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Friction Between Pillar Two and U.S. Tax Principles

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As I write this, the White House and Treasury are proposing new U.S. tax rules that they say are designed to more closely conform our international tax rules to better mesh with the OECD's Pillar Two minimum tax proposals.[1] The Pillar Two proposals, formally known as "Tax Challenges Arising from the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules," consist of model rules published in December 2021 and a commentary published together with examples in March 2022.[2] The rules are often referred to as the GloBE rules.

The challenges in integrating the Pillar Two design with U.S. tax rules are numerous. Some of these are well understood, including the fact that U.S. tax rules are not based on financial accounting income, as Pillar Two would be. Moreover, as described in more detail below, the Pillar Two rules apply on a strict country-by-country basis inconsistent with the design of the U.S. international tax rules.

But probably the greatest challenge in integrating these two regimes lies in the fact that the Pillar Two rules were designed based on an underlying assumed tax architecture that is fundamentally at odds with the underlying architecture of the U.S. tax rules. One such assumption is that an exemption, rather than a foreign tax credit, mechanism is used to avoid double taxation of active income earned outside a country's borders. The second assumption is that controlled foreign corporation (CFC) regimes apply only as anti-abuse regimes to passive income earned by CFCs in low- or no-tax countries.

Neither of these assumptions holds true in the case of the U.S. tax system. The United States employs a worldwide tax approach that taxes a U.S. person on 100% of the income of a branch or "permanent establishment" in another country. As for CFCs, even before GILTI[3] expanded the CFC rules to tax active income on a worldwide basis, subpart F applied across the board to all CFCs, whether operating in high- or low-tax countries. Subpart F also incorporates rules, such as §956 and the foreign base company rules, that reach beyond passive income as defined in the Pillar Two model rules. Both sets of U.S. tax rules use a foreign tax credit, which is limited in several important ways, to alleviate, at least in part, double taxation of the same income in the United States and the source

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[1] *See, e.g.*, Isabel Gottlieb, *House, Treasury Base Erosion Proposals Effective, Official Says*, Daily Tax Rpt., Apr. 15, 2022, quoting Treasury Assistant Secretary for Tax Policy Lily Batchelder.

[2] For the model rules, see OECD (2021), Tax Challenges Arising from the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS, OECD, Paris. The commentary is at OECD (2022), Tax Challenges Arising from the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two) Examples, OECD, Paris. Finally, the examples are at OECD (2022), Tax Challenges Arising from the Digitalisation of the Economy — Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), OECD, Paris.

[3] Global intangible low-taxed income, introduced by provisions of the Tax Cuts and Jobs Act, Pub. L. No. 115-97 (Dec. 22, 2017).

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country. As described below, the Pillar Two model rules contain special rules that are designed to address worldwide tax systems such as the one used in the United States. These rules, however, are a ''patch'' rather than a design feature.

Pillar Two is designed to ensure that a multinational group bears a minimum tax burden equivalent to 15% of its income earned in each jurisdiction where it operates. The 15% minimum is determined on a country-by-country basis. If direct taxation by the country in which a group member is resident falls below that minimum 15% rate, the rules impose a ''top-up tax'' on other members of the group, paid through a conforming Income Inclusion Rule (IIR) or Undertaxed Payments Rule (UTPR). In this design, it does not matter whether a parent corporation pays tax at home on the income earned in the low-tax jurisdiction. It also does not matter whether the home country rate is in excess of 15%; there is no averaging of members' tax rates in different countries.

It is clear that the U.S. worldwide tax rules do not meet the definition of a qualifying IIR. An IRR is a tax on purely domestic income calculated to top up the local tax rate to at least 15%. The tax on a shareholder of a CFC or on an owner of a branch is not taken into account toward the shareholder or owner's effective tax rate at home. Instead, it is pushed down to the CFC or to the branch and taken into account as a local tax.

Although the Pillar Two model rules do not treat taxes paid by a shareholder or owner of a CFC or branch as a conforming Pillar Two tax, the rules recognize that if the Pillar Two regime were to apply without taking these taxes into account, serious double taxation of the same foreign earnings could occur. The rules therefore permit the taxes imposed on a CFC shareholder or branch owner to be ''pushed down'' to the relevant CFC or branch, increasing the effective tax rate of the CFC or branch. This mechanism, which is broadly inconsistent with the design of Pillar Two, can best be understood as a practical patch to avoid double taxation.

Chapter 4 of the model rules allocates taxes of a group to the members of a group for purposes of determining the effective tax rate in each country. The point of this allocation is not to create tax revenues in a low-tax jurisdiction; rather, the point is to figure out whether a particular jurisdiction's tax rate on income assigned to that jurisdiction under the model rules is below the minimum after taking into account taxes allocated to group members resident in that jurisdiction. This exercise is critical to understanding how Pillar Two deals with branches and CFCs.

Article 4.3 deals with the attribution of taxes paid by a shareholder of a CFC or by a branch owner down to the CFC or branch. The rules applicable to branch attribution are spelled out in a three-step process. In step one, the income of the branch that is included in the branch owner's income is determined. In the case of the United States, this will always be 100% of the income properly attributable to the branch.[4] In step two, the owner's tax on that amount is calculated. Finally, any foreign tax credit allowed to the owner in respect of that tax is determined. Only the excess of the tax over the credit is pushed down to the branch.

The same three-step analysis applies to push down CFC taxes. However, the pushdown of CFC taxes to the CFC is limited in respect of what the model rules define as ''passive income.'' (No similar limitation applies to the pushdown of taxes to a branch, apparently on the theory that CFC taxes are limited to passive income whereas branch owner taxes are not.) Passive income is defined in a manner similar to the definition of foreign personal holding company income under §954(c) and thus includes most items of traditional passive income, but not foreign base company sales or services income or §956 investments in U.S. property. To avoid pushing high local taxes on passive income down to a subsidiary or branch, thereby blending the rates between passive and active income, the rules limit the amount that can be pushed down to the lesser of (1) the actual taxes imposed on the passive income, and (2) the top-up tax percentage in the CFC's home country multiplied by the CFC's passive income taken into account under the CFC regime. The top-up tax percentage is the excess of the 15% rate over the percentage rate applied in the CFC's home country. Applying this rule would be difficult under the U.S. system, because U.S. CFC rules are not limited to passive income as defined under Pillar Two.

The CFC patch, because it is a patch foreign to the architecture of Pillar Two, will inevitably result in double taxation in a variety of contexts. For example, if a U.S. corporation is not the controlling parent of a CFC such that it is not included in the same financial statement as the CFC, its GILTI inclusion cannot be allocated down to the CFC or any of the CFC's subsidiaries. If one imagines that the CFC is the common parent of a group of lower-tier CFCs — a not uncommon fact pattern — any IIR imposed on the CFC in respect of those lower-tier CFCs would be subject to tax twice: once under Pillar Two and again under GILTI.

Other problems arise in the interaction of the various components of Pillar Two across borders — for

[4] U.S. regulations provide several deeming or attribution rules to determine the income of the branch, which may not correspond to the branch's income as calculated for local tax purposes. This is a specific example of the general principle of U.S. tax law that income is determined using U.S. tax concepts rather than local ones, another principle at odds with Pillar Two.

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example, where the CFC is resident in a country that has a ''qualified domestic minimum top-up tax (QDMTT). A QDMTT is a tax imposed on domestic income. If the CFC's home country has adopted a QDMTT, any pushdown of a CFC or branch tax imposed on its U.S. shareholder would not reduce the QDMTT. Thus, unless the United States were to give a credit for the QDMTT, a substantial risk of double taxation of the foreign income of a CFC would be presented. The Pillar Two model rules are predicated on an assumption that a country like the United States, which employs a foreign tax credit rather than an exemption system, would give full credit for any local taxes. This assumption is inconsistent with U.S. norms. At the end of the day, it does not appear likely that the United States will abandon its traditional insistence on the primacy of residence taxation of worldwide income.

An irony of the Pillar Two approach is that it can create taxing jurisdiction in a country with no nexus at all to the income earned. For example, a UTPR is paid by all members of a group in proportion to employees and tangible assets located in their country. Presumably this allocation is based on the idea that employees and tangible assets contribute to worldwide profits. The U.S. foreign tax credit regulations were recently rewritten to preclude the allowance of any credit in respect of a tax not based on traditional concepts of jurisdiction or nexus. It is therefore unlikely that such taxes would be creditable, again leading to double taxation across borders.

It is worth asking why the United States should buy into the rationale underlying the global Pillar Two minimum tax system. Given its worldwide taxing system, the United States has traditionally been relatively indifferent to the tax rate imposed by the countries in which a branch or CFC of a U.S. resident is formed or operates. In fact, given the many significant constraints on the foreign tax credit, U.S. tax law actually encourages U.S. multinationals to keep the taxes of their CFCs low. In contrast, countries that employ a territorial approach to active business income, which includes most countries in the OECD, have reason to care about the rate of tax imposed locally. These countries lose tax revenues when a multinational group locates its active income-producing functions in low- or no-tax countries. Pillar Two was designed with these countries in mind.

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