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In this article, Lebovitz considers the future of the OECD's two-pillar approach and suggests that the OECD accept that the United States is a compliant jurisdiction and revisit the efforts already undertaken under the initial base erosion and profit-shifting project as a basis for redefining pillar 2 success.

The observations and conclusions in this article are solely those of the author.

As *Tax Notes* recently reported,[1] EU Tax Commissioner Paolo Gentiloni commented at the September 26 meeting of the Economic and Monetary Affairs Committee of the European Parliament that the book minimum tax (BMT) enacted as part of the Inflation Reduction Act (P.L. 117-169), while a "positive and interesting" decision, is "not fulfilling and implementing what we need for pillar 2."[2] As the base erosion and profit-shifting inclusive framework gets ready to meet again, Commissioner Gentiloni's remarks cast a further pall on the doom and gloom surrounding the future of pillar 2.

Commissioner Gentiloni is correct that the BMT is not a perfect implementation of pillar 2. However, whether the BMT complies with pillar 2 is not the right question. Rather than focusing on whether the BMT, global intangible low-taxed income regime, or any other regime fits within the complex constraints of pillar 2, it's time to take a fresh look at what would constitute success in moving to a 15 percent global minimum tax rate and to ask whether the pieces of the puzzle are already in place to enable the OECD to "take the win" and move on.

Remember BEPS 1.0?

The core objective of pillar 2 is to ensure that the global profits of large multinational enterprises are taxed at 15 percent. Because every country does not have a corporate tax rate of at least 15 percent, the complex pillar 2 architecture provides mechanisms to ensure that some country somewhere has the right to tax the portion of profits considered to be undertaxed. If one country is not willing to tax profits at a sufficient level, pillar 2 provides the mechanisms to enable another country to do so. The pillar 2 architecture prescribes which country goes first in this undertaxed profits "land grab." The prioritization rule is one of the main sources of pillar 2's complexity.

Pillar 2 assumes that there are significant pools of undertaxed profits circulating around the MNE universe. But while that may have been the case a decade ago, MNE tax behavior has changed significantly, driven in large part by what the OECD achieved with BEPS 1.0.

DEMPE: The Real Backstop to Undertaxed Profits

It is generally agreed that intellectual property is the main driver of the premium profits of an MNE. BEPS actions 8-10 substantially eliminated the ability of an MNE to concentrate IP-related

[1] Elodie Lamer, "Corporate Alternative Minimum Tax Is Not a Pillar 2 Substitute," *Tax Notes Int'l*, Oct. 3, 2022, p. 75.

[2] See discussion started at 17:50 of the clip at European Parliament, "Meeting of the Committee on Economic and Monetary Affairs," Multimedia Centre: European Parliament (Sept. 26, 2022).

profit in tax havens or low-tax jurisdictions. The development, enhancement, maintenance, protection, and exploitation (DEMPE) standard requires that before an entity can earn premium profits associated with IP, that entity must perform some combination of DEMPE functions associated with that IP.

While it is possible for DEMPE functions to be performed in a tax haven, it is much more likely that these functions will be performed in countries in which key personnel can be based and in which key personnel are willing to be relocated. With the exception of Hungary, all of the most likely jurisdictions that could support DEMPE substance have (or will have) statutory corporate tax rates of at least 15 percent, including Ireland, Singapore, Hong Kong, the Netherlands, Switzerland, Luxembourg, and the United Kingdom.[3] The DEMPE requirement together with the enactment of the Tax Cuts and Jobs Act (P.L. 115-97) in 2017 led many U.S. MNEs to onshore IP back to the United States or to countries with competitive tax regimes.

Hybrid Neutralization

The global implementation of the hybrid neutralization principles in BEPS action 2 also complement DEMPE and further reduce the likelihood of premium profits coming to rest in a low-tax jurisdiction. The elimination of the so-called double Irish and Dutch sandwich structures has forced MNEs to make truly operational decisions on where to locate IP. In response to action 2, a significant number of MNEs made the decision to onshore IP back to their home countries or to one of the "usual suspects" noted above.

Country-by-Country Reporting

For all its known faults, country-by-country reporting remains an important frontline tool for tax authorities to police accumulation of profit in a low-tax jurisdiction. Before profit can be considered undertaxed for pillar 2 purposes, that profit must first come to rest in a low-tax jurisdiction after the application of the arm's-length standard. CbC reporting is designed to enable a tax authority to undertake a risk assessment over whether profit is being shifted inappropriately. Used effectively, CbC reporting has a much greater potential to reduce undertaxed profits than pillar 2's undertaxed profits rule.

BEPS 1.0 Needed Time to Work

DEMPE, hybrid neutralization, and CbC reporting all work together to mitigate undertaxed profits. This has already been borne out by taxpayer behavior (in particular U.S. MNE taxpayer behavior) since 2017. In many respects, before rushing into pillar 2, the OECD should have waited to see how global tax receipts normalized after the changes in MNE tax behavior after BEPS 1.0. Instead, relying on stale taxpayer data that predates BEPS 1.0, the TCJA, the U.K. diverted profits tax, and other country initiatives, the OECD created a pillar 2 architecture so complex that achieving a uniform global consensus seems out of reach.[4]

The U.S. Has Done Enough

In his remarks on the BMT, Commissioner Gentiloni also noted that the enactment of the BMT through the Inflation Reduction Act was "not a completely bipartisan decision," apparently to reinforce his point that the BMT is not a substitute for pillar 2. Putting aside the question of whether any country will be able to meet the impossibly high bar set by the pillar 2 model rules in the near to medium future, let's first reflect on what the United States has already done in this regard.

Through the TCJA, the United States taxed all the unremitted accumulated earnings of every controlled foreign corporation (regardless of size) and then began to tax the current earnings of

[3] A number of these countries have patent boxes and other regimes that reduce the rate of tax on IP-related profits below 15 percent. However, these regimes generally apply only to IP-related profits. When the tax on those profits is combined with the much higher tax rate on other profits, the weighted effective tax rate is still generally above 15 percent.

[4] The OECD itself acknowledged this weakness in its economic impact assessment supporting the launch of the two-pillar initiative. There, it noted that the primary data set used to support the expected tax revenue to be generated from pillars 1 and 2 was taxpayer data from 2016-2017, well before the impact of BEPS 1.0 could be seen. *See* OECD, "Tax Challenges Arising From Digitalisation — Economic Impact Assessment," at para. 1.1.5 (Oct. 2020).

every CFC that were not already captured under subpart F. The United States is the only country in the world to have done this, going further than any other CFC regime by including active income in the GILTI tax base.

The base erosion and antiabuse tax regime, which was designed to prevent profit shifting in the spirit of BEPS 1.0, goes much further than pillar 2's subject-to-tax rule in that it denies deductions for payments to related parties regardless of whether the payee is subject to tax on the receipt in its country. The TCJA also included rules consistent with the anti-hybrid provisions envisioned in BEPS action 2, as well as the interest expense limitations outlined in BEPS action 4.

The main criticisms of GILTI as a pillar 2-compliant regime focus on the rate and jurisdictional blending. The GILTI rate is 10.5 percent, but the effective rate is 13.125 percent after taking into consideration the 80 percent limitation on foreign tax credits. Absent rate or other changes, the baseline GILTI rate will increase to 13.125 percent in 2026 and the real effective rate will increase to 16.4 percent. Moreover, in practice, the real effective GILTI rate is already higher than 15 percent after taking into consideration expense allocation rules and the inability to carry excess FTCs back or forward.

Even if it is argued that the GILTI rate does not meet the 15 percent standard, the new BMT is imposed at the 15 percent minimum rate and applies to the global earnings of an applicable U.S. MNE, including the earnings of the U.S. MNE's CFCs. But for the jurisdictional blending issue, there is no reason why the BMT should not turn off the application of pillar 2 even though it may not fit perfectly within the architecture of the OECD's model rules.

Some might argue that the BMT should not turn off pillar 2 because it permits the use of accelerated depreciation, and the tax can be reduced by nonrefundable credits. However, the BMT does not provide for a substance-based carveout or other pillar 2 relief provisions. Again, the question here is not whether the BMT is a perfect fit but whether it is a sufficient mechanism to advance the goals of pillar 2. Through GILTI, BEAT, and now the BMT, the United States has gone further than any other country in pursuing the objectives of BEPS 1.0 and 2.0.[5]

The Fixation With Blending

The lingering criticism of GILTI and now the BMT is that both are calculated on a global basis rather than on a CbC basis. The criticism is based on the fact that blending allows lower-taxed earnings to be blended with higher-taxed earnings resulting in a net lower effective tax rate after losses, FTCs, and other attributes are taken into account. Presumably, if the calculations were done on a jurisdictional basis, there would be no cross-crediting benefits and MNEs would be less incentivized to invest in lower-tax jurisdictions. That would then (arguably) force lower-tax jurisdictions to raise their corporate tax rates to collect the tax that would otherwise be collected through an income inclusion rule or other CFC regime.

While relevant as a theoretical issue, it would be better to focus on the countries that lead (or have led) to the blending opportunity. Taken from that perspective, the continuing need to focus on blending no longer matches the facts on the ground. The most likely pool of undertaxed profits are the premium profits associated with IP. As discussed above, except for a few outlier countries, those profits are now more likely to be in countries with tax rates at or above 15 percent.

The likely timetable for global implementation of pillar 2 is no earlier than 2024, and more likely 2025 or even later considering likely transition rules for some countries (for example, Hungary) and the need for both new legislation and treaty modification.[6] If DEMPE and the companion tools in BEPS 1.0 are allowed to do their work, by the time pillar 2 is implemented the tax rates on premium IP profits will likely have normalized at or above 15 percent. At that point there will be no need to worry about blending.

[5] The United States also terminated its income tax treaty with Hungary, a much harsher step than the EU itself seems prepared to take.

[6] *See* Michael Lebovitz et al., "If Pillar 1 Needs an MLI, Why Doesn't Pillar 2?" *Tax Notes Int'l*, Aug. 29, 2022, p. 1009.

A Path Forward

Important work was done by the OECD in BEPS 1.0. In many respects, the OECD should have simply taken the win and given BEPS 1.0 time to work. Instead, during a time of intense scrutiny of digital business models, it leapt into the two-pillar process, the quagmire that threatens to undermine its prior achievements. The inability of the OECD to complete its work on pillar 2 is eroding public confidence in the global tax system. It's time for the OECD to recalibrate its definition of success for pillar 2. Here are some suggestions to help it get there:

- secure recognition by the inclusive framework that the United States is a pillar 2-compliant jurisdiction;
- abandon the CbC approach to pillar 2 and either provide an exclusion for countries with headline national and subnational taxes of at least 25 percent or apply pillar 2 as a pool to the group of countries with headline corporate tax rates below 15 percent;
- reopen and simplify the model rules and establish a review process that allows for meaningful participation from the MNE community;
- reprioritize the subject-to-tax rule to enable developing countries to immediately start enforcing pillar 2; and
- capture the above in a multilateral instrument to eliminate concerns about the relationship between pillar 2 and treaties.

Just Breathe

The landmark agreement by the inclusive framework in October 2020 represented a sea change in the approach to the taxation of MNEs. Countries agreed to allow other countries to tax some profits of their MNEs in the absence of a taxable nexus, essentially resulting in a redistribution of global tax revenue. Countries also agreed to a baseline global minimum tax rate of 15 percent. The significance of that achievement is directly proportional to the challenges the OECD has faced in developing the model rules.

Much work went into the development of the model rules, but the rules are hopelessly complex and much of that complexity is unnecessary. The OECD's approach is understandable. Detailed rules are more likely to be implemented on a consistent basis. However, the model rules are so complex that they will likely produce the opposite effect.

Rather than insisting on global adherence to its detailed architecture, the OECD should follow the model it used in the various BEPS 1.0 action items — namely, developing high-level recommendations and letting countries implement according to the broad objectives of the landmark agreement. The United States has already done this through GILTI, BEAT, and the BMT. The OECD needs to relent on its rigidity and reopen the process so that the ambitions of the landmark agreement can start to be realized. ■