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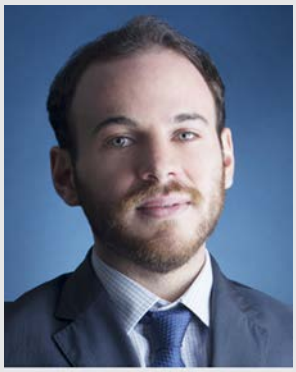

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In this article, Brandt and Avalos consider the interaction of the OECD's global anti-base-erosion rules and the U.S. global intangible low-taxed income regime to provide a roadmap on how the international tax system may work after jurisdictions implement an income inclusion rule and undertaxed payments rule.

The views expressed in this article are the authors' own and do not necessarily reflect those of Creel.

As part of its efforts to rewrite international tax principles and reallocate profits to the jurisdictions where value is created, the OECD devised a two-pillar plan to tackle challenges raised by the digital economy. Pillar 1 should be seen as a continuation of the work performed by the OECD in connection with the base erosion and profit-shifting initiative's final report on action 1, under which market jurisdictions are afforded — in the construct of amount A — a formulaic taxing right that recognizes their contribution to creating value, while deviating from traditional international tax principles on source taxation. Pillar 2 has been publicized as part of the same efforts, but it should not be seen as a solution to the same concerns that inspired BEPS action 1.

Pillar 2 has a broader policy goal than tackling the challenges of taxing the digital economy. Pillar 2 should be seen as the design of a new, fairer international tax system in which jurisdictions have implemented substantially similar rules that work in a coordinated manner to ensure that profits of multinational groups are taxed at an agreed minimum rate. Although pillar 2 was publicized as an overhaul of pending BEPS issues, it seems to have a different focus, given that its rules intend to tackle harmful tax competition (as opposed to strengthening rules to avoid profit shifting).

The origins of the global anti-base-erosion (GLOBE) rules can be traced back to the rules adopted by the United States in the Tax Cuts and Jobs Act. The GLOBE rules provide for an income inclusion rule, which acts as a primary rule to ensure that the jurisdiction of an ultimate parent entity (UPE) is able to tax profits that were not taxed at a minimum agreed rate in the form of a controlled-foreign-corporation-like inclusion. Although there are several design differences, the IIR is based on the U.S. global intangible low-taxed income regime, which at a high level requires U.S. shareholders to include their pro rata share of net income derived at the level of their CFCs (considering worldwide blending) over a fictional return on assets of 10 percent of the tax basis in tangible property owned by each CFC.

The GLOBE rules also rely on the undertaxed payments rule, which acts as a secondary rule to backstop any fact patterns in which an income inclusion is not created under the IIR. The UTPR was thought to be a rule that would prevent profit

shifting by denying deductions on intragroup payments to low-tax jurisdictions. Although it has significant design differences, the UTPR was said to be based on the U.S. base erosion and antiabuse tax because they seemed to address the same concerns (that is, profit shifting through intragroup payments). However, based on the OECD GLOBE model rules,[1] the UTPR does not deny deductions of intragroup payments. Rather, it allows a specific jurisdiction to deny deductions or perform an income adjustment based on a formulaic key that allocates the top-up tax that should have been paid by a particular low-tax constituent entity within the multinational group to that jurisdiction.

At a high level, the BEAT creates a minimum tax that some U.S. corporations must compute alongside their general income tax liability, but for purposes of the BEAT, some intragroup deductible payments would be scaled back to ensure that those U.S. corporations pay a minimum amount of tax. The UTPR is significantly different because it does not deny deductions based on whether intragroup deductible payments have been made, but rather allows the denial of deductions based on the existence of top-up tax at the level of affiliates within the same multinational group.

Finally, although its design and implementation are yet to be expanded through model rules and commentary, pillar 2 also considers the possibility of the subject-to-tax rule (STTR), which is a treaty-based rule that allows a source jurisdiction to modify its treaty network and impose a top-up tax on some deductible payments between related parties to ensure that those payments are subject to at least a 9 percent rate on a nominal basis. Unlike the UTPR, the STTR is not subject to the ordering rules that give the IIR prevalence, and thus it should apply even though the IIR is triggering an income inclusion at the level of the UPE. Any taxes triggered under the STTR should be considered part of the covered taxes that must be taken into account for purposes of computing a jurisdiction's effective tax rate (ETR).

Pillar 2 is intended as an overhaul of the existing international tax system and is meant to create a fairer system, ensuring that profits are taxed at an agreed minimum rate. However, the criteria to allocate profits of a multinational group clearly favor capital exporters over capital importers, because the UPEs of multinational groups are given the first bite of the apple through the IIR. In normal circumstances, given the mechanics of the GLOBE rules and the prevalence of multinational groups headquartered in developed countries, one would expect developed countries to benefit the most from the GLOBE rules. Because the STTR is not subject to the same ordering rules as the UTPR, it is seen as a favorable rule for developing countries that will be able to protect their tax base from base-eroding payments that benefit from low withholding taxes under an income tax treaty.

The STTR seems to have worked as a bargaining chip for developed countries to get developing countries on board with the new international tax system. Developed countries will be able to tax most of the revenue of a given multinational group, either in the form of the IIR at the UPE level or through the formulaic approach of the UTPR, which allocates taxing rights in proportion to the employees and tangible assets in each jurisdiction. Developing countries will be able to turn off treaty relief in connection to base-eroding related-party payments. It seems that developed countries are getting the better part of the deal because the existence of the IIR and UTPR would generally discourage multinationals from making base-eroding payments outside of a jurisdiction (only to be taxed in a different jurisdiction), and because some developing countries already provide for high withholding taxes in their treaty network.

Despite being publicized as a global agreement by the members of the inclusive framework, the redesign of the international tax system has several open-ended questions and challenges that must be overcome. Although the inclusive framework has agreed to a unified approach, jurisdictions must implement these rules under their domestic laws. The effectiveness of these rules and how they will apply remain to be seen. Multinational groups should pay close attention to U.S. tax reform developments,

[1] OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two)" (Dec. 20, 2021).

because it seems that the GILTI regime's characterization as a qualified IIR depends on the United States being able to pass legislation to switch from a worldwide blending approach to a country-by-country calculation. Also, U.S.-based multinationals may have a special interest in how the UTPR would work in foreign jurisdictions given that the creditability of any income taxes paid at the CFC level may be compromised under the final foreign tax credit regulations.

This article will explore the interaction of the GLOBE rules and the GILTI regime in order to provide a roadmap of how the international tax system may work after jurisdictions implement an IIR and UTPR. The operation of the rules — and which jurisdictions end up applying their rules — hinges on the fundamental questions of whether the GILTI regime should be considered a qualified IIR and whether the United States will be able to switch from a worldwide blending system to a CbC regime.

GLOBE Method

The first step to apply the GLOBE rules is to identify a multinational enterprise group. An MNE group is any group of entities, provided that at least one of the entities or a permanent establishment is located outside of the jurisdiction of the UPE (that is, an entity that owns a controlling interest in another entity and is not owned by another entity through a controlling interest). A group is a collection of entities that are related through ownership or control such that their assets, liabilities, income, and expenses are included in the consolidated financial statements of the UPE. After the MNE group has been identified, the next step is to determine whether it is in scope of the rules — if it has annual revenue of at least €750 million at the level of the consolidated financial statements of the UPE in at least two tax years of the four fiscal years preceding the tax year being tested.

If shareholders have identified the existence of an MNE group and have determined that the group is in scope of the GLOBE rules, then they need to compute the GLOBE income and covered taxes at the level of each constituent entity in order to compute the jurisdictional ETR. After they have computed the jurisdictional ETR, they will be able to identify a low-tax constituent entity within the group.

As a first step, taxpayers need to take into account the net income or loss of each constituent entity according to the financial statements prepared by the UPE. However, the net income or loss amount should be adjusted to provide for the recognition of specified book-to-tax adjustments that are recognized in jurisdictions of the inclusive framework. It is worth highlighting that the adjustments include net taxes expense (including covered taxes), excluded dividends, excluded equity gain or loss, asymmetric foreign currency gains or losses, and policy disallowed expenses. The adjustments follow specific policy rationales to exclude items from income that later will be excluded from covered taxes, to avoid double counting taxed income or distortions resulting from the use of different functional currencies for accounting and tax purposes, to align with participation exemptions, or simply to disallow illegal payments.

Taxpayers also need to identify the covered taxes paid at the level of each constituent entity. Covered taxes are broadly defined under the GLOBE rules and include any taxes that are imposed on income or profits, as well as taxes that are substantially similar to those taxes (such as taxes in lieu of an income tax), although adjustments need to be performed. Because the adjustments aim to take temporary differences and prior year losses into account, they use the deferred tax expense in the financial accounts of a constituent entity as a starting point; however, they exclude movements in deferred tax expenses accrued that relate to uncertain tax positions, deferred tax expense with respect to items excluded from the computation of GLOBE rules, and the amount of deferred tax expense with respect to the generation and use of tax credits. When applying the rules for adjustments to covered taxes, constituent entities can elect to establish a GLOBE loss deferred tax asset for fiscal years when there is a GLOBE loss for the jurisdiction, and carry forward the tax asset to the subsequent fiscal years.

A fundamental difference between the GLOBE rules and the GILTI regime is that the GLOBE rules compute GLOBE income by reference to net book income (adjusted for book-to-tax differences) as reported on the financial statements of the UPE, but the GILTI regime

requires taxpayers to apply U.S. tax principles to determine the tested income or tested loss derived through each CFC. The policy rationale for using accounting records, as opposed to having each jurisdiction apply its own tax law to compute the GLOBE income at the level of each constituent entity, is administrative simplicity, and it also ensures that the rules are applied consistently throughout all jurisdictions. Although GLOBE income is computed from existing information in the financial statements, the book-to-tax adjustments that must be performed are almost as complex as requiring each UPE to use its jurisdiction's tax principles to compute net income.

After taxpayers have identified their GLOBE income and covered taxes, they need to compute the ETR on a jurisdictional basis. They divide the total amount of covered taxes of all constituent entities in a particular jurisdiction (as adjusted under the GLOBE rules) by the net GLOBE income of all those entities, and the result shall be expressed as a percentage. Net GLOBE income is equivalent to the excess of the GLOBE income derived by all the constituent entities of a particular jurisdiction over the GLOBE losses of those entities. Although the GLOBE rules apply a CbC computation to calculate net GLOBE income, they differ substantially from the GILTI regime, which allows a U.S. shareholder to offset a CFC's tested loss against another CFC's tested income, irrespective of the jurisdiction in which they reside.

The jurisdictional ETR will allow MNE groups to identify the jurisdictions where they have low-tax constituent entities and will also allow them to compute the top-up tax percentage that would need to be applied over any net GLOBE income. The top-up tax percentage is computed by subtracting the jurisdictional ETR from the agreed minimum rate of 15 percent so that only the excess of the agreed minimum rate above the jurisdictional ETR will be applied to tax a low-tax constituent entity's profits under the IIR or the UTPR.

After taxpayers have identified the top-up tax percentage, they should apply that percentage to the excess profits (which is the jurisdictional net GLOBE income that exceeds the jurisdiction's substance-based income exclusion). The substance-based income exclusion under the GLOBE rules is a formulaic deemed return on payroll expenses and tangible assets (starting at 10 percent and 8 percent, respectively, and gradually scaling back to 5 percent) that allows taxpayers to exclude those amounts from the excess profits that will be subject to the IIR or the UTPR.

The substance-based income exclusion seems to be based on the GILTI regime because the rules provide that a U.S. shareholder's GILTI inclusion will be equivalent to the excess of the net CFC tested income that exceeds the net deemed tangible income return, which at a high level is also a fictional 10 percent return on the taxpayer's quarterly average basis in depreciable tangible property or qualified business asset investments.

To compute the top-up tax, taxpayers need to apply the top-up tax percentage (computed by subtracting the jurisdictional ETR from the 15 percent agreed minimum rate) over the excess profits (computed by subtracting the substance-based income exclusion from the net GLOBE income). Taxpayers will generally be able to identify the top-up tax triggered on a jurisdictional basis and should then allocate the top-up tax in each jurisdiction to each constituent entity in that jurisdiction. Before performing the allocation, the GLOBE rules also provide for the possibility of some adjustments to the jurisdictional top-up tax, including adjustments to account for any changes to the ETR in a prior tax year.

Also, the GLOBE rules provide for the possibility that a jurisdiction adopts a qualified domestic minimum top-up tax (QDMTT), which at a high level is a minimum tax regime that the jurisdiction of a constituent entity can adopt to ensure that any top-up tax triggered in that jurisdiction is reduced by the QDMTT. To the extent that a jurisdiction has a domestic minimum top-up tax that is considered a QDMTT, the jurisdiction would be able to apply any top-up tax before the GLOBE income is subject to the IRR and/or the UTPR in other jurisdictions. As mentioned before, capital exporters are given the first bite of the apple to tax profits within the MNE group. With a QDMTT, capital importers can ensure that any top-up tax derived from their

jurisdiction is taxed by them and not the jurisdictions of other constituent entities.

After these adjustments are made, the allocation of the jurisdictional top-up tax should be done only to entities within the jurisdiction that have GLOBE income through an allocation key based on the ratio of each entity's GLOBE income during the tax year divided by sum of the GLOBE income of all the constituent entities relevant to the allocation.

After taxpayers have identified the top-up tax allocated to each constituent entity, the IIR and the UTPR will be applied to bring in any top-up tax at the level of any low-tax constituent entities within the MNE group. As mentioned before, the GLOBE rules provide that the IIR acts as a primary rule and will allow the UPE of the MNE group to bring in any top-up tax allocated to a low-tax constituent entity. To the extent that the IIR is not applied within any jurisdiction of the MNE group, the UTPR acts as a backstop and will allow other constituent entities within the group to bring into charge the allocable share of the top-up tax in the group.

The IIR follows a top-down approach in the sense that it allows the UPE of the MNE group to apply the IIR — and only to the extent that the UPE does not apply the IIR (either because its IIR is not considered a qualified IIR or because its jurisdiction does not have an IIR) — then the following bottom-tier intermediate parent entity (IPE) will be allowed to apply its IIR.

Under the IIR, the jurisdiction applying the IIR — either at the level of the UPE or of an IPE — will be allowed to tax its allocable share of the top-up tax derived through a low-tax constituent entity by being the direct or indirect owner of the low-tax constituent entity during the tax year. The IIR works through a CFC-like inclusion in which the UPE or IPE applying the rule is allowed to tax its allocable share of the top-up tax, although no distribution of profits has taken place.

If a qualified IIR has not been applied throughout the MNE group, then the UTPR kicks in as a backstop to bring in any top-up tax of low-tax constituent entities in the form of a deduction denial or similar adjustment. Under the GLOBE rules, jurisdictions are allowed to apply the UTPR either as a deduction denial or a similar adjustment (additional inclusion), provided that the mechanism results in an incremental cost equal to the UTPR top-up tax amount. At a very high level, the notion behind the UTPR is allocating the top-up tax triggered within the MNE group between all the jurisdictions of the MNE group so that each jurisdiction is allowed to disallow deductions or create a similar adjustment that results in an incremental cost of the top-up tax allocated under the UTPR (the UTPR top-up tax amount). For example, as described under the GLOBE rules, if a constituent entity in a particular jurisdiction is allocated a UTPR top-up tax amount of 10 and the corporate income tax rate is 25 percent, the adjustment or denial of deduction should be equivalent to 40 (10 divided by 25 percent) because this amount would be equivalent to the incremental cost of the UTPR top-up tax amount.[2]

The UTPR relies on the same computation as the IIR to calculate the top-up tax at the level of each constituent entity as a starting point. After taxpayers have computed the top-up tax of each low-tax constituent entity within the MNE group, they need to aggregate all the top-up tax to compute the total UTPR top-up tax amount, which then will be allocated within the jurisdictions applying the UTPR. The allocation under the UTPR to participant jurisdictions is done by applying the UTPR percentage (as described below) to the MNE group's total UTPR top-up tax amount.

The UTPR percentage is calculated using quantitative factors that are meant to resemble economic activities in the particular jurisdiction and that are indicative of the jurisdiction's capacity to support the denial of the deduction of specified expenses under the UTPR. As a result, the UTPR percentage should be computed by taking the number of employees in a particular UTPR jurisdiction divided by the number of employees in all UTPR jurisdictions within the MNE group (including jurisdictions that are low tax or the jurisdiction of the UPE) and the net book value of tangible assets in a particular UTPR jurisdiction divided by the net book value of assets in all UTPR jurisdictions (including

[2] *See* OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)," at 32, article 2.4.1 (2022).

jurisdictions that are low tax or the jurisdiction of the UPE). Both are on an equal footing, so 50 percent of the UTPR percentage will be determined by the employee ratio and the remaining portion will be determined by the net book value of tangible assets ratio.

Although the GLOBE rules provide guidance on how the UTPR should operate, it should be noted that jurisdictions are free to choose how they implement the UTPR adjustments, namely whether the UTPR top-up tax amount allocated to a particular jurisdiction should result in the disallowance of deductible expenses or a similar adjustment (that is, additional income inclusion) that results in an equivalent incremental cost. The UTPR allocates the UTPR top-up tax amount within a particular jurisdiction in the MNE group, but jurisdictions are free to allocate that amount within all the constituent entities in the same jurisdiction using any allocation key under domestic law. There are still open-ended questions about how the UTPR will work in particular jurisdictions and the ramifications that different design rules could have.

It is relevant that the GLOBE rules provide that any denial of deductions or similar adjustments under the UTPR be done irrespective of whether there are any related-party payments within the MNE group. Therefore, the UTPR should not be seen as a mechanism to curtail base erosion like the BEAT, but rather as a secondary rule to ensure that profits that are not taxed at the agreed minimum rate are considered for purposes of adjusting the taxable base of other affiliates within the MNE group.

The U.S. Tax System

The GLOBE rules rely on a coordinated approach, and the application of those rules will ultimately depend on how jurisdictions implement them under their domestic laws. Although the inclusive framework has reached consensus on how the rules should operate, it should not be overlooked that this is a political consensus that does not consider any country-specific hurdles. A great example of this is the United States: Although the United States was a significant player in the global agreement and the TCJA was a big influence on the IIR and UTPR, it is still facing struggles to modify its tax system to be GLOBE compliant.

The application of the GLOBE rules to MNE groups will hinge on whether the United States can become GLOBE compliant. If it can, then the GLOBE rules are set to apply in a coordinated manner as they were intended; however, if the United States cannot become GLOBE compliant, MNE groups will need to apply both the OECD and the U.S. approach in hopes of not being subject to double taxation.

Perhaps the most important conundrum is whether the GILTI regime should or will be treated as a qualified IIR. This question is relevant because if the GILTI regime is not seen as a qualified IIR, any U.S.-parented multinational group will be required to apply the GILTI regime and the GLOBE rules on a simultaneous basis. A U.S.-parented corporation should be required to include in taxable income its pro rata share of GILTI during the tax year, but given its top-down approach, any non-U.S. IPE within the MNE group would also be required to include its pro rata share of any top-up tax triggered within the MNE group. Conversely, if there isn't any IPE within the MNE group or such IPE does not apply a qualified IIR, the U.S. parent should still be subject to the GILTI regime, but any CFCs within the MNE group may get deductions denied under the UTPR. In this case, the biggest question is whether the denial of deductions under the UTPR could result in any taxes paid by the CFC being disqualified as a net income tax under the final FTC regulations.

At a high level, the GILTI regime requires a U.S. shareholder to include its pro rata share of GILTI, which is equivalent to the excess of net CFC tested income over its net deemed tangible income return. To compute a U.S. shareholder's net CFC tested income, taxpayers need to compute the tested income and tested loss at the level of each CFC they participate in as a U.S. shareholder without regard to the jurisdiction where the CFCs are resident. Tested income is the excess of gross income (without regard to some items of income, including income considered subpart F) over deductions that are allocable to that income, and tested loss is the excess of the deductions over the CFC's gross income. After the U.S. shareholders determine the tested income

and tested loss of all the CFCs in which they are a shareholder, they must determine whether they have any net CFC tested income, which is the excess of a U.S. shareholder's pro rata share of its aggregate tested income — the tested income of all the CFCs in which it is a shareholder — over its pro rata share of its aggregate tested loss — the tested loss of all the CFCs in which it is a shareholder. If the U.S. shareholder has net CFC tested income for the tax year, its GILTI inclusion is equivalent to the excess of the net CFC tested income over its net deemed tangible income return.

The net deemed tangible income return is equivalent to 10 percent of the U.S. shareholder's aggregate pro rata share of the adjusted tax basis of tangible property owned by all CFCs in which it is a U.S. shareholder over any interest expense that is allocable for purposes of determining the net CFC tested income.

Conceptually, U.S. shareholders are required to include their pro rata share of GILTI, which intends to capture net income derived at the CFC level (that is not classified as subpart F) over a fictional return on assets of 10 percent of the tax basis in tangible property owned by each CFC. Although U.S. shareholder corporations will be required to include any GILTI for the tax year at a 21 percent rate, they are entitled to a deduction equal to 50 percent of the GILTI inclusion for the tax year (provided there are other items of taxable income during the tax year), which results in a reduced ETR. Also, the GILTI rules allow for an 80 percent FTC for any deemed paid foreign income taxes at the CFC level taking an aggregate approach.

From a policy perspective, the GILTI regime seems substantially similar to the IIR in the sense that it taxes on a current basis any foreign profits exceeding a fictional return, whether this is achieved through QBAI or the substance-based income exclusion. Further, both intend to tax foreign profits at a minimum rate, whether by computing the top-up tax percentage to be applied to the excess profits by subtracting the 15 percent agreed minimum rate or by requiring a full GILTI inclusion but allowing the section 250 deduction to lower the ETR and an 80 percent FTC.

Although the GLOBE rules were based on the GILTI regime and there are sound arguments that both systems tackle the same policy concerns, there are significant mechanical differences that support the notion that the GILTI regime should not be treated as a qualified IIR. The most pressing is that the IIR provides for a CbC computation in which the top-up tax is computed by considering the net income of each entity in an MNE group that is resident in the same jurisdiction, whereas the GILTI regime allows worldwide blending, and only the excess of all CFC income over all CFC losses is taken into account and FTCs are computed on an aggregate basis. Although the IIR is supposed to curtail MNE groups from locating their operations in low-tax jurisdictions, worldwide blending is not as effective as a CbC computation because MNE groups would still have an incentive to locate their operations abroad, given that the FTC aggregate approach under GILTI would allow using credits derived from high-tax jurisdictions to shelter income in low-tax jurisdictions and the fact that any losses triggered in a high-tax jurisdiction would be able to reduce the inclusion with respect to income derived from a low-tax jurisdiction.

The European Commission published its proposed directive on implementing pillar 2 and stated that an IIR implemented by a non-EU country can only be considered equivalent to the EU's IIR if the rules only allow blending within the same jurisdiction. The United States is clearly aware of this hurdle and has made an effort through the Build Back Better Act (H.R. 5376) to shift from a worldwide blending computation to CbC. However, pillar 2 is a political agreement between jurisdictions, and each jurisdiction needs to overcome any hurdles under its own domestic law in order to conform to the global deal. Will the United States be able to shift to a CbC system?

Another major difference — although less controversial — is the mechanics of the IIR and GILTI. The IIR takes into account book income and covered taxes (modified to reflect some book-to-tax adjustments) as reported in the financial statements, whereas the GILTI regime relies on U.S. tax principles to compute each CFC's tested income or tested loss. The IIR has a formulaic approach under which the top-up percentage —

the excess of the 15 percent agreed minimum rate over the jurisdictional ETR — is applied to the excess profits in a particular jurisdiction, and because the ETR paid by the low-tax constituent entity is taken into account to compute the top-up percentage, there is no need to provide any FTCs. Conversely, the GILTI regime requires a full inclusion for any GILTI so that any foreign taxes paid at the CFC level shall be deemed paid by a U.S. corporation with a 20 percent haircut. Whether it is by reducing the top-up percentage by the jurisdictional ETR or by requiring a full inclusion with the possibility of an 80 percent FTC for any taxes deemed paid, both regimes require an income inclusion of the residual taxes triggered.

Under U.S. law, it seems unlikely that the GILTI regime could be considered a qualified IIR given its worldwide blending approach and the fact that some members of the inclusive framework seem to have the view that a qualified IIR should only allow jurisdictional blending. Considering the prevalence of U.S.-parented multinationals, the relevance of this determination will be of significance to most inclusive framework jurisdictions.

As mentioned before, if the GILTI regime is not considered a qualified IIR, the top-down approach of any U.S. multinational would force multinational groups to apply the GILTI rules at the U.S. parent level and the IIR at the level of any IPE. Conversely, if an IPE does not exist or it does not have a qualified IIR, the UTPR would kick in as a backstop and would disallow a deduction or provide an income adjustment in connection to any entity within the MNE group. Any adjustment or disallowance of the deductions of an entity within the MNE group under the UTPR will coexist with any GILTI inclusions that the U.S. parent may have under the GILTI regime, and thus it will be relevant to determine whether any foreign taxes paid at the entity level should be considered as a net income tax after the application of the UTPR.

Assuming the GILTI regime is not treated as a qualified IIR, another relevant issue for U.S.-parented multinationals is whether any taxes triggered in connection to GILTI inclusions at the level of the ultimate U.S. parent could be pushed down to the constituent entities and considered as covered taxes for purposes of computing the constituent entity's jurisdictional ETR. Although the GLOBE rules are meant to favor a jurisdictional blending of taxes, there are some instances in which, because of the cross-border nature of the taxes imposed, the rules allocate taxes imposed in a jurisdiction with respect to income arising in another jurisdiction. The GLOBE rules generally allocate covered taxes imposed under a CFC tax regime to the jurisdiction where the income was derived (that is, taxes are allocated from the jurisdiction imposing the CFC regime to the CFC jurisdiction) for purposes of computing covered taxes and the jurisdictional ETR. At a high level, any taxes triggered in connection to the existence of a CFC regime are allocated to the constituent entity in the jurisdiction where the income arose using a three-prong process by (i) identifying the amount of CFC income included in the CFC jurisdiction; (ii) identifying the parent's tax liability from CFC income; and (iii) identifying the amount of FTCs triggered at the parent jurisdiction, such that the amount of covered taxes pushed down to the constituent entity is equivalent to the residual tax imposed at the parent level (that is, tax liability on any income inclusion minus any FTCs allowed). Also, to prevent blending with respect to passive income, the GLOBE rules provide for a cap under which any taxes that could be pushed down from a parent company to a constituent entity are limited to the lesser of (a) the actual amount of covered taxes in respect of any passive income, or (b) the top-up tax percentage that applies in the jurisdiction of the constituent entity times the passive income.

Although the GLOBE rules allow the pushdown of taxes imposed in connection to a CFC regime, it is uncertain whether the rules would allow a U.S.-parented MNE to push down any taxes triggered in connection to a GILTI inclusion, as it is not entirely clear the GILTI regime is a CFC tax regime within the meaning of the GLOBE rules. Under article 10.1, paragraph 8 of the GLOBE model rules, an IIR is not included in the definition of a CFC tax regime. Although it imposes tax on a current basis at the shareholder level, it is only meant to capture profits that are not taxed at an agreed minimum rate. The GILTI regime may not be considered a qualified IIR

because of its worldwide blending approach, but it may be considered akin to an IIR, which is not necessarily considered to qualify as a CFC tax regime. Therefore, U.S.-parented multinationals could be in a worse off position in terms of the computation of the jurisdictional ETR. Even if the GILTI regime were to be considered a CFC tax regime, its worldwide blending approach may create complexities regarding how to allocate the taxes triggered with respect to any GILTI inclusion to each constituent entity within the group, as tested income and tested losses of all CFCs are blended under the GILTI computation. Either taxpayers would need to take a tracing approach and try to figure out which portion of a GILTI inclusion was triggered by each constituent entity (which would be a complex exercise considering QBAI or the netting of tested losses), or they would need to use an allocation key to apportion the amount of GILTI paid at the U.S. shareholder level to each constituent entity within the MNE group.

Another relevant issue with respect to GILTI and taxes paid under a CFC tax regime in general is the interaction of a CFC tax regime and a QDMTT. The QDMTT should allow a jurisdiction to tax the top-up tax computed at the level of a particular constituent entity. If GILTI is considered a CFC tax regime, any taxes paid under GILTI should be pushed from the U.S. parent to a constituent entity to compute covered taxes and would presumably reduce the top-up taxes to be calculated at the constituent entity level under a QDMTT. However, assuming the taxes imposed under a QDMTT are creditable against a GILTI inclusion, query whether the amount of GILTI to be pushed down to the constituent entity should also be reduced by any QDMTT paid. In other words, there seems to be an absence of ordering rules to determine to what extent GILTI would be pushed down to a constituent entity in a jurisdiction with a QDMTT.

In January the U.S. Treasury Department published the final FTC regulations and significantly modified the standard to determine whether a foreign levy is treated as a net income tax and thus creditable against a taxpayer's U.S. tax liability. The regulations replaced the previous standard used to determine whether a foreign levy's predominant character was that of an income tax in the U.S. sense with a more objective standard that requires an assessment of whether the net gain requirement of the regulations would be met considering all relevant provisions under foreign law. The net gain requirement is composed of a realization requirement, a gross receipts requirement, a cost recovery requirement, and a new attribution requirement (also known as the jurisdictional nexus requirement under the prior iteration of the FTC regulations).

Under the cost recovery requirement, a foreign levy should meet such a test to the extent that foreign law allows the recovery of significant costs and expenses, or if foreign law does not permit the recovery of significant costs and expenses, it allows an alternative cost allowance method, which by its terms is greater than the actual cost and expense. The cost recovery requirement may be problematic for any jurisdictions that implement a UTPR, as the latter stands for the proposition of denying deductions in a particular jurisdiction within the MNE group by reference to the top-up tax triggered within the group.

As mentioned before, under the GLOBE rules, jurisdictions are allowed to apply the UTPR either as a deduction denial or a similar adjustment (that is, additional inclusion), provided that the mechanism results in an incremental cost equal to the UTPR top-up tax amount. To the extent that a particular jurisdiction chooses to deny deductions through the application of the UTPR and the denial results in significant costs and expenses being disallowed (such as interest, rents, royalties, wages, services, and research and experimental expenditures) for purposes of computing the foreign tax base, the UTPR would put into question whether the foreign levy meets the net gain requirements under the FTC regulations. The practical effect of this in an MNE group would be that any GILTI inclusions at the U.S. parent level would not benefit from the corresponding GILTI FTC for any taxes deemed paid at the CFC level, because any taxes paid at the CFC level would not be treated as income taxes for purposes of the FTC regulations.

Conversely, if a particular jurisdiction decided to perform an adjustment through the UTPR in the form of an income inclusion, the UTPR would

also be a pressure point on the creditability of those foreign taxes because of the realization requirement. At a high level, under the realization requirement, foreign law must provide for a triggering event that would result in the realization of income under the standards set forth in the U.S. IRC, or, if it's a pre-realization event, that serves as a substitute for a later triggering event. If the UTPR in a particular jurisdiction provides for an income inclusion that results in an incremental cost equal to the UTPR top-up tax amount, that inclusion would call into question whether the foreign levy meets the realization requirements under the FTC regulations, because the UTPR is unprecedented in the sense that it is an adjustment to the tax base of a particular jurisdiction, based on the results of a formulaic allocation key that considers the top-up tax within the whole MNE group. The UTPR is a backstop to prevent situations in which the top-up tax within an MNE group is not brought in solely because the UPE or IPE of the group does not have a qualified IIR; however, it is not consistent with the realization of income and has no other logic from a tax policy perspective other than to act as a collection mechanism for any top-up tax within the MNE group.

This construct of adopting a UTPR that acts through an income adjustment would also be a pressure point with respect to the gross receipts requirements of the FTC regulations, because the tax would not necessarily be imposed on actual gross receipts of a particular CFC.

On March 28 the U.S. Treasury released the green book, stating its intention to repeal the BEAT and adopt a UTPR that is consistent with the GLOBE rules. Based on the green book's limited detail, it seems Treasury intends to adopt the UTPR as a mechanism to disallow deductions to the extent necessary to collect the hypothetical UTPR top-up tax amount, as opposed to having an alternative mechanism under which income is adjusted. Although this may be helpful for determining whether a foreign levy complies with the cost recovery requirement, it seems that even if a UTPR is adopted in the United States, any country that decides to adopt the UTPR as an income inclusion mechanism would nonetheless have trouble complying with the realization requirement or the gross receipts requirement.

Under the cost recovery requirement of the FTC regulations, limitations on deductibility of significant costs and expenses are permitted if the disallowance of the deduction is consistent with principles under the IRC, including disallowances intended to limit BEPS. If the United States ends up adopting a UTPR as intended under the green book, it would seem that any concerns regarding the cost recovery requirement would disappear because the UTPR in a CFC jurisdiction may be consistent with the UTPR in the United States. However, so far the GLOBE rules only provide a conceptual baseline for how the UTPR should work, and they lack extensive detail. The United States may adopt a UTPR, but its rules may be different than the rules adopted by a CFC jurisdiction, and thus the rules may not be consistent as required under the FTC regulations. Although Example 3 of reg. section 1.901-2(b)(4)(iv)(C) provides that the disallowance of interest expense in a foreign country under rules similar to section 163(j) and section 267A does not run afoul of the cost recovery requirement, the example fails to provide guidance regarding how similar the rules would need to be. Although there may be a common baseline to adopt a particular set of rules, given that pillar 2 is only a political agreement and each jurisdiction will need to adopt the rules taking into account their domestic law, each country's iteration of the UTPR may vary.

The application of the GLOBE rules seems to hinge on the outcome of any potential U.S. tax reform, whether it is in the form of a CbC GILTI computation that would prevent the simultaneous interaction of the IIR/UTPR and GILTI regime in U.S.-parented groups or whether the income tax of jurisdictions that adopt the UTPR would still be creditable under the FTC regulations.

CFC Tax Regimes

As mentioned before, pillar 2 represents a political agreement between jurisdictions to adopt a set of coordinated rules to ensure that an in-scope MNE group's profits are taxed at a minimum rate. Despite committing to adopt these rules, each inclusive framework jurisdiction needs to observe its internal law procedures to adopt these rules and should also make sure that

it has accounted for guidance on the interaction of the rules and other domestic law provisions. Although the GLOBE rules provide a baseline for inclusive framework jurisdictions, they are not extensive and do not provide guidance on country-specific issues that may arise in connection to a jurisdiction's existing rules and the GLOBE rules.

A great example of this is the interaction with other domestic law CFC regimes. The GLOBE rules provide that an IIR should not be considered a CFC tax regime and that, given the policy and mechanical differences between a CFC tax regime and the IIR, each jurisdiction is not required to replace its existing CFC tax regime with an IIR. Rather, the rules provide for the possibility of each jurisdiction employing both rules.[3] Although a jurisdiction may have both a CFC tax regime and an IIR, neither the GLOBE rules nor the commentary seem to have guidance on how a jurisdiction could avoid an income inclusion of the same stream of income under the jurisdiction's CFC tax regime and the IIR.

A CFC tax regime would require a UPE to include on a current basis some items of income derived by a CFC (generally passive income) to avoid undue deferral of mobile income within the MNE group. Conversely, the IIR would allow the UPE to bring in a CFC's earnings, which are not taxed at the agreed minimum rate. Although the CFC tax regime would generally be imposed along with tax principles in the jurisdiction of the UPE, the IIR should be computed by considering book income adjusted for book-to-tax differences. The coexistence of the regimes and the fact that each regime adopts a different mechanism to compute the inclusion may create situations in which one stream of income is taxed through each of the regimes without a rule that would exclude that inclusion.

Perhaps the policy rationale not to include an ordering rule to avoid duplicative income inclusions under the IIR and a CFC tax regime is that the construct of covered taxes allows for any taxes triggered in a UPE to be pushed down to a constituent entity, so that, in theory, the jurisdictional ETR has already accounted for any taxes imposed in connection to a CFC tax regime and any top-up tax that needs to be brought in under the IIR has already been reduced by taxes triggered under the CFC tax regime (the top-up tax percentage that is used to compute the top-up tax would be lower if the jurisdictional ETR is increased by any CFC tax regime taxes). However, there does not seem to be a 1-1 correlation between the taxes imposed under a CFC tax regime and the reduction in the IIR, given that the systems use different taxable bases and that the GLOBE rules provide for a limitation of the amount of CFC tax regime taxes that can be pushed down to a constituent entity in the context of passive income. This approach taken under the GLOBE rules is substantially different from the ordering rules under the U.S. GILTI regime, which avoids duplicative income inclusions of the same type of income by providing some carveouts under section 951A to ensure that tested income does not include any subpart F income.

Another relevant issue that does not seem to be addressed under the GLOBE rules is the effect that income inclusions under the IIR should have in the context of subsequent distributions to the UPE. Although the IIR is similar to a CFC tax regime in the sense that it requires a current inclusion of undistributed profits at the CFC level, it seems to lack a mechanism to ensure that income that has already been included under an IIR-like mechanism is not taxed again in the hands of the UPE after it is distributed or after the CFC shares are sold. Generally, CFC tax regimes in worldwide income jurisdictions allow for the creation of some tax attributes at the level of the CFC to ensure that any income that has already been included through a CFC-like inclusion at the parent level is distributed in a tax-free manner in that jurisdiction. Also, the CFC tax regime generally allows for the possibility to adjust any tax basis in the CFC shares in connection to any income inclusions to avoid double taxation on a sale of any earnings that have already been included in taxable income.

Although the GLOBE rules are not designed to provide guidance on country-specific issues that may arise from their interaction with other regimes, they seem to be based on the notion that all the jurisdictions in the inclusive framework follow a territorial system and that any

[3] *See id.* at 194, para. 8.

subsequent distributions of earnings that have already been subject to an IIR would not be subject to tax under the UPE's domestic law. Perhaps worldwide systems could look at the construct of previously taxed earnings and profits in the United States that is created by any GILTI inclusions, and that allows for the repatriation of profits in a tax-free manner and basis adjustments in CFC shares.

Conclusion

The global agreement under pillar 2 represents an unprecedented effort to tackle tax competition in a coordinated manner and could be seen as the reordering of the international tax system. Given that the agreement on pillar 2 is political, and considering that jurisdictions need to overcome hurdles under domestic law to adopt the rules, it is hard to anticipate how these rules will work in practice. A significant factor in determining how the rules will operate in the coming years is whether the United States, which is home to the majority of the UPEs of the MNE groups that would be within the scope of the rules, will be able to become GLOBE compliant. Furthermore, how the rules are applied throughout other jurisdictions, and which jurisdictions will get to increase their tax revenues, hinges on whether those jurisdictions will adopt a QDMTT to ensure that any top-up tax that is triggered within a constituent entity in the MNE group is brought into that jurisdiction, and not as part of the IIR or UTPR in another jurisdiction. Although the QDMTT rule is not the primary rule under the GLOBE rules, it is likely that most of the inclusive framework jurisdictions will implement these rules to ensure that they are receiving any top-up taxes. The question is whether that rule will become the primary rule.

In our view, the only certain thing about pillar 2 is that it will substantially increase the compliance burden of MNE groups and add significant complexity to an existing international tax system. Although it is meant to work in a coordinated manner, it lacks a uniform application of the rules throughout all jurisdictions. ■