Bloomberg Tax

Tax Management
International Journal™

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OECD Provides Status Report on Pillars 1 and 2 Impact Assessment — Where Is the Money Coming From?

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On Thursday, February 13, the OECD presented a webcast which provided a status report on the development of an impact assessment of the anticipated tax collections and economic consequences of the proposed Pillar 1 and Pillar 2 revisions to the international tax framework. Businesses (and presumably governments even more so) have been eagerly anticipating a readout on this work, as one of the hallmarks of OECD policy making always has been to base policy decisions on rigorous economic analysis.

To its credit, the OECD is attempting to tackle one of the most challenging aspects of tax revenue estimation, namely the effect of behavioral changes encouraged by new law. The status report suggested that two possible behavioral changes could be that multinational enterprises reduce their profit shifting intensity, and that some low-tax jurisdictions increase their corporate income tax rate.

The headline figures are eye-catching; the estimate at the moment is that Pillar 1 and Pillar 2 in combination would result in an overall increase of annual corporate tax collections of up to $100 billion, or 4% of current corporate income tax collections.[1] The analysis indicates that tax revenue gains would be broadly similar across high-, middle-, and low-income economies.[2] The report projects that the only group of countries that would lose tax revenue in the aggregate under Pillar 1 (i.e., the ''surrender states,'' which would surrender tax rights over income that will be allocated to other jurisdictions) would be ''investment hubs.''[3] More than half of the Pillar 1 reallocated profit would come from 100 MNE groups. The OECD also expects that all three country groups — high, medium, and low income — would see an increase in corporate tax collections under Pillar 2.

One of the most interesting elements of this status report is the projected relative division between Pillars 1 and 2 as the source of the increased tax collections. Before adjustments for interactions between the two Pillars, reactions by MNEs to change profit shifting practices and reactions by governments to (presumably) increase tax rates, Pillar 1 accounts for only about 15% of the overall $100 billion tax increase. In relative terms, Pillar 2 is expected to raise over 5 times as much as Pillar 1.

That is an interesting result indeed, especially because the spirited public debate so far has focused principally on Pillar 1. The greater public attention to Pillar 1 has been mirrored in the relative pace of work by the Inclusive Framework. The Inclusive Framework statement endorsing the two-pillar approach released on January 31 included significant develop-

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[1] The status report also endeavored to model the effects of the interaction between Pillar 1 and Pillar 2, assuming that they are both implemented, and the effects based on reactions by multinational enterprises (MNEs) and by governments. The preliminary modeling indicates that the interaction between Pillars 1 and 2 results in a slight decrease in the overall additional global corporate income tax collections. Interestingly, the modeling projects that reactions by MNEs in response to the incentives created by Pillars 1 and 2 would lead to higher total tax collections than if the MNEs remained static and simply paid the new taxes created under the Pillars.

[2] Countries were grouped by income according to World Bank classifications.

[3] Investment hubs are defined as jurisdictions with inward foreign direct investment in excess of 150% of gross domestic product.

ments in the proposed design of the Pillar 1, while the material on Pillar 2 demonstrated much more modest advances in the technical development of that proposal.[4]

The revenue imbalance between Pillars 1 and 2 is surprising in part because the design assumptions used in the impact assessment status report would seem to favor robust Pillar 1 collections. The OECD assumed that Amount A would be based on a ''20 over 10'' profit allocation formula, namely that the ''routine profit'' threshold would be set at 10% of profits before tax, and that 20% of the global enterprise's profits above that level would be reallocated to market states.[5] Both of those figures would seem to reflect policy choices to enhance Amount A. Based on 2019 data, over 40% of the Fortune 1000 companies had profit-before-tax margins of at least 10%.[6] A 10% cutoff therefore suggests that a significant portion of groups with in-scope business models would become subject to the Amount A allocation formula.[7]

The OECD report noted that they had assumed that commodities and financial sectors were excluded from scope, but the presentation did not indicate how the OECD modeling exercise further isolated those enterprises that would be defined to be within scope of Amount A. Per the Inclusive Framework's January 31 statement, the in-scope enterprises for Amount A are only those engaged in providing ''automated digital services'' and ''consumer-facing businesses.'' Ultimately, the total aggregate amount of tax collections which will be reallocated under Amount A from residence states to market states will depend on many factors, including the definition of those businesses which will be in scope for this reallocation, a final decision on the numerical elements of the formula to determine the pool of allocable profit, the nexus definition and attribution principles to allocate the new tax rights to the market states, the identities and tax rates of the market states which will receive rights over this new tax base, and the identities and tax rates of the surrender states which will have to give up part of their current tax base.

For Pillar 2, the OECD presentation noted that their analysis was based on three important assumptions of critical Pillar 2 design features: (i) the estimates were based on a minimum tax rate of 12.5%; (ii) income and taxes were blended on a per-jurisdiction basis; and (iii) although not stated on the slides shown during the presentation, the income inclusion rule applies before the undertaxed payment rule. Blending on a per-jurisdiction instead of a global group basis or even just the group outside the home country would cause substantially more income to be in scope of the minimum tax rules, as the absence of global blending would not allow an MNE group to average up its overall rate through foreign operations in high-tax states and in its normally higher taxed home jurisdiction. On the other hand, the 12.5% rate would seem to leave undisturbed operating income reported in a host of lower taxed jurisdictions, including Ireland, Singapore, and Hong Kong.[8] There was no indication in the presentation as to whether carve-outs would be allowed for income that might be taxed at less than 12.5% under regimes that are compliant with the standards of BEPS Action 5 on harmful tax practices and or other substance-based incentive regimes.[9] A 12.5% threshold doesn't leave too many industrialized jurisdictions below that rate; Hungary, Bulgaria, and Qatar, at 9%, 10%, and 10%, respectively, might be feeling a bit exposed.

So where, then, will the $100 billion come from (or at least the 85% expected to be raised under Pillar 2)? One might suppose that the impact assessment assumes that the principal funding source for those additional corporate income tax collections would be profits now booked in traditional tax haven jurisdictions. The OECD presentation defined the primary source pool as those profits located in jurisdictions with (i) relatively high foreign direct investment (FDI); (ii) relatively low effective tax rate (ETR); and (iii) profitability exceeding a certain rate. That certainly describes the very low-tax jurisdictions that have been at the center of the BEPS debate.

It would be all fine and good for the reliability of the estimates if those profits indeed will remain in the havens by the time Pillar 2 comes into force. As the OECD representatives noted, however, one of the most difficult aspects of revenue estimation is to take into account dynamic taxpayer and government reactions to law changes. In the post-BEPS world, major U.S. multinationals indeed have been responding to

[4] OECD, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy — January 2020*, OECD/G20 Inclusive Framework on BEPS (OECD, Paris 2020). www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf.

[5] The impact assessment status report did not model any changes arising from Amounts B or C in Pillar 1.

[6] From the Capital IQ database using their 2019 Fortune 1000 (by revenue) listing, and screening on earnings before tax figures, including unusual items.

[7] All Fortune 1000 companies have global revenue in excess of €750 million in the event that that threshold turns out to apply for purposes of Amount A. The Fortune 1000 includes only companies headquartered in the United States.

[8] The current statutory tax rates in Ireland, Hong Kong, and Singapore are 12.5%, 16.5%, and 17%, respectively.

[9] As the report was not meant to provide insight on technical application of the rules, there also is no indication as to whether payments which benefit from foreign-derived intangible income (FDII) could be regarded as subject to the minimum tax rules.

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ISSN 0090-4600

BEPS changes in ways that might have a material effect on the OECD revenue estimates, depending on what data assumptions have been used for these estimates.

The OECD presentation noted the challenges to obtain solid data on how the Pillar 2 rules would apply to particular taxpayers or to all taxpayers in the aggregate. Several sources were used, including Orbis, Worldscope, country-by-country reporting (CbCR) information, AMNE data, national accounts material on international trade flows, and foreign direct investment statistics.[10]

Given the inherent limits on those data sources for purposes of determining the additional tax revenue to be generated through a Pillar 2 mechanism, it seems reasonable to speculate that the CbCR data was the principal data source to define the base case of what profits might be subject to Pillar 2 taxation. The OECD noted that the most recent CbCR data it had available was from 2016.

A lot has happened in the international tax landscape since 2016. At least for U.S. MNEs, implementation of the BEPS Actions, U.S. tax reform and other country new legislation have all decreased incentives to allocate incomeproducing assets to low-tax jurisdictions in the way that Pillar 2 is intended to combat.

The most significant development on the U.S. MNE side has been the continuous stream of migration of valuable IP assets out of haven jurisdictions to those jurisdictions where the MNE group has DEMPE[11] functions. While companies normally do not announce that they have entered into such transactions, some glimpses have entered the public record, and many more similar transactions have occurred without public acknowledgement.[12] By the time that Pillar 2 comes into force, those transactions will have drained a considerable amount of income from haven jurisdictions.

Other changes in law have hastened those transactions, as well as closed other opportunities for profit shifting of the sort targeted by Pillar 2. In the European Union, the Anti-Tax Avoidance Directives (ATAD 1 and ATAD 2) include a number of measures targeting the creation of low-taxed income, such as structures where income is excluded from taxation on the basis that it is allocated to a branch that does not rise to the level of a permanent establishment in the other state, hybrid financial instruments which are treated differently for taxation purposes in two (or more) states, residency mismatches that allow deductions of the same item in two jurisdictions, and payments to hybrid entities which are treated differently by two relevant jurisdictions.[13] While not all of the structures eliminated by ATAD 1 and (especially) 2 involved tax haven countries, many did, and all of them generally had as their goal the creation of relatively low-taxed income. The effect of ATAD 1 and 2 implementation, therefore, will be to take those low-tax results out of the CbCR pools which existed in 2016.

Other more prosaic elements of the BEPS program also have had the effect of allocating more income to the states where production and sales activity take place. In particular, tax administrations across the world have implemented the concepts in BEPS Action 8–10 to ''assure that transfer pricing outcomes are in line with value creation.'' Transfer pricing examinations underway even before the BEPS Action 8–10 changes were published in the OECD Transfer Pricing Guidelines relied on those concepts to support large transfer pricing adjustments. Prudent tax compliance normally suggests that once a taxpayer and a tax administration have resolved a transfer pricing dispute which relates to an ongoing commercial arrangement, such as sales and marketing activity or annual royalty payments, then the enterprise normally conforms transfer pricing arrangements for future years to avoid further controversies. The result of the BEPS changes to the Transfer Pricing Guidelines therefore has been a reallocation of profits from states of residence or asset ownership where residual profits had been booked to states of production and marketing activity. To the extent that the residual income holder had been a low-tax entity, those profit reallocations will affect the size of the profit pools available for a Pillar 2 tax charge.

Domestic legislation also has caused companies to make structure changes that will reduce the pool of

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[10] The Activity of Multinational Enterprises (''AMNE'') database, published by the OECD, presents detailed data on the activities of foreign affiliates in OECD countries (inward and outward activity of multinationals). The data indicate the increasing importance of foreign affiliates in the economies of host countries, particularly in production, employment, value added, research and development, labor compensation, and exports. The database contains 17 variables broken down by country of origin (inward investment) or location (outward investment) and by industrial sector for a large number of OECD countries. www.oecd.org/sti/ind/amne.htm

[11] Development, Enhancement, Maintenance, Protection, and Exploitation functions for intangibles.

[12] *See,e.g.*, Horst, T., *The TCJA's Incentives for and Impediments to Repatriating Intangible Property*, Tax Notes Int'l (Feb. 10, 2020).

[13] EU Directive 2016/1164 (ATAD 1) that includes measures against hybrid mismatches between EU Member States, as amended by EU Directive 2017/952 (ATAD 2) to include measures against mismatches between EU and non-EU countries. In general, ATAD 2 should have been implemented by Member States by December 31, 2019, to be effective as of January 1, 2020.

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ISSN 0090-4600

very low-taxed income. The U.K.'s offshore receipts tax (ORT) extends its reach beyond ATAD by addressing transactions that are completely offshore to the United Kingdom and do not necessarily involve hybrid transactions. Under the tax as structured, the great majority of the tax will be paid by entities that are the targets of the Pillar 2 proposals. As a consequence, the UK ORT has proven to be a powerful incentive for companies to exit those structures.

Last but not least, U.S. tax reform and the global intangible low-taxed income (''GILTI'') rules already have imposed a minimum tax on all offshore earnings of U.S. MNEs. It remains to be seen whether the Pillar 2 negotiations will result in a conclusion that the U.S. GILTI regime is a qualifying full inclusion regime for purposes of Pillar 2, and if so whether it then turns off the low-tax payment rule and the subject to tax rule for payments made to U.S. MNE CFCs. If the GILTI regime turns out to be a qualifying full inclusion regime that turns off the other rules, those design decisions essentially would remove the offshore tax base of U.S. multinationals from the scope of Pillar 2. That presumably would significantly reduce the pool of low-tax profits subject to a Pillar 2 tax compared to what the CbCR figures showed in 2016.

Even if the Pillar 2 regime turns out to have tighter parameters, such as entity level or jurisdictional level blending, the effect of U.S. tax reform has been to decrease the incentives for U.S. MNEs to hold assets in very low-tax environments. That change in law has provided further incentives for U.S. MNEs to transfer IP and other valuable intangibles out of such jurisdictions.

U.S. tax reform also introduced the base erosion and anti-abuse tax (BEAT). That tax acts like the undertaxed payments rule without the condition of applying only to payments that in fact are subject to a low rate of tax in the recipient entity. Nevertheless, it would seem that at least some of the tax collected under the BEAT might arise from cases intended to be covered by Pillar 2. That said, adjusting the OECD's Pillar 2 revenue estimates to account for BEAT collections on undertaxed payments would be challenging indeed.

The 2016 CbCR data precedes U.S. tax reform. The $100 billion estimate of increased taxes presumably is meant to measure the delta between the end of the original BEPS Action Plan implementation and the tax collection results of the Pillar 1 and 2 proposals. For the $100 billion to be accurate, therefore, it would need to factor into the baseline figure the increased tax on low-taxed offshore profits paid by U.S. multinationals post-2017 under the GILTI rules.

Action 11 of the original BEPS Action Plan committed the OECD to develop tools to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. Those tools are needed now. It would be extremely instructive for the OECD to prepare an analysis under Action 11 that assesses the impact of implementation by tax administrations and taxpayers of the various BEPS Actions around the world. That assessment then would set the base case for an impact assessment which models the incremental tax collections and reallocations expected to arise from the Pillar 1 and 2 proposals.

In today's very dynamic tax environment, 2016 feels like eons ago. The OECD noted that it will update the impact assessment as the Inclusive Framework reaches conclusions on the various important design features of Pillars 1 and 2. As those design features firm up, one hopes that the underlying data sources also will be updated. The updated sources presumably will provide a more accurate reflection of the consequences of U.S. tax reform and the structural changes implemented by many MNEs in harmony with and in response to the conclusions and implementation of the BEPS Action Plan. In that way, the projected incremental effect of the Pillar 1 and 2 implementations can be based on the financial landscape as it will exist at the time of implementation, as opposed to a highly questionable baseline from years which predate those BEPS-inspired changes.

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