

OECD Announces a Public Consultation for Global Minimum Tax Rules

November 25, 2019

On November 8, the OECD announced a request for comments and a December 9 public consultation on its Global Anti-Base Erosion (GloBE) proposal,¹ which would further the work of the BEPS Project by developing a coordinated set of rules to address ongoing risks of MNE profit-shifting to no- or low-tax jurisdictions. The GloBE proposal falls under ‘Pillar Two’ of the OECD’s project for tackling the tax challenges arising from the digitalization of the economy. Our sense is that the OECD’s Pillar Two work is more likely than its destination-based taxation efforts under Pillar One to lead to a consensus among the Inclusive Framework countries, and that the consensus will produce two new internationally-accepted frameworks: (1) some form of a global GILTI-like rule; and (2) some form of deduction/low-inclusion rule that disallows a current deduction where a payment’s inclusion is taxed at a low or zero rate. This Alert discusses the details of the OECD’s first steps toward producing that consensus.

Under Pillar One, the OECD Secretariat recently proposed the Unified Approach, high-level recommendations that aim to reconcile countries’ competing policy proposals for taxing highly digitalized, “consumer-facing” businesses by creating a new taxing right for market jurisdictions and modifying long-standing transfer pricing and profit allocation guidance. In contrast, the GloBE proposal “is not limited to highly digitalized businesses.” In fact, it could cover all cross-border businesses.

The consultation document for Pillar Two defers the most important aspect of the GloBE project—setting the minimum tax rate—and instead “focusses on [three] technical issues in respect of the GloBE proposal where input from stakeholders would be valuable in progressing the work”:

- *Tax base determination* – the use of financial accounts as a starting point for determining the tax base under the GloBE proposal and mechanisms to address timing differences;
- *Blending* – the extent to which an MNE can combine high- and low-tax income from different sources to determine the effective tax rate;
- *Carve-outs and thresholds* – possible approaches for limiting the application of the GloBE proposal.

The consultation concerns only the ‘income inclusion rule,’ which is one of four components of the GloBE proposal identified in the Programme of Work.² Omission of the other three components (described in the Appendix to this Alert) from the current consultation could mean that the income inclusion rule will have substantive priority, as many commentators have argued should be the case. Alternatively, the Secretariat may simply need more time to develop questions for consultation on the other components.

The income inclusion rule would impose tax on the income of a foreign branch or foreign controlled entity if

¹ *Global Anti-Base Erosion Proposal (“GloBE”) – Pillar Two, Public consultation document, OECD (November 8, 2019)*

² *Program of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy, OECD (May 2019).*

that income is subject to tax below a minimum rate. Conceptually, the income inclusion rule resembles the U.S. GILTI rules. Yet, whereas GILTI evaluates the effective tax rate on income under tax accounting rules, the consultation document suggests the income inclusion rule would operate on the basis of financial accounting numbers—a distinction that could potentially present insurmountable technical complications for U.S. companies. One way to reconcile the two regimes would be to “white-list” GILTI, in effect exempting companies subject to GILTI from application of the income inclusion rule. Even in this case, however, many technical aspects—e.g., coordinating between the GILTI tax imposed on the U.S. parent and the possible Pillar Two tax imposed on the intermediary entity—would need further consideration. The potential application of the GloBE’s other three components also presents uncertainty.

We summarize here the three areas of technical inquiry in the Pillar Two consultation and address some of the challenges the GloBE proposal presents.

Developing a Consistent Tax Base

To improve compliance and administrability, and to neutralize differences in tax base calculations across jurisdictions, the consultation document proposes using financial accounts as a starting point for determining the tax base to which the income inclusion rule would apply. Agreed upon adjustments would be made to financial accounting income, and an effective tax rate would subsequently be calculated.

This approach raises a number of technical issues, including, but not limited to, whose accounting standard should be used (*i.e.*, the parent’s or the subsidiary’s) and which financial accounting standards should be accepted (*i.e.*, IFRS and/or certain local GAAP). Although not definitive, the consultation document implies that the ultimate parent entity’s accounting standard should apply, with IFRS, U.S. GAAP, and Japanese GAAP all being accepted.

The consultation document also recognizes the need to adjust for permanent and temporary differences between financial accounting income and taxable income. It identifies three adjustment mechanisms, with some operational examples provided in its Annex:

- (1) *Carry-forward of excess taxes and tax attributes method* – This approach has three components: (i) carry-forward of excess tax paid at the subsidiary level,³ (ii) carry-forward for income inclusion rule tax paid (*i.e.*, crediting/refunding parent entity’s tax when the subsidiary-level tax exceeds the minimum rate),⁴ and (iii) carry-forward of subsidiaries’ operating losses.
- (2) *Deferred tax accounting method* – Incorporating the method currently in use under most financial accounting standards to eliminate swings in the effective tax rate calculation caused by temporary differences.⁵
- (3) *Multi-year averaging method* – calculating the effective tax rate over a specified number of years to address the volatility caused by periodic differences.

³ Example 1 of Annex A.

⁴ Example 2 of Annex A.

⁵ Examples 3-5 in Annex A.

As the consultation document acknowledges, designing and implementing rules for addressing temporary differences using any of these approaches would require consideration of many factors, including, but not limited to, whether the approach addresses permanent differences as well as temporary differences; whether the approach can accommodate tax rate changes, ownership changes, and loss situations; and whether and to what extent implementation of the approach requires the use of subjective judgment. Recordkeeping burdens—a key practical concern for taxpayers—must also be taken into account.

Designing a Blending Mechanism to Determine Effective Tax Rates

In calculating the effective tax rate on income potentially subject to the inclusion rule, the GloBE proposal leaves open whether such rate would be calculated on an income item-by-income item basis, or whether some level of blending—across income items, jurisdictions, or legal entities—should be permitted. The Programme of Work called for exploration of three options for blending low- and high-tax income: (i) worldwide blending, (ii) jurisdictional blending, and (iii) entity blending.

The consultation document implicitly supports worldwide blending, i.e., aggregating in-scope foreign income and the associated tax paid or accrued at the global level for purposes of computing the effective tax rate. The document emphasizes that this approach would presumably “lower the overall compliance costs” and “provide more benefits to larger MNEs with significant and diversified operations across a number of low- and high-tax environments.” These observations almost certainly hold true with respect to U.S. companies subject to the GILTI regime, which employs worldwide blending. The consultation document also notes, however, that worldwide blending may be “less effective in creating a floor for tax competition” than would other blending approaches (or an income item-by-income item approach).

The consultation document also addresses design features of the blending mechanism, among them, possible reliance on consolidated financial accounts, income allocation between and among a head office, branches, and tax-transparent entities, the credit mechanism for taxes paid or accrued in foreign jurisdictions, and the treatment of dividends and other distributions. These features are clearly inter-connected—and complicated—but a worldwide blending approach reliant on consolidated financial accounts could mitigate the complexity.

Designing Carve-outs and Thresholds

The Programme of Work called for exploration of three carve-outs from the income inclusion rule: (i) substance-based carve-outs based on BEPS Action 5 standards on harmful tax practices, (ii) a return on tangible assets, and (iii) controlled corporations with related party transactions below a certain threshold. The consultation document discusses policy and design considerations for such carve-outs, including whether they should be objective and formulaic or qualitative and facts-and-circumstances based. The Programme of Work also called for exploration of applicability thresholds for the income inclusion rule based on turnover or other indications of the size of the group as well as de minimis thresholds and carve-outs for specific sectors and industries. The consultation document acknowledges that these elements of the GloBE proposal will depend on policy decisions but observes that thresholds based on broad criteria may be easier to administer.

Short-Term Outlook: The Difficult Questions Remain Unasked

The Pillar Two consultation will focus on technical design details but is silent on the bigger policy questions that will inevitably drive a consensus-based global minimum tax rule. What rate, or range of rates, will be used to identify a low-tax jurisdiction? How will the other three GloBE components, such as the “undertaxed payment rule” that provides a secondary taxing right to the source jurisdiction, be harmonized with the income inclusion rule? What incentives do the income inclusion rule and, more broadly, all GloBE rules, create for developing countries with respect to increasing revenue and ending the ‘harmful race to the bottom’? Will Pillars One and Two be identical in scope, and if not, what is the policy rationale for the difference? It is hard to imagine how any country or company could provide thoughtful comments on the technical aspects discussed in the consultation document without having even general answers to these broader questions.

Amidst this ambiguity, the OECD nevertheless aims to reach consensus on Pillars One and Two by the end of 2020, with an interim milestone in January 2020. In advance of a public consultation on December 9, public comments on the Pillar Two consultation document are due by December 2. Companies with a stake in the stability and predictability of the international tax system should take advantage of this historic opportunity to engage with and help to shape the coming changes.

For more information on this Alert, please contact a member of [Caplin & Drysdale](#).

[H. David Rosenbloom](#)
drosenbloom@capdale.com
202.862.5037

[J. Clark Armitage](#)
carmitage@capdale.com
202.862.5078

[Kirsten Burmester](#)
kburmester@capdale.com
202.862.7826

[Elizabeth J. Stevens](#)
estevens@capdale.com
202.862.5039

Jaehong Lee
jlee@capdale.com
202.862.7844

[Appendix] Background on Pillar Two

In January 2019, the Inclusive Framework issued a Policy Note on Addressing the Tax Challenges of the Digitalisation of the Economy.⁶ The Policy Note, agreed to by the Inclusive Framework members, set forth two Pillars of technical work that were further detailed in a May 2019 Programme of Work. Under Pillar One, the OECD Secretariat has since proposed a Unified Approach to creating new taxing rights and nexus rules for market jurisdictions combined with a formulaic approach to profit attribution that departs from the arm’s length principle.

With regard to Pillar Two, the Policy Note and Programme of Work explored issues and design options in connection with the development of a coordinated set of rules to address ongoing risks from structures that allow MNEs to shift profit to jurisdictions where they are subject to no or very low taxation:

- (i) 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;

⁶ *Addressing the Tax Challenges of the Digitalisation of the Economy, Public Consultation Document, OECD (February 13, 2019)*.

- (ii) an *undertaxed payments rule* that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate;
- (iii) a *subject to tax rule* that would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate; and
- (iv) a *switch-over rule* to be introduced into tax treaties that would permit a residence jurisdiction to switch from an exemption to a credit method where the profits attributable to a permanent establishment (PE) or derived from immovable property (which is not part of a PE) are subject to an effective rate below the minimum rate.

Pillar Two would not only comprehensively address remaining BEPS challenges linked to the digitalization of the economy but would also address these challenges more broadly. The GloBE proposal posits that coordinated global action is needed to stop a harmful race to the bottom on corporate tax rates and recommends steps to ensure that MNE profits are subject to a minimum rate of tax. In doing so, the GloBE proposal would influence taxpayer and tax authority behavior.

The Programme of Work, released in May, specified that the Pillar Two proposal will operate as a top-up to an agreed-upon fixed rate. The actual rate to be applied, however, was deferred to further discussion while other key design elements of the proposal were developed. The November 2019 consultation document likewise refrained from addressing the minimum tax rate and was also silent on the mechanics and operation of the ‘undertaxed payment rule’ and ‘the subject to tax rule’—the two rules that presumably will increase source jurisdictions’ revenue. Instead, the November 2019 consultation document seeks public comments on three technical aspect of the ‘income inclusion rule’—the tax base calculation, blending, and carve-outs.



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Washington, DC Office:
One Thomas Circle, NW
Suite 1100
Washington, DC 20005
202.862.5000

New York, NY Office:
600 Lexington Avenue
21st Floor
New York, NY 10022
212.379.6000

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