The OECD minimum tax: What US companies need to know

> Today's agreement will make our international tax arrangements fairer and work better.
>
> This is a major victory for effective and balanced multilateralism. It is a far-reaching agreement which ensures our international tax system is fit for purpose in a digitalised and globalised world economy.
>
> OECD Secretary-General Mathias Cormann

The current international tax landscape has been in place for decades. But now dramatic changes may be on the horizon. The Organisation for Economic Cooperation and Development (OECD), backed by countries around the world, has been pursuing a "Two-Pillar Solution" aimed at alleviating certain global tax challenges that it believes arose from the "digitalisation of the economy." This OECD two-pillar framework will significantly alter many international tax practices we follow today with a related impact on reported earnings. In preparation, all companies should begin to assess what the OECD's proposed framework will mean to them.

In their simplest terms, Pillar 1 would change where sales to customers in other jurisdictions are taxed. Pillar 2 proposes a global minimum tax assessed for each jurisdiction where a multinational company operates. The ease with which the model can be described belies the complexity of its application and potential impact.

The OECD's agenda

OECD comprises 38 member countries that collaborate to help set standards for global policies in a number of areas, including tax. In the tax arena, OECD members are joined by 102 additional countries, forming what's called the Inclusive Framework. Over time, the OECD has increased its focus on mismatches between tax systems of different countries and how multinational enterprises organize their international operations to manage their global tax burden. Base Erosion and Profit Shifting and country-by-country reporting are OECD-driven initiatives that have influenced changes in tax laws around the world over the last few years. More recently, the OECD has focused on ways to reallocate some taxable profits to jurisdictions where the related goods are sold and services are consumed, resulting in the proposed Two-Pillar Solution.

The OECD does not have the authority to actually legislate or implement laws. The goal is for a general consensus among the countries that are represented at the OECD (and the broader Inclusive Framework group). From there, it will rely on each government to implement laws and treaties to achieve the agreed-upon objectives. Even though the OECD cannot set laws, the member countries typically agree to revise their own laws to comply with OECD initiatives. Essentially, what the OECD creates as policy today will often drive tax law changes in various jurisdictions, including the US.

Pillar 1 would change nexus

The objective of Pillar 1 is to reallocate more profits to market jurisdictions — essentially where customers are — from where it is currently taxed, which is generally where the productive property or employees reside or decisions are made, changing nexus (where a company is taxed) for multinationals. Many think of Pillar 1 as a focus on the technology sector and "digital services taxes," similar to a tax that France enacted in 2019. Pillar 1 would actually be much more far-reaching, and would have an impact well beyond tech companies. Pillar 1 would apply to any multinational entity with global turnover (revenues) above €20 billion (just under US$20 billion) and profit margin greater than 10% (i.e., profit before tax divided by revenue). With some exceptions for the extractives and financial services sectors, any globally-engaged company that exceeds the established threshold would be subject to Pillar 1.

Pillar 1 is still being negotiated; agreement has not been reached on several key issues, including scope, nexus, and revenue sourcing.

"These rules will shape our international tax arrangements for decades to come.

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Pillar 2 taxes would be based on book income

The objective of Pillar 2 is to ensure that large multinational enterprises pay a minimum level of tax (a threshold effective tax rate of 15%) on the income arising in each jurisdiction where they operate. This is per the proposal, or "Model Rules," which are also referred to as the "Anti Global Base Erosion" or "GloBE" rules).

Unlike many current tax systems, the Pillar 2 minimum tax would be determined based on book income: pre-tax results reported in a company's consolidated financial statements, with certain modifications. This would result in a very complex set of calculations that would require new processes, controls, and systems. Among other considerations, a company would have to maintain separate books and records for each jurisdiction — potentially for each consolidated subsidiary — using the accounting framework of the group's parent entity (e.g., US GAAP for most US-headquartered companies).

The OECD released the Pillar 2 Model Rules in December 2021; each jurisdiction needs to enact them into law for the rules to have effect. While no laws have yet been enacted, the UK and South Korea recently released draft legislation for public commentary, and the EU is pursuing agreement within its member countries to adopt Pillar 2.

What would cause a US company to be in the scope of Pillar 2?

The GloBE rules would apply to any **Constituent Entity** that is a member of a multinational group with annual revenue of €750 million or more (about US$730 million as of September 30) 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.

The group would need to include at least one entity or permanent establishment that is not located in the ultimate parent entity's jurisdiction. Therefore, the rules would apply to US entities with non-US subsidiaries. The rules would also be applicable to the US income (not just the foreign income) of a US-headquartered company if its US income is taxed at a rate less than 15%.

The Model Rules include a **de minimis exception**. There would be no Pillar 2 incremental tax ("top-up tax") for a Constituent Entity if its revenue and income are below a specified threshold.

Because the effective tax rate is calculated by jurisdiction, companies would be required to prepare financial reports on a recurring basis at entity levels that previously may not have been necessary. Specifically, items that may be eliminated in consolidation or recorded only in consolidation and not "pushed down" to the individual constituent entity's books and records may affect both the ultimate tax due and in which jurisdiction such tax is payable. These items would include intercompany sales, intellectual property transfers and management fees, and transfer pricing charges.

Key requirements of the Pillar 2 Model Rules

As proposed, companies would need to have a GloBE effective tax rate of at least 15%. The effective tax rate under Pillar 2 ("GloBE ETR") is determined by dividing (a) Adjusted Covered Taxes by (b) GloBE income or loss. To the extent that the GloBE ETR is less than 15%, a "top-up" tax calculation would need to be performed. The top-up tax would be determined by applying the difference between GloBE ETR and 15% to Pillar 2 income less what is referred to as a "substance-based carve out."

The following illustration demonstrates how the calculation is expected to work.

Step	Summary	Reference
1	Calculate GloBE income or loss on jurisdictional basis	A
2	Calculate Adjusted Covered Taxes on jurisdictional basis	B
3	**GloBE ETR**	C = B / A
4	Top-up tax percentage	D = 15% - C
	Tangible assets plus payroll on jurisdictional basis	E
	Substance-based carve-out	F = E * 5%
5	**Excess profit** (i.e., the tax base for top-up tax)	G = A - F
6	Top-up tax	H = D * G

Who is responsible for paying any top-up tax?

This is a challenging question. While we've talked about a "top-up tax" as if it were a single calculation, the reality is that it can be administered in several ways, adding to the complexity of this model. While each approach would generally be calculated under the same methodology as detailed above, the approaches will differ with respect to which jurisdiction collects the tax and the mechanism by which the tax is collected.

First, many countries are considering implementing minimum taxes to apply to their own domestic taxable income so they can collect and administer the taxes within the jurisdiction (these are referred to as Qualified Domestic Minimum Top-up Tax or QDMTT).

Under the Model Rules (to the extent that a QDMTT does not exist at the local level) if the ultimate parent entity is located in a jurisdiction that has adopted the Pillar 2 Model Rules, any required top-up tax on lower tier subsidiaries would be collected by the tax jurisdiction of the parent entity, which is addressed in Pillar 2's Income Inclusion Rule (IIR).

If the ultimate parent is not located in a taxing jurisdiction that has adopted the Pillar 2 Model Rules (and no QDMTT is present at the jurisdiction of the relevant lower-tier subsidiary), then the responsibility for applying the Pillar 2 rules may flow to other lower-tier subsidiaries under the Undertaxed Payments (or Profits) Rule (UTPR). In this case, a jurisdiction that has adopted the Model Rules may be able to tax income earned in another jurisdiction.

The ability to apply and collect this tax may vary among each of the three methods (IIR, QDMTT, or UTPR). Additionally, actual tax legislation enacted in the various jurisdictions will require coordination to ensure double taxation is minimized.

How should you account for the top-up tax?

There is no definitive answer to how to account for the top-up tax under the Pillar 2 Model Rules. It is not yet clear how ASC 740 or IAS 12 would be applied to the Pillar 2 Model Rules or whether additional guidance from regulators or standard-setters may be necessary

Example

The following example demonstrates a calculation of the effective tax rate under the Pillar 2 Model Rules, as compared to how it would be calculated under general income tax accounting principles under US GAAP. Specifically, the calculation highlights the determination of **Adjusted Covered Taxes** under the Pillar 2 Model Rules and the impact of certain required adjustments. For purposes of this example, it is assumed that there are no differences between pre-tax income and GloBE income and that the statutory tax rate is 25%.

	US GAAP	ETR	GloBE	ETR	Difference	ETR
Pre-tax income	$1,000		$1,000			
Tax expense at statutory rate	$250	25.0%	$250	25.0%		
Tax benefit of non-refundable tax credits	(50)	(5.0%)	(50)	(5.0%)		
Uncertain tax position	12	1.2%	-	-	$12	1.2%
Tax benefit of permanent book/tax difference	(50)	(5.0%)	(50)	(5.0%)		
Impact of temporary items	-	-	(10)	(1.0%)	10	1.0%
Total	**$162**	**16.2%**	**$140**	**14.0%**	**$22**	**2.2%**
Total current expense (GloBE reflects the removal of UTPs)	$137		$125		$12	
Total deferred tax benefit	25	A	15	B	10	C
Total	**$162**		**$140**		**$22**	

Deferred tax reconciliation			
Change in temporary difference for plant assets		$(100)	*Increase in taxable temporary differences*
Statutory tax rate		25%	
Deferred tax expense, ASC 740	A	**$25**	
Change in temporary differences for plant assets		$(100)	*Increase in taxable temporary differences*
Adjustment to 15% minimum rate, Pillar Two		15%	
Deferred tax expense, covered taxes for Pillar Two	B	**$15**	
Difference related to deferred taxes	C	**$10**	

What's next?

This is the pivotal question. While the OECD released the Model Rules in December 2021, which was followed by supporting Commentary in March 2022, they have said they expect to release implementation guidance later this calendar year, or possibly early next year. In the meantime, countries including the UK, Switzerland, and Korea have begun the process to introduce the Model Rules. Separately, the EU continues to push for member agreement of the Draft Council Directive on implementing the Pillar 2 GloBE rules, most recently revised in March 2022, despite Hungary's withdrawal of support in June 2022. While each country needs to enact its own Pillar 2 legislation, there is much for multinational businesses to do to prepare for compliance with these rules.

Given the expected effort involved to obtain information and develop and implement processes and systems to comply with the rules, companies would be well served to prepare now. A common starting point would be to model the impact of the rules on cash taxes and the effective tax rate. This exercise may identify gaps in the systems, including ERP systems, and processes necessary to collect the data, and related internal controls, to determine income and covered taxes at a constituent entity / jurisdictional level.

The proposed rules represent a fundamental change to how companies have been taxed for over sixty years. Importantly, the fact that Pillar 2 leverages financial reporting income makes preparing for its implementation a cross-functional effort that requires engagement with the operational and finance organizations well beyond the tax function; early planning and consistent communication will be critical.

The implementation of Pillar 2 compliant tax legislation in the US may take time. But given actions already taken in other jurisdictions, it's clear that momentum is swinging in that direction. Proactive leadership and substantive preparations now will make the eventual transition to a new tax landscape that much easier.

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Description of key terms

Constituent Entity

The term “Constituent Entity” refers to an entity included in a “Group” that is subject to the GloBE rules (i.e., a multinational enterprise). A Group comprises entities (including those that prepare separate financial accounts, such as partnerships or trusts) that are related through ownership or control and generally included in consolidated financial statements of an Ultimate Parent Entity. This includes any permanent establishments of a Constituent Entity. Certain entities, such as governmental entities and non-profit organizations, are not subject to the GloBE rules.

Adjusted Covered Taxes

Once the relevant GloBE income is determined, the amount of taxes associated with that GloBE income or loss will be needed to calculate a jurisdictional level ETR. These associated taxes, referred to as “covered taxes,” are broadly defined as taxes imposed on a Constituent Entity’s income, as well as certain taxes that are “functionally equivalent to such income taxes.” The definition of taxes considered to be income taxes under the Model Rules may be broader than those considered to be income taxes under financial reporting standards. That said, “covered taxes” does not include taxes such as indirect, payroll, or property taxes, which are not taxes based on income.

Covered taxes are adjusted under the Model Rules before calculating ETR. Adjusted covered taxes start with current tax expense accrued at the separate company/ jurisdictional level, and are then adjusted for a number of items. While not an exhaustive list of all adjustments contained within the Model Rules, the more significant adjustments to current taxes include the following:

- The exclusion of deferred taxes
- The removal of any tax impacts associated with uncertain tax positions (until the year in which, and only if, such taxes are ultimately remitted to tax authorities)
- Adjustments for accrued taxes relating to items of income or loss that are specifically excluded from the GloBE tax base (said another way, if certain taxes were accrued on an item of income that is not included in GloBE income, the associated taxes would generally also be excluded)
- Any increase or decrease in covered taxes recorded in equity or OCI relating to amounts included in the computation of GloBE income or loss that will be subject to tax under local tax rules
- Any amount of GloBE Loss Deferred Tax Asset (as defined in the Model Rules)
- Certain adjustments for qualified refundable and non-qualified refundable tax credits
- A reduction for any amount of current tax expense that is not expected to be paid within three years of the last day of the fiscal year

Deferred taxes

The proposed adjustments for deferred taxes received significant attention during the development of the Model Rules. Deferred taxes normally represent the difference between the financial statement basis and tax basis of an asset or liability at the statutory tax rate of the relevant jurisdiction in which that asset or liability will be recovered or settled. They essentially represent the future tax benefit or expense of recovering an existing asset or settling an existing liability at its carrying amount. The Model Rules propose to leverage the financial statement deferred tax model to alleviate incremental tax when it is only a matter of differences in timing as to when an item of income or expense is includible in financial statement income versus taxable income. There are, however, two key departures from that financial statement deferred tax model when adjusting a company's current tax for deferred taxes in Pillar 2. Specifically:

1. The deferred tax expense or benefit will be remeasured to 15% if the local statutory rate is above the 15% minimum tax. For example, the starting point for Pillar 2 in the US would be the federal tax rate plus the applicable state tax rate, which would be in excess of 15%. Therefore, US deferred tax expense or benefit would have to be remeasured for purposes of calculating adjusted covered taxes.
2. If a company has recorded a deferred tax expense to establish or increase a deferred tax liability, and that deferred tax liability will not be paid or recovered within five years, then the deferred tax expense related to that liability would not be included in the adjustment to covered taxes until paid or recovered.

There are several exceptions to this rule. The Model Rules include a list of items for which companies would not need to track the expected timing of reversal. One of the most significant items is fixed assets (for which cost recovery is typically accelerated for tax purposes as compared to the timing of depreciation for financial reporting).

Application of this rule to the recognition of deferred tax liabilities with respect to tax-deductible goodwill or other indefinite-lived assets such as trade names, when the “deduction event” for book purposes is only upon an impairment, rather than a predictable pattern of amortization, may be challenging for many multinationals.

Both of these adjustments can lead to significant differences between outcomes under Pillar 2 and effective tax rate reconciliations under US GAAP (or IFRS).

Treatment of qualified vs. non-qualified refundable tax credits

With respect to covered taxes, the Model Rules treat qualified refundable tax credits and non-qualified refundable tax credits differently, which will have a significant impact on whether a top-off tax is triggered given its impact on the calculation of GloBE ETR.

Refundable tax credits are generally tax credits that are not dependent upon an income tax liability for monetization. For example, certain UK research and development incentives can be monetized against income tax liabilities or other non-income based taxes. In certain jurisdictions, a taxpayer may also receive a direct cash refund even if the taxpayer has no other tax liabilities against which the credit can be applied. For financial statement purposes, refundable tax credits are generally not included within the scope of the income tax accounting standard. As the monetization of such credits is not dependent upon taxable income, such amounts are included in pre-tax income.

Non-refundable income tax credits, on the other hand, are generally reflected on the tax line in the financial statements. The Model Rules generally follow this same approach by including the impacts of certain “qualified” refundable credits in GloBE income, as opposed to reducing covered taxes. However, certain “non-qualified” refundable tax credits (generally, credits that are not recovered within four years) may require further adjustment.

Importantly, while a company may receive the same economic benefit of a credit regardless of whether it is refundable or non-refundable (i.e., the same net income in both scenarios), companies that generate non-refundable credits (e.g., US research and development credits) may be significantly disadvantaged under Pillar 2 as compared to companies that benefit from qualified refundable credits, given the mechanics of the GloBE ETR calculation.

This is best illustrated by an example:

	Refundable tax credit	Non refundable tax credit
Revenues	$1,800,000	$1,800,000
Expenses	(800,000)	(800,000)
Refundable tax credit	200,000*	-
Pre-tax income	**$1,200,000**	**$1,000,000**
Tax computation - add back refundable credit*	(200,000)	
Taxable income	**$1,000,000**	**$1,000,000**
Tax provision		
Current tax expense (taxable income at 25%)	$250,000	$250,000
Tax credits	-	(200,000)
Total tax expense	**$250,000**	**$50,000**
Effective Tax Rate under US GAAP	**21%****	**5%**
GloBE		
Pre-tax income	$1,200,000	$1,000,000
Adjusted covered taxes	250,000	50,000
Net income	**$950,000**	**$ 950,000**
GloBE Effective Tax Rate	**21%****	**5%**

*Refundable tax credit assumed to be non-taxable in this scenario.

** Rounded

De minimis exception

At the election of the MNE Group, there would be no Pillar 2 incremental tax ("top-up tax") for the Constituent Entity for fiscal years in which:

1. the average revenue of such jurisdiction, as defined by the GloBE rules, is less than €10 million; and
2. the average income or loss of such jurisdiction, as defined by GloBE rules, is a loss or is less than €1 million.

GloBE income or loss

GloBE income is defined as earnings under the parent company accounting framework on a separate company basis, adjusted for certain items enumerated in the Model Rules. These adjustments to financial statement net income include:

- Net tax expense (generally, current and deferred income taxes);
- Excluded dividends;
- Excluded equity gains or losses (including, but not limited to certain income or loss from investments accounted for under the equity method);
- Certain revaluation method gains or losses;
- Certain gains or losses from the disposition of assets and liabilities;
- "Asymmetric" foreign currency gains or losses (generally, foreign currency gains and losses that arise due to differences between the functional currency for accounting purposes and the currency used for local tax purposes);
- Policy disallowed expenses (e.g., certain fines or penalties);
- Prior period errors and changes in accounting principles; and
- Accrued pension expense.

Importantly, GloBE income may be different depending on the accounting framework of the UPE. For example, differences exist between US GAAP and IFRS. Under US GAAP, a transfer or sale of certain assets (e.g., intangible assets) between related parties is reported at the original carrying amount of the asset in both the seller's and the buyer's separate company financial statements (i.e., there is no "step-up" in the financial statement basis, even in the buyer's separate financial statements). However, under IFRS, which is largely the frame of reference for financial statement income under the Model Rules, such a transfer would generally result in a gain for the seller and a step-up in basis for the buyer in their respective financial statements. As such, GAAP differences, such as this, have raised questions about how companies should consider the OECD's intent in modeling their Pillar 2 tax impacts. Further guidance from the OECD or local tax authorities will be needed, but this example demonstrates that understanding the accounting framework of the Ultimate Parent Entity, specifically how book income is calculated, will be critical to calculating the top-up tax under the GloBE rules.

A practical challenge for companies will be determining financial statement income at the “Constituent Entity” level. These complications may include the following:

- If Constituent Entity level accounts are maintained using local statutory accounting principles, companies will need to understand all local statutory-to-reporting GAAP adjustments to prepare the Constituent Entity level financials under parent company GAAP.
- Companies will need to determine if any consolidation entries made by the UPE or intermediate holding companies relate to a specific Constituent Entity (e.g., late-arising adjustments) that were not “pushed-down” to the Constituent Entity’s local ledgers.
- As the Model Rules generally do not allow the impacts of acquisition or purchase accounting to be included in the GloBE income or loss base, understanding where those entries are recorded (particularly if those impacts have been “pushed down” to the legal entity level) will be important.
- Understanding the company’s consolidation process with respect to the elimination of intercompany transactions, as the separate company financial statements are required to be determined on a pre-elimination basis.