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Pillar Two: No Time to Die, Die Another Day, You Only Live Twice?

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Recent OECD Pillar Two guidance introduces new safe harbours for global minimum tax implementation, offering simplification for some multinational groups while maintaining complexity for others.

October 8, 2021 witnessed two hugely significant world events. The OECD Inclusive Framework ("IF") agreed to the GloBE Pillar Two solution, establishing the foundation of a global minimum tax that at some point in each subsequent year looked close to dying, but ultimately lived on. Much like the way James Bond always found a way to survive (for 59 years, over 24 films, from the highs of *Goldfinger* and *On Her Majesty's Secret Service* to the lows of *Die Another Day*). But, on October 8, 2021, the unthinkable happened—James Bond died.

The parallels between the world of 007 and GloBE may not be obvious to everyone, but we are not the only ones to make the connection. (One of the key architects behind the deal, former Deputy Assistant Secretary (Multilateral Negotiations) in the Office of Tax Policy in the US Department of the Treasury, Itai Grinberg, also saw the connection. *The Re-entry Interview: After Securing Landmark International Tax Agreement, Prof. Itai Grinberg Returns to Campus* Georgetown Law (Feb. 23, 2023)). After all, there are the glamorous locations that formed the backdrop to both, as well as the love of acronyms and initialisms. James Bond had SMERSH and SPECTRE, GloBE now has SBTISH and SETRSH to add to QDMTT, IIR, etc. (more on these later). While we know what happened to Bond in October 2021, which James Bond title or titles would best describe the fate of Pillar Two was unclear. Until last week.

On January 5, the IF released its long-awaited Side-by-Side Package—a document that we refer to as the "SbS Package." The SbS Package promises "material simplifications" for the implementation of Pillar Two and is exclusively devoted to Safe Harbours—specifically, a Simplified Effective Tax Rate ("ETR") Safe Harbour ("SETRSH"), an extension of the Transitional Country-by-Country Reporting ("CbCR")

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Safe Harbour ("TCSH"), a Substance-based Tax Incentive Safe Harbour ("SBTISH"), a Side-by-Side Safe Harbour ("SbSSH"), and an Ultimate Parent Entity ("UPE") Safe Harbour ("USH").

If there is anything more shockingly obvious than the special effects in the *Die Another Day* kitesurfing scene, it is that Pillar Two needed simplification. The Pillar Two Model Rules document is less than 70 pages long. But what started out as a relatively simple concept has, over the past five years, developed into a highly complex rule set that has regularly seen fundamental changes to even its core concepts. Each release of new guidance is designed to help people understand and apply the relevant provisions. But new guidance has always brought additional complexity and, ultimately, raised more questions than it answered. This increasingly intricate scheme of evolving rules—which require an understanding of multiple accounting, tax, and transfer pricing regimes—presents a challenge for both in-scope MNE Groups and the relevant taxing authorities/governments that must legislate for, and then administer, the system. Accordingly, any attempt to provide some form of simplification is welcome, much like a shaken martini. Some would even say that without it, Pillar Two would face the same fate as 007. So, does the SbS Package actually deliver on this critical aim?

Side-by-Side Safe Harbour

We begin with the SbSSH, even though it comes at the end of the SbS Package, because it appears to be the most significant of the Safe Harbours in the Package. We say "appears to be" because, as we explain, the ramifications of this, and the other, Safe Harbours are not yet clear.

Under the SbSSH, an MNE Group whose UPE is located in a jurisdiction with a "Qualified SbS Regime" (defined below) may elect into the SbSSH for a Fiscal Year and reduce Top-up Tax with respect to (i) jurisdictions where the Group's Constituent Entities are located, and (ii) interests in Joint Ventures or JV Subsidiaries that Group Constituent Entities hold, to zero for purposes of the Income Inclusion Rule ("IIR") and the Undertaxed Profits Rule ("UTPR"). (The SbS Package uses terms that the Pillar Two rules define (such as Constituent Entity, Fiscal Year, etc.) without defining them again, and we follow this convention. Where a capitalized term is not defined, readers should assume the definition to be found in the Pillar Two Model Rules or Commentary.) The SbS Package limits the operation of the SbSSH to the IIR and the UTPR because a condition for what the Package terms the SbS System is that it not "interfere with or prevent QDMTTs [Qualified Domestic Minimum Top-Up Taxes] applying to the operation of all MNE Groups." The SbS Package expressly states that "[a]ll MNE Groups…remain subject to the QDMTT in all QDMTT jurisdictions in which they operate." Thus, the SbSSH may reduce Top-up Tax to zero for purposes of the IIR and the UTPR, but it deliberately has no impact on the computation of Top-up Tax for purposes of QDMTTs.

The SbSSH further mandates that each Qualified SbS Regime provide a foreign tax credit for QDMTTs and reiterates that QDMTT liability is computed before allocating permanent establishment ("PE") and controlled foreign corporation ("CFC") taxes, thereby continuing to give priority to source jurisdictions in this regard.

To ensure that QDMTTs remain in place, notwithstanding the SbSSH or other Safe Harbours, the IF promises to undertake and complete a "stocktake" by 2029. This "stocktake" will involve the IF assessing whether QDMTTs are still in place, as well as whether the Safe Harbours have given rise to "unintended effects," such as "material competitive imbalances identified between MNE Groups and any negative trends in taxpayer behaviours including changes in corporate structures to shift profits to achieve low-tax outcomes (for example, inversions or a material increase in profits located in low-tax jurisdictions without QDMTTs)."

Top-up Tax Deemed to Be Zero. We walk through the definition of a Qualified SbS Regime below, but, as readers know, the IF concluded that the US tax system (and, as of now, only the US tax system) constitutes a Qualified SbS Regime (see Central Record for purposes of the Global Minimum Tax | OECD). For MNE Groups whose UPE is located in the US (with UPE and location determined under the Pillar Two rules), any potential Top-up Tax under an IIR or a UTPR is therefore deemed to be zero if the Group elects to apply the Safe Harbour. The SbSSH does not state that jurisdictions' IIR and UTPR regimes do not apply to eligible MNE Groups, however. This approach is similar to the UTPR Safe Harbour that the IF introduced in July 2023 and the TCSH that the IF introduced in December 2022, both of which prevent the collection of Top-up Tax by deeming Top-up Tax to be zero as opposed to providing that jurisdictions' IIR, UTPR, and QDMTT regimes, as relevant, do not apply.

The Pillar Two Model Rules envisioned Safe Harbours operating along the lines above since their inception, as the concept of a GloBE Safe Harbour appeared in the Model Rules themselves. The rationale for deeming Top-up Tax to be zero under the SbSSH (or any Safe Harbour), as opposed to providing that Pillar Two regimes do not apply, is ostensibly that certain data—whether from CbCR reports or about a jurisdiction's tax regime—support the conclusion that a below 15% tax outcome is unlikely and justify excusing an MNE Group from the onerous compliance burden that the Pillar Two rules impose. Providing instead that Pillar Two regimes apply to some MNE Groups and not others could give the appearance of privileging certain countries and would undermine the notion that Pillar Two is a *global* minimum tax. As a result, Constituent Entities within a US-parented MNE Group are equally subject to Group members' IIR and UTPR regimes as are Constituent Entities within a non-US-parented MNE Group—the Top-up Tax under those regimes for Constituent Entities in a US-parented MNE Group is simply deemed to be zero because the US tax system already ensures that profits that could be subject to tax under an IIR or UTPR are generally subject to a 15% rate of tax.

The observation that the SbSSH does not actually affect the operation of IIR and UTPR regimes within an eligible MNE Group may be relevant to the question of how to approach the interaction of Constituent Entities in jurisdictions with QDMTT regimes and Constituent Entities in jurisdictions without them (e.g., Stateless Constituent Entities). For instance, if a Constituent Entity in a QDMTT jurisdiction makes a payment to a Constituent Entity in a jurisdiction that does not have a QDMTT, or a Constituent Entity in a jurisdiction that does not have a QDMTT transfers an asset to a Constituent Entity in a jurisdiction that does, determining the Pillar Two consequences could be similar to the analysis taxpayers have done in relation to the TCSH or the UTPR Safe Harbour over the past few years. We are not saying that numerous questions do not remain, of course – we are simply making the observation that the operation of the SbSSH appears similar to the operation of the TCSH and the UTPR Safe Harbour.

Electivity. As noted above, the SbSSH is not automatic; an MNE Group must elect to apply it for a Fiscal Year. This electivity is beneficial, as not all MNE Groups may want to elect the SbSSH. For instance, if an MNE Group has already come to terms with Pillar Two compliance and operates principally in high-tax jurisdictions, the SbSSH may actually complicate the operation of the Group's structure. That is because, among other things, the Pillar Two analysis with respect to the movement of assets is simpler for transactions involving solely non-Safe Harbour jurisdictions than for transactions between Safe Harbour and non-Safe Harbour jurisdictions. Similarly, the consequences of M&A activity may be more predictable and readily determined if no Constituent Entities are within a Safe Harbour because, in that case, the Pillar Two rules apply equally to all parties.

Joint Ventures and Co-Ownership Arrangements

The Pillar Two rules for Joint Ventures and JV Subsidiaries (as those terms are defined by the Pillar Two rules and not to be construed as all commercial joint ventures) compute Top-up Tax for those Entities on a standalone basis but allocate Top-up Tax collection rights to other MNE Group members. The SbSSH therefore reduces Top-up Tax to zero in respect of Joint Venture interests that eligible MNE Group Constituent Entities hold. Interests Constituent Entities of other MNE Groups hold do not benefit from this reduction, however. If, for example, a CFC of a US corporation holds a 50% interest in a Joint Venture, and a subsidiary of a non-US corporation holds the other 50% interest, the IIR or the UTPR may cause Top-up Tax to be payable by one or more Constituent Entities in the non-US corporate group.

The result would be similar in other types of co-ownership structures, such as structures involving Minority-Owned Constituent Entities. If a Constituent Entity in an eligible MNE Group holds 25% of the interests in an Entity, and a Constituent Entity in an ineligible MNE Group holds 75% of the interests, the Top-up Tax with respect to the 25% stake is zero. If the percentages are swapped, and the Constituent Entity in the eligible MNE Group holds the majority interest, there, too, Top-up Tax with respect to the majority interest is zero, while Top-up Tax may be charged with respect to the minority interest.

The result for Partially-Owned Parent Entities is different. The SbSSH deems the Top-up Tax with respect to a Partially-Owned Parent Entity to be zero as well. If, for instance, a Constituent Entity in an eligible MNE Group holds 75% of the interests in another Entity (Entity 1), and that Entity holds 100% of the interests in a third entity (Entity 2), making Entity 1 a Partially-Owned Parent Entity, the Top-up Tax under the IIR that the Partially-Owned Parent Entity is required to apply with respect to Entity 2 also is reduced to zero—even if the Constituent Entity that holds the 25% interest in the Partially-Owned Parent Entity is a member of an ineligible MNE Group. Thus, the members of the ineligible MNE Group do not have Top-up Tax collection rights with respect to Entity 2 under an IIR or a UTPR.

US Groups in Non-US-Parented Structures. As the SbSSH applies only where the UPE jurisdiction has a Qualified SbS Regime, a US subgroup within an MNE Group whose UPE is not located in such a jurisdiction remains subject to Top-up Tax under IIR and UTPR regimes, as do foreign subsidiaries of that US subgroup. A UPE could therefore pay Top-up Tax with respect to a CFC whose income is already subject to tax under the NCTI regime—though one would expect the cross-border tax allocation rules to mitigate Top-up Tax by treating NCTI tax as a Covered Tax of the CFC.

Qualified SbS Regime. Eligibility for the SbSSH turns on whether the UPE jurisdiction has a Qualified SbS Regime. A jurisdiction must have an "eligible domestic tax system" and an "eligible worldwide tax system" to have a Qualified SbS Regime. An eligible domestic tax system must have (i) a nominal tax rate of at least 20%, (ii) a corporate alternative minimum tax, and (iii) no material risk of ETR outcomes below 15%. The first requirement takes into account both "preferential adjustments that generally apply to all income of in-scope MNE Groups" and sub-national corporate income taxes, provided that "the combined rate generally applicable to in-scope MNE Groups will be equal to or greater than 20%." The US tax regime does not offer a deduction, exclusion, or tax credit with respect to *all* income. FDDEI, for instance, applies only to certain categories of income and therefore does not constitute a preferential adjustment of the type the SbS Package describes. Similarly, the combined US federal, state, and local tax rate is generally equal to or greater than 20%, such that US state and local taxes ought to factor into the nominal rate computation (to the extent necessary).

An eligible domestic tax system also must have a QDMTT or "a corporate alternative minimum tax based on financial statement income at a nominal rate of 15% or above" (the second requirement). The inclusion of a corporate alternative minimum tax, such as CAMT, alongside the reference to a QDMTT acknowledges that book minimum taxes like CAMT can achieve the objectives of Pillar Two even if they do not follow the Pillar Two rules.

In addition, the effective rate of tax on profits of domestic operations must not be below 15% (the third requirement). A rate slightly below 15% on certain types of income does not prevent a regime from satisfying this requirement if MNE Groups are likely to have substantial other domestic income that is taxed at a rate well above 15%—e.g., the 14% FDDEI rate coupled with the 21% US corporate income tax rate. The presence or absence of a corporate alternative minimum tax, anti-hybrid rules, and interest limitation rules also factor into the analysis. The SbS Package nevertheless cautions that the scope and size of a jurisdiction's incentives might cause that jurisdiction to be viewed as subjecting MNE Groups to an effective tax rate of less than 15%.

An eligible worldwide tax system must represent (i) a comprehensive tax regime, (ii) contain mechanisms to address base erosion and profit shifting ("BEPS") risks, and (iii) not present a material risk of ETR outcomes below 15%. A CFC regime, such as the current subpart F and GILTI regime, which captures all active and passive income, with exclusions only for, e.g., high-tax income, satisfies the first requirement. The SbS Package illustrates the second requirement with the example of rules that prevent crediting foreign taxes on active income against tax on passive income or do not allow blending low-tax income and high-tax income. The assessment of the third requirement in the foreign context is similar to the assessment in the domestic context. Accordingly, using the US tax regime as an illustration, while NCTI is ostensibly subject to a targeted effective rate of 14% (12.6% nominal rate, increased by the 10% haircut on NCTI taxes), subpart F income remains subject to a 21% rate, and the tax rate for both GILTI and subpart F income may be further increased by state and local taxes.

Timing. The SbSSH applies to Fiscal Years beginning on or after Jan. 1, 2026, and therefore does not address IIR or UTPR liability in prior periods. Generally speaking, a jurisdiction must have enacted its Qualified SbS Regime before Jan. 1, 2026, to qualify for the Safe Harbour—a requirement that led many observers to question whether the SbSSH applies only to the US. A jurisdiction may also ask the IF to assess its regime in 2027 and 2028, meaning that other members of the IF have an opportunity to qualify for the SbSSH as well. We may therefore see a number of higher tax jurisdictions (Brazil, for example) that already have QDMTT and CFC regimes assert that their regimes are Qualified SbS Regimes or modify those regimes to come within the standard in the next few years.

The IF expects jurisdictions to adopt the SbSSH into their domestic law with effect starting Jan. 1, 2026, unless domestic law precludes adoption of laws with retroactive effect. Even then, the SbS Package makes clear that outlier jurisdictions will only receive their ratable share of any UTPR Top-up Tax. Thus, if a handful of jurisdictions are unable to enact the SbSSH into law with effect as of Jan. 1, 2026, those jurisdictions will not be entitled to 100% of the 2026 Top-up Tax that would have been due in the absence of the SbSSH. All that said, given that this rule is itself contained in the SbS Package, presumably it also raises retroactivity concerns.

UPE Safe Harbour

In tandem with the SbSSH, the SbS Package also introduces the USH, which the IF intends to replace the UTPR Safe Harbour. The USH deems the UTPR to be zero with respect to the UPE jurisdiction for MNE Groups whose UPE jurisdictions satisfy the eligible domestic tax system requirements set forth in the SbSSH discussion. Like the SbSSH, it applies for Fiscal Years beginning on or after Jan. 1, 2026, but, unlike the SbSSH, it applies only to UPEs whose jurisdictions satisfy the eligible domestic tax system requirements on Jan. 1, 2026. There is no 2027 or 2028 opportunity for jurisdictions to align their domestic tax regimes with these requirements.

The USH may provide flexibility to MNE Groups that do not want to elect the SbSSH because they prefer subsidiaries to operate within the same minimum tax regime (e.g., QDMTTs, IIRs, UTPRs) but do not want the potential headache of a UPE being subjected to the UTPR by those same subsidiaries. We assume that the political nature of the SbS Package is why the window within which MNE Groups can qualify for the USH is so narrow.

Simplified ETR Safe Harbour, Extension of the TCSH

For those MNE Groups that do not qualify for the SbSSH, the SETRSH will be of interest.

The first point to note is that SETRSH is closer in design to the Model Rules than it is to the TCSH (the SETRSH is perhaps best viewed as Model Rules lite). This feature will be a disappointment to many that hoped for more meaningful simplification along the lines of the TCSH. There will have been concern from the IF members that a permanent Safe Harbour based off CbCR data would fail to prevent certain bad actors/behaviors that could undermine the integrity of the system, and the need to prevent this outcome has won over offering additional compliance relief to MNE Groups.

In an ominous sign, even the starting point for the SETRSH calculations has a caveat. MNE Groups would hope to be able to use consolidated financial statement (“CFS”) data for their SETRSH, but that might not be the case. If the jurisdiction in question is one where local generally accepted accounting principles ("GAAP") is used for the purposes of the relevant QDMTT calculation, the SETRSH may need to be calculated by reference to local GAAP. Jurisdictions have been encouraged to allow the CFS to be used. But the IF has had to acknowledge that some taxing authorities may not have the capacity to manage calculations in a GAAP that they are not familiar with.

The SETRSH does allow for Entities in a jurisdiction to be aggregated together (to some extent). The calculations do not need to be done on an Entity-by-Entity basis. Whether aggregation is a meaningful simplification will depend on how an MNE Group currently collects its data.

Once the right financial accounting starting point has been established, SETRSH does then make a number of adjustments to Jurisdictional Profit (or Loss) before Income Tax ("JPBT")—some required, some optional—to get to a Simplified Income number. Simplified Income forms the denominator in the Simplified ETR calculation. Some of these adjustments to JPBT are quite simple, such as excluding dividends received from Group companies. But some of them are complex. For example, while the M&A Simplification may be a positive adjustment for some to make (it allows for the effect of Purchase Price Allocation accounting to be respected), it may require a Group to calculate numbers that it would not be allowed to use for the full rules while also not simply following what is in the accounting system. (The IF has determined that a special rule is required for goodwill arising in connection with M&A activity.)

The starting point for the numerator in the SETRSH ETR calculations is the Jurisdictional Income Tax Expense, which is then adjusted to arrive at Simplified Taxes (again, for a jurisdiction). Like with the income measure, a number of these adjustments are required, and some are optional. Some of the key differences to the full rules involve ignoring certain deferred tax liability movements. In addition, unless certain elections are made, taxes that arise in a Main Entity/Constituent Entity-owner jurisdiction in relation to a PE or CFC are ignored in *all* jurisdictions for the purposes of the SETRSH ETR.

Once a Group has Simplified Taxes and Simplified Income numbers, it computes the Jurisdictional ETR to see if the SETRSH is met. There was talk that maybe the relevant rate for the SETRSH would be above 15%, presumably to provide a buffer effect. We assume that the IF accepts that any rate other than 15% would be unnecessary and unfair given the complexity of the SETRSH and its proximity to the full rules. The thought of needing to recast deferred tax items not at 15%, or the actual rate required for the relevant GAAP, but at a new rate (while also ignoring certain deferred tax items) just for the purposes of the SETRSH would not have been a pleasant one.

To do the SETRSH justice requires a whole article. There are rules on dealing with post-period adjustments. There are standalone integrity rules. There are lots of rules (58 pages in fact!), such that the SETRSH rules are not much shorter than the Model Rules themselves.

Unlike the TCSH, there is no “once out always out” rule. Rather, an MNE Group can enter/re-enter the SETRSH if it has not owed Top-up Tax in either of the prior two periods in the jurisdiction that is being tested.

To give taxing authorities/governments and MNE Groups time to come to grips with the new SETRSH, there is the positive development that the existing TCSH has been extended by another year. This extension will give MNE Groups the ability to rely on the TCSH for 2027. Whether MNE Groups would have been happier for the TCSH not to be extended in exchange for a more simplified permanent Safe Harbour that was agreed to sooner will remain a much debated question (much like how which Bond theme is best is often debated—the correct answer is *A View To A Kill*).

Substance-Based Tax Incentive Safe Harbour

Under the Pillar Two rules, tax credits that qualify as QRTCs and Marketable Transferable Tax Credits (“MTTCs”) have a less dilutive effect on an MNE Group’s Pillar Two ETR than other tax credits because QRTCs/MTTCs increase GloBE Income whereas other tax credits decrease Covered Taxes. This disparity was a core design feature of the rules. But the SBTISH now aims to remedy this disparity by allowing MNE Groups to elect annually to prevent Qualified Tax Incentives (“QTIs”) from reducing Covered Taxes or increasing GloBE Income, up to a cap. The goal of the SBTISH is therefore to “eliminate[] the Top-up Tax that would otherwise be attributable to QTIs.”

QTIs. QTIs can be expenditure-based or production-based. An expenditure-based tax incentive provides a benefit—e.g., credits or “super deductions"—based on qualifying expenditures in the jurisdiction. An expenditure-based tax incentive does not qualify as a QTI if the benefit exceeds the expenditure. Production-based incentives that constitute QTIs provide similar benefits (though generally through credits) based on economic output in the form of the volume of production in a given jurisdiction (i.e., manufacturing, production of electricity, and processing, such as extraction and refining).

To constitute a QTI, an incentive must be generally available to taxpayers. Thus, an incentive that is only available to taxpayers with revenues above a certain threshold or that would not have arisen absent an agreement with the government is not a QTI.

Adjustments for QTIs. The SBTISH identifies the tax value of a QTI that a Constituent Entity uses in a given jurisdiction in a Fiscal Year (e.g., the amount of a credit that the Constituent Entity uses to reduce tax or the amount of a super deduction multiplied by the applicable tax rate), excludes that amount from GloBE Income, and increases Covered Taxes by that amount, up to what is termed the "Substance Cap." The Substance Cap is either (i) 5.5% of the greater of certain payroll costs or depreciation/depletion expense in respect of certain tangible assets in the jurisdiction or (ii) 1% of the carrying value of certain tangible assets in the jurisdiction. The computation in (i) is the default, and an MNE Group must make a Five-Year Election to use (ii).

Given the favorable treatment for QTIs, the SbS Package allows an MNE Group to elect annually to treat QRTCs and MTTCs as QTIs if they meet the definition of a QTI. The election is flexible, and an MNE Group may treat only some QRTCs/MTTCs as QTIs. Once the Substance Cap is exhausted, QTIs are again treated unfavorably, and QRTC/MTTC treatment would then be superior. The SBTISH is undoubtedly favorable, but the Substance Cap diminishes its attraction. For many MNE Groups, 5.5% of eligible payroll costs or depreciation/depletion expense is far less than the amount of the QTI. This disparity may be particularly relevant to foreign-parented MNE Groups that hoped the SBTISH would put the US R&D credit on equal footing with QRTCs, like the UK R&D credit, and eliminate the need to collect Top-up Tax in respect of their active US subsidiaries. Increasing the Substance Cap could therefore both establish parity between QTIs and QRTCs/MTTCs and limit the potential for distortive behavior.

Takeaways

Does the SbS Package mean that Pillar Two is ready to *Only Live Twice*? It most certainly simplifies the operation of Pillar Two to some degree. By and large, US-parented MNE Groups will be happy to be free of IIR and UTPR Top-up Tax and compliance. In addition, the SETRSH and the SBTISH are a step in the right direction for all MNE Groups. But while hinting at further simplification and stability, the SbS Package warns of further anti-arbitrage rules to curtail perceived abuses and a near term "stocktake" that could unwind the very Safe Harbours that taxpayers hope to rely on, potentially putting the fate of Pillar Two in jeopardy once again. For now at least, it appears that Pillar Two gets to *Die Another Day*!