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International Tax ADVISORY ■

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Has the Global Tax(man) Ended the "Race to the Bottom"? 136 Countries Agree to Overhaul International Corporate Tax System

On October 8, 2021, 136 countries reached a long-awaited agreement on a two-pillar plan to overhaul and modernize the international corporate tax system to address the challenges of digitalization. The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting published a statement laying out the details of the agreement and an implementation plan.

U.S. Treasury Secretary Janet Yellen released a statement the same day lauding the agreement, stating that it "represents a once-in-a-generation accomplishment for economic diplomacy" and that "virtually the entire global economy has decided to end the race to the bottom on corporate taxation."

While the OECD/G20 statement marks a major development after four years of haggling and stalled negotiations, there is still much work to be done. On October 13, 2021, the Group of 20 (G20) ministers and central bank governors met in Washington, D.C. and issued a statement endorsing the two-pillar plan outlined in the OECD/G20 statement. G20 leaders are expected to approve the plan at a summit in Rome at the end of October 2021. Implementation of major facets of the agreement are targeted for 2023, but anticipated and unanticipated roadblocks might impede those plans, including potential hurdles in the U.S. Congress.

Pillar One

Put simply, Pillar One will: (A) create a new taxing right that reallocates 25% of profits above a 10% margin for the roughly 100 largest and most profitable multinational enterprises (MNEs); and (B) provide a fixed return for baseline marketing and distribution activities in market jurisdictions. Pillar One jettisons prior proposals that focused on "consumer-facing businesses" and "automated digital services" and carves out two industries: extractives and regulated financial services.

Amount A

Pillar One gives a new taxing right, referred to as Amount A, to countries to ensure that MNEs pay tax on a portion of residual profits earned from activities in those countries even if they lack sufficient taxable physical presence under current law.

Generally, MNEs with global turnover above €20 billion and profitability above 10% (computed based on averaging concepts to be developed) are in scope for purposes of Amount A. The new special purpose nexus rule will allow the allocation of Amount A from a surrender country to a market country when an in-scope MNE has at least €1 million in revenue in the market country (the threshold is reduced to €250,000 for jurisdictions with GDP lower than €40 billion).

For MNEs that are in scope, 25% of residual profit (profit exceeding 10% of revenue) will be allocated to market countries with nexus using a revenue-based allocation key. Revenue will be sourced to the end-market countries where goods or services are used or consumed using detailed sourcing rules to be developed. A marketing and distribution profits safe harbor will cap the residual profits allocated to the market country through Amount A, the details of which have yet to be determined.

Amount A creates some yet-to-be-resolved concerns related to double taxation. For example, if a U.S. MNE (a surrender country entity) with an Amount A allocation to another country (a market country) does not receive relief from the United States to compensate for that Amount A allocation, that surrendering U.S. MNE will pay tax twice on such amount. While the OECD/G20 statement provides that double taxation of profit allocated to market jurisdictions will be subject to binding dispute resolution mechanisms and relieved using either the exemption or credit method, the details of the binding dispute resolution and relief mechanisms are not determined, including how relief will be granted and which country will provide relief.

The OECD/G20 statement includes an implementation plan for Amount A. Under the plan, Amount A will be implemented through a multilateral convention (MLC) that will be developed and opened for signature in 2022, with Amount A coming into effect in 2023. The MLC will introduce a multilateral framework for all jurisdictions that join, regardless of whether a tax treaty currently exists between those jurisdictions. If a tax treaty already exists between parties to the MLC, that tax treaty will remain in force and govern cross-border taxation outside of Amount A. The MLC will require all parties to remove all digital services taxes and other similar measures applicable to all companies, whether within scope of Pillar One or not, and to commit not to introduce such measures in the future.

Amount B

Pillar One also introduces Amount B, which represents a fixed return for baseline marketing and distribution activities in market jurisdictions, that is intended to reduce transfer pricing and other disputes. The OECD/G20 statement provides that the application of the arm's-length principle to in-country baseline marketing and distribution activities will be simplified and streamlined and that such work will be completed by the end of 2022.

Pillar Two

Put simply, Pillar Two introduces a global minimum effective corporate tax rate set at 15%.

Pillar Two consists of two interlocking domestic rules (together the Global Anti-base Erosion (GloBE) Rules) and a treaty-based rule:

- The first domestic rule is the Income Inclusion Rule (IIR), which imposes a top-up tax on a parent entity that takes into account the low-taxed income (meaning income taxed at an effective tax rate below 15%) of a constituent entity.
- The second domestic rule is the Undertaxed Payment Rule (UTPR), which denies deductions or requires an equivalent adjustment to the extent the low-taxed income of a constituent entity is not subject to tax under the IIR.
- The treaty-based rule is the Subject to Tax Rule (STTR), which allows source jurisdictions to impose limited source taxation on certain related-party payments subject to tax below a minimum rate of 9%. The STTR will be creditable as a covered tax under the GloBE rules.

The GloBE rules apply to an MNE that has sustained and significant involvement in the economy of a market jurisdiction, irrespective of its level of physical presence in that jurisdiction. These rules apply to an MNE that meets the €750 million threshold as determined under BEPS Action 13 (country by country reporting). The OECD/G20 statement provides that a country is free to apply the IIR to an MNE headquartered in its country even if the MNE does not meet the threshold.

MNEs that are just starting international activities will be temporarily excluded from the UTPR. MNEs with no more than €50 million in tangible assets abroad and operations in no more than five other countries will be exempt for five years after the first time the MNE falls under the scope of the GloBE rules.

The GloBE rules provide a carveout that excludes income that is 5% of the value of tangible assets and payroll. This carveout is phased in gradually—in a transition period of 10 years, the amount of income excluded will be 8% of the value of tangible assets and 10% of payroll, declining annually by 0.2% for the first five years, and by 0.4% for tangible assets and by 0.8% for payroll for the last five years. The GloBE rules also provide for a de minimis exclusion for those jurisdictions where the MNE has revenues of less than €10 million and profits of less than €1 million.

The OECD/G20 statement provides that consideration will be given to the conditions under which the U.S. GILTI regime will co-exist with the GloBE rules, to ensure a level playing field. Interactions between the GloBE rules and tax-law changes to the U.S. GILTI regime and the base erosion and anti-abuse tax being considered by the Biden Administration and Congress will also need to be evaluated.

The OECD/G20 statement includes an implementation plan for Pillar Two. Generally, the goal is that Pillar Two should be brought into law in 2022, to be effective in 2023, with the UTPR coming into effect in 2024. Model rules to give effect to the GloBE rules, as well as a model treaty provision to give effect to the STTR, will be developed by the end of November 2021. A multilateral instrument will be developed by mid-2022 to facilitate the implementation of the STTR in relevant bilateral treaties. By no later than the end of 2022, an implementation framework will be developed to facilitate the coordinated implementation of the GloBE rules.

The Road(blocks) Ahead

Questions abound regarding whether the implementation plan in the OECD/G20 statement is overly optimistic. The EU appears likely to implement Pillars One and Two without too much difficulty now that the former EU Inclusive Framework member holdouts have signed onto the OECD/G20 statement. While the nonparticipation of four dissenters in the Inclusive Framework—Kenya, Nigeria, Pakistan, and Sri Lanka—likely will not significantly impede the near-global implementation of Pillars One and Two, other factors may prove to be roadblocks to implementation.

In the United States, a legal debate might ensue before legislation can proceed. At a September 2021 congressional committee hearing, Senator Pat Toomey (R-PA), who opposes the OECD/G20 statement, told Yellen that a key portion of the tax deal would require a formal treaty approved by a two-thirds Senate majority, while the Biden Administration has indicated that it may be possible to use alternate means. It remains to be seen how, or if, Pillars One and Two can be implemented. Notably, the United States has entered into binding international agreements, including the North American Free Trade Agreement, without a formal treaty.

The scope of items to be tackled in the implementation plan itself is daunting. In addition to the points above, it will be necessary to develop rules for which MNE entities will be treated as surrendering profit that is reallocated under Amount A. Definitions of the carveout industries (extractives and regulated financial services) are required, as well as rules for adjustments to MNE financial data to calculate the tax base for Pillars One and Two. Regardless of any roadblocks that may arise, many big and small questions must be answered before Pillars One and Two can be implemented, and substantial work remains.

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