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Pillar Two and the U.S.: A Policy Explainer for Navigating the Global Minimum Tax

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ABSTRACT

The OECD expects countries to implement components of Pillar Two, its framework for a global minimum tax, starting in 2024. This paper provides policymakers with a comprehensive resource for navigating the Pillar Two framework. We review key components of Pillar Two and related aspects of US tax policy, including: (i) how the global minimum tax is likely to expose portions of the current US corporate tax base to new foreign taxes; (ii) potential modifications to US tax law that would increase compliance and protect US tax rights; and, (iii) the extent to which Pillar Two is likely to succeed in its policy objectives of reducing corporate profit shifting and international tax competition. The US is likely to cede tax rights to foreign jurisdictions if it does not enact new tax law. Pillar Two will likely reshape the nature of tax competition between countries, incentivizing greater use of subsidies and refundable tax credits to counteract higher statutory rates.

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Key Points

- Under the current Pillar Two framework, nonrefundable tax credits generate significantly more tax liability than equivalent refundable credits. Because the tax code in the United States relies more heavily on nonrefundable credits in comparison with other jurisdictions, large components of US corporate tax policy that are meant to incentivize certain behavior—e.g., the R&D tax credit, the low-income housing credit, and the orphan drug credit—may generate significant tax liability under Pillar Two rules. If the US does not adopt tax rules that comply with Pillar Two, this tax liability could be collected by foreign jurisdictions. This risk persists despite recent favorable guidance from the Inclusive Framework regarding treatment of transferable tax credits passed under the Inflation Reduction Act and the CHIPS Act.
- So far, the US has not acted to adopt key components of the Pillar Two framework. To the extent that it remains out of compliance with Pillar Two, the US will cede significant corporate income tax revenue to foreign jurisdictions assuming that the current framework is adopted by member countries without major modifications.
- The overall effect of Pillar Two on US corporate tax revenue remains highly uncertain. Pillar Two could result in a net revenue gain or loss for the US depending on the reaction of US multinationals and the extent to which the US enacts Pillar Two compliant tax rules. If US multinationals react to Pillar Two by reshoring foreign earnings, tax revenue may increase. Conversely, if these multinationals shift foreign earnings from low-tax jurisdictions to Pillar Two compliant jurisdictions, tax revenue may decrease.
- Pillar Two is likely to achieve some success at disincentivizing profit shifting by multinationals and tax competition between jurisdictions. Higher statutory tax rates may incentivize jurisdictions to increase tax competition through the corporate tax code by offering more generous refundable tax credits and subsidies. These tax incentives can be used to reduce firms' tax liabilities while technically remaining in compliance with the Pillar Two framework.

1. Overview of Pillar Two

1.1. Background

Over the past several decades, there has been growing concern around the ability of MNEs to avoid the corporate income tax.¹ Corporate income taxes have historically been based on corporate residence, a concept that is increasingly ill-defined as the modern economy has shifted toward the production of digital services and “footloose” industries that can more easily shift the location of production. Additionally, modern firms increasingly rely on intellectual property (IP) and intangible assets, which allow for geographic decoupling of production and revenue generation. These trends have forced policymakers to rethink the design of corporate tax systems.

In the United States, international corporate taxation was redesigned under the Tax Cuts and Jobs Act of 2017 (TCJA). This law exempted a portion of US multinationals’ foreign income from US tax while eliminating deferral for the remainder, which is deemed “Global Intangible Low-Taxed Income” (GILTI) and is subject to a new minimum tax.

Globally, a multilateral approach led by the Organization for Economic Co-operation and Development (OECD) and the G20 introduced a coordinated effort between countries to stem avoidance. This effort, the “Inclusive Framework on BEPS”, also includes non-OECD and non-G20 countries and currently incorporates 143 members.² The Inclusive Framework has championed two major policy packages or “Pillars.” Pillar One allocates taxation rights of large companies to the locations of their markets. Pillar Two, the focus of this paper, proposes a global minimum tax with three layers of corporate taxation to ensure that mobile income does not escape taxation.

1.2. GloBE Income and the Pillar Two Tax Base

Pillar Two aims to impose a 15 percent minimum tax on a measure of corporate profits called “Global Base Erosion” (GloBE) income, which is based on financial statement income. The minimum tax will apply to large MNEs—defined as firms with more than €750 million in revenue according to their consolidated financial statements. This measure is calculated for each constituent entity of a multinational firm, including parent entities, subsidiaries, branches, and permanent establishments.

To compute the tax base, GloBE income is adjusted by a factor called the “substance-based income exclusion” (SBIE) or the “substance carve out.” This adjustment is made so that the minimum tax is levied only on “excess profit.” As a proxy for “normal” profits not subject to the tax, the SBIE excludes a share of payroll and tangible assets from the tax base. The carve out

¹ Tax literature often distinguishes between “evasion,” which refers to illegal tax underpayment and “avoidance,” which refers to legal strategies used to minimize tax bills. Pillar Two focuses on closing down legal avenues for tax minimization.

² BEPS is an acronym for “Base Erosion and Profit Shifting.” A list of member countries is available at <https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf>.

starts at 10 percent of payroll and 8 percent of tangible assets for FY 2023, with a transition period to 5 percent for both categories over the following 10 years.³

Pillar Two imposes tax only after considering certain “covered taxes,” which generally includes corporate income tax imposed by countries’ existing tax regimes.⁴ The additional tax imposed by Pillar Two on excess profit is called the “top up tax.” The top up tax increases the effective tax rate to at least 15 percent in each jurisdiction where the MNE operates. If income in a jurisdiction is already taxed at an effective rate of 15 percent or higher after considering covered taxes, no additional tax is due. For example, consider an MNE affiliate that operates in a country with a statutory rate of 20 percent. The affiliate is eligible for tax credits that reduce its tax liability as a percentage of income to 13 percent. In this case, Pillar Two compliant jurisdictions impose a top up tax equal to 2 percent of income after accounting for the substance carve out. This tax could be collected by the jurisdiction where the affiliate operates, or by other jurisdictions where the MNE operates. A more precise summary of how the top up tax is computed under Pillar Two is provided in the Appendix.

The Pillar Two framework provides a three-layer system by which the top up tax may be collected. These three layers determine which jurisdictions have the right to collect the top up tax.

1.3. The Three Layers of Pillar Two’s Minimum Tax

Pillar Two consists of three layers of corporate taxes that are successively applied to excess profit of MNE constituent entities to collect the top up tax:

- The first layer is the **Qualified Domestic Minimum Top Up Tax (QDMTT)**. This layer gives initial taxation rights to the jurisdiction in which an entity is located. QDMTTs are similar to domestic corporate income taxes, except they apply only to GloBE income.
- If a QDMTT is not levied or if the effective tax rate of an MNE remains under 15 percent after incorporating both covered taxes and QDMTTs, then taxation rights are passed to the jurisdiction of the MNE’s ultimate parent entity (UPE), which can levy a residual minimum tax under the **Income Inclusion Rule (IIR)**.⁵
- Finally, if the QDMTT and the IIR do not apply, jurisdictions that contain other entities of the MNE can collect residual top up tax under the **Undertaxed Payments Rule (UTPR)**.⁶

³ See Figure 2 for details. This transition begins slowly, with reductions of 0.2 percentage points per year in each carve out over the first five years of the transition period, followed by reductions of 0.8 percentage points for payroll and 0.4 percentage points for tangible assets over the last five years of the transition period.

⁴ An exact definition of covered taxes is contained in Article 4.2 of Pillar Two’s Model Rules. Pillar Two technically uses an adjusted form of covered taxes (adjusted covered taxes) to compute relevant tax rates and the top up tax.

⁵ If the UPE is not subject to an IIR, the top up tax is imposed on the next intermediate parent entity (IPE) in the ownership chain that is subject to the IIR using a top-down approach.

⁶ This can be achieved by denying income deductions or via similar income adjustments. The share of the UTPR collected by each jurisdiction would be allocated based on the relative share of employees and tangible assets in that jurisdiction, i.e. according to the following formula:

Interaction with Other Corporate Taxes

Pillar Two taxes do not replace existing corporate taxes imposed by governments. Most countries have a preexisting corporate income tax that would be layered with a QDMTT. Because existing corporate taxes can apply to different tax bases that allow for different deductions and result in different effective rates, they may or may not collect the Pillar Two minimum rate on the standardized Pillar Two tax base (GloBE income). Tax collected under a domestic corporate income tax will be factored into the determination of Pillar Two tax liability.⁷ Member countries are incentivized to pass a QDMTT as an additional layer of domestic taxation to ensure that they collect the minimum tax liability due under Pillar Two instead of ceding taxation rights to other countries, such as the UPE’s jurisdiction. For example, tax havens that adhere to Pillar Two may retain a low statutory rate on the normal returns of domestic corporations while maintaining taxation rights over GloBE income by enacting a QDMTT in compliance with Pillar Two.

Similarly, Pillar Two incorporates countries’ ability to tax foreign affiliates of their own MNEs according to their domestic tax law. Mechanically, they allow for taxation under “CFC Tax Regimes.” Analogous to the role played by the QDMTT with respect to domestic corporate taxes, the IIR can complement CFC taxes as an additional layer collected on the GloBE income base. If CFC taxes and the IIR are imposed on a similar base and at a similar rate to Pillar Two, the IIR may be redundant. The US CFC tax regime, which includes GILTI, is similar to, but distinct from an IIR, as discussed in Section 4 of this paper.

1.4. Tax Credits and Adjustments to GloBE Income and Covered Taxes

The determination of a firm’s GloBE income and tax payments in a given year can be complex. Firms often have tax credits that can be used to offset either income or tax. This distinction is somewhat arbitrary but can have large implications for the calculation of firms’ effective tax rates and resulting top up taxes under Pillar Two. Additionally, Pillar Two is computed using data from firms’ financial statements, with adjustments to account for timing differences in the recognition of revenues, expenses, and taxes that can generate artificially low or high tax rates.

A hotly debated aspect of Pillar Two relates to the treatment of government tax credits. Many governments use tax credits to incentivize certain behavior by firms or to directly subsidize private entities. Pillar Two treats different forms of tax credits in different ways, with large implications for the effectiveness of these credits. The key distinction is whether Pillar Two treats tax credits as reducing taxes or reducing income for the purposes of the effective tax rate calculation.

$$s_j = .5 \times \frac{N_j}{\sum_j N_j} + .5 \times \frac{A_j}{\sum_j A_j},$$

where s_j is the share of tax, N_j is the number of employees, and A_j is the net book value of tangible assets for entities located in jurisdiction j .

⁷ In Pillar Two parlance, they are “covered taxes.”

The following simple example, summarized in Table 2, shows why this distinction matters. Consider a firm that has pretax income of \$1000 and is subject to a domestic statutory corporate income tax rate of 15 percent.⁸ If the firm receives a \$100 refundable tax credit, this will be treated as an increase in the firm’s GloBE income, raising it by \$100 to \$1100. The firm’s covered taxes will be equal to its domestic tax payment of \$150 (15 percent of \$1000), yielding an effective tax rate on GloBE income of 13.64 percent (\$150 divided by \$1100). The firm will owe top up tax equal to 1.36 percent of its \$1100 of GloBE income (the 15 percent minimum rate minus 13.64 percent already paid), or \$15 in additional tax.

Alternatively, if the \$100 credit is nonrefundable, the GloBE calculation treats this as a reduction in covered taxes rather than an increase in income. Therefore, the firm’s GloBE income will be \$1000 (the same as its pretax income), and its covered taxes under the GloBE calculation will be \$50 after removing the effect of tax credits. Dividing its covered taxes by GloBE income yields an effective tax rate of 5 percent. Under Pillar Two, the firm will be charged a top up tax of 10 percent of GloBE income (\$100) to bring its effective rate back to the minimum rate of 15 percent. This effectively invalidates the tax credit from the perspective of the firm.

Table 1: Top Up Tax Calculation, Refundable vs. Nonrefundable Credit

		Refundable	Nonrefundable
a	Pretax Income	1000	1000
b	Domestic Tax Before Credits (15% statutory rate)	150	150
c	Credit	100	100
d	GloBE Income	1100	1000
e	GloBE Covered Tax	150	50
f = e / d	GloBE ETR	13.64%	5%
g = 15% - f	Top Up Rate	1.36%	10%
h = g * d	GloBE Top Up Tax	15	100

Notes: This table provides a simplified example of a top-up tax calculation for a firm with no SBIE carveout and a \$100 tax credit. If the tax credit is refundable, it results in an adjustment to GloBE income. If the tax credit is nonrefundable, it results in an adjustment to GloBE covered taxes. The firm pays a higher top-up tax under the nonrefundable regime that is equal to the tax credit if the firm’s pre-credit effective rate is less than or equal to the GloBE minimum rate of 15 percent.

Pillar Two rules were initially silent regarding the treatment of transferable tax credits such as those included to incentivize clean energy investments in the US as part of the Inflation Reduction Act. More recently, the OECD has issued updated guidance that effectively allows firms to treat such credits in a manner similar to refundable credits.⁹

From a policy perspective, it is not clear why a refundable tax credit should have a smaller impact on a firm’s global tax bill when compared with an equivalent nonrefundable credit. Technically, the difference seems to have arisen from similar treatment in accounting standards. Practically, however, this distinction appears to disadvantage tax systems such as the US, where

⁸ For simplicity, we ignore the SBIE carveout in this example.

⁹ See “Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two).” OECD, July 13, 2023, Section 2.

nonrefundable credits are used more heavily than refundable credits and direct subsidies. A broader discussion of how Pillar Two interacts with US tax law and specific tax credits is contained in Section 3 of this paper.

One reason the Inclusive Framework may be reluctant to incorporate similar treatment for nonrefundable credits is to prevent Pillar Two participants from offering generous system of tax credits in tandem with Pillar Two tax rates, which could effectively nullify the intent of Pillar Two while technically remaining in compliance. Although countries could pursue a similar approach using refundable credits, it would come at a higher fiscal cost for governments.

1.5. Compliance Costs

One of the primary responses to the potential implementation of Pillar Two from the business community has focused on the cost of corporate compliance with the international minimum tax. Pillar Two is likely to generate a considerable compliance burden from the multinationals that it targets.

First, Pillar Two is applied on a highly disaggregated basis through “constituent entities” that operate in different jurisdictions, which can include unincorporated branches and passthrough entities. Compliance with Pillar Two will require that firms report the financial activity of each of these entities.¹⁰

Additionally, Pillar Two will be implemented on a country-by-country basis, with differences in how the guidelines are translated to law in each jurisdiction. For example, Pillar Two rules require that countries collect standardized information about the entities that operate in their jurisdiction via a GloBE information return (GIR). However, the guidance that was issued for the GIR in July 2023 contains an outline of information that each jurisdiction will collect. It is likely that different jurisdictions will create distinct GIRs with heterogeneous disclosure requirements. Separately, accounting standards may differ for the application of the QDMTT—Pillar Two guidance has indicated that jurisdictions may use domestic accounting standards to collect this tax that may differ from standards used in a firm’s consolidated reporting.¹¹

Computations of the top up tax will also likely be complex in some circumstances. The separate layers of Pillar Two may require two separate computations of GloBE income and covered taxes since the QDMTT takes precedence over CFC taxes, which will then have to be accounted for when computing residual tax burdens collected under the IIR and UTPR.¹² This burden may be partially relieved by the QDMTT safe harbor discussed in Section 1.6.3 below.

¹⁰ There is a transitional period where some aggregation is allowed by jurisdictions if firms do not have to pay a top up tax.

¹¹ See “Tax Challenges Arising from the Digitalization of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two).” OECD, July 13, 2023.

¹² See Devereux, Michael P., and John Vella. “Pillar 2’s Impact on Tax Competition.” *World Tax Journal*, August 2023. <https://doi.org/10.2139/ssrn.4203395>, Section 5.1.

1.6. Other Aspects of Pillar Two

1.6.1. Implementation Timeline

A number of member countries of the Inclusive Framework have passed or introduced legislation implementing components of Pillar Two. Many of these laws will take effect starting in 2024. This includes major US trading partners such as members of the EU, the UK, Japan, Canada and South Korea.¹³

Implementation of the IIR is expected to begin in 2024, while the UTPR is expected to be implemented starting in 2025. Implementation details vary widely by country and are currently in flux as member countries evaluate legislation that is responsive to the provisions of Pillar Two.¹⁴

1.6.2. Tax Treaty Provisions

Pillar Two Model Rules and commentary incorporates two provisions that address the use of bilateral tax treaties that might prevent its application.

The first of these is called the **Subject to Tax Rule (STTR)** and is aimed at preserving taxation rights for source jurisdictions in developing countries that have bilateral treaties exempting certain intragroup transactions (e.g., interest and royalties) from taxation.¹⁵ This rule allows these jurisdictions to modify treaties to impose a withholding tax on certain intracompany payments from constituent entities located in their jurisdiction where the recipient faces a nominal tax rate of less than 9 percent.¹⁶ Recently, the OECD introduced a multilateral mechanism to facilitate countries' ability to modify treaties according to this rule without engaging in potentially burdensome bilateral negotiations.¹⁷

Commentary to Pillar Two also recommends that countries protect their ability to apply an IIR in the case that it has a bilateral treaty that exempts categories of income using a **Switch-Over Rule**. This rule would modify bilateral treaties to allow resident countries to implement an IIR on exempted income.¹⁸

¹³ See “Background and Analysis of the Taxation of Income Earned by Multinational Enterprises.” Joint Committee on Taxation, July 17, 2023, Appendix B.

¹⁴ PwC provides an up-to-date platform for tracking implementation of Pillar Two by country. See PwC. “OECD Pillar Two Country Tracker.” <https://www.pwc.com/gx/en/services/tax/pillar-two-readiness/country-tracker.html>.

¹⁵ “The Subject to Tax Rule in a Nutshell.” OECD, July 2023. <https://www.oecd.org/tax/beps/pillar-two-subject-to-tax-rule-in-a-nutshell.pdf>.

¹⁶ Unlike other aspects of Pillar Two, the STTR is not obligatory.

¹⁷ This mechanism is called the “STTR Multilateral Instrument.” See “Multilateral Convention to Facilitate the Implementation of the Pillar Two Subject to Tax Rule”. OECD, September 2023. <https://www.oecd.org/tax/beps/multilateral-convention-to-facilitate-the-implementation-of-the-pillar-two-subject-to-tax-rule.htm>.

¹⁸ See March 2022 Commentary to the GloBE Model Rules, <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf>.

1.6.3. Safe Harbors

The OECD has issued guidance around a set of safe harbors that ease the compliance burden for certain multinationals.

The most important of these from the perspective of US multinationals is the “Transitional UTPR safe harbor,” which was introduced in OECD guidance issued in July 2023. This rule stipulates that the UTPR will not be collected for multinationals that have parent companies in jurisdictions with corporate income tax rates of at least 20%. The US has a corporate rate of 21%, making US multinationals eligible for this exemption.

A second rule is the “QDMTT safe harbor.” One concern with the QDMTT has been that it may use different domestic accounting standards that generate a different tax base when compared to other Pillar Two layers. The QDMTT safe harbor exempts certain multinationals from additional top up tax in jurisdictions that have already collected a QDMTT.¹⁹ This also eases compliance, as the multinational does not have to make two GloBE calculations (one for a QDMTT and another for an IIR and UTPR).

A third rule, the “Transitional CbCR safe harbor,” exempts certain multinationals from GloBE reporting requirements in certain jurisdictions if they satisfy one of three tests. The first is a de minimis test that applies if GloBE revenue for a jurisdiction is less than €10 million and GloBE income is less than €1 million.²⁰ The second is a simplified ETR calculation where firms can compute an aggregated ETR for entities in a jurisdiction and claim exemption if this aggregated ETR is above a certain threshold (15% in 2023 and 2024, 16% in 2025, and 17% in 2026). The third is a routine profits test that allows firms to claim exemption if their aggregate SBIE carveout exceeds its pretax GloBE income. A similar rule may become permanent after 2026.

¹⁹ Only certain “qualified” QDMTTs are eligible for this safe harbor.

²⁰ Alston and Bird. “International Tax Advisory: Seeking Shelter in Your International Tax Safe Harbors, Even If They Are Temporary.” Accessed October 11, 2023.

<https://www.alston.com/en/insights/publications/2023/09/international-tax-safe-harbors>.

2. Overview of the Current US Global Tax Regime

The effort to implement a global minimum tax under Pillar Two follows major reforms to US international tax policy as part of the 2017 TCJA. The TCJA implemented new taxes both on inbound income (foreign income earned by US entities abroad) and on outbound income (income earned in the US and remitted to foreign entities). At the same time, it maintained some tax policy that existed prior to TCJA. More recently, the US implemented a separate minimum tax, the “Corporate Alternative Minimum Tax” (CAMT) on large US corporations. This minimum tax applies to an aggregated measure of worldwide income and is layered onto other US corporate taxes.

This section provides a brief description of these tax rules. Section 3 discusses how these rules conform and interact with the provisions of Pillar Two.

2.1. Tax on Foreign Income of US Multinationals

There are numerous provisions in the tax code that determine the tax rate on inbound foreign income. Foreign income earned by US entities can be earned either through unincorporated branches or “controlled foreign corporations” (CFCs).²¹ Branch income typically passes through to the US parent entity and is taxed in the year that it is earned at the US corporate tax rate. CFC income is taxed through a combination of provisions in the tax code (Subpart F and GILTI). Some foreign source income (FDII) receives a preferential tax rate.

Subpart F

Subpart F is an anti-abuse provision that has existed since the 1960s. Certain types of CFC income that can be easily transferred between jurisdictions, such as dividends, interest, and royalties, are classified as “Subpart F income” and taxed as though they are earned directly by the parent MNE. However, there are a number of ways to exempt foreign income from Subpart F, e.g. by reclassifying foreign entities through a regulation known as Check the Box.²²

Global Intangible Low-Tax Income (GILTI)

Prior to the enactment of TCJA in 2017, most CFC income was taxed only if it was remitted to the US parent by means of a dividend payment from the foreign affiliate. This allowed for “deferral” of US tax on most foreign income if it remained on the books of foreign affiliates or was reinvested abroad. After TCJA was enacted, the US imposed a new tax on a subset of foreign

²¹ This refers to incorporation as viewed from the lens of the US Treasury, which is an elective decision for foreign entities that are not flagged as per se corporations by the Treasury under regulations commonly referred to as Check the Box. Check the Box allows US firms to create “hybrid” entities that are viewed as branches or partnerships by the US Treasury and as corporations by the foreign country in which they are domiciled. A discussion of hybrid entities is beyond the scope of this paper.

²² For a discussion of how Check the Box enabled avoidance of tax due under Subpart F, see Mutti, John, and Harry Grubert. “The Effect of Taxes on Royalties and the Migration of Intangible Assets Abroad.” In *International Trade in Services and Intangibles in the Era of Globalization*, 111–37. University of Chicago Press, 2009. <https://www.nber.org/system/files/chapters/c11607/c11607.pdf>.

income known as GILTI. GILTI partially exempts foreign source income from US tax while eliminating deferral on the non-exempt portion of foreign income.

At a high level, GILTI consists of “excess income” above a 10 percent normal return allowed on certain tangible assets.²³ The US levies a tax on GILTI equal to the US corporate tax rate of 21 percent, after allowing a 50 percent deduction. This deduction effectively cuts the tax rate on GILTI in half. Foreign tax credits can be used to offset GILTI with a 20 percent haircut. The 50 percent deduction and the 20 percent haircut for the foreign tax credit results in a minimum tax rate on GILTI of between 10.5 percent and 13.125 percent.²⁴ The foreign tax credit means that, depending on the foreign tax rate, the US may collect none, some, or all of this tax.

Foreign-Derived Intangible Income (FDII)

One aim of GILTI was to discourage US-developed IP from being transferred to foreign entities, where it could avoid US tax. FDII is a complementary provision of TCJA that gives preferential tax treatment to income generated by US-domiciled entities from sales to foreign markets. Tax experts commonly refer to GILTI as a “stick” and FDII as a “carrot,” providing dual incentives to retain IP in the United States.

Like GILTI, FDII includes excess income above a 10 percent normal return allowed on certain tangible assets, adjusted by the entity’s foreign income share.²⁵ A tax deduction of 37.5 percent is allowed on FDII, resulting in a 13.125 percent effective tax rate.²⁶

2.2. Tax on Outbound Income to Foreign Entities

Outbound income to foreign entities is classified in two categories that have different tax treatment: FDAP and ECI. Payments to foreign affiliates by US-based corporations may also be subject to minimum tax known as BEAT.

FDAP and ECI

Foreign corporations are taxed on US-source income, which is categorized in two separate categories—passive income (FDAP) and active US business income (ECI).²⁷ FDAP income, which includes payments such as interest and royalties, is subject to a 30 percent withholding tax that in practice is often exempted due to US tax treaties or other provisions in the tax code. ECI is generally business income generated by US sales and is taxed at standard US tax rates unless exempted under a tax treaty.

²³ Net interest payments are also deducted from GILTI.

²⁴ The GILTI deduction will decrease from 50 percent to 37.5 percent in 2026, yielding an effective tax rate between 13.125 percent and 16.406 percent.

²⁵ FDII is calculated from “deduction eligible income,” which excludes certain types of foreign income, e.g. Subpart F income, GILTI, CFC dividends, oil and gas extraction revenue, and foreign branch income. FDII is calculated in a similar manner to GILTI, i.e. by deducting an allowance based on tangible assets.

²⁶ This deduction will decrease to 21.875 percent starting in 2026, yielding an effective tax rate of 16.406 percent.

²⁷ FDAP stands for “fixed or determinable annual or periodical gains, profits, and income” and ECI stands for “effectively connected income.”

Base Erosion and Anti-Abuse Tax (BEAT)

Whereas Subpart F, GILTI, and FDII together determine tax levied on foreign income of US-based entities, BEAT creates a minimum tax on a measure of income that includes income to the US parent as well as qualifying outbound payments (“base erosion payments”) to foreign affiliates.²⁸ BEAT is restricted to large corporations with average three-year gross receipts of more than \$500 million, and is only imposed if qualifying outbound payments are greater than 3 percent of total deductions.

The minimum tax rate applied by BEAT started at 5 percent in 2018. Starting in 2019, it increased to 10 percent with another increase to 12.5 percent planned for tax years starting in 2026. US multinationals have responded to the implementation of BEAT by significantly lowering forms of outbound transactions targeted by the regulation.²⁹

2.3. The Corporate Alternative Minimum Tax (CAMT)

CAMT is a new minimum tax that was passed as part of the Inflation Reduction Act in 2022. CAMT enacts a 15% minimum tax on corporate income and applies to large US corporations with an average of \$1 billion in adjusted financial statement income in the preceding three years. Once a US corporation meets the conditions for CAMT, it is permanently subject to the tax going forward.

CAMT applies to worldwide income, i.e., it taxes both foreign and domestic operations.³⁰ Estimates suggest that only a small portion of US firms would be subject to CAMT.³¹ There remains considerable regulatory uncertainty surrounding its implementation that will likely be resolved in the coming years as it comes into force.

A number of domestic tax credits are allowed under CAMT, but would generate tax liability under Pillar Two, including many general business credits such as the R&D credit, the low-income housing credit, and the orphan drug credit.

²⁸ These payments generally do not include standard operating expenses, e.g. cost of goods sold.

²⁹ See JCT, “Background and Analysis of the Taxation of Income Earned by Multinational Enterprises,” (July 17, 2023), p. 69, which tabulates that the average “base erosion percentage” has fallen from 8.4 percent to 2.9 percent for a sample of multinationals between 2018 and 2020.

³⁰ The CAMT base is tied to a corporation’s book income, as opposed to taxable income, although there are adjustments made that somewhat align the two concepts. The CAMT base is called “adjusted financial statement income” (AFSI).

³¹ See CRS, “The 15% Corporate Alternative Minimum Tax,” (January 19, 2023).

3. Interactions Between US Tax Law and Pillar Two

As discussed above, Pillar Two consists of three layers of tax on GloBE income. To fully align with Pillar Two, the United States would need to implement each of these layers.³² Further, there has been uncertainty related to the US system’s taxation of CFCs, and whether these taxes would be recognized under Pillar Two.

US Domestic Taxes and a US QDMTT

The US has a number of preexisting taxes on US-source income of MNEs, including a 21 percent statutory corporate income tax rate, a recently enacted minimum tax on financial statement income (CAMT), and several other taxes that apply to outbound income transfers from US to foreign entities.³³ These taxes are levied on a different tax base than GloBE income—the US corporate tax is levied on taxable income as defined by Congress and the IRS, the CAMT applies to a measure of worldwide financial statement income of US multinationals, and other taxes apply to other distinct bases.³⁴ As a result, it is likely that some US-source income would generate tax liability under Pillar Two rules that would not be captured by this preexisting set of US tax.

If the US were to implement a QDMTT, it would guarantee that tax liabilities on US source income due under Pillar Two would be collected by the US Treasury. Under the status quo, the US would cede this tax revenue to other Pillar Two jurisdictions that would be able to collect it through an IIR or UTPR. Implementation of a US QDMTT could also, unintuitively, reduce the compliance burden of US multinationals who would otherwise have to compute tax liability for US operations pursuant to other countries’ IIR and UTPR rules.

GILTI, CFC Regimes, and a US IIR

GILTI is similar to the IIR proposed under Pillar Two. Like the IIR, it is a minimum tax imposed by the parent jurisdiction (in this case, the US) on profit from foreign affiliates with an exemption for normal returns. In fact, the design of Pillar Two’s tax base appears to draw heavily from the design of GILTI. There are key differences, however. First, the GILTI tax rate (between 10.5 percent and 13.125 percent) is currently lower than the Pillar Two rate (15 percent). After 2025, however, GILTI rates will increase to a range of 13.125 percent and 16.4 percent. Further, GILTI aggregates the income of the US entity’s foreign affiliates, whereas the IIR applies on a country-by-country basis.³⁵ This implies that some US foreign entities may be subject to a top up tax under Pillar Two even if the aggregate MNE pays an average foreign effective rate of 15 percent or greater. Finally, GILTI and Pillar Two both include a carveout that is tied to firms’

³² Pillar Two guidelines indicate that enactment of a QDMTT is optional. However, it is in the interest of member countries to enact a QDMTT, otherwise they would cede tax rights to other jurisdictions.

³³ See Section 2 for details.

³⁴ CAMT also has different eligibility requirements than multinationals targeted by Pillar Two. There is general uncertainty regarding the implementation of CAMT, especially regarding its treatment of foreign affiliates.

³⁵ Notably, initial proposals of the Build Back Better legislation would have modified GILTI to increase its effective rate and to apply on a country-by-country basis in alignment with Pillar Two.

capital or labor inputs (QBAI for GILTI and SBIE for Pillar Two), but there are differences in the way these carveouts are computed.

Recently, the OECD issued guidance recognizing GILTI as a valid CFC tax regime for fiscal years ending prior to June 30, 2027.³⁶ This implies that during its early years, Pillar Two will accommodate GILTI in a manner similar to a compliant IIR and alleviate major concerns regarding double taxation. Double taxation may still occur, however, if the US does not allow foreign QDMTTs to be credited against GILTI tax.

The UTPR

The US currently has no plans to implement a UTPR in accordance with Pillar Two. If it were to enact this layer of Pillar Two, it could capture significant additional revenue to the extent that foreign governments choose to comply with Pillar Two.³⁷

4. Effects on the US Corporate Tax Base

The enactment of Pillar Two will have significant effects on the US corporate tax base, although the magnitude of the net effect remains uncertain. US tax revenue under current domestic law will be affected by the imposition of foreign QDMTTs, which will likely redirect revenue collected under Subpart F and GILTI to foreign governments. US tax revenue may increase or decrease depending on the extent to which US foreign earnings shift back to the US or to other Pillar Two jurisdictions. Additionally, US tax receipts may be significantly affected by whether the US chooses to enact legislation that brings its system into closer alignment with the Pillar Two framework. Initial estimates suggest that the impact on federal tax revenues could be as high as \$200 billion over the next 10 years, although this could materialize as a net increase or decrease depending on a number of factors. Framed as a percentage of aggregate federal tax revenue this is equivalent to about 0.3 percent of total projected federal tax revenue over the same period, or between 3 and 4 percent of projected federal corporate income tax revenue.³⁸

³⁶ This is despite the fact that GILTI is not applied on country-by-country basis. OECD refers to this type of system as a “blended” CFC regime. See “Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two).” OECD, February 1, 2023. Section 2.10.358.3 specifies how GILTI will be considered for purposes of calculating covered taxes under Pillar Two.

³⁷ JCT estimates that if the US were to adopt a UTPR and countries that are not compliant with Pillar Two remain non-compliant, the UTPR could result in about \$130 billion in additional revenue between 2023 and 2033. See “Background and Analysis of the Taxation of Income Earned by Multinational Enterprises.” Joint Committee on Taxation, July 17, 2023, Table 10.

³⁸ JCT published a wide range of potential revenue effects from the implementation of Pillar Two between 2023 and 2033. See “Background and Analysis of the Taxation of Income Earned by Multinational Enterprises.” Joint Committee on Taxation, July 17, 2023, Table 9. Total projected federal tax revenue over the same period is about \$64.6 trillion (\$5.57 trillion in corporate income tax revenue) according to the CBO. See Congressional Budget Office. “Budget and Economic Data,” May 2023. <https://www.cbo.gov/data/budget-economic-data>.

Ordering Rules

A primary determinant of the revenue impact of Pillar Two is the order in which corporate income tax is collected by different jurisdictions. Although some uncertainty remains, Pillar Two rules and guidance point to the following ordering of tax rights on corporate entities:³⁹

1. Local corporate income taxes
2. QDMTTs
3. CFC rules (including GILTI and Subpart F)
4. IIRs
5. UTPRs

Notably, foreign jurisdictions that pass a QDMTT will be able to collect tax liability that would have otherwise been collected under US tax law (GILTI and Subpart F), effectively transferring revenue to foreign governments. As foreign governments assert tax rights over income generated by foreign affiliates of US multinationals, the US will lose tax revenue relative to the status quo.

MNE Profit Shifting

Another key determinant of US tax revenue will come from the reaction of multinationals to the implementation of Pillar Two. To the extent that Pillar Two incentivizes firms to shift earnings back to the US, domestic tax revenue will likely increase. Conversely, if multinationals react by shifting earnings currently located in tax havens to Pillar Two compliant foreign jurisdictions, these jurisdictions will impose taxes that have priority over current US CFC taxes. There is a lack of consensus regarding the net direction and effect of any potential profit shifting, reflecting significant uncertainty. One reason for this uncertainty is that US foreign earnings are concentrated within the largest firms. The net effect on federal tax revenue may therefore depend on the decisions of a handful of the largest US MNEs.

Foreign UTPRs

Even after paying foreign corporate tax, foreign QDMTTs, and US tax, US multinationals may be subject to top up tax levied by foreign jurisdictions that implement the UTPR if their GloBE ETR remains under 15 percent. There are several reasons, however, why the UTPR may not generate significant tax liability for US multinationals. In the short term, it will not be imposed until at least 2027 due to the UTPR safe harbor described in Section 1.6.3, which applies because the statutory US corporate tax rate exceeds 20 percent. After this period, GILTI and FDII are less

³⁹ There is uncertainty regarding how foreign CAMT will be treated under Pillar Two. February guidance from the OECD did not discuss allocation of a tax on worldwide income such as CAMT. At least one tax expert argues that CAMT should be ordered before foreign QDMTTs. See “Is the United States Already Compliant With Pillar 2?” Accessed September 28, 2023. <https://www.taxnotes.com/tax-notes-today-federal/base-erosion-and-profit-shifting-beps/united-states-already-compliant-pillar-2/2022/11/15/7fc55>. In its analysis of Pillar Two, JCT assumes that a domestic portion of CAMT will be ordered with the same priority as the domestic US corporate income tax, and a foreign portion of CAMT will be ordered with the same priority as CFC taxes.

likely to generate exposure to the UTPR per se because their rates are due to increase after 2025.⁴⁰

The UTPR may still apply to US entities primarily due to the use of tax credits that reduce covered taxes computed under the GloBE calculation. These credits are discussed in Section 5.3 below. If the US were to modify its tax code to become compliant with Pillar Two, it could reassert tax rights over this base and eliminate the threat posed by foreign UTPRs.

Potential Changes in US Tax Law

If the United States were to implement aspects of Pillar Two, it could collect considerable revenue by capturing tax revenue that might otherwise accrue to foreign governments. First, as discussed above, the US could pass its own QDMTT, which would ensure that it would collect the Pillar Two top up tax on foreign and domestic entities operating within the US, instead of ceding these tax rights to foreign jurisdictions that implement an IIR or UTPR. Second, the US could impose an IIR or modify GILTI and Subpart F to fully align with the Pillar Two IIR framework, which would ensure that it could collect tax revenue from foreign affiliates of US multinationals that otherwise might be ceded to foreign jurisdictions that implement an IIR or UTPR. Finally, the US could also implement a UTPR, which along with a fully compliant IIR would allow it to collect additional revenue to the extent that foreign jurisdictions do not comply with Pillar Two.

There is considerable uncertainty regarding the potential revenue effects of legislative action, but it seems likely that the US would minimize any potential loss in tax revenue by increasing compliance with the Pillar Two framework.⁴¹ Some of these changes were included as part of the Build Back Better proposals but were not passed into law. Since then, Pillar Two has come under stronger criticism from US legislators, making it less likely that the US will enact compliant legislation in accordance with the framework in the near term.⁴²

Effect on the Individual Tax Base

To the extent that Pillar Two successfully achieves its goal of increasing effective tax rates on certain MNEs, it will also reduce after-tax returns to individual shareholders. US tax imposed at the individual level on the returns of investors may partially counteract increased tax revenue from Pillar Two policies.

⁴⁰ Multinationals may still be exposed to top up tax due to the blended nature of GILTI. If there is significant heterogeneity in the profitability of foreign affiliates, then low-tax affiliates may generate tax liability under Pillar Two.

⁴¹ JCT, for example, estimates a wide range of potential fiscal effects from Pillar Two that generally increase as the US become more compliant. See “Background and Analysis of the Taxation of Income Earned by Multinational Enterprises.” Joint Committee on Taxation, July 17, 2023, p. 84.

⁴² For example, instead of bringing the US into compliance with Pillar Two, there have been recent proposals to impose a retaliatory response on foreign jurisdictions that attempt to tax US entities under the UTPR. See Guggenheim, Benjamin. “2024 and the Global Minimum Tax.” POLITICO, October 10, 2023. <https://www.politico.com/newsletters/weekly-tax/2023/07/24/2024-and-the-global-minimum-tax-00107759>.

5. Effects on Productivity, Tax Competition, and US Tax Incentives

In addition to the fiscal effects described above, Pillar Two is likely to have substantive effects on countries and multinational firms. Pillar Two could potentially increase corporate productivity by eliminating inefficiency and change the way that countries compete for multinational investment. From a US perspective, Pillar Two could also reduce the effectiveness of certain corporate incentives in the tax code.

5.1. Corporate Profit Shifting and Productivity

One of Pillar Two's main goals is to stem profit shifting behavior by multinational firms. Measuring the extent of profit shifting is difficult, but there is wide agreement that such behavior is currently widespread.

Profit shifting is not a costless behavior, and if Pillar Two succeeds in reducing tax minimizing behavior, the policy could translate into higher corporate productivity. Corporations may inefficiently allocate investment to certain jurisdictions aiming to take advantage of low corporate tax rates even though they might be able to produce goods and services more efficiently in high-tax jurisdictions. To the extent that Pillar Two reduces tax rate differentials between jurisdictions, it could remove distortions that generate inefficiency.⁴³

5.2. Tax Competition After Pillar Two

Another primary goal of Pillar Two is to weaken incentives for tax competition between countries and prevent a “race to the bottom,” in which countries iteratively compete to drive down corporate tax rates to zero.⁴⁴ The policy framework is expected to achieve some success along these lines, but there may still be strong incentives for countries to compete. Countries may continue to reduce or maintain low corporate tax rates. Perhaps more importantly, they may use refundable credits and subsidies more heavily. As noted above, these types of provisions can allow countries to reduce firms' tax burdens while on paper remaining compliant with Pillar Two.

Regarding competition on tax rates, Pillar Two policies target profits generated by intangible assets through an exemption that is based on firms' tangible assets and payroll (the SBIE carveout). Firms that have larger carveouts will be less affected by Pillar Two policies but will still be subject to domestic corporate income taxes. Countries may continue to compete for these types of firms by maintaining or reducing corporate rates while still collecting the Pillar Two minimum tax through a QDMTT. These policies will be less effective at incentivizing the primary target of Pillar Two, however, which includes firms that generate profits through intangible assets, and which are not exempted by the SBIE carveout. Among countries that maintain statutory rates above 15 percent, competition on rates is likely to continue and may

⁴³ Economists refer to this inefficiency as “deadweight loss.”

⁴⁴ For a more extensive discussion of how the design of Pillar Two affects these two factors, see Devereux, Michael P., and John Vella. “Pillar 2's Impact on Tax Competition.” *World Tax Journal*, August 2023. <https://doi.org/10.2139/ssrn.4203395>.

even intensify.⁴⁵ The incentive to compete on the corporate rate, however, could be weakened as the SBIE carveout grows smaller after the initial years of Pillar Two, and by continued use of CFC tax regimes such as GILTI to the extent that they cover the base exempted by the SBIE.

Tax competition is also likely to continue in a different form. As discussed in previous sections, the design of Pillar Two allows countries to subsidize corporations through the tax code by other means than the corporate rate, including refundable credits and direct subsidies. Countries may attempt to use these fiscal measures to reduce firms' tax burdens under Pillar Two. Some critics have suggested that, as a result, Pillar Two will tend to favor states that rely on direct subsidies and public intervention.⁴⁶ Others have responded that countries are more constrained with respect to this form of tax competition given fiscal and political costs and suggest other international organizations such as the WTO could serve as a countervailing force to any potential increase in the use of state subsidies.⁴⁷ OECD guidance has explicitly suggested that rules governing tax credits may be modified going forward if states attempt to circumvent the primary intent of the Pillar Two agreement.⁴⁸

Pillar Two is an attempt to prevent competition between countries with respect to the corporate tax rate. Countries will (and some argue, should) continue to compete for business activity along other dimensions such as regulation, infrastructure, and the individual tax code.

5.3. Effects on Tax Incentives in the US Tax Code

As discussed in Section 1.4, Pillar Two rules result in different forms of tax credits having starkly different implications when determining the top up tax. Refundable tax credits have a smaller negative impact on corporations' effective tax rates when compared to a similar nonrefundable credit. This differential treatment implies that US tax incentives relying on nonrefundable credits may be offset by Pillar Two to the extent that it causes certain firms' GloBE ETRs to fall below 15 percent. In this case, tax credits meant to incentivize certain behavior would instead constitute a revenue transfer to foreign governments.

The United States is particularly affected by these accounting rules given that it relies heavily on nonrefundable credits. This contrasts with policy in other countries that rely more on direct subsidies and refundable credits.⁴⁹ Some of the largest tax credits in the US tax code are

⁴⁵ Tax Notes. "Pillar 2 Can Increase Tax Competition," August 7, 2023. <https://www.taxnotes.com/tax-notes-today-international/base-erosion-and-profit-shifting-beps/pillar-2-can-increase-tax-competition/2023/08/07/7h1jy>.

⁴⁶ See Tax Notes. "The Biggest Casualty of Pillar 2's Bias for State Subsidies? The U.S." Accessed September 28, 2023. <https://www.taxnotes.com/tax-notes-today-international/digital-economy/biggest-casualty-pillar-2s-bias-state-subsidies-us/2023/09/19/7h8hq>.

⁴⁷ See Clausing, Kimberly. "The International Tax Agreement of 2021: Why It's Needed, What It Does, and What Comes Next?" Peterson Institute for International Economics, April 2023. <https://www.piie.com/publications/policy-briefs/international-tax-agreement-2021-why-its-needed-what-it-does-and-what>.

⁴⁸ See "Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global AntiBase Erosion Model Rules (Pillar Two)." OECD, March 11, 2022, par. 138.

⁴⁹ See Tax Notes. "The Biggest Casualty of Pillar 2's Bias for State Subsidies? The U.S." Accessed September 28, 2023. <https://www.taxnotes.com/tax-notes-today-international/digital-economy/biggest-casualty-pillar-2s-bias-state-subsidies-us/2023/09/19/7h8hq>.

nonrefundable, including the R&D tax credit, the low-income housing credit, and the orphan drug credit.⁵⁰

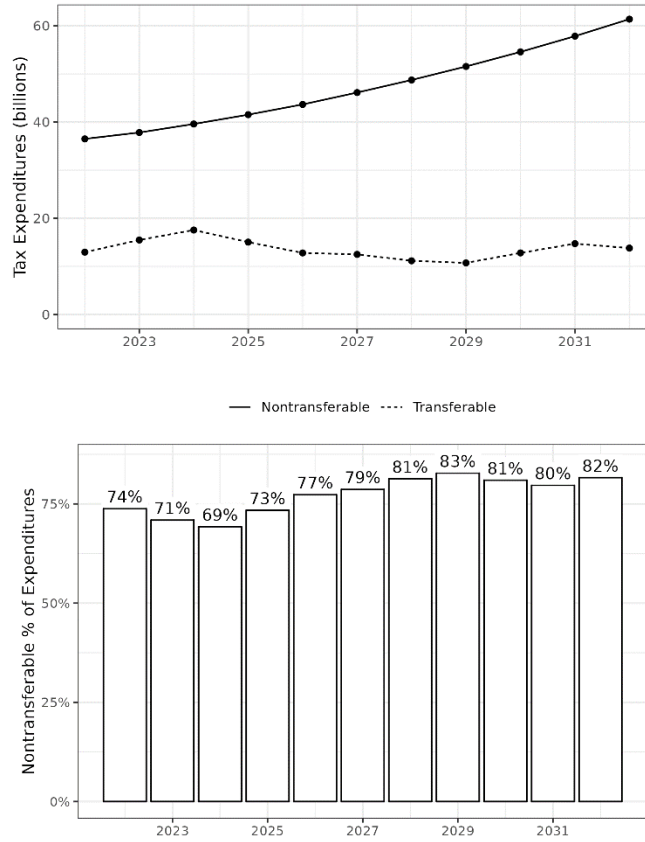
Notably, the US has recently implemented a large set of tax credits that are generally not refundable but can be resold in a secondary market. These “transferable” credits will be treated similarly to refundable credits under recent guidance published by the OECD, which has alleviated concerns that the international tax agreement could invalidate major pieces of recent energy and industrial policy enacted by the United States.

In aggregate terms, however, transferable credits are a relatively small portion of overall tax expenditures in the US. Figure 1 below shows selected tax expenditures classified by whether they rely mainly on refundable credits or transferable credits. Over 70 percent of these tax expenditures are nonrefundable, and this share is expected to grow over the coming decade. This suggests that large components of US tax policy could be vulnerable to the implementation of Pillar Two. Modifying the tax code to convert these credits into a refundable form could generate significant fiscal costs for the US government—refundable credits are typically more generous because they can generate negative tax payments when firms are in loss positions, and firms may respond to any conversion by increasing their use of such credits.⁵¹

⁵⁰ See Merrill, Peter R., Karl Russo, Aaron Junge, Damien Boudreau, and Florian Holle. “Where Credit Is Due: Treatment of Tax Credits Under Pillar 2.” Tax Notes. Accessed September 27, 2023. <https://www.taxnotes.com/special-reports/credits/where-credit-due-treatment-tax-credits-under-pillar-2/2023/03/17/7g743>. The Tax Foundation notes that the US incentivizes R&D almost entirely through a nonrefundable credit, unlike other countries that use a mix of different incentives. See Cole, Alan. “Risks to the U.S. Tax Base from Pillar Two.” Tax Foundation, August 30, 2023. <https://taxfoundation.org/research/all/federal/global-minimum-tax-us-tax-base/>.

⁵¹ Recent estimates suggest that the conversion could cost on the order of \$200 billion over 10 years. See Merrill, Peter R., Karl Russo, Aaron Junge, Damien Boudreau, and Florian Holle. “Where Credit Is Due: Treatment of Tax Credits Under Pillar 2.” Tax Notes. Accessed September 27, 2023. <https://www.taxnotes.com/special-reports/credits/where-credit-due-treatment-tax-credits-under-pillar-2/2023/03/17/7g743>.

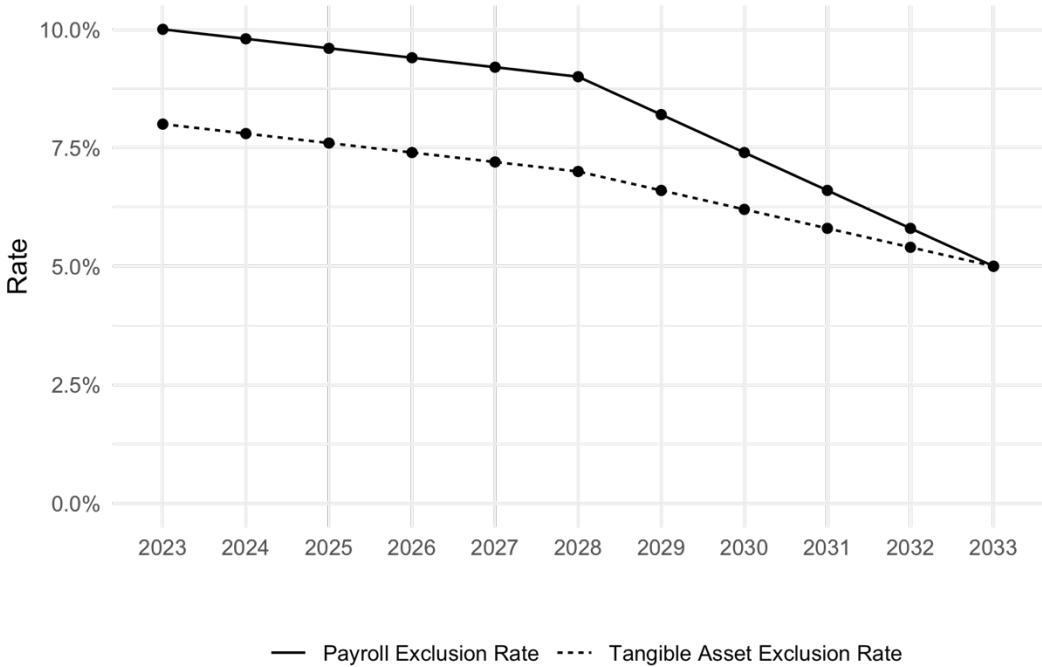
Figure 1: Transferable vs. Nontransferable Credits



Notes: Calculations based on tax expenditure data provided by Treasury’s Office of Tax Analysis for FY 2024 (updated March 2023). Transferable credits include the energy production credit, the energy investment credit, tax credits for clean-burning vehicles and refueling property, the advanced energy property credit, the advanced nuclear power production credit, and the carbon oxide sequestration credit. Nontransferable credits include the credit for increasing research activities, the credit for low-income housing investments, and the tax credit for orphan drug research.

Appendix

Figure 2: SBIE Transition Rates



Simplified Calculation of the Pillar Two Top-Up Tax

A simplified version of the minimum tax calculation for each jurisdiction is described by the four equations below.⁵²

$$ETR = \frac{\textit{Covered Taxes}}{\textit{GloBE Income}}$$

$$\textit{SBIE} = \textit{Payroll} \times \textit{Payroll Exclusion Rate} + \textit{Tangible Assets} \\ \times \textit{Tangible Asset Exclusion Rate}$$

$$\textit{Excess Profit} = \textit{GloBE Income} - \textit{SBIE}$$

$$\textit{Top Up Tax} = (15\% - ETR) \times \textit{Excess Profit}$$

These computations are performed for each jurisdiction. The first equation computes the GloBE effective tax rate. The second equation computes the SBIE, which is used to determine excess profit in the third equation. The fourth equation computes the top up tax that brings the minimum tax on excess profit to 15 percent.

⁵² Additional top up taxes might be levied due to differences in treatment of deferred tax assets or adjustments from previous years. These details are beyond the scope of this example.