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Explainer: New OECD Global Anti-Base Erosion Model Rules

Unless the OECD Model Rules are changed, U.S. tax incentives to invest in important targeted economic, social, and environmental activities will be severely diminished, undermining U.S. sovereignty and explicit Congressionally mandated objectives.

In December 2021, the OECD released Global Anti-Base Erosion Model Rules for "Pillar Two" of the OECD/G20 Inclusive Framework project on Base Erosion and Profit Shifting.

The Model Rules describe a 15% country-by-country minimum tax that applies to a large multinational company if the company's effective tax rate is less than 15% in any country where it has operations.[1] A country adopting the Model Rules would apply the minimum tax to the foreign income of its own multinational companies under the Income Inclusion Rules (IIR).[2] If not taxed under the IIR, a second component of the Model Rules would allow a country to impose tax on the local subsidiary of a multinational company if the company had an effective tax rate less than 15% in any other country where it operates under a back-up system referred to as the UTPR.[3]

The most surprising element of the Model Rules is that a foreign country can impose the UTPR on a U.S. multinational company if the U.S. company's effective tax rate is less than 15% <u>on its U.S. income</u>.

The Model Rules severely reduce the effectiveness of U.S. tax incentives intended to encourage targeted investments that promote a broad range of economic, social, and environmental objectives in the United States. To the extent these Congressionally designed tax incentives reduce a U.S. multinational company's U.S. effective tax rate below 15%, the UTPR authorizes foreign countries to impose additional tax on the U.S. company's foreign affiliates equal to its U.S. tax savings from investing in the activities targeted by the U.S. tax incentives. As a result, the U.S. company would have no tax incentive for making additional investments in the areas targeted by Congress once its effective tax rate on U.S. income is less than 15%.

- A wide range of important U.S. tax incentives would be frustrated by the proposed rules, because the UTPR would effectively allow foreign countries to recapture the tax incentive intended to encourage U.S. companies to invest in the targeted activities. Affected incentives include:
    - Tax credits for research and development (research and experimentation tax credit), affordable housing (low-income housing credit), disadvantaged workers (work opportunity tax credit), distressed communities (new markets tax credit and opportunity zone incentives), renewable energy (e.g., solar, wind, and geothermal electric production facilities), and carbon sequestration, and other business tax credits;
    - Deductions for foreign-derived intangible income (FDII) and accelerated depreciation (including expensing and bonus depreciation)[4]; and
    - Exclusions for tax-exempt interest on state and local government bonds.

The U.S. Treasury's agreement to the Model Rules is inconsistent with the design in the Build Back Better legislation of the 15% Book Minimum Tax, which explicitly preserves the benefit of targeted tax incentives by preventing the Book Minimum Tax from being imposed if a company's tax liability has been reduced through the use of general business tax credits. Similarly, the Build Back Better legislation amends the 2017 Base Erosion and Anti-Abuse Tax to preserve the benefit of targeted tax incentives by allowing the full use of general business tax credits.

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[1] The Model Rules apply to any multinational company with over €750 million of global revenues.

[2] In the United States, the tax on Global Intangible Low-Taxed-Income (GILTI), enacted in 2017, is a form of IIR. No other county has yet adopted an IIR. If the parent country does not impose the IIR, it may be imposed by the country where lower-tier affiliates are located.

[3] The UTPR was previously referred to as the Under-Taxed Payment Rule in the OECD's October 2020 Pillar Two Blueprint. The acronym is no longer defined in the OECD Model Rules, possibly because under the Model Rules the UTPR can now be applied even in the absence of a payment to a low-taxed jurisdiction.

[4] The impact on accelerated depreciation is the result of the cap on deferred taxes and interactions with permanent book-tax differences under the OECD Model Rules.

Example of OECD Model Rules Resulting in Foreign Country Tax on a U.S. Company

Consider a U.S. company that operates only in the United States and the UK. (The same outcome would follow if the U.S. company had a subsidiary in any country that adopts the Model Rules.)

In this example, a U.S. company (with over €750 million of global revenues) earns $700 million of income in the United States and $100 million of income in the UK, and its book and taxable income are equal. U.S. corporate income tax on the company's U.S. income is $90 million before credits and $70 million after a $20 million research credit (20-percent credit rate *x* $100 million of assumed credit-eligible research expenses). UK tax liability is assumed to be $18 million before consideration of the UTPR.

Under the Model Rules, the income base for the UTPR is "excess profits," calculated for the U.S. parent as its $700 million income less a substance-based carveout equal to 5% of its U.S. tangible property and payroll.[5] Assuming the sum of its U.S. tangible property and payroll is $2 billion, the substance-based carveout is $100 million (5% of $2 billion), and the resulting income base for purposes of determining the UTPR is $600 million ($700 million less $100 million).

The UK can impose the UTPR on the U.S. company's UK subsidiary if the U.S. parent company's adjusted U.S. tax provision is less than 15% of the $600 million of excess profits ($90 million). In this example, in the absence of the research credit, no UTPR could be imposed by the UK on the U.S. company. However, as a result of claiming the $20 million U.S. research credit, the U.S. company's domestic tax rate would drop below 15%, authorizing the UK to impose $20 million of additional UK tax on the U.S. company under the UTPR that would fully recapture the U.S. company's tax benefit from its investment in R&D. (The UTPR would not only recapture the U.S. tax benefit from the research tax credit, but from many other targeted U.S. tax incentives, including renewable energy credits, low-income housing credits, new markets tax credits, work opportunity tax credits, etc.)

The mechanism by which the UK imposes the $20 million UTPR is by levying an additional tax liability on the UK subsidiary. In this example, in addition to the UK subsidiary's regular income tax payment of $18 million, the subsidiary will owe an additional $20 million in UTPR to the UK, resulting in a total income tax payment of $38 million and an effective tax rate of 38% on its income in the UK.[6]

U.S. Parent Company	
U.S. income	$700M
U.S. substance-based carveout	$100M
UTPR tax base	$600M
U.S. income tax before research credits	$ 90M
Research tax credits	$ 20M
U.S. income tax after credits	$ 70M
UTPR Calculation:	
15% of UTPR tax base	$ 90M
Actual U.S. tax after credits	$ 70M
Under-taxation by U.S.	$ 20M
UTPR to be collected by the UK	$ 20M

UK Subsidiary	
Income in the UK	$100M
UK income tax before UTPR	$ 18M
UTPR tax	$ 20M
Total UK tax	$ 38M

[5] The substance-based exclusion is initially 8% of tangible property plus 10% of payroll. Both percentages phase down to 5% over a 10-year transition period.

[6] If, alternatively, the U.S. company operated in multiple foreign countries, each foreign country could collect a portion of the amount by which the adjusted U.S. income tax provision were less than $90 million, with the portion determined by the share of tangible property and payroll in each foreign country levying the UTPR.