A Primer on Pillar 2

By Caroline H. Ngo

I. Background

The Organisation for Economic Co-operation and Development (OECD) released Pillar Two Model Rules on December 20, 2021 ("Model Rules") and Commentary on the Model Rules on March 14, 2022 ("Commentary"). This column provides a brief primer on Pillar 2. This column also briefly explains why, if implemented, the Model Rules would significantly affect the taxation of multinationals and could nullify tax incentives of multinationals.

As background, Pillar 2 applies to large multinational groups.[1] The main regime of Pillar 2 is the global anti-base erosion regime ("GloBE"), which applies through an income inclusion rule ("IIR") and an undertaxed payments rule ("UTPR") acting as a backstop. The IIR is perhaps more familiar in concept to practitioners, but as described below, the UTPR could apply in many situations (including with respect to U.S. income of U.S. parented multinationals).[2]

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II. Top-Up Tax Under the GloBE

The following approach is taken to calculate the top-up under the GloBE: (1) calculate effective tax rate ("ETR") of each jurisdiction (because GloBE applies on a country-by-country basis), (2) calculate the top-up tax, and (3) determine the liability for the top-up tax.

The ETR[3] is equal to the sum of the "Adjusted Covered Taxes"[4] of each constituent entity in the group/"Net GloBE Income"[5] of the jurisdiction for the year. The starting point of Net GloBE Income is the amount of financial accounting net income or loss determined for the constituent entity for the year, and the Model Rules provide various adjustments.[6] The starting point of Adjusted Covered Taxes is the current tax expense accrued in its financing accounting net income or loss, and the Model Rules provide various adjustments, including adjustments to reflect certain timing differences based on deferred tax accounting mechanisms.

The top-up tax is calculated under the following steps. The first step is to determine the top-up tax percentage for a jurisdiction, which is the 15% minimum tax rate minus the ETR for the particular jurisdiction. The second step is to calculate the excess profit for a jurisdiction, which is the net GloBE income minus a substance-based income exclusion[7] (which is somewhat comparable to the 10% qualified business asset investment ("QBAI") exclusion[8] in calculating

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global intangible low-tax income ("GILTI")). The third step is to calculate the jurisdictional top-up tax, which is generally the following:[9]

> Jurisdictional top-up tax = top up tax percentage × excess profits

The jurisdictional top-up tax is reduced by an amount payable under a qualified domestic minimum top-up tax, which is a minimum tax that is included in the domestic law of a jurisdiction and that operates in line with the GloBE rules. In other words, a jurisdiction could choose to top up its own low-taxed income (rather than allowing another jurisdiction to impose a top-up tax with respect to its low-taxed income).

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Next, we determine liability for the top-up taxes. In general, the amount of top-up tax is attributed to the top parent that has a qualified IIR[10] and any residual top-up tax, if any, is attributed to UTPR jurisdictions.[11] More specifically, the ultimate parent entity ("UPE") of the group that owns, directly or indirectly, an ownership interest in a low-taxed constituent entity pays a tax equal to its allocable share of the top-up tax of that low-taxed constituent entity. However, if the jurisdiction of the UPE does not have an IIR, the income inclusion applies to the highest intermediate parent entity in the group's ownership structure that is subject to an IIR. Thus, a top–down approach is applied to determine which parent (or intermediate parent) has the income inclusion under the IIR.

The UPTR acts as a backstop to the IIR. The total UTPR top-up tax is the sum of the top-up taxes, reduced by any top-up taxes that are taken into account under a qualified IIR.[12] Thus, the IIR takes priority over the UTPR, and if the top parent has a qualifying IIR, the UPE's subsidiaries are not subject to the UTPR. Conversely, any low-taxed income that is not subject to an IIR is subject to the UTPR. This could occur where: (1) low-taxed constituent entities are owned directly or indirectly by parent entities that do not have a qualified IIR, or (2) the UPE's income is considered low-taxed (because there are no direct or indirect owners that can apply the IIR).

The UTPR top-up tax is then allocated to each jurisdiction based on a formula that takes into account employees in the jurisdiction over all employees in all UTPR jurisdictions and tangible assets in a jurisdiction over all tangible assets in all UTPR jurisdictions. Constituent entities of an multinational enterprise ("MNE") group located in a jurisdiction are then denied a deduction (or required to make an equivalent adjustment under domestic law) in an amount resulting in those constituent entities having an additional cash tax expense equal to the amount of UTPR top-up tax allocated to the jurisdiction.

The point that the UTPR could arise when the UPE's income is low-taxed has received significant attention recently.[13] If the United States is the jurisdiction of the UPE and the income is low-taxed by reason of tax incentives provided by the U.S. Congress, the benefit could be nullified by reason of other jurisdictions applying a UTPR (even if hypothetically the United States had a qualified IIR). The Commentary confirms that the fact that the UPE is required to apply a qualified IIR does not mean that the UPE is outside the scope of the UTPR. The Commentary states the following:[14]

> The fact that the UPE is required to apply a Qualified IIR does not mean there is no scope for the operation of the UTPR with respect to Constituent Entities located in the UPE Jurisdiction. Where the UPE is required to apply a Qualified IIR for the Fiscal Year, it may only be required under the laws of the UPE Jurisdiction to apply the IIR in respect of PEs and subsidiaries located in other jurisdictions. In this case, no Top-up Tax will be allocated under the UTPR in respect of foreign [low-taxed constituent entities] (*i.e.* located outside of the UPE Jurisdiction) … If the Top-up Tax arising in the UPE Jurisdiction is not reduced to zero [*e.g.*, by reason of a Qualified Domestic Minimum Topup Tax described above], it will be included in the UTPR Top-up Tax Amount and allocated to each UTPR Jurisdiction …

Thus, if OECD Pillar 2 goes forward as set forth in the Model Rules and U.S. tax law stays the same, significant issues arise. For example, GILTI might not be considered a qualifying IIR unless GILTI were modified so that it applied on a country-by-country basis at a minimum 15% tax rate. If GILTI were not considered a qualifying IIR, an intermediate parent entity, rather than the U.S. UPE, could impose top-up taxes under the IIR with

respect to controlled foreign corporations ("CFCs") of a U.S. UPE. Whether or not GILTI is a qualifying IIR, under the UTPR, other countries could impose top-up taxes by reason of low-taxed U.S. income.

U.S. policymakers recognize these issues. First, the Build Back Better Act (which was passed by the House, but not passed as law) contains many proposals designed to bring GILTI more in line with Pillar 2 (*e.g.*, modifying GILTI so that it applies on a country-by-country basis and increasing the tax rate on GILTI to 15%). Second, the 2022 Green Book[15] includes a proposed domestic minimum top-up tax that would apply when another jurisdiction adopts the UTPR. The 2022 Green Book also proposes that when another jurisdiction adopts the UTPR, the proposal would also ensure that taxpayers continue to benefit from tax credits and other tax incentives that promote U.S. jobs and investment. However, no detail is provided, and it is unclear how the proposal would preserve the benefit of U.S. tax incentives.

The Pillar 2 agreement provides for the IIR to be implemented in 2023 and the UTPR to be implemented in 2024. However, the timing and implementation of Pillar 2 remain to be seen.

III. Conclusion

Pillar 2, if implemented, will significantly impact the taxation of foreign- and U.S.-parented multinationals. Companies should consider how Pillar 2 would impact their particular facts. Under the Model Rules, not only do low-taxed foreign earnings give rise to additional taxation under Pillar 2 but U.S. tax incentives could also give rise to additional taxation under Pillar 2.

ENDNOTES

1 The GloBE rules apply to constituent entities that are members of a multinational group that has annual revenue exceeding €750 million or more in the consolidated financial statements of the ultimate parent entity in at least two of the four fiscal years immediately preceding the tested fiscal year.

2 *See generally* Caroline H. Ngo, *Mind the Gap: Observations on the Differences Between the Minimum Tax Under GILTI and the OECD Framework* (July–August 2021).

3 Article 5 of the Model Rules provides rules on how to compute the ETR and top-up tax.

4 Article 4 of the Model Rules provides rules on how to compute the Adjusted Covered Taxes.

5 Article 3 of the Model Rules provides rules on how to compute Net GloBE Income.

6 These adjustments include adjustments for net taxes expense, excluded dividends, excluded equity gain or loss, included revaluation method gain or loss, gain or loss from disposition of certain assets and liabilities, asymmetric foreign currency gains or losses, policy disallowed expenses, prior period errors and changes in accounting principles, and accrued pension expense. Model Rule 3.2.1.

7 Article 5.3 of the Model Rules provides detail on the substance-based income exclusion.

8 *See* Code Sec. 951A(d).

9 An additional current top-up tax could apply in certain limited situations as described in Article 5.2.3 of the Model Rules.

10 *See* Article 2.1 to Article 2.3 of the Model Rules.

11 *See* Article 2.4 to Article 2.6 of the Model Rules.

12 The UTPR top-up tax is reduced to zero during the initial phase of a multinational group's international activity as discussed further in Article 9.3 of the Model Rules.

13 *See generally Mindy Herzfeld, The Myth of GILTI Conformity*, Tax Notes Int'l (February 14, 2022); Brian Jeff, Annette Keller, Dirk Pohl, James Ross, Andrea Tempestini, Antoine Vergnat, Romain Desmonts, and Alessio Persiani, *An Overview of OECD Pillar 2* (February 14, 2022), available online at *www.mwe.com/insights/an-overview-of-oecd-pillar-2/#:~:text=Pillar%202%20includes%20two%20proposals,(SOR)%20as%20required%3B%20and*; Jeff Vanderwolf, *U.S.-Based Multinationals Face a Double Tax Whammy*, BNA Tax Insights & Commentary (February 7, 2022); Richard Rubin, *Global Tax Deal Would Undercut U.S. Tax Breaks, Businesses Warn*, Wall Street J. (February 3, 2022); Daniel Bunn, *U.S. Tax Incentives Could Be Caught in the Global Minimum Tax Crossfire*, Tax Foundation (January 28, 2022).

14 Commentary on Article 2.5.2 on page 38.

15 General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals (the "Green Book").

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