Proceedings of the 3rd International Conference on International Law and Legal Policy
DOI: 10.54254/2753-7048/65/2024MU0024

Research on the Two-Pillar Solution and Its Implication

Jiaxin Yuan[1,a,*]

[1]ANU College of Law, The Australian National University, Canberra, ACT 2601, Australia
a. u7849957@anu.edu.au
**corresponding author*

Abstract: With the rapid development of economic globalization and digitalization, new business models are activating the world economy while exacerbating the remaining problems of base erosion and profit shifting (BEPS). In the face of intensifying international tax avoidance, The Organisation for Economic Co-operation and Development (OECD) has announced its Two-pillar solution to the international community, proposing a global minimum tax regime, which is effectively a coordination of global anti-tax avoidance measures. At present, Pillar 2 has come into effect, and Pillar 1 has also been opened for signature, marking the implementation stage of the two-pillar solution. In this paper, the two-pillar solution is the main research object. Firstly, from the perspective of large-scale tax avoidance by multinational corporations, this paper systematically analyzes the historical background of the introduction of the two-pillar solution of the OECD. After a detailed analysis of the provisions of the two-pillar solution, the existing institutional deficiencies and obstacles to its implementation are proposed. Finally, in response to the issues raised, practical recommendations are made that the elements of the two-pillar solution should aim to achieve general equity, balance the interests of developing countries and be in harmony with existing international tax policies. The governments should also optimize the structure of tax incentives.

Keywords: Tax avoidance, OECD, Two-pillar solution.

1. Introduction

With the acceleration of global capital flows, the scale of multinational enterprises has expanded rapidly. In order to maximize their own interests, multinational enterprises, in the process of growing their business operations, take advantage of the differences in tax regimes between countries and the legal loopholes that exist in international tax relations to adopt various methods of tax avoidance, causing great economic losses to host and home countries. Domestic tax base erosion and profit shifting (BEPS) relates to tax planning strategies that multinational enterprises use to exploit loopholes in tax rules to artificially shift profits to low or no-tax locations as a way to avoid paying tax. The United Nations estimates that the diversion of profits by multinational enterprises results in an annual loss of tax revenues to Governments of up to $500 billion to $600 billion. BEPS creates inefficient allocation of resources and erodes the tax base of tax sovereigns. In the area of international taxation, how to effectively curb aggressive tax avoidance behaviour by multinational corporations has become a major challenge. Against the backdrop of the growing BEPS problem and the slow

DOI: 10.54254/2753-7048/65/2024MU0024

progress of international tax governance reform, there is an urgent need to implement a new international tax scheme.

Since 2013, international tax reform has undergone an evolution from BEPS 1.0 to BEPS 2.0 (i.e. the two-pillar solution). The introduction and entry into force of the two-pillar solution is a serious blow to tax avoidance by multinational corporations, and tax havens, as represented by the Irish double-decker sandwich, will no longer exist. Pillar I of the two-pillar solution does not take into account existing tax laws in individual countries, but rather creates a new, fully globalised tax calculation system (based on a number of financial accounting rules) and distributes tax revenues to virtually all of the market jurisdictions of a particular taxpayer. Pillar Two requires close cooperation between individual taxpayers and jurisdictions to ensure that no income is taxed at less than 15%. The international community has spared no effort in promoting the restructuring of the international tax system. Although the two-pillar solution has largely advanced the international anti-avoidance process, it still has some shortcomings. On the basis of introducing the historical development of the Two-Pillar solution and the content of the system, this paper analyses its existing problems and gives feasible suggestions.

2. History of the Two-Pillar Solution

Protracted and aggressive tax avoidance by multinational enterprises and progressive reforms of the international tax system have contributed to the introduction of the two-pillar solution. From the overall conception of the rules to the multilateral consultation and negotiation; from the reaching of multilateral consensus to the implementation of the system, the special historical process of the BEPS project reflects the integration and diversification of international tax reform.

2.1. The Problem of Tax Avoidance by MNEs

Tax avoidance by multinational corporations has been a long-standing problem for Governments. The tax avoidance scheme of multinational enterprises represented by Apple has made the "Double Irish with Dutch sandwich" synonymous with tax avoidance by multinational enterprises. Ireland, an island nation with only 70,000 square kilometres of land, is known as the "Silicon Valley of Europe". Apple, Google, Microsoft and other world famous large multinational companies have set up their European headquarters in Ireland. The reason why multinational companies prefer Ireland is its low tax rate.

Briefly, suppose Apple establishes a sales subsidiary A in Ireland and a shell subsidiary B based in a tax haven, and another shell company C in the Netherlands. The U.S. parent company attributes all revenues outside the U.S. to subsidiary A, while transferring intellectual property at a low price to shell company B, which in turn transfers it to C, which in turn licenses it to A for sale. Once A has generated revenues as a sales channel, it pays royalties on the IP to C, which in turn pays royalties to B. Under Irish law, company C is exempt from the 12.5 % corporation tax paid by company A to company C because it is a Dutch company. In addition, the three companies are in the European Union and under Dutch law are exempt from withholding tax, so transfers of funds into and out of Company C are not subject to tax. Also, under Irish tax law, a foreign company is recognised as such if its head office or parent company is in a foreign country, so there is no tax on transfers from company B to its tax haven parent company. A and B are like two slices of bread sandwiching C in the middle, and the whole process requires Apple to pay only a low Dutch transaction tax and a very small Irish income tax [1].

This method of tax avoidance is extremely popular among companies that own intellectual property. Especially with the growth of the digital economy, it has become more difficult to trace the source of taxes. Over the past decades, aggressive tax avoidance by multinational enterprises has accumulated huge sums of money for multinational corporations, while at the same time causing significant losses in fiscal revenues for both host and home countries.

2.2. Implementation of BEPS 1.0

In response to intense public, political and media criticism of pernicious tax planning by multinational enterprises (MNEs), in June 2012, the Group of Twenty (G20) Finance Ministers and Central Bank Governors agreed to address the BEPS issue through international co-operation and commissioned a study by the Organisation for Economic Co-operation and Development (OECD) [2]. Since then, from the release of a detailed action plan by the OECD in June 2013, which was endorsed by leaders at the G20 St. Petersburg Summit in September of the same year, to the publication of the final report of the 15 BEPS action plans in October 2015, the core institutional design of BEPS 1.0 international tax reform has been largely completed. The overall objective of the BEPS 1.0 measures is to close loopholes in existing international tax rules. MNEs are prevented from intentionally shifting profits to low or no-tax jurisdictions or eroding the tax base through deductible payments such as interest or royalties. The 15 reform measures of BEPS 1.0 focus on three directions in three categories, which are “minimum standards”, “common approaches” and “best practices” [3]. The first direction is to improve the coherence of domestic tax policies across countries in relation to cross-border transactions; the second is to strengthen the economic substance requirements of tax policies; and the last is to ensure greater tax transparency and tax certainty.

As of 1 January 2016, BEPS 1.0 entered its full implementation phase. In order to monitor the implementation of BEPS projects globally, the 2015 G20 Antalya Summit mandated the OECD to establish an inclusive framework. The framework will include non-G20 members, including developing economies, who are interested and committed to the implementation of the BEPS project, on the basis of equal participation. BEPS 1.0 did not start a tax revolution in the global sense, but it advanced the transformation of international tax governance and laid the foundation for BEPS 2.0.

2.3. Birth of the Two-Pillar Solution

At the end of December 2017, the U.S. passed the Tax Cuts and Jobs Act, taking the lead globally in implementing a minimum tax regime, which opened up new prospects for global tax reform. As the world has failed to reach a consensus on the taxation of the digital economy, a number of countries have committed themselves to a renewed reform of international taxation. For example, the UK, Italy and Spain have proposed unilateral or regional measures. In order to avoid trade tensions, the G20 mandated the OECD to design a reform programme. Subsequently, the OECD published the Tax Challenges from Digitalisation: 2018 Interim Report on 16 March 2018. The Report, which summarised the different positions of the members of the BEPS Inclusive Framework at the time, was met with strong pressure and opposition from the United States. Even at the request of Gary Cohn, Director of the National Economic Council of the White House, the chapter on ‘Transitional Measures’ was completely removed from the report before its release. Even so, no consensus on reform was reached in the final version.

It was not until June 2018 that the idea of a global minimum tax was raised by Germany and France at the Group of Seven (G7) meeting, with the support of all countries except the UK. Subsequently, at the urging of Germany and France, the Global Minimum Tax Initiative, along with the established mandate to address the tax challenges posed by the digitalisation of the economy, was included in the BEPS Inclusive Framework and the G20 agenda in December 2018. On 23 January 2019, the BEPS Inclusive Framework endorsed the publication of Addressing the Tax Challenges of the Digitisation of the Economy: A Policy Statement, which for the first time sets out the mapping of the “Two-Pillar” solution for BEPS 2.0 international tax reform, interpreting Pillar Two as addressing the broader

DOI: 10.54254/2753-7048/65/2024MU0024

challenges of the digitisation of the economy and focusing on the distribution of taxing power. Pillar Two is positioned to address the legacy BEPS issues. Thereafter, after several years of consultations and a change in the attitude of the United States, on 8 October 2021, the 136 members of the BEPS Inclusive Framework reached a consensus on the Statement on the "Two-Pillar" Solution to the Tax Challenges of Economic Digitisation, which set out the details of a number of provisions to be agreed upon, marking the official transition of the new "Two- Pillar" solution into the BEPS 2.0 era. Since February 2022, the OECD has been open for public comment on the Pillar I programme on a rolling basis, article by article, section by section and item by item. The content covers linkage and revenue sources, determination of the tax base, scope of application, exclusion of extractive industries and regulated financial services, and tax certainty. In the following two years, the OECD issued a number of reports and outcome statements, and Japan, the United States, the United Kingdom, Germany and many other countries began to introduce the two-pillar solution into their domestic legislation. After a decade of concerted efforts by the international community, the Pillar II programme has entered the domestic legislative phase, and the Pillar I programme has been opened for signature in 2024, but the progress remains slow. The BEPS 2.0 era is about to begin a new chapter of global legislative transformation and full implementation.

3. Content of the Two-Pillar Solution

The Two-Pillar solution is divided into two components, pillar 1 and pillar 2, which are described separately in this paper.

3.1. Content of the Pillar I

Due to the development of the digital economy, many trading activities are difficult to be determined on the basis of geographical or physical attributes. In other words, a determination of tax jurisdiction can no longer be satisfied solely on the basis of a permanent establishment in the traditional sense. For multinational corporations, headquartered in the home country, they produce and operate in the host country and may also make profits in other market countries [4]. According to the territorial or personal principle, multinational corporations are liable to pay taxes to both or all three parties. So how exactly should taxing rights be allocated? Pillar I is discussing the allocation of taxing rights.

Pillar I consists of two parts: Amount A, which applies to multinational enterprise groups with annual revenues of more than 20 billion euros and pre-tax profit margins of more than 10%; Amount B is used to determine the safe harbor amount for distribution and marketing oriented business activities. Through the application of the Amount A and Amount B rules, a portion of the multinational enterprise's residual and regular profits would be taxed in the market State, while the share of profits beyond that would need to be allocated for taxation to the State of production of the products and services through the existing international tax rules. These two methods of taxation complement each other, ultimately resulting in the taxation of all profits of multinational enterprises in their countries of residence, production and market. Pillar I focuses on improving the mechanism for the allocation of taxing rights to large multinational enterprises and allocating more taxing rights and taxable profits to market countries in order to balance the distribution of international tax benefits in the context of digitization.

3.2. Content of the Pillar II

In order to prevent multinational corporations from using the tax havens mentioned above for tax avoidance, OECD has confirmed the global minimum income tax rate at 15%. This approach aims to ensure that multinational enterprises bear no less than a certain percentage of the tax burden in all jurisdictions. Pillar II applies to multinational enterprise groups consolidated at the level of the financial statements of the ultimate parent company, and specifically includes the Income Inclusion Rule (IIR), the Under taxed Payment Rule (UTPR), and the Subject to Tax Rule (STTR). The IIR and UTPR rules are collectively referred to as the 'Global Anti-Base Erosion' (GloBE), which applies to multinational conglomerates whose annual revenues in the consolidated financial statements of the parent company have been 750 million euros or more in at least two of the four preceding fiscal years. The IIR is the main measure of the global anti-base erosion rules and takes precedence over the UTPR in favour of preserving the tax interests of capital-exporting countries. It provides that if the effective tax rate of a multinational enterprise group's foreign entities (including subsidiaries and permanent establishments) is less than 15% on a jurisdiction-by-jurisdiction basis, the jurisdiction in which the multinational enterprise group's ultimate (intermediate) parent company is located has the right to impose a retroactive tax on the ultimate (intermediate) parent for the portion of the income that is under-taxed. The UTPR is a supplemental rule to the IIR. The UTPR provides that if a member entity of the MNEs does not have low-taxed income to which the IIR back tax applies, it may be back taxed up to 15% by limiting the pre-tax deduction or making other equivalent adjustments in respect of the other group member entities [5].

4. Analysis of Current Systems

According to the OECD, once the two-pillar solution is implemented, the problem of multinationals using tax havens and transfer pricing to evade taxes will be solved. In the case of Apple, for example, it is a company that should distribute surplus profits to the market as defined by Pillar I, and at the same time the countries where its subsidiaries are located are subject to a minimum tax rate of 15%. Tax havens, represented by the Double Irish with Dutch sandwich, will fall apart. However, even the Two-Pillar solution can help the home state save the lost tax revenue, there are still some design and implementation shortcomings, which can be explained by the following [6].

4.1. Obstacles to Pillar I

Pillar I has been facing obstacles from its design to its implementation. In the author's view, the main reasons for this situation are political factors and the deficiencies of Pillar I. The implementation of Pillar I depends on the signing of multilateral conventions. If there is no critical mass of countries signing the Pillar I multilateral convention, it will end in failure due to delays. As it stands, the draft multilateral convention on Pillar I, which was scheduled to be concluded by 30 June 2024, is still missing [7]. Currently, the EU is showing a relatively positive attitude towards Pillar I and continues to promote the adoption of Pillar I rules. However, for some net-exporting countries, multinationals may be net victims of redistribution of residual profits in the market country, as they lose more tax benefits by paying taxes on foreign profits than foreign firms pay in their home countries. At the same time, the hesitant attitude of the United States towards Pillar I will be one of the biggest obstacles to reaching an agreement. As mentioned above, Amount A applies to companies with revenues of more than €20 billion and profit margins of more than 10 %. A large proportion of these companies are US multinationals. It is difficult to reach agreement on Pillar I within the US government. For the Convention to enter into force, it needs to be ratified by the legislatures of at least 30 countries. At least 60% of the companies in those countries were headquartered in the United States, which meant that the number of ratifications might not be sufficient without the participation of the United States [8].

4.2. Difficulties in Balancing the Interests of Developing Countries

For developing countries, the Pillar II is more of a "coerced" programme. Developed and developing countries face different levels of BEPS problems, it is undoubtedly unfair to be required to bear the

DOI: 10.54254/2753-7048/65/2024MU0024

same obligations. Developing countries have relatively imperfect tax systems, and the relative costs of accompanying tax reforms are higher. In terms of collection and management and information exchange, developing countries will face greater pressure due to their own limited collection and management capabilities. For low- and middle-income countries, there will be greater resistance to the implementation of pillar I, as it implies the need to sign a legally binding multilateral convention to forego the digital services tax and replace it with highly uncertain and unpredictable revenues. In addition, tax incentives are a major tool for developing countries to attract overseas investment, and developing countries also rely on corporate income tax to a much greater extent than developed countries. The failure of tax incentives under the global minimum tax rules of pillar II could significantly affect the attractiveness of developing countries to foreign investment and reduce their fiscal revenues.

4.3. Challenges of Integration with Domestic Law

The OECD requires countries to use their legislative templates as a blueprint to introduce global minimum tax rules into their national laws. Although Pillar II has now entered the stage of domestic legislation, the legislation and implementation of the relevant elements of Pillar II are bound to vary greatly due to the vast differences in national circumstances [9]. Tax authorities in various countries need to face a number of complex issues such as the adaptation of the Pillar Two solution to the existing tax laws, the implementation of new laws and regulations as well as the administration of tax collection. There are also incompatibilities between the taxation provisions of the two Pillar solution and the domestic tax laws. Taking China as an example, in terms of provisions, China's CFC rules are aimed at corporations controlled by resident shareholders located in countries (regions) with an effective tax burden of less than 12.5%, while the IIR is aimed at multinational enterprises with an effective tax rate of less than 15%. In terms of coverage, the CFC rules cover both positive and negative income, while the IIR covers both positive and negative income. So, for China, should the IIR rules completely replace the existing CFC rules or should the two be applied in an integrated manner? This is an issue that needs to be considered in tax and legislation.

5. Proposed Solutions

5.1. Promoting International Cooperation

The two-pillar programme, as a landmark achievement of BEPS 2.0, cannot be thoroughly promoted for implementation by a few countries or international organisations. International tax reform is not only a tax and legal issue, but also a political issue that involves the immediate interests of each country. Given the difficulties in promoting Pillar I, international organisations should take on a greater responsibility to mediate between governments and find a balance between politics and economics as far as possible. In addition, the Pillar I programme should not seek to perfect the system to the neglect of the differences between countries. The Pillar I programme should uphold the principle of general fairness and set an amount with room for flexibility, so that Governments can easily accept it.

5.2. Balancing the Interests of Developing Countries

The Two-Pillar programme is designed to address the legacy of BEPS, however, its current programme takes more account of the position of developed countries and fails to effectively take into account the interests of developing countries. Therefore, the Two-Pillar solution should comprehensively consider the national conditions of each country, and reflecting the interests and demands of developed and developing countries. The African Tax Forum, for example, mentioned

DOI: 10.54254/2753-7048/65/2024MU0024

that the statutory corporate income tax rate in African countries is mostly between 25% and 35%, and that a minimum tax rate of 15% has the potential to affect the interests of countries where corporate income tax is the main source of revenue. In order to facilitate the introduction of the Two-Pillar solution into domestic legislation in more countries and regions, it was suggested that the international community should set a flexible space for tax rates to allow countries to make adjustments according to their national circumstances.

5.3. Integrating the Domestic Tax System with the Pillar II

Countries should fully analyse the differences between their tax laws and Pillar II. The legislative body should be guided by the legislative template of Pillar II for the transformation of domestic law. In addition, the current reform plan for the global minimum tax impose strict restrictions on unilateral tax incentives in various countries, greatly weakening the effectiveness of traditional tax incentives [10]. In this case, countries should actively adjust their tax preferential structures, simplify their tax systems, and strive to better integrate with pillar two schemes. Moreover, countries should strengthen their tax collection and management capabilities. Taking the EU as an example, two days after the release of the legislative template for the Pillar II plan, it issued a proposal for the implementation of the plan. Only with the active participation of Governments can international tax reform progress steadily on a rational track.

6. Conclusion

The Two-Pillar solution of the OECD has to some extent dealt a blow to the problem of tax avoidance by MNEs, leading international tax administration towards a more systematic goal. However, there are issues with the implementation and content of the Two-Pillar solution. Firstly, the implementation of international tax rules is influenced by the global political landscape. Secondly, the institutional design of the two-pillar programme does not strike a reasonable balance between the interests of developing countries. Finally, due to the differences in legal systems among countries, integrating the dual pillar scheme with domestic law is also a challenge that cannot be ignored. In order to make the Two-Pillar solution more effective, international organizations and economies should use their good offices to promote the participation of governments with the notion of fairness in mind. At the same time, the international community should take into account the interests of developing countries when undertaking tax reforms. The tax issues of multinational corporations are long-lasting and not a problem that can be solved quickly. The lag and differences in domestic legislation in various countries also prevent the rapid application of the two-pillar solution in tax practice. Governments should be granted flexible transformation zones, guided by legislative templates, in order to facilitate better advancement of Pillar II domestic legislation. The successful implementation of the Two-Pillar solution would require the international community to work together to overcome many difficulties.

References

[1] *Institute on Taxation and Economic Policy. (2017) Fact Sheet: Apple and Tax Avoidance.*

[2] *OECD. (2013) Addressing Base Erosion and Profit Shifting, OECD Publishing.*

[3] *OECD. (2021) Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy.*

[4] *OECD. (2020) Tax Challenges Arising from Digitalisation: Report on Pillar One Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project.*

[5] *Shen Tao, Lliu Qichao, Li Ruikang. (2024) A panoramic view of the taxable rules of Pillar II. International Taxation, 7,38-44.*

[6] *Robert J. Misey, Jr. Michael, S. Schadewald. (2018) Practical Guide to U.S. Taxation of International Transactions (Eleventh Edition). Wolters Kluwer.*

[7] *Y. Brauner. (2022) Agreement? What Agreement? OECD Statement in Perspective. Intertax, 50(1),2.*

[8] *Zhu Qing, Bai Xueyuan. (2023) OECD Two-Pillar International Tax Reform Solution: Transposition and Response. International Taxation in China, 7.*
[9] *Peter A. Barnes, H. David Rosenblum. (2023) Pillar 1 and Pillar 2: Pursuing perfection is a good idea, but the road ahead is difficult. International Taxation, 4,29-35.*
[10] *Sol Picciotto. (2023) International Taxation of Multinational Enterprises at the Crossroads. International Taxation, 5,32-38.*