll back those digital services taxes once Pillar One is implemented.

The Biden administration has generally supported the implementation of the Pillars in the U.S. Treasury Secretary Janet Yellen has publicly advocated for the Pillars on several occasions, and she has eliminated a Trump-era negotiating position that would have made compliance with the Pillars essentially optional for U.S. companies. In addition, the U.S. joined approximately 140 other countries in agreeing to the OECD's implementation framework released in October 2021, which committed its signatories to implement the Pillars, including the adoption of a minimum corporate income tax rate of 15%.

The U.S. tax reform proposals in 2021 reflected this new openness to the BEPS project. Several provisions in the Build Back Better Act (BBBA) would have changed U.S. federal tax law to conform to the Pillars. These provisions did not become law in 2021, although they may be revived in future legislative proposals. For example, the tax provisions described in the 2023 Green Book (a description of tax proposals published in connection with the President's federal budget for 2023) include changes that support the implementation of the Pillars.

The main targets of these proposed tax law changes are the rules relating to the Base Erosion and Anti-Abuse Tax (BEAT) and Global Intangible Low-Taxed Income (GILTI). A brief description of each set of proposals follows (although none of these proposals has yet become law).

The BEAT

The BEAT was enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA). Generally, the BEAT is a minimum tax of 10% imposed on certain income of a large corporate group if deductions attributable to cross-border payments to related parties exceed more than 3% of the group's total deductions. The BEAT only applies to corporate groups with gross receipts of at least $500 million.

The BEAT is inconsistent with Pillar Two's "undertaxed payments rule," which denies a deduction (or requires some other adjustment) when one group member makes a deductible payment to a second group member that is resident in a low-tax jurisdiction. The policy statements that preceded the BBBA proposed replacing the BEAT with a new tax regime called the "shield" that would have conformed more closely with the undertaxed payments rule. The "shield," however, was ultimately omitted from the legislative text of the BBBA.

The 2023 Green Book included a new provision, also intended to replace the BEAT, that is clearly modelled on Pillar Two and is called the "undertaxed profits rule." This provision would deny deductions for payments to affiliates in low-tax jurisdictions to ensure that the underlying income is subject to a "top-up tax" with a combined rate of at least 15%.

GILTI

The TCJA created a new tax regime under which certain U.S. owners of certain foreign corporations are taxed on their GILTI on a pass-through basis. These rules apply to a U.S. shareholder of a controlled foreign corporation (CFC), which is generally a U.S. taxpayer that meets certain actual and constructive ownership thresholds with respect to the CFC, either on its own or in combination with other U.S. taxpayers.

Very generally speaking, GILTI is all of the income of a CFC other than its Subpart F income (which mostly consists of passive income that was already subject to a similar pass-through regime before the TCJA was enacted), and a hypothetical fixed return on the CFC's depreciable assets (known as "qualified business asset investment" or QBAI). The GILTI regime works in parallel with the Subpart F regime to ensure that, generally speaking, a U.S. shareholder pays tax on its share of the CFC's income on a current basis (other than the fixed return on QBAI).

From a Pillar Two perspective, the problem with the GILTI regime is that the minimum effective tax rate on GILTI is 10.5%, which is less than the Pillar Two's minimum corporate tax rate of 15%. The effective GILTI tax rate is scheduled to increase in 2026, but until then the U.S. GILTI rate is too low for Pillar Two. Some other aspects of the GILTI rules are also inconsistent with Pillar Two, such as the exception for QBAI.

The BBBA, if enacted, would have increased the effective tax rate on GILTI to 15.8%, which would have brought the U.S. into compliance with the Pillar Two minimum corporate tax requirement. The 2023 Green Book surprised commentators by assuming that the provisions of the BBBA relating to GILTI had already become law (even though they had not), and then went on to propose an additional increase to bring the effective tax rate on GILTI up to 20%. The 2023 Green Book also proposed some other changes to the GILTI regime, such as eliminating the QBAI exception.

Open Questions

The proposals described above would increase U.S. tax law's compatibility with Pillar Two, but they do not represent a comprehensive treatment of all the issues that will have to be considered if the U.S. is going to succeed in implementing Pillar Two.

For example, when a country like the U.S. allows a U.S. taxpayer to take a foreign tax credit for taxes paid to a foreign jurisdiction, it creates an incentive for the foreign jurisdiction to raise its taxes on the underlying income to match the U.S. tax rate. This essentially allows the foreign jurisdiction to appropriate tax revenue that would otherwise be collected by the U.S. Treasury Regulations under the foreign tax credit deny a credit for these "soak-up" taxes. None of the provisions described above addresses soak-up taxes, which may turn out to be a side effect of the undertaxed payments rule and accompanying top-up tax.

Another omission in the proposals described above is the lack of any dispute resolution mechanism. The Pillars require dozens of countries to coordinate their highly complex tax systems based on a brand-new international nexus standard. Controversies are sure to arise. Historically, the U.S. has been hesitant to submit to the kind of international arbitration that would be necessary to resolve those disputes, but it is not clear how the provisions of the Pillars would otherwise be enforced.

Conclusion

The tax proposals from 2021 and the statements of policy in the 2023 Green Book show that the current government in Washington is serious about adopting the tax changes required by the Pillars.

The necessary changes, however, cannot realistically be accomplished without bipartisan support in Congress. In addition to the legislative changes described above, all of the countries involved in the Pillars will have to make significant changes to their tax treaties. In the U.S., tax treaties (and changes to them) must be approved by the Senate, which makes tax treaties dependent on Senate procedural rules that can even be controlled by a single senator. For instance, one Senator has famously obstructed the ratification of new tax treaties for almost a decade.

Some members of Congress have already been voicing skepticism about the Pillars and the Biden Administration's approach to their implementation in the U.S. In a sharply worded letter to Janet Yellen released last February, Republicans from the Senate Finance committee have criticized the Administration's approach to the negotiations and expressed their concern that the deal being struck will "harm U.S. businesses and jobs."

The mid-term elections this fall will determine the balance of power in Congress. Depending on that outcome, efforts to prepare the U.S. for the Pillars will either proceed or stall. In any case, the future of the Pillars in the U.S. will hinge on politics.

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