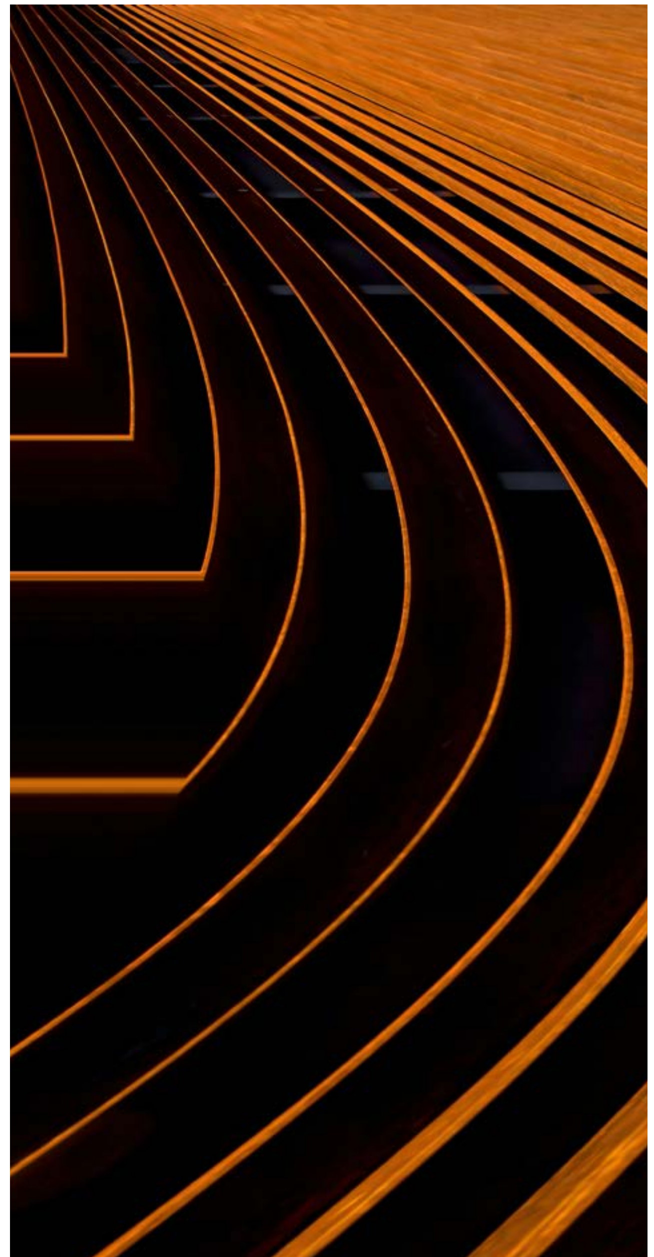
A MINIMUM TAX THAT ISN'T: IS THERE A REAL PURPOSE FOR PILLAR TWO?

By Dr. Valentin Bendlinger, MSc, LLM (NYU), Senior Consultant at ICON Wirtschaftstreuhand GmbH in Austria and lecturer at the Institute for Austrian and International Tax Law at Wirtschaftsuniversität Wien (WU) in Vienna, Austria.[1]

The OECD's Pillar Two project has shaped the global tax community in recent years. Hardly any other topic has been discussed and debated as intensively and emotionally as the global minimum tax. In May 2019, as a pre-doctoral researcher, the author of this article started analysing Pillar Two. At that time, the OECD had released only a single policy note and a work program.[2] It's likely that even the authors of those reports did not anticipate how rapidly the global minimum tax would evolve into a concrete reality within five years. By December 2023, when the author published his book on Pillar Two, he already sensed that it was becoming outdated.[3]

Against many odds, Pillar Two has become effective in the EU and many other jurisdictions for fiscal years beginning on or after the 31st of December 2023, and the first Pillar Two returns are due in mid-2026.[4] However, a significant regulatory change leaves more traces the faster it happens, and now that the waters around the Pillar Two project are calming down for the first time, these traces are becoming visible. The real challenges of Pillar Two implementation are becoming apparent. This is particularly true for the Caribbean, with many different tax jurisdictions less reliant on public revenues than large Western economies. Some of them are keen to attract foreign direct investment despite remote geographical locations and economic difficulties via targeted tax incentives. Therefore, how to react to a new framework that aims to take local tax incentives away? How can small jurisdictions, like Small Island Developing States (SIDS), still attract large MNE Groups to invest locally?



There has been a lot of literature on the question of how small taxing jurisdictions and tax havens should react to the upcoming global minimum tax.[5] In my opinion, a rational reaction requires a technical understanding of the rules and a sense of the system's weaknesses. Nevertheless, this article does not aim to summarize technical details. The systematics of Pillar Two are well known and do not need to be recalled once again. This article does not aim to discuss how jurisdictions or MNE Groups can plan around Pillar Two either. This contribution intends to highlight what this author views as the technical shortcomings and ambiguities of the OECD's global minimum tax and their potential influence on its effectiveness. The article concludes by exploring the following question: Does Pillar Two serve a real purpose?

IS PILLAR TWO A MINIMUM TAX ON PROFITS?

Pillar Two aims at MNE Groups exceeding an annual revenue threshold of EUR 750 million read from the Group's consolidated financial accounts. The MNE Group is then split into legal entities and PEs to compute accounting figures of taxes and income, which are aggregated on a jurisdictional basis. Finally, Pillar Two divides the taxes and income per jurisdiction to calculate an effective tax rate that is to be compared to the minimum rate of 15 %. If the effective tax rate is below the minimum, the difference to the minimum will be levied as a so-called 'Top-up Tax'.

This has led the OECD and public media to promote Pillar Two as a successful "Global Deal to End Tax Havens" as large MNE Groups will have to pay at least 15 % of corporate tax from now on, regardless of how they structure their businesses. However, the right question is regularly overseen: Is it a 15 % minimum rate on what?

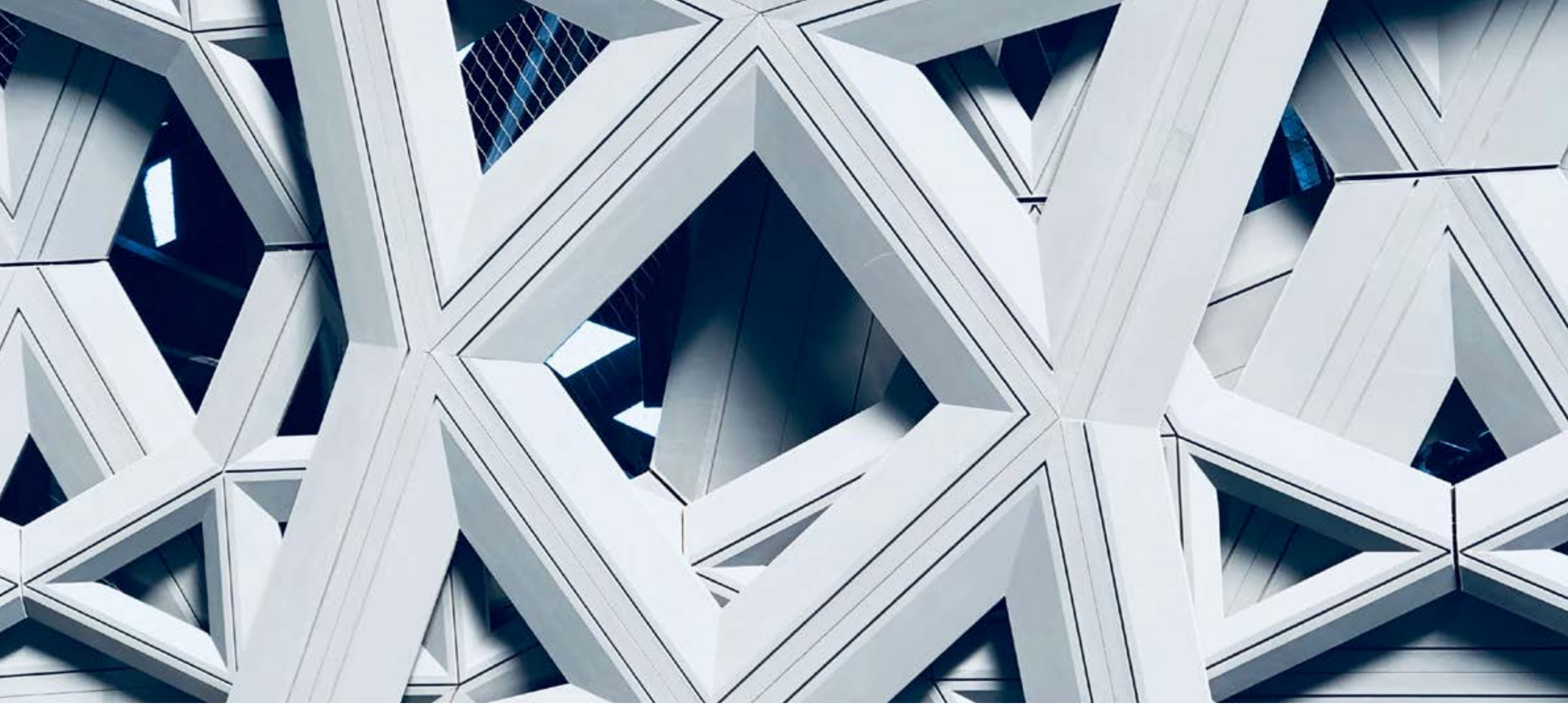
The amount of tax liability is the result of a multiplication of a tax rate and a tax base and the definition of the latter, is the true merit of the global minimum tax. Article 3 of the OECD GloBE Model Rules defines the tax base of the global minimum tax which is basically equal to "the Financial Accounting Net Income or Loss" adapted for exhaustively listed adjustments of common differences between accounting and tax profits.[6] Thus, in principle, the minimum base is accounting profits. However, this is only part of the truth.

The profits subject to Pillar Two are reduced by a "Substance-based Income Exclusion" (SBIE), that is, a free amount computed from a payroll and a tangible asset component. The global minimum tax only subjects the profits exceeding the SBIE to the minimum tax rate of 15%. Consequently, if the SBIE exceeds the profits received in the tested jurisdiction, these profits are not subject to a minimum tax, irrespective of the effective taxation of those profits in the respective jurisdiction. There would be no 'Top-up Tax' even if the jurisdiction would not levy corporate tax at all, or even gives tax refunds. The SBIE takes a fixed percentage of payroll and so-called 'Local Tangible Assets' that the MNE Group can set off from its jurisdictional 'Net GloBE Income' of a specific Fiscal Year. However, what can be concluded from this design? The SBIE in its current form reveals the assumably most interesting flaw of what is called the global minimum tax or Pillar Two: [7]

First, the SBIE seems to incentivise less efficient businesses over more efficient ones. The higher the profits compared to payroll and 'Local Tangible Assets' within a specific jurisdiction, the more likely GloBE Income will exceed the SBIE. In other words, the higher a business's rate of return on payroll and tangible assets, the more likely it will be subject to a 'Top-up Tax'.

Second, the SBIE can be used fraudulently by multinational corporations, as can be shown hyperbolically: If a corporation wants to avoid 'Top-up Tax' in a low-tax jurisdiction, it could simply employ a local manager, raise his or her payroll and buy her or him a Porsche. The management fee is a payroll, and the Porsche is a local tangible asset, and both increase the minimum tax-free amount that we call the SBIE. Of course, this would not be rational business as the SBIE is limited to a small percentage of both payroll and book values of tangible assets. However, the example shows that the SBIE is a strange alien.

The OECD knows the SBIE is prone to abuse. Indeed, a good example is that the OECD has explicitly excluded investment property from the scope of the tangible asset carve-out to avoid that investment in such properties enables MNE Groups to reduce their 'Excess Profits'. However, this example demonstrates that the mere existence of the SBIE is clearly at odds with the rationale of a global minimum tax. What is the point of implementing an impressively complex set of rules to establish a minimum tax if the minimum, e.g., due to the SBIE, can be equal to zero?



DOES PILLAR TWO END TAX COMPETITION OR PROMOTE IT?

The OECD always promoted Pillar Two to establish an end to the “race to the bottom”. That is, to prevent jurisdictions from competing among each other using tax incentives for the gain of investment. Pillar Two is supposed to work like a “tax cartel” among jurisdictions: All agree on a certain price for business making, so nobody needs to grant a rate below 15 %. The more jurisdictions decide to implement a minimum tax, the less attractive it is to shift profits to low-tax jurisdictions, as the MNE Group is at risk of having to tax the same profits anywhere else. It is certainly true that Pillar Two’s “diabolic machinery” affects tax competition.[8] However, it is undoubtedly that Pillar Two does not signify the end of tax competition. Moreover, under some circumstances, one could fairly conclude that it ends up promoting it. There are different reasons for this.[9]

First, every tax has its scope, and so does Pillar Two. In other words, Pillar Two does not pose any limits for jurisdictions to compete by way of tax measures concerning corporate taxpayers that are, for whatever reason, not within the scope of its framework. Above all, this includes individuals irrespective of any revenue threshold and all MNE Groups that stay below the EUR 750 million threshold. Moreover, there are also ‘Excluded Entities’ which are either completely or partly outside the scope of Pillar Two. These entities do not need to provide any evidence that their profits are taxed at any minimum and, thus, jurisdictions might still compete to attract such entities.

Second, every tax has its exemptions, and so does Pillar Two. Nearly every corporate income tax system provides for certain tax exemptions or specific deductions like free amounts to incentivise certain activities of corporate taxpayers specifically. Within the context of Pillar Two, such a deduction is, as has been demonstrated already, the SBIE. The same is true for ‘International Shipping Income’ enjoying a general exemption under the Pillar Two regime. Thus, Pillar Two does not limit tax competition with respect to profits covered by the SBIE or falling within the definition of ‘International Shipping Income’.

Third, every piece of tax legislation leaves loopholes for interpretation, and so does Pillar Two. It is true that Pillar Two's set of rules is highly comprehensive and has already closed many conceivable gaps. However, Pillar Two exceeds any notion of complexity, and it is well known that complex provisions are necessarily more complicated to interpret. It is impossible to list all the interpretation problems here. Still, there is no question that both national tax administrations and MNE Groups will interpret the provisions of Pillar Two as much as possible to their respective advantage. For example, those jurisdictions that wish to attract foreign direct investment will subject the SBIE to the broadest possible meaning vis-à-vis other jurisdictions to prevent collection of 'Top-up Tax' by way of IIR and UTPR. Similar problems are likely to arise for 'Qualified Refundable Tax Credits' (QRTCs), enabling jurisdictions to give a tax credit to corporate taxpayers by allowing them to include such credits as income within the Pillar Two base in the denominator of the ETR fraction instead of reducing the amount of 'Adjusted Covered Taxes' in the numerator, which mitigates the reduction of ETR caused by such QRTCs. The question of interpretation arises with every piece of law and Pillar Two is not an exception.

Fourth, and finally, it is not absurd to think that Pillar Two rather than limiting tax competition, it may end up promoting it. According to Devereux, Vella & Wardell-Burrus,[10] for example, since the SBIE allows for any tax rate on profits that are covered within the amount of SBIE, Pillar Two might even create an incentive to reduce the nominal CIT rate as low as zero, at least for those profits covered within the SBIE. Evidently, reducing the CIT rate necessarily includes the risk that any profits not covered within the SBIE might be subject to a 'Top-up Tax' collected by jurisdictions that implemented Pillar Two. However, jurisdictions could still implement a QDMTT skimming off the 'Top-up Tax' on those profits that are not covered within the SBIE of an 'MNE Group' within a specific jurisdiction.

IS THERE A PURPOSE FOR PILLAR TWO AFTER ALL?

As demonstrated already, Pillar Two is less of a minimum tax than it is supposed to be. One of the author's most appreciated tax law professors, Daniel Shaviro, has pointed out the essence of a minimum tax, explaining that a minimum tax is a comparison between the rate achieved and a politically agreed minimum that is said to be "sufficient".[11] Therefore, there might be good arguments in favour of minimum taxes, including a raise in tax revenues, the tackling of abusive structures, and the reduced incentive to shift anything artificially. However, there are also major counterarguments.

If the world is satisfied with the current

international tax framework, there would not be a need to test the tax level against an artificial minimum in the first place. The fact that Pillar Two exists demonstrates a political dissatisfaction with the current tax system. Yet, instead of rethinking and renegotiating the current tax system, the OECD decided to place a highly complex and challenging-to-maintain framework on top of the current tax system. Even worse, the new framework is far from flawless. As demonstrated already in this article, Pillar Two is not the end of tax competition. On the contrary, it might be well the beginning of the "race towards the minimum of 15%", triggering even more pressure on the developing world to provide for even more favourable corporate tax environments.

If a minimum tax is already difficult to justify from a purely academic perspective, even if it was implemented in a consistent manner, a minimum tax that isn't, is simply undefendable. This should not be read as a general blunt criticism against Pillar Two but rather as a plea for a more targeted and systematic focus on a coordinated and inclusive future international tax policy.

Valentin Bendlinger

[1] The author thanks Dr. Leopoldo Parada, PhD, LLM for valuable comments on an earlier draft of this article.
[2] OECD/G20 Inclusive Framework on BEPS, Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy (29 May 2019), available at https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf.
[3] V. Bendlinger, The OECD's Global Minimum Tax and Its Implementation in the EU - A Legal Analysis of GloBE in the Light of Tax Treaty and EU Law (Kluwer 2023).
[4] Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, OJ L328 (2022) [hereinafter Pillar Two Directive (2022/2523)].
[5] M. Devereux, J. Vella & H. Wardell-Burrus, Pillar 2's Impact on Tax Competition, 26 Aug. 2022 SSRN, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4203395; M. Devereux, J. Vella & H. Wardell-Burrus, Pillar 2: Rule Order, Incentives, and Tax Competition, 14 Jan. 2022 SSRN, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4009002; J. Englisch, GloBE Rules and Tax Competition, 50 Intertax 12 (2022).
[6] See Art 3.2. OECD GloBE Model Rules.
[7] See Bendlinger, supra n. 2, at sec. 4.5.2.
[8] R. Mason, A Wrench in GLOBE's Diabolic Machinery, 107 Tax Notes Intl. 1391–1395 (19 Sept. 2022).
[9] Bendlinger, supra n. 2, at sec. 4.5.6.
[10] Devereux, Vella & Wardell-Burrus, Pillar 2: Rule Order, Incentives, and Tax Competition, supra n. 4.
[11] D. Shaviro, What Are Minimum Taxes, and Why Might One Favor or Disfavor Them?, 40 Va. Tax Rev. 2 (2021).