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The finance ministers of France, Germany, Italy, Spain, and the Netherlands have announced their intention to enact global minimum tax legislation regardless of whether other countries do so. Jeff VanderWolk of Squire Patton Boggs discusses whether this will prompt others to follow suit.

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Would GloBE Adoption by Europe’s Big Five Have a Domino Effect?

By Jeff VanderWolk2022-10-05T04:45:20000-04:00

Those who have been following the OECD’s two-pillar global tax reform plan will know that the European Union countries have so far failed to reach unanimous agreement on a draft directive to implement Pillar Two’s global minimum tax regime. The US is not taking any steps to implement either of the two pillars, nor are developing countries moving toward implementation.

However, five European countries—France, Germany, Italy, Spain, and the Netherlands—recently indicated their intention to proceed with implementation of the Pillar Two, regardless of whether other EU member states agree to do so. Pascal Saint-Amans, the outgoing head of the Organization for Economic Cooperation and Development’s tax policy center, said in a recent interview that if Pillar Two is enacted by a first mover or a group of first movers, other countries will follow “like dominoes.”

The argument for such a domino effect is based on the so-called backstop rule in Pillar Two, which provides for countries that have enacted Pillar Two to collect top-up tax from a locally resident company with respect to undertaxed profits booked in foreign affiliates in countries that have not enacted Pillar Two. In short, the concept is, “if you don’t tax it, we will.”

However, it isn’t clear that the backstop rule would actually work—particularly if one or more tax treaties are in place between the country that has adopted Pillar Two and the countries where the undertaxed profits arose.

Adopting Pillar Two—the global minimum tax proposal, or GloBE rules—as provided in the proposed EU directive would require each of the adopting countries to pass legislation imposing top-up tax with respect to the undertaxed profits of businesses with at least 750 million euros in annual revenue, based on their financial statement income (with certain adjustments). Undertaxed profits are determined on a country-by-country basis. If the business's effective tax rate in a country is less than 15% of the adjusted financial statement income booked in group companies resident in that country, additional tax is payable by the locally resident parent company to bring the effective rate up to 15%.

Under the backstop rule, also known as the UTPR, if a locally resident company is part of a foreign-owned group, and the foreign parent company's country of residence has not adopted the Pillar Two rules, the Pillar Two country would receive an allocation of top-up tax with respect to the undertaxed profits of the entire global group. The allocated amount could be collected from one or more locally resident group companies in any manner chosen by the Pillar Two country. The allocation of undertaxed profits would be based on the number of employees and the net book value of tangible business assets of the group in each Pillar Two country.

For example, let's assume that a foreign-parented group includes companies in each of the five European countries that intend to adopt the Pillar Two rules and includes a US company doing business only in the US. If the US doesn't adopt Pillar Two and the US company's effective tax rate (based on adjusted financial statement income) is less than 15% due to nonrefundable tax credits such as the R&D credit, the amount of top-up tax necessary to bring the US company's rate up to 15% would be allocated among the five European countries based on the group's employees and assets in each of the five countries. The allocated amount would be payable by the local group company in each country.

Given that the US has tax treaties with the five countries in question, the US company in this scenario could arguably claim that its profits were being taxed in violation of the treaties—since each treaty provides that business profits of a resident of a contracting state (the US company's profits) cannot be taxed in the other contracting state (France, Germany, etc.) unless those business profits are attributable to a permanent establishment in that country.

The OECD said in its 2020 Blueprint report on the proposed Pillar Two global minimum tax that treaties shouldn't prevent the backstop rule from functioning effectively because treaties have been interpreted as allowing the taxation of foreign affiliates' profits under controlled foreign company rules, and many treaties include a so-called saving clause that preserves each country's right to tax its own residents as it chooses. But the rationale regarding CFC rules—namely, that the parent company is participating in the earning of the foreign profits through its control of the foreign subsidiaries—would not exist in many cases of the Pillar Two backstop rule.

It is doubtful whether the saving clause in a treaty would be sufficient to justify taxing a local resident on profits of a resident of the other country that were earned in the other country from business having no connection with the taxing country. Surely, such taxation would be inconsistent with the purpose of the treaty.

Thus, it is unlikely that the operation of the Pillar Two backstop will be as simple in practice as saying, “if you don’t tax it, we will.” The existence of thousands of tax treaties undermines the rationale for predicting a domino effect from early adoption of Pillar Two by first movers.

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