

OECD Publishes a Public Consultation Document on the Global Anti-Base Erosion Proposal (Pillar Two)

A month after unveiling its proposal for a “Unified Approach” to Pillar One of the work program on tax and digitalization ([analyzed here](#)), the OECD Secretariat has issued a [public consultation document on Pillar Two](#).

Quick Summary

The Pillar Two consultation document does not significantly advance the stated design features of the proposed global minimum tax regime (GloBE), as described in the Inclusive Framework’s Programme of Work published at the end of May 2019 ([analyzed here](#)), and an earlier consultation document published in February 2019 ([analyzed here](#)).

Those features are:

- An **income inclusion rule** that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate
- A **tax on base eroding payments** that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax), together with any necessary changes to double tax treaties, for certain payments, unless that payment was subject to tax at (or above) a minimum rate

The new consultation document seeks input on two sets of technical issues related primarily to the income inclusion rule:

- The use of financial accounting information to determine the income tax base
- The computation of the effective rate of foreign income tax

The document also asks for comments on possible carve-outs from the scope of the overall proposal. The discussion of possible approaches to the challenges posed by the use of financial accounts as the tax base, and by the need to determine a foreign effective tax rate, makes it clear that the proposal would involve significant complexity for multinational taxpayers and tax authorities alike.

The document notes that the Inclusive Framework has not yet agreed to adopt the proposal, but is merely considering it on a “without prejudice” basis, acknowledging that further work is needed on various aspects of the proposal, after which there will likely be further public consultation.

As a result, there is still no clarity on how the Pillar Two rules would work in practice and no way of assessing their impact and no way for businesses to accurately model or otherwise prepare for their introduction. Much important work remains during the months ahead.

The remainder of this note summarizes the Pillar Two consultation document in more detail and comments on certain aspects of it.

The Proposed GloBE Regime

The GloBE proposal of Pillar Two relates to the taxation of all types of multinational businesses (not just highly digitalized businesses).

In summary, GloBE would operate through the combination of two interrelated sets of rules (between them comprised of four elements):

- **Income inclusion rules**
 - **Income inclusion rule** – A top-up tax charged at the shareholder level on the income of a foreign branch or subsidiary subject to foreign tax at an effective rate below a minimum rate.
 - **Switch-over rule** – A new provision in tax treaties allowing residence jurisdictions that use an “exemption method” in respect of profits attributable to a permanent establishment to “switch-over” to a “credit method” in circumstances where such profits are subject to foreign tax at an effective rate below a minimum rate.
- **Complementary anti-base erosion rules**
 - **Undertaxed payments rule** – A disallowance of deductions for payments made to a related foreign entity that is not subject to tax at (or above) a minimum rate.
 - **“Subject to tax” rule** – The imposition of source-based tax (e.g., withholding tax) on, and an adjustment to the eligibility for treaty benefits for, payments made to a related foreign entity that is not subject to tax at (or above) a minimum rate.

The four elements would work together and operate to “top up” tax paid on realized profits to an agreed, fixed minimum rate.

GloBE aims to address “comprehensively [the] remaining BEPS challenges by ensuring that the profits of internationally operating businesses are subject to a minimum rate of tax.” The idea is that imposing a worldwide minimum rate of tax would curtail international tax competition between states and reduce (if not eliminate) the profit-shifting activities of multinational enterprises (MNEs).

Contrary to the premise of the BEPS project this implies that low rates of corporate income tax are a problem, even if an MNE conducts the business activities producing the taxable profits in the low-tax jurisdiction. It also assumes, without evidence, that significant profit shifting will continue to be possible despite the implementation of the BEPS project recommendations around the globe.

Like the Pillar One proposals, the GloBE proposal would necessitate a rewiring of current international tax law. It would entail changes to double tax conventions and domestic laws and require enhanced mechanisms for information exchange, co-operation, and dispute resolution between tax authorities and taxpayers.

Many key components of GloBE remain unclear. Most obviously, the minimum effective tax rate is unknown and will not be determined until the proposal is fully developed. It will be the last, but obviously most important, piece of the puzzle. Furthermore, the priority of each element of GloBE (i.e., which rule is “switched off” when another rule applies to the same transaction) is unspecified. Other principal areas that lack further detail in the Pillar Two consultation document include:

- The interaction of GloBE with other international and domestic tax rules
- The mechanics and operation of the undertaxed payment rule
- The nature and scope of the subject to tax rule

Although the Pillar Two consultation document welcomes general comments on the proposal, it concentrates on issues in three areas, namely:

- Determining the foreign income tax base
- Blending (or non-blending) of foreign income taxes
- Scope carve-outs and thresholds

Determining the Tax Base

Regarding the income inclusion rule, the working assumption of the document is that the income tax base of a foreign branch or subsidiary would be determined using existing controlled foreign company (CFC) rules or, where CFC rules do not exist, domestic corporate income tax rules.

The problem with that approach, according to the document, is that differences between the income tax rules of different jurisdictions (e.g., in relation to the use of losses) could result in unintended consequences.

Therefore, the Pillar Two consultation document (building on a suggestion made in the Programme of Work) seeks comment on the possibility of using financial accounting rules (subject to agreed adjustments for tax).

While attractively simple, the suggestion immediately raises numerous questions around consistency, administration and transparency. These include:

- Which accounting standard is relevant? Is it the one used by the parent entity or the one used by the subsidiary? Is the International Financial Reporting Standard (IFRS) (often used for the purposes of a group’s consolidated financial statements) most appropriate? Alternatively, should there be a list of approved generally accepted accounting principles (GAAPs) for the purposes of GloBE?
- In any case, is the chosen accounting standard suitable for the GloBE regime? If multiple options are available, will it be necessary for each subsidiary of the parent entity to use the same accounting standard? If not, will different choices significantly distort results?

- Once a set of financial accounting statements is selected, what adjustments (if any) will be necessary for tax purposes? If adjustments are necessary, should they only apply to permanent differences (e.g., income exclusions and disallowed deductions)? Alternatively, should they apply to temporary differences (e.g., loss carry-forwards and deferred taxes) as well?
- If adjustments are necessary, whose tax rules (i.e., those of the parent jurisdiction, those of the subsidiary jurisdiction or some other) should apply to determine the nature and extent of the adjustments?

These questions indicate the technical complexity involved in the GloBE proposal. They also hint at the practical complexity, and compliance difficulties, that MNEs would be likely to face.

Blending of Foreign Taxes (or Not)

The four elements of GloBE would operate by reference to a minimum effective rate of tax. The extent to which an MNE is able to “blend” high-taxed income with low-taxed income (whether within a single entity or across a number of entities in different jurisdictions within a group) would materially affect that MNE’s exposure to a liability under GloBE.

The consultation document requests comments on three different blending options, namely:

- **Worldwide blending** – The MNE aggregates total foreign income and total foreign tax on that income. The GloBE rules would apply where the global effective foreign tax rate is below the minimum rate, with the liability being the amount necessary to bring the total amount of tax on foreign income up to the minimum rate.
- **Jurisdictional blending** – The MNE apportions foreign income between different foreign taxing jurisdictions but aggregating all members of the group resident in that jurisdiction. The GloBE rules would apply where the tax paid in any given jurisdiction is below the minimum rate, with the liability being the amount necessary to bring the amount of tax paid with respect to income apportioned to that jurisdiction up to the minimum rate.
- **Entity blending** – The MNE determines the income and taxes of each individual entity in the group. The GloBE rules would apply wherever the effective foreign income tax rate of an entity is below the minimum rate, with the liability being the amount necessary to bring the amount of tax paid by each entity up to the minimum rate.

Generally but not always, the greater the degree of blending, the more likely it would be that an MNE’s GloBE tax liability would be reduced or eliminated. However, the wider the blending allowable, the lower the compliance burden (as fewer calculations would be required).

The consultation document outlines several blending issues, including:

- The effectiveness and desirability of blending in mitigating the volatility of effective tax rates caused by tax adjustments made for temporary differences
- The blending implications of using different types of financial accounting statements (under the simplification proposals outlined above) to determine the tax base
- The need for an appropriate and consistent approach to allocating income:
 - Between head office and branch jurisdictions
 - To fiscally transparent entities (e.g., partnerships)
- In relation to both the jurisdictional and entity blending options, how best to develop robust principles to account for:
 - Taxes levied in another jurisdiction
 - Dividends and other distributions

The blending options are interdependent with the options on how to determine the foreign income tax base. A decision to follow one particular direction on tax base would most likely have direct consequences for the type of blending adopted.

Carve-Outs and Thresholds

The consultation document suggests that certain carve-outs and thresholds from GloBE could be appropriate and should be considered.

Possible carve-outs include:

- Business income subject to a foreign tax regime compliant with BEPS Action 5 (on harmful tax practices) or otherwise imposing suitable substance conditions
- A specified level of return on tangible assets
- Specified business sectors, industries, or business models (e.g., business to business)

Possible thresholds include:

- The total value of transactions between CFCs and related parties
- Turnover, assets or other indications of group size
- *De minimis* levels of income required for inclusion of a group entity or transaction in the GloBE computation

The impact of a given carve-out depends on its design. Two broad options are considered:

- **Qualitative facts and circumstances basis** – Targeting specific circumstances. Tightly designed qualitative carve-outs would reduce the opportunity for abuse but come at the expense of simplicity, certainty and administrative ease.
- **Objective, formulaic basis** – Providing simplicity and more consistency by applying a set formula referencing one or more bases. However, objective carve-outs are susceptible to being either too wide or too narrow (and may require targeted anti-abuse rules).

In terms of thresholds, there is a general concern that they can create volatility and/or a cliff-effect (and therefore incentivize aggressive planning) around the threshold level.

The OECD Secretariat is hoping that the collective experience of the global tax community in addressing similar questions in other policy areas will help it to resolve them in relation to the GloBE proposal.

Next Steps

The OECD is seeking comments on all aspects of Pillar Two, particularly on the three technical design aspects outlined above. Comments must be sent by [email](mailto:taxpublicconsultation@oecd.org) (to taxpublicconsultation@oecd.org), in Word format, addressed to the International Cooperation and Tax Administration Division, OECD Centre for Tax Policy and Administration, no later than Monday, December 2, 2019. A public consultation meeting on Pillar Two will take place in Paris on December 9, 2019.

The Bigger Picture

As noted, the GloBE proposal is part of a larger, two-pronged work plan approved by both the 135-member Inclusive Framework on BEPS and the G20 leaders.

The rationale for Pillar One, which aims to revise existing international tax standards on nexus and profit allocation, is quite clear: digital technologies now enable non-resident businesses to compete effectively in remote markets without any income tax cost, so new tax rules are needed.

In contrast, the rationale for Pillar Two (GloBE) is far less clear. If the premise is the desirability of eliminating tax rate competition between countries where the relevant business substance is located, neither the Inclusive Framework nor the OECD Secretariat has articulated that policy argument. If, on the other hand, the premise is the notion that the BEPS project recommendations, when implemented, will not prevent continued base erosion and profit shifting to low-tax entities having little or no substance, one is left wondering what the purpose of the original BEPS project was, and why its recommendations are not expected to be effective.

In any case, the consultation document on Pillar Two makes it clear that the proposal is not as far advanced as many have thought. The document deals with only a subset of the many issues arising from the overall proposal, and it merely raises more questions, rather than answering them. It seems possible that the discussion of GloBE will go on for many months, if not years, to come. It is important, however, for potentially affected MNEs to engage in the discussion now, when there is a chance to have a material impact on the policy outcome.

We Can Help

We have a dedicated team of leading tax experts to help you with issues arising in the taxation of the digital economy. Jeff VanderWolk, who has extensive experience in private practice and government and agency work, leads our digital tax team. Most recently, Jeff was head of the Tax Treaty, Transfer Pricing and Financial Transactions Division at the Centre for Tax Policy at the OECD. He has also served as International Tax Counsel to the US Senate Committee on Finance and as a Special Counsel in the Office of the Chief Counsel at the Internal Revenue Service.

We can strategize and support your engagement with the OECD's Inclusive Framework on BEPS. We can help you understand the possible business and technical tax impacts of the proposals under Pillar One and Pillar Two. We are also ready to assist with the implementation of strategies to position you to respond efficiently and effectively when change comes.

As a full-service global law firm, we are connected both locally and globally on the tax challenges arising from digitalization. We can provide unique insight at the point where law, business and government meet. We place our clients at the core of everything we do, giving them a voice, supporting their ambitions and achieving successful outcomes.

We look forward to engaging with you as your trusted adviser, as national and international tax law continue to evolve and respond to the digitalization of the economy.

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