Pillar Two and the "Side-by-Side" Agreement: A Guide for the Perplexed*

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Abstract: The ambitious "Pillars" proposed by the OECD have received mixed reviews. Pillar One is moribund and Pillar Two, though accepted in the European Union, has been ignored by some of the world's largest jurisdictions. The United States has insisted on a special "Side-by-Side" regime that largely exempts it from the complex Pillar Two rules. This essay takes the position that, for many reasons, Pillar Two cannot replace the international tax regime that has prevailed for more than 100 years, and that the OECD must know this. The intention of the OECD, however, may not be to insist on worldwide adoption of Pillar Two but rather to promote a consensus of as many jurisdictions as possible to adopt a minimum 15 percent tax on financial statement income of members of large corporate groups. The "Side-by-Side" exception threatens this goal by preferential treatment to US multinational groups, thereby inviting many jurisdictions to forgo any such consensus.

Keywords: Pillar Two; "Side-by-Side" Agreement; OECD Model; Global minimum tax; Tax competition; International tax

1. Evolving Mission of the OECD

The Organisation for Economic Co-operation and Development (OECD) is, of course, an international organization based in Paris, France. It came into existence in December 1960 as a successor to the Organisation for European Economic Co-operation (OEEC), which had been formed shortly after World War II to deal with a variety of European economic issues. In 1963 the OECD released a draft of a "model" income tax convention — a document that had widespread impact almost immediately. The OECD Model Convention for the Avoidance of Double

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Taxation with Respect to Taxes on Income and on Capital (hereinafter referred to as the "OECD Model") was issued formally in 1977 and rapidly became the accepted template for tax treaty negotiations throughout the world. The US Model Income Tax Convention, first released in 1976, built on the work of the OECD. The United Nations Model, published in 1980, was also based on the OECD model.

The OECD has remained the custodian of its Model, interpreting and re-interpreting it, expatiating on its every word, releasing reams of commentary that, like the Model itself, have had worldwide repercussions. In 1979, the OECD set out on a new path. It issued a report on Transfer Pricing and Multinational Enterprises and followed that up in 1995 with Transfer Pricing Guidelines — a second major topic in the area of international taxation. The OECD Guidelines have since been supplemented and modified many times, culminating in the current 2022 version. The Guidelines have come to occupy a position in the realm of international taxation that is nearly as important as the OECD Model.

In 2013, the OECD shifted its attention in a new direction. With its Base Erosion and Profit Shifting (BEPS) Project, it began to make suggestions for the content of domestic laws relating to the taxation of cross-border investments and income. It eventually issued 15 reports, dealing with a variety of international tax issues, from taxation of the digital economy to corporate income tax avoidance to the resolution of international tax disputes. The aim was "introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty."

The OECD's move from an "international" subject — advising jurisdictions on how to coordinate their domestic tax laws in treaties — to advising on the content of domestic legislation was not especially radical, given its prior foray into transfer pricing. Nevertheless, undertaking to advise jurisdictions on how to negotiate with respect to cross-border activity and setting guidelines for the analysis of transfer pricing issues are both quite different from providing advice on what domestic laws should say. The shift placed the organization in a position where it would need to defend its legitimacy: It had moved from providing guidance for how jurisdictions might deal with each other's domestic tax laws to issues of far more political sensitivity. With the expanding OECD reach, the question was increasingly voiced: How does an international organization in Paris have standing to suggest, advise, or tell national governments what their domestic tax legislation should say? This question is not answered, at least not in a politically satisfactory sense, by assembling representatives of those governments in a large forum and soliciting consensus on the substance of the organization's advice. Just possibly, the OECD overreached.

2. State of the Pillars

Today the world labors to understand, and possibly to assimilate, the advice that the OECD has provided in its two "Pillars", Pillar One and Pillar Two. Pillar One would have a portion of the profits from cross-border transactions assigned to jurisdictions where markets are located. This aspect of the OECD's advice has not been well received. The organization has not yet managed to bring itself to put Pillar One out of its misery, but most observers agree there is no appetite for a profit allocation to jurisdictions that were never previously seen as having a justifiable claim to a piece of the pie.

Pillar Two, on the other hand, has been formally adopted by the European Union, has been accepted by a number of non-European jurisdictions, and remains under active consideration throughout the world. Recently, it has undergone substantial modification at the instance of the United States, which was alarmed and offended by the likely impacts of the original Pillar Two rules, and which therefore negotiated a substantial — but not complete — exemption for itself in the innocuously labelled "Side-by-Side" Agreement. Some other jurisdictions have suggested they may want to follow suit.

So what is Pillar Two all about, and what is

the effect of the "Side-by-Side" Agreement that the United States secured for itself? The remainder of this essay seeks to respond to those questions in clear, acronym- and jargon-free terms.

The core idea behind Pillar Two is that competition among jurisdictions with respect to tax benefits is potentially harmful and should be reduced or eliminated. This requires the proverbial "level playing field" — tax of approximately 15 percent on income earned by corporate groups in every jurisdiction in which the groups operate. For the time being the rules apply only to large groups, those with more than EUR750 million of annual revenue. The effective rate of tax is computed on the basis of financial statement income, adjusted in various ways, and "recognizes" only taxes that meet specific qualifications under the OECD's rules. Jurisdictions are assumed to understand the Pillar Two tax base in a uniform way. The adjustments, tweaks, and exceptions that the OECD has proposed to financial statement income are assumed to pose no threat to this common understanding. These assumptions may be questionable. More than two-thirds of the text issued in connection with the "Side-by-Side" Agreement was devoted to a "simplified" calculation of the Pillar Two effective tax rate.

If the 15 percent effective tax rate target is not met in a jurisdiction where income is earned, the OECD calls for additional tax to bring that rate up to 15 percent. The priority claim to impose this additional tax is assigned to the jurisdiction where the income is earned. If that jurisdiction fails to impose sufficient additional (and qualifying) tax to meet the 15 percent test, the next jurisdiction in line is the jurisdiction of the parent of the multinational group. If that jurisdiction does not impose additional qualifying tax sufficient to bring the effective tax rate to 15 percent, the entitlement moves downward to the jurisdiction of another group company that controls the entity that earned the income, if there is such an entity. If the 15 percent target is still not hit, other jurisdictions where the group operates and earns income are permitted to impose additional tax on group entities operating within their borders. The aim is always to collect the difference between the qualifying taxes imposed by the designated claimants and the target rate of 15 percent.

3. Reaction of the United States to Pillar Two

The United States bridled at these rules. It has long had a robust system for imposing tax on parent companies whose affiliates earn low-tax income in foreign jurisdictions. For a variety of reasons, these US rules were deemed by the OECD not to qualify for Pillar Two's effective tax rate calculation. In addition, the OECD determined that credits afforded by US law to incentivize certain types of US domestic investment were, if not refundable (as most were not), effectively tax refunds, lowering the rate of tax on the US income of US entities. An eventual OECD concession provided that if incentive credits were transferable, they would be viewed as additional income rather than a direct reduction of US tax. This was still a potentially negative result because the effective rate of tax can be driven lower by either lower qualifying taxes or additional income.

The United States thought it unfair that its elaborate system for taxing low-tax foreign income was given no credence in the calculation of the Pillar Two effective tax rate. And the rules with respect to credits for certain US domestic investments (for example, the credit for research and development, or for investments in green energy facilities) had the effect of subjecting US domestic income earned by US affiliates of foreign parent entities to additional taxes levied by foreign jurisdictions on the ground that the US effective tax rate on the US income was too low, either because the amount of qualifying tax was reduced or because the amount of US income was increased. This meant tax benefits intended by US legislation for taxpayers who made favored investments in the United States would be transferred to treasuries of foreign jurisdictions — a peculiar result, to say the least.

So, the United States loudly proclaimed that it wanted out. It insisted it would accept no additional Pillar Two tax to bring the effective rate up to 15 percent except for the additional

Pillar Two tax levied by the jurisdiction where income was earned. US companies were thus excused from many of the rules accompanying Pillar Two, though not from the need to report effective tax rates computed pursuant to the elaborate Pillar Two rules in all jurisdictions where they operate. Insofar as investments by foreign parented groups in the United States are concerned, at least some US incentive credits would be treated as additional taxes that did not reduce the amount of US qualifying tax and did not result in additional income for purposes of computing the effective tax rate.

4. Whither the OECD?

It is perhaps appropriate, at this juncture, to pause and take note of the prodigious task the OECD has performed. Revising an international tax order that the world has known for more than 100 years has been an enormous task. Attempting to enlist the efforts, and seek the approvals, of most of the world's taxing jurisdictions is, independently, an exceptional undertaking. No person who is serious about tax policy, especially international tax policy, can fail to be impressed by both the effort and the results.

And yet, it seems clear, Pillar Two in its current form is not a workable proposal. The system it embodies cannot work in practice. There are too many inherent uncertainties, too many complex and confusing rules, too much reliance on knowing what is happening in other jurisdictions in real time, and too many assumptions that the jurisdictions of the world will agree on what the complex rules will mean in practice. In addition, too little attention has been devoted to the efficient resolution of disputes, on the apparent assumption that the rules of Pillar Two will run smoothly of their own accord in every jurisdiction where they are adopted. There is hubris in these rules, which seems to have been fueled by a belief that the OECD's objectives are so obviously laudable.

OECD staff is supremely competent and has much real-world expertise. It surely understands the unworkability of the proposed Pillar Two rules. Moreover, the United States cannot be the only jurisdiction that will refuse to accept the extensive and highly intrusive rules of Pillar Two. Many developing jurisdictions have been tentative. Pillar Two has not yet managed to earn support from even half of the world economy. So what is going on here?

5. A Potentially Fatal Flaw

My own assessment is that the OECD — seeking to move jurisdictions toward that elusive level playing field and away from a world in which tax haven jurisdictions siphon off revenue from other jurisdictions, thinks it has developed a mechanism that will incentivize jurisdictions, even low-tax jurisdictions, to impose a tax of at least 15 percent on income earned within their borders. In other words, the objective is not to ask the international tax world to live with the highly detailed, sometimes surprising, rules of Pillar Two. Rather, the aim seems to be far simpler: a world in which all jurisdictions, wishing to avoid triggering levies by other jurisdictions, preclude that result by themselves imposing tax of at least 15 percent. In such a world, parent entities, intermediate entities, other entities within the group have no call to impose tax they would not otherwise impose; the income in question, wherever it may be earned, is subject to an acceptable 15 percent tax in the jurisdiction where that income is earned.

The United States would have no quarrel with this world and, indeed, would probably welcome it. There would be no tax havens where income could be earned without being subjected to a non-trivial rate of tax. And the OECD could justly take credit for having achieved the much desired "level playing field."

There is, however, a flaw in the structure and its existence is made clear by the "Side-by-Side" Agreement sought by the United States. That agreement left US multinational groups outside the realm of Pillar Two except with respect to Pillar Two additional tax imposed by the jurisdiction where income is earned. The "Side-by-Side" system was deemed acceptable by the OECD because certain jurisdictions were seen as imposing minimum tax requirements with respect to domestic and foreign income independent of the Pillar Two rules. The United

States was identified as an example — thus far the only example — of such a jurisdiction.

The OECD spelled out the requirements of a tax system "eligible" for "Side-by-Side" treatment. Among other requirements, the jurisdiction must have at least a 20 percent nominal corporate income tax. It must have a corporate alternative minimum tax, or some other domestic tax regime based on financial statement income, that ensures an effective corporate income tax rate of at least 15 percent. There must be no material risk that multinational groups will be subject to tax on their domestic operations at a rate lower than 15 percent. And there must be no material risk that foreign operations will be subject to tax at a rate lower than 15 percent.

The problem, of course, is that the US tax system does not clearly meet all these requirements. Its system for taxing the income of foreign subsidiaries imposes tax at a rate of 12.6 percent, not 15 percent. It is true that most large US multinational groups will likely pay tax on their foreign income at an overall rate of at least 15 percent, given that in most cases the income of these groups is earned in many jurisdictions, including relatively high-tax jurisdictions. This, however, does not mean the effective rate of tax with respect to a particular foreign country will equal or exceed 15 percent. Nor can it fairly be said that there is "no material risk" that the overall rate of tax on the foreign income of some large US parented groups will fall short of 15 percent.

In other words, US multinational groups may be advantaged by the "Side-by-Side" Agreement by comparison with competing groups with parent entities in jurisdictions where Pillar Two prevails. The advantage is countered by certain disadvantages of the US system, including especially a notable stinginess with respect to foreign tax credits. Nevertheless, there certainly can be a potential advantage for large US groups that avoid the strictures of Pillar Two. That advantage will disappear if every jurisdiction where a US group earns income adopts a Pillar Two tax requiring at least a 15 percent rate on income earned within the jurisdiction. The enormous compliance burden that Pillar Two entails will remain, but that may be a price worth paying for that talismanic "level playing field."

What happens, however, if some jurisdictions, wishing to attract investment from the United States, decline to adopt, or retain, the additional Pillar Two taxes on income earned within those jurisdictions? Some jurisdictions may decide, in other words, that their interest lies in competition, not cooperation. That would leave US groups benefiting from the advantage of an effective tax rate lower than 15 percent in those jurisdictions, a notable advantage vis-à-vis groups from jurisdictions that have not sought exemption from the Pillar Two rules.

Only time will tell whether this flaw proves fatal. The source of international tax competition, and thus of the non-level playing field that the OECD wishes to alter, was always the desire of some jurisdictions to attract investment to their borders at the expense of other jurisdictions. What makes anyone believe that desire has been extinguished by the rules of Pillar Two?