An Overview of OECD Pillar 2

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The Organisation for Economic Co-operation and Development (OECD)/G20 Global Anti-Base Erosion (GloBE, Pillar 2) Model Rules, published in December 2021, intend to address perceived challenges to long-standing international taxation principles from the increasing digitalization of the economy. If implemented, these rules (Model Rules) would significantly impact the taxation of multinational groups, introducing new complexity to international taxation and nullifying the benefit of tax incentive regimes employed by many countries to attract foreign investment.

Addressing the tax challenges raised by digitalization has been a priority of the OECD/G20 Inclusive Framework on base erosion and profit shifting (BEPS) since 2015. Inclusive Framework members agreed to examine proposals in the two pillars forming the basis for a long-term solution to these tax challenges. In mid-2019, a program of work to be conducted on Pillars 1 and 2 was adopted and finally endorsed by the G20 finance ministers in July 2021. As of 4 November 2021, 137 OECD/G20 countries and jurisdictions—out of the 140 members of the OECD/G20 Inclusive Framework on BEPS—representing more than 90% of global gross domestic product (GDP) agreed to join the official statement of the Two-Pillar Solution. Pillar 1 foresees reallocating international taxing rights and stabilizing the international system of tax law. Pillar 2, which was introduced jointly by the (at that time) Vice Chancellor and Finance Minister of Germany Olaf Scholz and his French counterpart Bruno Le Maire, imposes a global minimum 15% tax rate for certain multinational enterprises (MNEs) from 2023 onwards.

The OECD illustrated the most relevant aspects of Pillar 2 in a blueprint published in 2020. The Model Rules published in December 2021 add significant detail but offer limited indication as to how the rules might apply in practice. A commentary on the Model Rules to be published in the first quarter of 2022 is expected to provide additional guidance in this regard.

IN DEPTH

PILLAR 2 AT A GLANCE

Pillar 2 rules apply to multinational groups with global revenues exceeding a €750 million threshold, in line with current Country-by-Country Reporting (CBCR) obligations. A group is defined as a collection of enterprises that are consolidated for financial accounting purposes. Pillar 2 applies to the constituent entities (CEs), i.e., subsidiaries included in the consolidation and permanent establishments (PEs), including branch operations and entities that are disregarded for US income tax purposes.

Pillar 2 includes two proposals that operate almost independently of each other:

1. A global anti-base erosion regime (GloBE rules) applies through an income inclusion rule (IIR) and an undertaxed payments rule (UTPR) with support from a switchover rule (SOR) as required; and

2. A minimum level of tax on certain payments between connected parties, which are deemed as having a heightened base
eroding potential (subject to tax rule (STTR)).

The interaction between the two is that the top-up tax imposed under the STTR is taken into consideration for the purpose of calculating the effective tax rate (ETR) under GloBe rules. Thus, the STTR operates in priority to GloBe rules.

The different elements of the GloBe rules can be described as follows:

1. The IIR requires the ultimate parent entity (UPE) to pay a top-up tax on its proportionate share of the income of any low-taxed CE in which the UPE has a direct or indirect ownership interest. The tax is the top-up amount required to bring the overall tax on the profits up to the 15% ETR. The IIR is a residence-based income tax rule. However, further to the OECD Model Rules, the amount of the top-up tax payable under the IIR and the UTPR are net of any Qualified Domestic Minimum Top-Up Tax (QDMTT), i.e., of minimum tax included in the domestic law of a jurisdiction and shaped consistently with GloBe rules. This ensures that source countries retain the primary right to tax profits sourced in their territory at the 15% rate (if they choose to do so). The UPE is given priority for applying the IIR. If the UPE is located in a jurisdiction that has not implemented the IIR, then responsibility for applying the IIR falls on the CE that is directly owned and controlled by that UPE, and so on, down the chain of ownership.

2. The IIR is complemented by a tax treaty-based SOR that allows a jurisdiction to override the exemption method and switch to the credit method to the extent necessary to apply the IIR to the profits of a PE. This ensures equality of treatment of exempt PEs and foreign subsidiaries under GloBe rules.

3. The UTPR serves as a backstop to the IIR and is aimed at dealing with cases in which the IIR is unable to bring low tax jurisdictions in line with the 15% minimum ETR. The UTPR allocates the taxing rights over the under-taxed income (deriving from a low tax jurisdiction) to jurisdictions different from the UPE residence.

The STTR complements GloBe rules. It is a tax treaty rule that specifically targets intragroup payments, which benefit from low nominal tax rates in the jurisdiction of the payee. As mentioned above, the STTR operates before the IIR and confers a primary taxing right to the source jurisdiction. Thus, being “de facto” a priority rule under GloBe rules. To a certain extent, the STTR constitutes a counterweight for source jurisdictions against the IIR, which is a residence-based tax rule. It is activated where intragroup payments are made by an entity in one contracting state to a group entity in another contracting state that is subject to an adjusted nominal tax rate below the 15% minimum ETR. In that case, the source state may levy a withholding tax equal to the top-up tax on the gross payment.

PILLAR 2—A MORE IN-DEPTH VIEW OF GLOBE RULES

In-Scope Entities

GloBe rules apply to taxpayers who: (1) are members of a multinational group and (2) its multinational group had an annual revenue of €750 million or more in the consolidated financial statements of at least two of the four fiscal years preceding the tested fiscal year. A group will not be subject to GloBe rules if it: (1) does not have at least one subsidiary or PE located in a jurisdiction different from the UPE residence. Some specific exclusion rules are provided. The most relevant exclusions are: (1) pension funds, (2) investment funds or real estate investment vehicles qualifying as UPE, (3) nonprofit organizations and (4) governmental entities and international organizations.

Application of GloBe Rules

GloBe rules should be applied in the following steps:

1. Calculation of the ETR
2. Calculation of the top-up tax
3. Determination of the liability for the top-up tax

Calculation of the ETR

First, each CE should determine its GloBe income or loss. The CE income or loss as reported in the UPE’s consolidated financial statements (before the elimination of intragroup transactions) constitutes the starting point.

Then, the CE’s accounting income or loss must be adjusted to remove specific book-to-tax differences (e.g., excluded dividends, excluded equity gains or losses, asymmetric foreign currency gains or losses, prior period errors and changes in accounting principles). GloBe income includes tax credits refundable within four years (Qualified Refundable Tax Credits (QRTC)), while tax credits that do not meet such requirement are excluded. International shipping income is also excluded for GloBe purposes. Further details and rules are laid under Chapter 3 of the OECD Model Rules.

Chapter 4 of the OECD Model Rules provides the calculation of the tax attributable to the GloBe income. Covered taxes include all income taxes, including taxes on distributed profits and deemed profit distributions, accrued for financial statements purposes. Taxes due by the CE’s owners and resulting from the application of a controlled foreign company (CFC) regime are allocated to the CE for GloBe purposes. As far as temporary differences are concerned, OECD Model Rules rely on deferred tax accounting concepts with some specific adjustments (e.g., credit for deferred tax liabilities are capped at 15%; a recapture mechanism applies for deferred tax liabilities that have not been reversed within five years). Alternatively and with respect to losses, a taxpayer may elect to utilize a simplified GloBe loss carryforward mechanism.

The ETR is calculated on a jurisdictional basis as a result of the covered taxes divided by the net GloBe income referred to the relevant jurisdiction (i.e., GloBe income of all CEs located in the jurisdiction minus the GloBe losses of all CEs located in the
Let's assume the following scenario:

**Calculation of the Top-Up Tax**

The top-up tax rate is equal to the difference, if any, between the 15% minimum rate and the ETR of the relevant jurisdiction. It is then multiplied by the group’s jurisdictional excess profit, which is defined as the group’s GloBE income minus a substance-based income exclusion (SBIE) equal to 5% of the carrying value of tangible assets plus 5% of total payroll costs in the jurisdiction. The group’s jurisdictional top-up tax is equal to the resulting value minus the amount of any QDMTT imposed by the relevant jurisdiction. Further details are provided under Chapter 5 of the OECD Model Rules.

**Determination of the Liability for the Top-Up Tax**

After computing the group’s top-up tax for each jurisdiction in which it has a CE, the entity liable for the top-up tax should be determined. The IIR constitutes the primary rule and results in the application of the top-up tax to the UPE. The UPE pays the top-up tax in proportion to its ownership interests in the CE's that have low-taxed income. If the jurisdiction of the UPE does not apply an IIR, the income inclusion applies to the highest intermediate parent entity in the group’s ownership structure that is subject to an IIR.

Exceptions to this top-down approach are provided under split ownership rules, whereby the IIR must be applied by an intermediary company instead of its parent if minority shareholders outside the group hold an equity interest that represents more than 20% of that intermediary company. However, this split ownership rule does not apply if the intermediary company is entirely owned directly or indirectly by shareholders who are subject to the IIR.

As mentioned above, the IIR is complemented by a tax treaty-based SOR that allows a jurisdiction to override the exemption method and switch to the credit method to the extent necessary to apply the IIR to the PE profits.

If any top-up tax liability remains after applying the IIR, OECD Model Rules apply the UTPR as a backstop mechanism. The UTPR would be triggered, for example, where: (1) CEs are located in low tax jurisdictions, which are owned directly and indirectly by entities resident in jurisdictions that have not implemented the IIR, or (2) the UPE is resident in a low tax jurisdiction (so that there are no entities in the chain of ownership that can apply the IIR).

The UTPR operates through an adjustment (such as a denial of a deduction for otherwise deductible expenses or an equivalent adjustment provided under domestic law) that increases the tax at the level of the subsidiary. The share of the top-up tax is allocated among jurisdictions based on the value of the group’s tangible assets and the number of its employees in jurisdictions that have implemented the UTPR, with both factors given equal weight.

Further details on the IIR and the UTPR are provided under Chapter 2 of the OECD Model Rules.

**Carve Outs and Transition Rules**

Chapter 9 of the OECD Model Rules lays down a few transition rules.

Among them, an exclusion from the UTPR for groups in the initial phase of their international activity is provided. Such groups are defined as those that have a maximum of €50 million worth of tangible assets in all jurisdictions different from the one in which it has the highest amount of tangible assets and operates in no more than six jurisdictions. This exclusion is limited to a five-year period after the group comes into the scope of the GloBE rules for the first time. For groups that are in the scope of the GloBE rules when they go into effect, the five-year period will start at the time the UTPR rules go into effect.

Furthermore, as said above, a SBIE equal to 5% of the value of tangible assets plus 5% of total payroll costs in the jurisdiction is provided. In a transition period of 10 years, the amount of income excluded will be 8% of the carrying value of tangible assets and 10% of payroll, declining annually by 0.2% for the first five years (for both tangible assets and payroll) and by 0.4% for tangible assets and by 0.8% for payroll for the last five years.

GloBE rules also provide for a de minimis exclusion for jurisdictions where the group has revenues of less than €10 million and profits of less than €1 million.

**GILTI Coexistence**

US global intangible low-taxed income (GILTI) rules and other income inclusion regimes are currently being examined to determine if they meet the objectives of GloBE rules. In that context, the OECD has indicated that consideration will be given to the conditions under which the GILTI regime will coexist with GloBE rules to ensure a level playing field. The GILTI rules might not be considered a qualifying IIR unless US Congress modifies the GILTI regime so that it applies a 15% minimum ETR on a country-by-country basis—currently an uncertain prospect. If the existing regime is not amended, US-parented groups may be subject to application of UTPRs to top-up tax amounts of their CFCs.

Additionally, regardless of whether GILTI is modified, other countries' UTPRs may apply to top-up tax calculated with respect to the US parent company and any disregarded entities or foreign branches it owns.

**A NUMERIC EXAMPLE**

Let’s assume the following scenario:
Company A qualifies as UPE and Companies B and C are wholly-owned by Company A.

1. Calculation of the ETR in State B

- GloBE Income in State B: 100 (120-20 → B Accounting Income – B Excluded Dividends and Cap. Gains)
- Covered Taxes in State B: 10
- ETR in State B: 10% (10/100 → Covered Taxes in State B/GloBE Income in State B)

2. Calculation of the Top-Up Tax

- Top-up tax rate: 5% (15%-10% → GloBE Minimum Rate – ETR in State B)
- SBIE in State B: 20 (5%*100 + 5%*300 → 5% of B Payroll Costs + 5% of B Tangible Assets)
- Group Excess Profit in State B: 80 (100 – 20 → GloBE Income in State B – SBIE in State B)
- Top-up tax (without QDMTT\(^2\)): 4 (5%*80) → Top-up tax rate * Group Excess Profit in State B
- Final amount of top-up tax (with QDMTT\(^3\)): 3.2 [4-(1%*80)] → [Top-up tax – QDMTT]\(^3\)

3. Determination of the Liability for the Top-Up Tax

The company liable for the top-up tax will be determined in the following order:

- If State A implemented the IIR → Company A is liable for the top-up tax (3.2) on the basis of IIR
- If State A has not implemented the IIR → Company C or Company B and C are liable for the top-up tax on the basis of the UTPR (see below).

4. UTPR Mechanism

- **Scenario A** → State C is the only state that implemented the UTPR
  - Company C is liable for the top-up tax (3.2)
- **Scenario B** → Both State B and State C implemented the UTPR

UTPR percentage of State B: 48.75% (50%*30/80 + 50%*300/500 50% * Number of employees in State B/Number of Employees in all UTPR States + 50% * Value of Tangible Assets in State B/Value of Tangible Assets in all UTPR States)

UTPR Percentage of State C: 51.25% (50%*50/80 + 50%*200/500)

- **Company B** liability for the top-up tax: 1.56 (3.2*48.75%)
- **Company C** liability for the top-up tax: 1.64 (3.2*51.25%)

NEXT STEPS

As mentioned above, in the first quarter of 2022, the OECD should adopt and publish a commentary on OECD Model Rules.
Further work and elaborations by the OECD are expected throughout the course of 2022 with the goal of first applying Pillar 2 rules (together with Pillar 1 rules) as from 2023.

In parallel with OECD elaborations, in December 2021, the European Commission proposed the adoption of a directive with regard to the EU area (COM 2021 823). The draft directive closely follows the OECD Model Rules but extends their scope to large-scale purely domestic groups (meaning that in the EU area, GloBE rules would also apply to groups that do not have subsidiaries/PEs in more than one jurisdiction). While the European Commission officially stated that the extension is provided “in order to ensure compliance with the EU fundamental freedoms,” a few scholars raised some doubts on the compliance of the directive with those freedoms.

The draft directive also exercises an option set out in the OECD’s commentary for the Model Rules to require an EU Member State of an in-scope multinational enterprise applying the IIR (as said above, usually the jurisdiction of the UPE) to ensure effective taxation at the minimum agreed level (15%) for not only foreign subsidiaries but all CEs resident in that Member State and the PEs of the group established in that Member State.

Provided that the draft directive is approved by EU institutions (remarkably, a unanimous agreement of EU Member States at the Council level is required), the relevant rules should be implemented in the domestic tax systems by the end of 2022 and should apply as from 2023.

In this respect, we also note that Spanish Budget Law for 2022 has already provided a 15% minimum tax applicable as from 1 January 2022. The minimum tax applies to taxpayers with a net turnover of at least €20 million and those subject to the tax consolidation regime (thus having a scope of application wider than both the OECD rules and the proposed EU directive).

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1 We are assuming that State B adopts a 1% QDMTT for purely illustrative reasons (i.e. in order to allow the applicability of the IIR and UTPR mechanism). We are aware that, in case a given State decides to adopt a QDMTT, the rate of the QDMTT would likely be determined in a way that the overall tax rate of the State reaches 15%.

2 Please note that OECD Model Rules do not encompass separate steps for the calculation of the ‘Top-up tax (without QDMTT)’ and ‘Final amount of Top-up tax (with QDMTT)’ and include the deduction of the QDMTT in the step named ‘Jurisdictional Top-up Tax’ under Art. 5.2.3.

3 This point should be further analysed and checked also on the basis of the Commentary to OECD Model Rules to be adopted in next weeks.

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