

OECD/G20 PILLAR TWO: IS IT A COMPATIBLE AND FEASIBLE SOLUTION?

Vita Apriliasari

Polytechnic of State Finance STAN

Correspondence email address: vita.apriliasari@gmail.com

INFORMASI ARTIKELDiterima Pertama
[dd mmyyyy]Dinyatakan Diterima
[dd mm yyyy]**KATA KUNCI:**Pillar Two, OECD, Globe, Income Inclusion Rule,
Minimum Tax, BEPS**ABSTRACT**

This study aims to contribute to the continuing discussion about the compatibility and feasibility of the OECD/G20 Pillar Two measures as a solution to address the remaining base erosion and profit-shifting (BEPS) issues. One triggering such a discussion is the significance of Pillar Two for developing countries. In so doing, a literature review is conducted to gain relevant considerations to the Pillar Two implementation. The analysis led to the comprehension of the issues surrounding Pillar Two, i.e. justification, complicated design, fairness issues, and effectiveness.

ABSTRAK

Penelitian ini berkontribusi pada diskusi berkelanjutan tentang kompatibilitas dan kelayakan Pilar Dua OECD/G20 sebagai solusi dalam mengatasi permasalahan penggerusan basis pajak dan penggeseran laba (BEPS) yang belum terselesaikan. Salah satu pemicu diskusi tersebut adalah pentingnya Pilar Dua bagi negara berkembang. Untuk itu, penelitian ini melibatkan studi literatur untuk memperoleh berbagai pandangan yang relevan terkait implementasi Pilar Dua. Analisis tersebut menghasilkan pemahaman terhadap isu-isu seputar Pilar Dua, yaitu justifikasi sebagai penangkal BEPS, desain yang rumit, isu keadilan pemajakan, dan efektivitas penerapan.

1. INTRODUCTION

Tax avoidance has become a never-ending issue in taxation, particularly in the cross-border context. Recently, base erosion and profit shifting appear a more familiar terms reflecting the evolution of tax avoidance practices. There have been several factors contributing to BEPS, which finally result in an unintended non-taxation.

Within the international setting, digitalization leads to an increase in economic efficiency, due to its ability to boost innovation, competitiveness, and economic growth (Silva, 2020). In addition, rapid globalization has driven MNEs to run more integrated business operations. On the other hand, those two are also crucial factors of the BEPS practices. The BEPS issues are rooted in the incompatibility of the existing international tax laws to capture the business model advances.

In this regard, the Organisation for Economic Co-operation and Development (OECD) and G20 have worked together under the Inclusive Framework on BEPS (IF on BEPS). The platform also involves non-OECD and/or G20 member countries to collaborate on an equal footing. In 2015, the OECD/G20 BEPS Project has delivered a final report, which contains 15 Actions plan for countries to adopt. However, while the recommendations under such a report have increasingly been implemented across countries, the IF on BEPS continues its work through the delivery of the Two-Pillar Solution to address tax challenges arising from the digitalization of the economy. While Pillar One focuses on the nexus and profit allocation, Pillar Two has targeted the remaining BEPS issues (OECD, 2020). Pillar Two consists of two kinds of measures, the Global anti-Base Erosion (GloBE) rules and the Subject to Tax Rule (STTR). In October 2021, 136 IF on BEPS member jurisdictions have joined a statement on the two-pillar solution.

However, as one concern underlying the Pillar Two development is the tax competition between countries, the further debate goes on questioning whether Pillar Two is the appropriate solution to address BEPS issues. Under the GloBE rules, a minimum level of tax would be agreed upon and become a threshold for tax paid by each MNE in its jurisdiction. Naoki (2021) and Devereux et al. (2020) suggest that such a minimum tax tends to reduce profit-shifting opportunities. Whereas, Silva (2020) criticizes Pillar Two as it reflects legislative complexity, uncertainty, and international coordination. Quite recently, Barake et al. (2021) conduct a study to estimate the revenue effects of the 15 percent minimum tax for several countries. They conclude that revenue would be unequally distributed, with developed countries gaining more additional revenues than developing countries.

Therefore, this research would further investigate the design of Pillar Two measures and draw more attention to developing countries' interests. To the best of my knowledge, current research has not been conclusive on the compatibility and feasibility of

the Pillar Two measures. It will focus on the costs and benefits of such a proposal as Hines Jr. (2014) suggests that any proposal should involve careful consideration of the BEPS magnitude and both associated costs and benefits. This research thus will answer whether Pillar Two provides a compatible and feasible solution.

2. THEORETICAL FRAMEWORK

2.1. International Tax Policy and Its Objectives

In a sovereign country, there are 3 (three) elements that should be present, the territory, the residents, and the government (Sørensen, 1999). As part of its sovereignty manifestation, a country may establish the right to tax on income derived by its residents and/or arising in its jurisdiction. It simply reflects the existence of control over the first two elements mentioned above. Such taxing rights thus give rise to the jurisdiction to tax, which depends on the personal allegiance or economic allegiance (Gunadi, 2014). The former results in residence-based taxation, while the latter leads to source-based taxation.

However, in exercising those rights in a cross-border context, a country not only has to refer to its domestic law but also the other sources of international tax law, such as the other respective countries' domestic law and bilateral or multilateral tax treaties concluded with its partners. Often, the interaction between all those laws leads to unwanted outcomes. First, double taxation may occur due to the conflict between residence-based taxation in the country of the recipient and source-based taxation in the country where income arises. Second, single taxation, no more and no less, (Avi-Yonah, 2015) would occur if income is only liable to tax in source jurisdiction and exempt from tax in the residence jurisdiction (i.e. a result of participation exemption system). Such an outcome will also present due to the impact of tax treaty provision in limiting source-based taxation and allowing the residence jurisdiction to exercise the residual taxing right. Third, a non-taxation outcome may happen as an intended or unintended outcome. The unintended non-taxation can be caused by BEPS practices. I will describe BEPS further in the next section.

As part of the tax sovereignty, a country is also free to design its international tax system. In so doing, such a country may formulate its tax policy based on several objectives. In this regard, Holmes (2014) identifies 5 (five) primary objectives of incorporating international tax rules in a country's domestic law, which consists of (1) national wealth maximization; (2) tax equity; (3) economic efficiency; (4) administrative efficiency; and (5) international compatibility.

The first objective deals with international tax rules which give rise to optimal return on foreign investment earned by a resident on the one hand, and fair tax revenue on the other hand. The second ensures that taxes are imposed corresponding to the ability to pay, both vertically and horizontally. The third would

take the neutrality principle into account. Under the third objective, a neutral tax policy should not distort the investment decision. The fourth directs the international tax rules that minimize the cost of compliance from the taxpayers' side and the administrative cost from the tax administrations' side. And, the last objective underlies the international tax policies that are comparable to other countries' rules and thus enhancing the certainty for cross-border investment.

With technological advances and rapid globalization, business models are likely to depart from conventional ones. Silva (2020) even regards digital transformation as the only essential trigger of business innovation, increased competitiveness, and the growth of the economy. On the one side, it seems to result in integrated and efficient economies. On the other side, the existing international tax laws were built on the concepts that are no longer relevant for capturing such growing business models, such as the physical presence requirement to impose a tax on active income by the source jurisdiction and treating the integrated multinational enterprises (MNEs) as separate entities for taxation purposes¹ (Avi-Yonah, 2015). Having said that, the international tax laws seem to pose serious challenges, more particularly due to the massive BEPS practices utilizing the loopholes in the international tax system.

2.2. Base Erosion and Profit Shifting (BEPS)

With respect to the BEPS issues on corporate taxation, it is the role of MNEs that even more integrated and thus engaging in a cross-border tax planning to minimise their tax liabilities (Crivelli et al., 2015). Having said that, corporate taxation has attracted much attention in the effort to prevent the BEPS. If compared to the progressivity of the individual income tax, the decreased corporate tax rates seem to offer more opportunity for rich individuals. They would be able to use corporation as their vehicle to conduct business, generate profit, and defer the dividend distribution indefinitely (Avi-Yonah, 2015). Further, corporate tax regimes tend to compete between countries and thus being more attractive for both 'real' investors and tax avoidance player (Crivelli, 2015).

Within a successful BEPS practice, taxable income is to be located in low-tax jurisdictions; while, expenses are set to be deductible for tax purposes in high-tax jurisdictions (Hines Jr., 2014). BEPS issues then arise when the location of taxable income does not align with the jurisdiction where the economic activities take place (Hines Jr., 2014). Also, such a premise underlies the development and delivery of the OECD/G20 BEPS Projects between 2013 and 2015 (Devereux & Vella, 2018).

MNEs seem to conduct BEPS practices using several techniques. Hines Jr. (2014) illustrates the use

of debt financing instead of equity may result in a base-eroding interest payment. In addition, he mentions the other profit reallocation technique by using transfer pricing. Hines Jr. (2014) identifies 2 (two) categories of empirical studies in the area of tax avoidance. The first category covers those comparing the percentage of reported profit in countries with different tax rates. While, the second category involves investigation of particular aspects where taxpayers reduce their tax liabilities and taxpayers' reaction to the changes of such conditions. The particular aspects consist of, inter alia, suspicious transfer prices; relocation of corporate taxpayers' residence status; locating valuable intangibles to low-tax jurisdictions; and dividend deferral. Based on the available evidence, Hines Jr. (2014) concludes that it is the tax rate differences affecting the behaviour of MNEs.

2.3. Anti-BEPS Measures

According to Crivelli et al. (2015) BEPS issues have spread since years ago. However, the massive awareness from policymakers seems raised later, with the notably OECD/G20 BEPS Project finally released in 2015. They further underline that such issues have primarily arisen in the developed countries, though the arrangements also involve developing countries. However, BEPS practices seem to place a disproportionate burden on developing countries. Whereas corporate taxation is unlikely the most important tax revenue source for the advanced economies, it often constitutes over 25 percent of total tax revenues for developing countries (Avi-Yonah, 2015). Similarly, Crivelli et al. (2015) show that developing countries rely on corporate income taxes heavier than developed countries. Concerning the impact of BEPS on tax revenues, Hines Jr. (2014) in fact suggests that the magnitude seems modest.

To address the BEPS issues, there have been many proposals, recommendations, or even countries' unilateral actions. Of those proposals, the most talkable recently is the Two-Pillar Package proposed by the OECD/G20. Previously, the OECD/G20 has delivered the BEPS Projects, consisting of 15 Actions to counteract the BEPS issues.

However, Hines Jr. (2014) highlights that such a solution should consider the BEPS magnitude as well as its costs and benefits of the implementation. Learning from the implementation of BEPS Actions, Brown (2021) highlights that developing countries faced the following challenges due to the imperfect design of the BEPS project:

- a. much simpler tax avoidance schemes occurred in developing countries than those targeted by BEPS proposals;
- b. insufficiently complete tax legislation in developing countries to mitigate tax avoidance area posing a greater risk;

¹ Avi-Yonah (2015) argues that the use of a country-by-country basis when it comes to taxing MNEs leads to the spread of tax competition between countries.

- c. inability to obtain information needed to appropriately perform the tax avoidance risk assessment;
- d. a lack of administrative capacity in developing countries, when it comes to enforcing complex anti-avoidance rules;
- e. a lack of political support to combat BEPS practices;
- f. the existence of tax incentives to attract more inward investment, which contrasts with the revenue goals.

Such challenges have left developing countries from better engaging in the international reform project (Brown, 2021). Even, Herzfeld (2017, as cited in Brown, 2021) underlines that those challenges happens ever since the BEPS Projects failed to conceive the tensions between developed and developing countries, and to understand a set of philosophical concerns regarding economics and fairness in global economic development.

3. RESEARCH METHODOLOGY

To answer the above mentioned research question, this research follows a qualitative method through a literature review. According to Creswell (2014), qualitative research is designated for the purpose of exploring and understanding. He further states that *"qualitative methods rely on text and image data"*.

To conduct such a literature review, I collect and analyse data and information in related articles, books, and videos. For the purpose of the research limitation, the Pillar Two design refers to the 2020 blueprint (Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint) by the Inclusive Framework on BEPS.

This research will explore the relevant issues concerning the compatibility and feasibility of Pillar Two as a solution for addressing the said remaining BEPS issues. Prior to discussion about those issues, I will describe the proposed design of Pillar Two to provide a general understanding.

4. DISCUSSION

4.1. OECD Says on Pillar Two: Background and Recent Development

In 2016, the OECD with the support from the G20, involved non-G20 countries and jurisdictions through a discussion platform, known as Inclusive Framework (IF) on BEPS. The establishment of IF on BEPS has gained wider engagement to the implementation of OECD/G20 BEPS Package finalized in 2015 to combat the BEPS issues.

Under BEPS Action 1, the OECD recognized that the digital economy has massively required fundamental changes in the international taxation landscape. Even more important, the digital economy would transform, and could not be ring-fenced from, the economy. The 'scale without mass', 'reliance on intangible assets', and 'centrality of data' are three essential elements of digitalization posing serious challenges to the current global tax system. The

concept in place for taxing income arising from digital transactions could not fit the advent of huge penetration of digitalization. From the perspective of the physical presence doctrine, it is unlikely that market jurisdiction would be able to collect tax revenue from offshore suppliers operating digitally due to failing to fulfill the definition of permanent establishment. Meanwhile, OECD (2021) adds the digitalization has also led MNEs to shift their profits to tax haven countries.

Accordingly, in 2018, Task Force on the Digital Economy established under the IF on BEPS suggested that a global solution is crucial to anticipate the impact of digitalization (OECD, 2018). It discussed the need for a new nexus of global income taxation and new allocation rules to distribute fairly taxing rights between countries, thereby addressing the BEPS issue. Further, the discussion went further to add an agreed minimum level of effective tax, which targets low-taxed foreign profits. The latter was previously initiated by the German-French proposal but was considered by the OECD after the United States introduced the Global Intangible Low Taxed Income (GILTI) regime (Englisch, 2021).

The work has then progressed with the delivery of a two-pillar package. Pillar One focuses on developing the new nexus and profit allocation rule, applicable to large MNEs, including digital companies, and so ensure taxing right for market jurisdiction. Meanwhile, IF on BEPS propose the need for Pillar Two to deal with the remaining BEPS issue, particularly due to the race to the bottom of corporate income tax rate across jurisdictions, which naturally facilitates the tax avoidance. Later, I will center the discussions on Pillar Two.

To describe further Pillar Two, I refer to the Report on Pillar Two Blueprint by the OECD (2020). The design of Pillar Two is principally based on the assumption that the gaps of tax systems, including corporate income taxes, between countries have created an opportunity for MNEs to flow their taxable profits to low or no-tax jurisdiction, resulting in minimized global income tax burden. Such an issue seems unresolved through the other OECD/G20 BEPS Package measures, says the OECD. As a consequence, Pillar Two set a minimum level of tax paid by MNEs with no regard to where they are headquartered or which jurisdiction they are operating.

To do so, Pillar Two consists of the rules imposing what is so-called top-up-tax on parent entity (Income Inclusion Rule-IIR) and denying deductions or requiring equivalent adjustment if the residence countries of the ultimate parent entity and intermediate parent entity do not apply the IIR (Undertaxed Payment Rule-UTPR). Both are referred to as the Global Anti-Base Erosion (GloBE) rules. In addition, Pillar Two also contains the rule which allows source jurisdictions to impose an additional tax on payment subject to tax below a minimum threshold (the Subject to Tax Rule-STTR). Whereas the GloBE rules are to be implemented by amending each respective country's domestic law, the

STTR will require a bilateral or multilateral agreement between countries (treaty-based measure).

4.1.1 Global Anti-Base Erosion (GloBE)

Across the MNE group, jurisdictional difference in the tax system, particularly the corporate income tax rate has led to tax avoidance practices. In this regard, the GloBE rules operate two mechanisms (primary and secondary) to ensure that the MNE pays at least a minimum level of tax. The implementation of the primary rule (Income Inclusion Rule-IIR) depends on whether the residence jurisdiction of the parent entity of the MNE group opts for it. Additionally, the MNE group will only be subject to the GloBE rules provided the consolidated group revenue is at least EUR 750 million, which aims to align with the Country-by-country Report (CbCR) threshold and exclude small and medium-sized enterprises (SMEs).

The IIR is, in principle, similar to the concept of the Controlled Foreign Corporation (CFC) rule. However, the IIR implementation by a jurisdiction may condition to its application by another jurisdiction, that is the jurisdiction of an ultimate parent entity (UPE) of an MNE group. A UPE is one of the members of an MNE group (constituent entities) preparing the consolidated financial statement and holding the greatest interest compared to the other MNEs within the group. In short, the IIR firstly asks to identify all constituent entities of an MNE and determine which one becomes the UPE. Nonetheless, there are several entities excluded from being a constituent entity, such as an investment fund, governmental entity, pension fund, and so forth.

Hereafter, the residence country of the UPE may apply IIR by imposing top-up-tax to the UPE if the effective tax rate (ETR) in each jurisdiction (jurisdictional ETR), where the income of a constituent entity is assigned, is lower than the threshold stipulated. As such, under the jurisdictional blending approach, the top-up-tax liability for the UPE would be the total amount of additional tax to catch up with the ETR threshold in each jurisdiction. As of 8 October 2021, 136 member jurisdictions of IF on BEPS have joined a statement on the two-pillar solution, which agreed to the 15% threshold for such an ETR (OECD, 2021). For the purpose of calculating the jurisdictional ETR, covered taxes serves as the numerator and tax base acts as the denominator.

The covered taxes basically are any taxes on income. It may be in the form of corporate income taxes, or taxes in lieu of generally applicable income tax, i.e. withholding taxes on interest, rents and royalties, and other taxes imposed on gross payments, to the extent that such taxes substitute the corporate income taxes. Accordingly, it would bring taxes paid under CFC rules into the net.

Meanwhile, the tax base is determined firstly according to the financial-accounting profit (or loss) before income taxes, which then be adjusted. However, the blueprint says that adjusted book profit (or loss) does not necessarily arrive at the taxable profit in each jurisdiction. The permanent differences would be evaluated from the book profit (or loss) based on their materiality and IF on BEPS commonality. In the case of dividend distribution, permanent differences also happen on the ground of 'separate entity' computation. As such, the dividend will be included in the amount of book profit (or loss), notwithstanding the participation exemption in place, either wholly or partly. Further, when it comes to intra-group dividends, the recipient should exclude such dividends from its GloBE tax base to prevent economic double taxation. Speaking of the timing differences, the GloBE proposal recognizes the need for a mechanism to anticipate top-up tax when the lower jurisdictional ETR is due to the loss carry-forward and excess taxes paid in the prior period. The blueprint proposes a mechanism using a carry-forward approach or a deferred tax accounting approach. But still, the issue revolves around how to make it less burdensome both for MNEs and the tax administrations.

After computing the amount of tax base assigned in each jurisdiction, and performing the relevant adjustment, we finally get the adjusted ETR. The primary rule (IIR) for settling the top-up tax liability is then to be implemented by the residence jurisdiction of the UPE of an MNE group. The liabilities would be the aggregate amount of top-up tax determined on a jurisdictional basis. To calculate that top-up-tax amount, the adjusted ETR will be multiplied by the tax base amount, which has further been adjusted by the carve-out amount. The latter adjustment serves as a mechanism to exclude the routine return, contributed by both employee and tangible assets. According to the OECD/G20 latest statement, the excluded amount of income from the tax base is 10 percent of the carrying value of tangible assets and 8 percent of the payroll, which will progressively decrease to 5 percent of both within the 10-year transition period.

In a situation where a parent entity conducts business through permanent establishments (PEs) in other jurisdictions, the provision of a double tax agreement requiring the parent jurisdiction to exempt PE income from residence-based taxation would prevent such a jurisdiction to impose the top-up tax. Therefore, a switch-over rule (SOR) is required to limit the application of the exemption method, allowing that jurisdiction to apply the IIR.

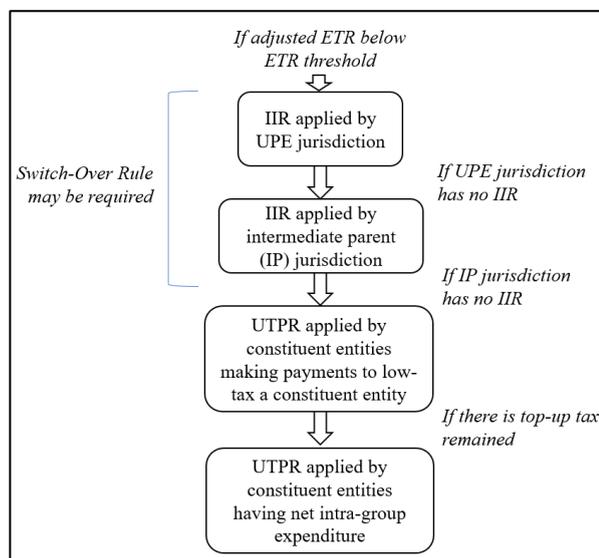
As the IF on BEPS member countries are free to adopt the IIR, the GloBE rules also facilitate the implementation under the secondary rule in the absence of IIR implemented by the UPE jurisdiction and the intermediate parent jurisdiction.² Pursuant to the Undertaxed Payment Rule (UTPR), constituent entities

² IIR is to be implemented on a top-down approach, giving the UPE jurisdiction the priority to impose the additional tax.

in an MNE group would be able to deny a deduction or impose a top-up tax, allocated proportionately, by prioritizing those making direct payments to the constituent entity resident in a low-tax jurisdiction. Since UTPR require the application of such an ordering rule and thus coordination between jurisdictions, it seems to involve a higher level of complexity.

To perform the UTPR, there are two steps with the first one taking priority. First, a top-up-tax would be allocated to the jurisdictions of constituent entities, which adopt UTPR and make payments to a low-tax constituent entity, in proportion to the total amount of deductible payments made to such entities. Second, the remaining top-up tax would be allocated to jurisdictions of constituent entities, which adopt UTPR and has net intra-group expenditure, in proportion to the total amount of net intra-group expenditure incurred by all those entities.

Figure 1 Ordering rule for GloBE



Source: summarised from OECD (2020)

4.1.2 Subject to Tax Rule (STTR)

Whereas the GloBE rules operate to top up the tax payment of resident corporations, from the perspective of introducing jurisdictions, the STTR targets the tax paid by the counterparty of those resident corporations. In particular, the STTR works to impose top-up taxes on certain base eroding payments related to mobile capital, intangibles, and assets, such as interest and royalties to an agreed minimum rate. According to the OECD/G20 statement as of 8 October 2021, the minimum rate on payment under the STTR will be 9 percent. As the top-up tax under the STTR would be imposed to non-resident taxpayers from the eye of the introducing jurisdiction, a treaty-based provision is required for it to apply.

Based on the blueprint, the scope of STTR will cover payments made between connected persons, referred to as the “closely related persons” in Articles 5(8) and 5(9) of the OECD dan UN Model Double Tax Convention, respectively. The “closely related persons” exist where a person has control of the other or both persons are under the control of the same person or

persons. Direct or indirect ownership of more than 50% beneficial interests then serves as the automatic test for such a control. Further, as with the GloBE, the STTR will not apply to the same excluded entities yet have a different threshold concerning the materiality. For the sake of limiting the impact of the STTR to SMEs and anticipating a disproportionate burden to them, such a threshold may refer to the size of the MNE, the value of the payment, and/or the ratio of payments to total expenditures of the MNE.

The STTR will serve as a complementary rule to the GloBE rules when a jurisdiction introduces all of them. The STTR introduced by a payer jurisdiction would first apply to impose additional withholding tax to payee jurisdiction. Such an additional tax payment would then be included in the computation of the covered taxes when the payer jurisdiction applies the GloBE rules.

4.2 Emerging Issues

In this section, I will outline several issues corresponding to both the existence and the design of Pillar Two. Further, as part of the two-pillar package on addressing BEPS concerns, the discussion may also include how Pillar Two connects to the prior BEPS Action recommended in the 2015 and subsequent BEPS deliverables.

The following explanation begins with the existence of Pillar Two as one of the anti-BEPS measures. As it is under the same package as Pillar One, the discussion will also explore the interaction between them. It then will continue to elaborate on the contribution of Pillar Two in creating a fairer distribution of taxing rights as the main problem resulting from BEPS practices. Further, as previously mentioned, the BEPS projects were initially developed by the OECD, gaining support from the G20 and eventually involving much more countries that represent a diverse level of economies. Therefore, conflicting interests between jurisdictions seem inevitable. In this regard, how Pillar Two deals with such an issue will be discussed afterward. Last but not least important issue is the practical complexities adhered to the implementation of Pillar Two tools. They arise due to the mechanisms proposed for Pillar Two and also the interaction with other BEPS measures or even with Pillar One.

4.2.1 Is it a fit anti-BEPS measure?

The two-pillar solution aims to address the tax challenges arising from the digitalization of the economy. Pillar One deals with defining new nexus thereby fairly re-allocating taxing rights to jurisdictions where value is created. Meanwhile, Pillar Two, the focus of this research, is expected to address the remaining BEPS issue. The further question is which are the remaining BEPS issues?

According to the OECD (2020), the digitalization of the economy leaves profits generated from intangible assets often shifted in the case of the highly digitalized

businesses, notwithstanding the application of Pillar One measures. Riccardi (2021) goes further to think about whether the implementation (or implementation progress) of BEPS Action measures has also left some unresolved BEPS issues. Having regard to the Pillar Two design, it seems to resemble the prior OECD/G20 BEPS Actions recommendations, the strengthened CFC rules (Action 3), and the amendment or abolishment of preferential tax regimes (Action 5). Further, it is the mobility of intangibles and risks between groups that makes the existing OECD/G20 BEPS Action measures could not primarily prevent the BEPS to occur (Englisch, 2021). In this regard, Pascal Saint-Amans of the OECD in CBT (2020, as cited in Riccardi, 2021) assures that Pillar Two is beyond the recommendations under the BEPS Action 3 and is also a tool to address the weaknesses of the work under the BEPS Action 5.³

If this is the case, Arnold (2019) suggests that the appropriate response should be a reassessment of those previous recommendations, Action 3 in particular, instead of delivering a new measure. It seems that the OECD has changed its policy direction as the GloBE is to set a minimum level of tax and thus creating a deviation from the original BEPS concern (Silva, 2020). Also, Silva (2020) doubts the argument on the weaknesses of the BEPS Actions, which causes the profit shifting to still exist, due to the absence of empirical evidence under the BEPS Action 11.

Pillar Two basically works to allow the residence jurisdiction to exercise its residual taxing right on income arising in the respective source jurisdiction. Avi-Yonah (2021) argues that Pillar Two theoretically is based on the single tax principle. According to such a principle, “[i]ncome from cross-border transactions should be subject to tax once (that is, neither more nor less than once)” (Avi-Yonah, 2021). In so doing, the IIR permits the residence jurisdiction of UPE or intermediate parent entity to tax income that is not sufficiently taxed in the jurisdiction where it operates. Conversely, the UTPR and STTR generally allow the source jurisdictions to impose an additional tax or deny deduction on payments not sufficiently taxed in the residence jurisdiction. Therefore, on the ground of the single tax principle, what Pillar Two does seems justified.

However, speaking of Pillar Two as an anti-BEPS measure, Devereux et.al. (2020), De Wilde (2021), and Silva (2020) agree that it departs from the underlying rationale of the BEPS Project, thus seeming not to serve as an anti-avoidance measure. Instead, it deals with setting the floor for tax competition. In this regard, I will further examine its proposed mechanism and link

it to the other anti-BEPS measures either recommended or proposed by the OECD.

Having regard to Amount A under Pillar One, only 20-30% of the residual profit of in-scope MNEs will be allocated to market jurisdictions (OECD, 2021). The remaining profit then will end in the residence jurisdiction of each MNE. The problem is that these MNEs may locate their residence in a low or no-tax jurisdictions, which leads to a minimized global tax burden for MNEs within the same group. However, to the extent that Pillar Two focuses on the gap between the effective tax rate of each group MNE and the agreed minimum tax, Riccardi (2021), Devereux (2020), and De Wilde (2021) argue that it aims to curb the competition of corporate tax rate between countries, and is beyond addressing the BEPS issue. Besides, if the OECD is consistent with its previous anti-BEPS measures, the principle of aligning profits to the location where value is created should govern the mechanism proposed in Pillar Two, as also applied in Pillar One. The fact is that Pillar Two works on allowing the residence jurisdiction of UPE or intermediate parent entity to impose additional tax regardless of its contribution to the value creation. In that, Pascal Saint-Amans of the OECD in CBT (2020, as cited in Riccardi, 2021) surprisingly recognized that what Pillar Two does will be little contradictive to the efforts to tackle BEPS, which focus on how to align taxable profit to the location of value creation. Thus, Devereux, et. al. (2020) finds it less justified and Picciotto, et.al. (2021) consider that no principled reason is provided for parent jurisdiction to impose such a tax.

In some situations, however, taxation by parent jurisdiction may show a connection to value creation. According to Englisch (2021), intangibles, one of the main problems creating BEPS issues and an essential element in the digital economy, maybe develop primarily in the parent (headquarter) jurisdiction. Therefore, granting the taxing right to the parent jurisdiction seems to align with such involvement. Unfortunately, the identification of parent contribution does not happen in the case of Pillar Two as the only requirement for imposing the top-up tax is the effective tax rate of other group MNEs below the minimum level of tax. De Wilde (2021) even emphasizes that no anti-avoidance characteristics could be found in Pillar Two.

Notwithstanding the continuing debate on the compatibility of Pillar Two as an anti-BEPS measure, the happening race to the bottom⁴ arguably affects the economic efficiency. As MNEs' operations get far more integrated, tax rate gaps between countries seem inevitably to distort taxpayers and violate the

³ Trivedi (2021) argues that the compliant jurisdictions to the Action 5 recommendations should be excluded from the GloBE scope. However, having regard to the acknowledgment that Action 5 has been considered an unfinished business, making those jurisdictions out of Pillar Two scope seems contradictive for the OECD. Looking at the coverage of the harmful preferential tax regime under BEPS Action 5, the type of tax competition

in which a lower rate is not limited to certain businesses or activities will not be considered harmful (Brown, 2021). This suffices the argument of introducing Pillar Two due to the imperfect work of the BEPS Action 5.

⁴ According to empirical study by Dewantara and Riandoko (2018), no tax competition is explicitly found among ASEAN countries.

neutrality principle. Tax competition is likely to create a 'real' BEPS issue if profit is booked at low or no-tax jurisdiction without substantive economic activities. Further, as Hines Jr. (2014) mentions that the root of many tax avoidance practices is empirically the tax rate differences, tax competition is clearly an issue for fair taxation across countries. In this regard, I tend to agree that it would be considered as a problem to the extent that it results in BEPS practices.

4.2.2 How does it balance different interests between countries?

As the most obvious objective of Pillar Two is to reduce tax competition by setting a minimum level of tax paid by MNEs in each jurisdiction they operate, it seems to put pressure on developing countries. According to Clausing (2018 as cited in Riccardi, 2021), the United States, China, Japan, and the United Kingdom, are of the top 5 (five) home countries for MNEs' headquarter, and indeed world big companies. Whereas the adoption of the GloBE rules by those countries (or other developed/capital exporting countries) may promise additional tax revenue, the implication for developing economies as market or perhaps locations of manufacturing activities is to be questioned. Indeed, Silva (2020) suggests that unless the host jurisdiction of investment raises its tax rate, a potential shift of tax revenue from that jurisdiction to the residence jurisdiction seems to occur. This tends to generate a more favorable outcome for capital exporting countries than the capital importer. Avi-Yonah (2015) nevertheless ensures that eliminating tax competition would not hurt developing countries if they can use other factors to attract investment. He builds his argument on the following ground: even though based on an extensive literature, taxes do matter in investment location decision, the use of tax incentives in a country have been triggered by the competition between countries.⁵ Had the tax competition been prevented, developing countries would be able to collect more tax revenues without any fear of other countries offering more preferred tax incentives (Avi-Yonah, 2015).

As part of countries sovereignty, tax holiday or incentives sometimes are incorporated in a country's corporate tax system, especially that of net capital importer countries. Such incentives however have created an issue for those countries. The GloBE rules' design seems to make the previously untaxed income, in the source jurisdiction, be taxable in the developed countries as the residence jurisdiction. A quite similar debate once happen to the existence of tax sparing provision to prevent the deprived tax incentive granted by developing countries (Arnold, 2019).

Although it is particularly relevant for developing countries, Silva (2020) highlights that nowadays tax breaks and incentives are also employed by the developed economies. He further argues that tax incentives do not necessarily reflect a tax avoidance practices to the extent that business activities are also present. In contrast, the application of IIR and UTPR under the GloBE rules of Pillar Two does not involve any test to ensure those substantive economic activities conducted by group MNEs in their jurisdiction (Riccardi, 2021). As a consequence, the minimum level of tax imposed according to the IIR or UTPR may infringe the sovereignty of source jurisdictions to limit taxes collected in that situation (Riccardi, 2021; Silva, 2020).⁶

Further concern for developing countries or countries with no significant number of UPE or intermediate parent entities is whether the GloBE rules could still benefit them. By the design, Pillar Two incorporates a top-down approach for the IIR to apply and an ordering rule to curb the double taxation outcome. According to Picciotto et. al. (2021), granting first taxing right to UPE jurisdiction under the top-down approach seems unjustified and unfair. They then argue that it results in a revenue mobilisation from lower income countries as the source states to the OECD member countries as the parent (UPE in particular) jurisdiction. If a developing countries are to grant tax breaks for MNEs, it is clearly the parent jurisdiction that would get additional tax revenue from the top-up tax imposed to the headquarter of such MNEs (Silva, 2020).

To counteract the above mentioned issues, a substance carve-out has been added to exclude genuine businesses from the GloBE application. It brings out a certain percentage (10 percents of total of GloBE income regarded as a return for immobile production factors, namely tangible assets and employees, from the top-up tax calculation. While appearing relevant for some industries, such a carve-out may not represent what substance is in other sectors (Trivedi, 2021). Besides, it also negates the underlying principle within Pillar One whereby intangibles may result in both routine and non-routine profit (Trivedi, 2021). In fact, the high reliance on intangibles is one of the characteristics of highly digitalised businesses.

The other concern for developing countries relates to their tax policy to incentivise investment in research and development (R&D) which would promote innovation, employment, and economic growth (Trivedi, 2021). However, the proposed substance carve-out in the Pillar Two blueprint has not yet covered all expenditures incurred for the purpose of that investment. It would add another issue for

⁵ This explanation is based on the opinion of Avi-Yonah (2015) for the proposal of taxing MNEs on their global profit under a multilateral approach. Such a proposal tends to align with the principle of unitary business operation of MNEs. It thus basically raises a similar issue

to Pillar Two, that is the existence of the tax incentives granted by developing countries.

⁶ It is like the other side of a coin where for the perspective of countries in favor of imposing high taxes, Pillar Two tend to bring back their sovereignty through setting a floor for moderate tax rate (Englisch, 2021).

developing countries granting such kind of tax incentive had it not been included in the said carve-out.

A study by Barake et al. (2021) estimates the additional tax revenues for selected countries representing both developed and developing countries if the minimum tax of 15% is applicable. The result of such a study reveals that developed countries would gain far more tax revenues through the implementation of the minimum tax than developing countries. It also measures the impact of taking the substance carve-out into account, which decreases the amount of top-up taxes.

In addition to the GloBE rules, Pillar Two introduces the Subject to Tax Rule (STTR), a standalone rule to the GloBE rules. It will deny tax treaty benefits to base eroding payments made to connected persons. The mechanism appears more straightforward than the GloBE rules. Nonetheless, as the additional tax revenue is conditional to the taxability of such payments in the residence jurisdiction, Riccardi (2021) argues that STTR should not be viewed as a 'gain' for developing countries. She thus suggests that it should be viewed as an indirect measure to prevent inefficiencies and unfairness resulted from the interaction between tax treaty system vs resident jurisdiction's tax system.

Above all, it appears true that in general Pillar Two would benefit developed countries more than developing countries. Meanwhile, developing countries should revisit their tax incentive policy if they want to collect more revenues once the minimum tax is broadly applied. Whereas the proposed substance carve-out tends to contribute to fewer revenues flowing to developed countries, the use of a formulaic approach may not precisely represent the routine return that should not be subject to additional tax.

4.2.3 To which extent of its complexities and fairness?

When formulating a domestic tax policy, administrative efficiency becomes one of the objective that the government considers (Holmes, 2014). To achieve the administrative efficiency, the design of a tax policy should minimise burden both from the taxpayer's side (compliance cost) and from the tax administration's side (administrative cost). This also becomes one of the critical issues pertaining to the application of Pillar Two and has been considered by the OECD (2020), once it comes into effect. Nonetheless, fairness or tax equity that serves as the other consideration for designing a sound tax policy often goes in opposing direction to the effort to simplify the administrative issues. This section therefore will particularly investigate whether the design of the IIR, UTPR, and STTR under Pillar Two has minimized such burden, while maintaining fair taxation.

4.2.3.1 Income Inclusion Rule (IIR)

To apply the IIR, one of the initial steps to do is determining which jurisdiction is the residence of the

UPE. Following the top-down approach in the 2020 proposal, the UPE jurisdiction has the priority to apply the IIR. In the absence of the IIR in that jurisdiction, the intermediate parent jurisdiction will be allowed to impose the top-up tax. In this regard, the top-down approach requires co-operation between countries before a jurisdiction can claim its right, as the UPE or the intermediate parent jurisdiction. Otherwise, double taxation may occur, which clearly is an unwanted outcome.

The OECD (2020) recognized the need for such a coordinated way in the said blueprint. However, it has not explained further how to perform the mechanism to identify the eligible jurisdiction, and how to get the data from other jurisdictions, thus preventing the overlapping actions between jurisdictions. Comprehensive documentation that jurisdiction may consider utilizing is the Country-by-Country Report (CbCR) either filed by UPE or other constituent entities of an MNE Group. Unfortunately, the CbCR lacks the information about the structure and level of ownership within an MNE Group (Wahyuni & Anggoro, 2018), which is essential for the UPE and intermediate parent entity identification purpose under the GloBE rules.

Further, the top-down approach that prohibits the intermediate parent jurisdiction to apply the IIR if the UPE jurisdiction adopts such a rule tends to result in uncertainty and unfair treatment. Imagining that the latter has not yet applied the IIR though adopted in its domestic law, the former still could not impose the top-up tax. If in the end that UPE jurisdiction does not execute its taxing rights, "a remaining BEPS issue" would arguably still exist.

After jurisdiction confirms its right to impose an additional tax on UPE or intermediate parent entity, it has to calculate the ETR on jurisdictional basis to determine the top-up tax amount, called the a jurisdictional blending approach. The ETR computation involves covered taxes as the numerator and GloBE income as the denominator. In addition, it should be highlighted that the implementation of such an approach would need further concern if there is more than one constituent entity in a jurisdiction. In such a situation, both the covered taxes and the GloBE income of all those entities need to be aggregated in the calculation of the said jurisdictional ETR.

On the denominator side, the 2020 blueprint says that the GloBE income will refer to accounting income calculated according to the accounting standard applicable in the UPE jurisdiction to (1) minimize the impact of different calculations of taxable income under the domestic tax law of constituent entities' jurisdiction; and (2) focus on the information normally available for non-tax purpose (Englisch, 2021). This is how the proposal tries to maintain the administrative simplicity. However, the adjustment on the following items is required to have the closest amount of GloBE income to taxable income in each jurisdiction, while maintaining a common and material adjustment only, inter alia, (1) permanent differences; (2) exempt dividend under the participation exemption given by the recipient jurisdiction; (3) intra-group dividend; (4)

gain or losses on restructuring; and (5) loss carryforward. (OECD, 2020). To perform such an adjustment, the respective parent jurisdiction will need (1) the separate entity-based amount of profit before income tax; and (2) the amount of particular items to be adjusted on an entity basis. Thus, coordination between jurisdictions is needed to arrive at the latter amount and so anticipate an overlapping adjustment. It is arguably a "simplified" method to calculate GloBE income. Financial accounting, nonetheless, aims for a different objective than tax accounting (Devereux, et. al., 2020). Consequently, this cannot refrain from the thought of whether it provides a fair computation of a tax base for the top-up tax.

On the numerator side, calculating the covered taxes should involve all taxes imposed on the GloBE income as the tax base. Accordingly, a subsequent adjustment is required to align with the adjustment made to the GloBE income, for example, taxes imposed on the intra-group dividend. Besides, the other adjustment should be made on the account of Pillar One outcomes. In that case, taxes imposed by market jurisdiction on Amount A under Pillar One should be added to the covered taxes amount as it also constitutes taxes imposed on the GloBE income. Finally, the temporary differences tend to create further complexities for the covered taxes calculation. Accordingly, the proposal has incorporated a mechanism allowing the excess taxes (when the covered taxes exceed the minimum tax) to be carried forward. The excess taxes will be utilized in the subsequent year to bring the covered taxes of that year up to the minimum tax, thereby reducing the top-up tax. However, the detailed mechanism appears complicated since there would be excess taxes that create a top-up tax credit (if the respective MNE has paid top-up taxes in the previous tax year) and the local tax carry-forward (if the opposite situation happens). The top-up tax credit can be utilized to reduce the top-up tax liability in any jurisdictions and both the same or future tax year. In contrast, the local tax carry-forward can only reduce the top-up tax liability in the same jurisdiction. Consequently, the tax administration of the UPE or intermediate parent jurisdiction will need to maintain chronological documentation of the top-up tax credit and the local tax carry-forward. Besides, since the IIR needs to be incorporated in the domestic law of the respective countries, there is a possibility that a UPE jurisdiction adopts the IIR in a later tax year than the year when the intermediate parent jurisdiction imposes the top-up tax. In such a situation, the UPE jurisdiction will also need the information about the existing top-up tax credit and local tax carryforward generated from the IIR implementation by the intermediate parent jurisdiction.

Further, it is also worth noting that sometimes a country's domestic tax law provides a tax-free income or a tax credit, as an incentive to stimulate its economy.

To better reflect such a fair computation,⁷ first, GloBE income arguably should exclude the tax-free income. The second concern to achieve a fair computation is that the incentive in the form of a tax credit may lead to a disproportionate burden for the parent entity if it is not included in the amount of covered taxes. Thus, the covered taxes should also consider the amount of tax credit provided through the government incentive.

For the top-up tax calculation, the exclusion of the substance carve-out that would exclude the amount referred to as the return for possessing tangible assets and incurring payroll,⁸ seems justified. For the administrative efficiency purpose, the simplified mechanism for calculating the substance carve-out has been considered. A formulaic-based substance carve-out indeed creates an easy procedure to arrive at the amount regarded as a fixed or routine return. However, Riccardi (2021) argues that leaving the residual profit (profit out of the substance carve-out) to residence jurisdiction through this formulaic mechanism would not lead to a satisfied (fair) result. She states that such a formula to calculate the residual profit seems arbitrary. The two types of expenditure to calculate the substance carve-out may not sufficiently reflect the routine return, according to analysis in the previous section. In this regard, if another proxy for routine return is added, the amount of GloBE tax base should further be adjusted.

Based on the above explanation, calculating ETR has involved multiple mechanisms of which the relevant data is required to make the appropriate adjustment. Those procedures seem complicated to administer, having regard to the need of careful identification on the adjusted items and also the determination of the excess taxes caused by timing differences. Having said that, in the absence of such complexities, the calculation of the ETR may fail to achieve the desired level of fairness.

Considering the complexities of the IIR, the previously existing rule, that is the CFC rule, then comes across my mind. CFC rule which was firstly introduced by the United States basically shares a common mechanism with the IIR but serves as an anti-avoidance measure due to tax deferral. In fact, the CFC rule tends to vary between countries because of their different consideration when determining an "inappropriate deferral (Koffler et. al., 2020 as cited in Riccardi, 2021). In addition, Riccardi (2021) emphasizes that such a rule is considered complex and so implementing the CFC rule seems costly for a country with no sufficient ground, such as regarding the amount of outbound investment and high tax avoidance risk. Therefore, she concludes that a CFC rule alike may not be a priority for all countries. In addition, developing countries are unlikely homes for many MNEs (Riccardi, 2021). Having said that, as the CFC rule will co-exist with the GloBE rules, the implementation of the GloBE rules seems to double

⁷ In this case, the designated objective of Pillar Two to address the said remaining BEPS issues should not be left behind.

their complexities. In this regard, any simplification mechanisms are necessary to anticipate the excess burden compared to the benefit of implementing IIR, more particularly for the developing countries. OECD (2020) has proposed simplification options, consisting of country-by-country reporting ETR safe harbour, de-minimis profit exclusion, single jurisdictional ETR calculation covering several years, and tax administrative guidance. Nonetheless, such simplified procedures should be agreed by as many countries as possible. Instead, it would create other loopholes for profit-shifting.

Further, to enable the application of the IIR in the case of MNEs operating in other jurisdictions through permanent establishments (PEs), a switch-over rule (SOR) is required. The SOR would eliminate a limitation for a UPE jurisdiction to tax back (impose a top-up tax) due to low tax paid by its PE in the jurisdiction where the PE is located. Such a limitation exists if the tax treaty says that the UPE jurisdiction applies an exemption method for foreign income. Consequently, the SOR should be incorporated in the tax treaty. In this regard, it appears to add another complexity to the IIR as the treaty conclusion necessitates time, resources, and of course a set of domestic legal procedures to be followed. Whereas a multilateral instrument may facilitate swift implementation of the SOR, still it needs to be coordinated between countries and at the same time involve other treaty-based measures such as those under Pillar One. Indeed, the benefit of establishing such an instrument should outweigh its associated cost.

4.2.3.2 Undertaxed Payment Rule (UTPR)

Following the order under the GloBE rules, jurisdiction will be entitled to the right to impose a top-up tax to or deny a deduction of a UTPR taxpayer under the UTPR if no IIR is adopted by UPE and intermediate parent entity jurisdiction. As a consequence, such an ordering rule makes the UTPR a backstop for the IIR. Further, the UTPR prioritizes the payer jurisdiction to impose the additional tax or deny a deduction. Had the priority rule is not applicable, i.e. due to no entities making direct payment to other group MNEs with ETR of below the minimum tax, the second stage of UTPR would apply.

The UTPR principally operates quite similarly to the IIR. In this regard, sufficient data for calculation of the ETR, and thus the top-up tax that the UTPR taxpayers would be liable to, is required. In fact, the ETR calculation also resembles that of the IIR. Besides, the other financial data concerning intra-group payments, including those made to constituent entities with ETR of below the minimum tax should be available. Before a jurisdiction applying the UTPR can impose an additional tax or deny a deduction, it should investigate how many other group MNEs also make payments to such entities and how much such payments are. That information would determine the proportion of a top-up tax that would be taxable in the UTPR jurisdiction. However, when it comes to

gathering that data, the two-stage approach (the ordering rule) under the UTPR appears to result in further complexities than the IIR. This argument is based on the need to coordinate between respective jurisdictions for the UTPR not to lead to conflicting actions and also the double taxation outcome. Indeed, the OECD has been aware of this issue and has highlighted that in practice, the scope of UTPR application is predictably narrow (OECD, 2020).

4.2.3.3 Subject to Tax Rule (STTR)

As a separate rule from the GloBE, STTR however would have priority before the parent jurisdiction applies the IIR. STTR works to deny tax treaty benefits for to payments to a connected person resident of the treaty partner which imposes no or lower tax than the agreed minimum tax rate. If such payment is not sufficiently taxed in the residence jurisdiction, the payee will be liable for the top-up tax. Such a minimum rate will require an amendment of the existing tax treaties, particularly, tax treaties concluded with countries considered as conduits or investment hubs (Picciotto, et.al, 2021).

To calculate the top-up tax, the source jurisdiction needs the information of how much taxes imposed to those eroding payments. Picciotto, et.al (2021) acknowledge the complexities and difficulties in administering the STTR, for example, when it comes to determining the taxes paid on those payments in the residence jurisdiction. However, conceptually, determining the top-up tax under the STTR differs from that of the IIR and the UTPR. First, it only applies to specific payment, normally interests and royalties. Second, it refers to the nominal tax rate in the payee jurisdiction (Englisch, 2021), instead of the effective tax rate for all taxable income. In this regard, such complexity and difficulty could be anticipated if a database of countries' tax rates is made available and accessible (Chand, 2020). Besides, Riccardi, (2021) argues that the STTR's intention in curbing tax avoidance seems clearer than the GloBE rules as the latter involves more complex 'anti-avoidance' mechanism by excluding the substance carve-outs. However, a special consideration in determining the nominal tax rates is necessary in the case of certain tax treatment applied to such payments, for instance, when it remains untaxed unless distributed further, or if the tax base is extended to equity (in addition to income, according to the payee perspective), which happens in the country imposing Zakat *in lieu* of income tax (OECD, 2020). As a result, the payee may need to certify that the minimum tax rate is achieved with an appropriate justification, regardless the low nominal tax rate (OECD, 2020).

4.2.4 Will Pillar Two measures become an effective solution in addressing the 'remaining BEPS issues'?

After assessing the compatibility and complexities of Pillar Two measures, now I get back to the objective of Pillar Two. The main objective of Pillar Two is to

address the remaining BEPS issues after the implementation of the BEPS Actions and also the Pillar One measure. Notwithstanding the debate on the anti-BEPS characteristic under Pillar Two, the further discussion in this section is that whether Pillar Two measures are an effective solution to those BEPS issues or simply reducing the tax avoidance opportunity.

Devereux, et.al. (2020) conducted a simulation to portray the impact of the IIR introduced on profit shifting. On a country-by-country approach (called the jurisdictional blending approach in the 2020 blueprint), the results show that the increase in the minimum level of tax leads to a decline in profit-shifting. When the minimum tax rises to 19 percent, equal to the statutory tax rate in the hypothetical high tax country used in the simulation, there would be no gain of conducting a profit-shifting. Also, using the Google case as a reference, Naoki (2021) found a similar result. If Pillar Two is applicable, Google US would be taxable on the profit of Google Ireland (a lower tax jurisdiction) under the IIR; and if there are royalty payments from Google France to Google Ireland, France will be able to impose an additional tax or deny deduction under the STTR.

Nonetheless, as Pillar Two involves significant cost when it comes to implementation stages, Silva (2020) doubts that Pillar Two will be able to bring such advantages into reality. He questions whether Pillar Two would prevent an MNE resident in a high tax jurisdiction to establish CFC in low tax jurisdictions (tax havens). This is based on the argument that such an MNE would only be subject to the minimum tax as opposed to the statutory tax rate in the residence jurisdiction. Further, Englisch (2021) argues that the GloBE potentially creates the other form of tax competition, through promoting location for MNEs' headquarter.

In the same direction, it does not seem convincing for De Wilde (2021) that Pillar Two is the appropriate solution for addressing the remaining BEPS challenges. He even found that Pillar Two might be leaking. Using a simulation on the ETR inflation and deflation, an MNE group could arrange the ETR through the hybrid mismatch strategy.

Using a similar scenario, I will modify the simulation performed by De Wilde (2021) as according to the OECD (2021), the agreed minimum tax is 15%. Supposing Y Co., a resident in country Y, establish X Co. in country X, a low tax jurisdiction, and Z Co. in Country Z, a high tax jurisdiction. To minimize the tax burden due to the implementation of IIR by Country Y, here is the possible arrangement. X Co. takes a loan from Z Co., with the principal amount of 10.000 and 3.5% arm's length interest (350). Such a loan is then structured in a way that it would be classified as an equity instrument for the corporate taxation purpose in both Country X and Z, but a debt for financial accounting purposes. The interest paid to Country Z thus is classified as a dividend for tax purposes. Such a payment is not deductible in Country X and is not

taxable in Country Z due to the participation exemption method. As it results in a non-deduction and non-inclusion, BEPS Action 2 will not be applicable in that situation, and thus no change in tax liability in both jurisdictions (supposing 100 in Country X and 200 in Country Z). When it comes to ETR calculation, that interest would be deductible from the financial accounting profit when calculating the GloBE income in jurisdiction X as it is treated as debt interest for accounting purposes. If the GloBE income in jurisdictions X and Z prior to the arrangement is 1.000, such a mismatch tends to decrease the GloBE income in the former jurisdiction to 650 (1.000-350) and thus increase the ETR (ETR inflation) to 15% (100/650). Meanwhile, GloBE income in jurisdiction Z will increase to 1.350 (1.000+350) and so result in a decrease in the ETR (ETR deflation) to 15% (200/1.350). Moving on to parent jurisdiction, Country Y, prior to such an arrangement, it will impose a top-up tax of 50 due to the low-taxed profit of X Co. (the agreed minimum tax rate is 15%). In contrast, the arrangement seems to result in no top-up tax as the ETR in both jurisdictions X and Z is as the minimum tax of 15%.

Table 1 Ordering rule for GloBE

Prior to arrangement				
Jurisdiction	GloBE income	Covered Taxes	ETR	Top-up Tax
X	1.000	100	10%	
Z	1.000	200	20%	
Y	N/A	N/A	N/A	50
Post arrangement				
Jurisdiction	GloBE income	Covered Taxes	ETR	Top-up Tax
X	650	100	15%	
Z	1.350	200	15%	
Y	N/A	N/A	N/A	-

Source: Modified from De Wilde (2021)

The above illustration may show the shortcoming of the IIR under Pillar Two. However, I would argue that the effectiveness of Pillar Two in combatting BEPS issues would also depend on several factors, more importantly, the coordination between jurisdictions. For both IIR and UTPR to effectively apply, overlapping actions should be anticipated and thus the coordination is necessary. However, developing countries may not have sufficient capacity to perform such a task. Not to mention the complexities identified in the previous section, which involve the need to coordinate between countries.

Further, it is unlikely that all countries would be willing to 'sacrifice' their sovereignty to help each other maximize their tax revenue and enhance fairness in the global economic development⁹ while preventing additional burden for taxpayers. Following the discussion in the earlier section, on the one hand, the capital exporter countries tend to benefit from the additional tax revenue from the implementation of the IIR under Pillar Two. It appears more certain for such countries as the exclusion from the IIR implementation

⁹ As mentioned by Herzfeld (2017, as cited in Brown, 2021).

is quite certain and predictable, i.e. through the formulaic substance carve-out, without ensuring the existence of economic substance or even any BEPS-motivated practices. On the other hand, capital importer countries may need to restructure their tax incentives, either through providing other subsidies to replace the tax incentives or abolishing such incentives to secure their tax revenue due to the uncertainty on the investment inflow after the IIR is in place. In this regard, Devereux et.al. (2020) emphasizes that the GloBE proposal may curb the profit shifted from developing countries, but at the same time, it is likely to reduce their investment inflow.

The above concerns seem to remind of the challenges faced by developing countries in the implementation of the previous BEPS Projects as identified by Brown (2021).¹⁰ Thus, from the perspective of developing countries, it seems relevant to investigate whether the challenges on the previous BEPS Projects have been mitigated in the Pillar Two proposal. First, concerning the compatibility of Pillar Two for BEPS practices in developing countries, I would argue that the BEPS issue handled by the IIR may not reflect the general situation in the developing world, which is less likely home countries for many MNEs. As such UTPR may present greater benefit to the developing countries, yet reduced by the fact that the UTPR only serves as a backstop. Second, the need for domestic legislation changes for the implementation of the IIR and UTPR may put pressure on developing countries due to both involving complex mechanisms. In the absence of the necessary details in the legislation, their implementation may give rise to fairness issues and other loopholes for BEPS to occur.¹¹ Lastly, Pillar Two measures require a range of administrative tasks for the tax administration in developing countries, i.e. collecting and maintaining the necessary data to appropriately claim the taxing rights and so calculate the ETR and the top-up tax. I would argue that the administrative capacities needed for such tasks are higher than those under the previous BEPS Projects. Further, if the adoption of the IIR alike rule (CFC rule) poses challenges in the implementation stage, similar challenges appear to happen to the IIR. On the other hand, the developing countries may not face equal risk of profit-shifting schemes to the developed ones.

5. CONCLUSION AND RECOMMENDATION

Under the two-pillar solution, Pillar Two aims to address the remaining BEPS issues even though the 2015 and subsequent OECD/G20 BEPS Actions as well as Pillar One measures have been implemented. As a designated anti-BEPS measure, Pillar Two mechanisms nevertheless do not necessarily target the only BEPS

practices. As a result, it seems to focus on the tax competition issue which may trigger a range of tax-avoidance practices. Such a proposal appears to benefit both developed and developing countries. However, the associated benefit for developed countries is likely far greater, due to the several issues, such as the number of ultimate parent entities that locate their residence in developing countries, and the existence of tax incentives granted by developing countries. To create a fairer outcome, the proposal tends to employ quite complicated mechanisms, such as the ordering rules, the top down approach, the substance carve-out, and so forth.

Those complexities should be taken into account when adopting Pillar Two measures. It seems relevant for developing countries as arguably Pillar Two measures would require a higher level of coordination between countries and sufficient administrative capacity. Otherwise, the Pillar Two adoption will incur higher costs than potential benefits, having regard to the modest BEPS magnitude for developing countries (Hines Jr., 2014).

6. LIMITATION

This research is a preliminary assessment of the Pillar Two under the 2020 blueprint and the OECD/G20 statement as of 8 October 2021. Thus, any subsequent development of such documents may influence to the result of this study. Further, a country-specific investigation of the Pillar Two's compatibility and feasibility may contribute to the future implementation of Pillar Two.

REFERENCES

- Arnold, B. J. (2016). *International Tax Primer*. Kluwer Law International B.V.
- Arnold, B. J. (2019). The Evolution of Controlled Foreign Corporation Rules and Beyond. *Bulletin for International Taxation*.
- Avi-Yonah, R. S. (2015). *Advanced Introduction to International Tax Law*. Edward Elgar Publishing Limited.
- Avi-Yonah, R. S. (2021). The International Tax Regime at 100: Reflections on the OECD's BEPS Project. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3908575
- Barake, M., Chouc, P. E., Neef, T., & Zucman, G. (2021). Revenue Effects of the Global Minimum Tax: Country-by-country Estimates. *EUTAX Observatory*.
- Brown, K. B. (2021). Tax Incentives and Sub-Saharan Africa. *Pepperdine Law Review*, 48(4), 995-1022.

¹⁰ See section 4.2.3

¹¹ Meanwhile, the other measure, SOR, and STTR will require tax treaty amendment. Once the OECD facilitates the swift implementation through a multilateral instrument, the burden of each country to

negotiate bilaterally will be reduced. It will also be preferable from the developing countries' perspective as the STTR addresses more clear and relevant tax avoidance issues.

- Chand, V. (2020). *Case studies of Pillar Two of the OECD Report on taxation of digital economy*. IFA India Academy. <https://youtu.be/7AJ9TDKm9BI>.
- Creswell, J. W. (2014). *Research Design: Qualitative, Quantitative, and Mixed Methods Approaches*. Sage Publications.
- Crivelli, E., De Mooij, R. A., & Keen, M. M. (2015). Base erosion, profit shifting and developing countries. International Monetary Fund.
- De Wilde, M. F. (2021). *Is there a leak in the OECD's global minimum tax proposals (GLOBE, Pillar Two)?* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3792531.
- Dewantara, A. R., & Riandoko, R. (2018). "Bad Leader For Bad Game" Empirical Study of Harmful Tax Competition in ASEAN Countries Using Nash-Stackelberg Competition Approach. https://www.researchgate.net/publication/319703695_Bad_Leader_For_Bad_Game_Empirical_Study_of_Harmful_Tax_Competition_in_ASEAN_Countries_Using_Nash-Stackelberg_Competition_Approach.
- Englisch, J. (2021). International Effective Minimum Taxation—analysis of GloBE (Pillar Two). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3829104.
- Gunadi. (2014). *Pajak Internasional*. Lembaga Penerbit Fakultas Ekonomi Universitas Indonesia.
- Holmes, K. (2014). *International Tax Policy and Double Tax Treaties*. IBFD.
- Hines Jr., J. R. (2014). How Serious Is the Problem of Base Erosion and Profit Shifting? *Canadian Tax Journal*, 43-53.
- Devereux, M. P., & Vella, J. (2018). Value Creation As the Fundamental Principle of the International Corporate Tax System. *European Tax Policy Forum Policy Paper*.
- Devereux, M. P., Bares, F., Clifford, S., Freedman, J., & Güçeri, İ. (2020). *The OECD Global Anti-Base Erosion Proposal*. Oxford University Centre for Business Taxation.
- Naoki, O. (2021). Fight against Tax Havens and International Tax Law: New Taxing Right and a Global Minimum Tax. *Public Policy Review*, 17(1).
- OECD. (2018). *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting*. Paris: OECD Publishing.
- OECD. (2020). *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project*. Paris: OECD Publishing.
doi:<https://doi.org/10.1787/abb4c3d1-en>.
- OECD. (2021, October 2). *Action 1 Tax Challenges Arising from Digitalisation*. Retrieved from [www.oecd.org](https://www.oecd.org/tax/beps/beps-actions/action1/):
<https://www.oecd.org/tax/beps/beps-actions/action1/>.
- OECD. (2021). *OECD/G20 Base Erosion and Profit Shifting Project: Addressing the tax challenges arising from the digitalisation of the economy*. OECD.
- Picciotto, S., Faccio, T., Kadet, J. M., Jansky, P., Cobham, A., Garcia-Bernando, J. (2021). For a Better GLOBE. METR: A Minimum Effective Tax Rate for Multinationals. Retrieved from <https://ssrn.com/abstract=3796030>.
- Riccardi, A. (2021). Implementing a (global?) minimum corporate income tax: an assessment of the so-called "Pillar Two" from the perspective of developing countries. *Nordic Journal on Law and Society*, 4(1), 1-38.
- Silva, B. d. (2020). Taxing Digital Economy: A Critical View Around the GloBE (Pillar Two). *Frontiers of Law in China*, 15(2), 112-141.
- Sukardi, I., & Jiaqian, S. S. (2021). *ITR*. <https://www.internationaltaxreview.com/article/b1rzld56l6vg6w/changing-landscape-of-the-indonesian-taxation-system-and-beyond>.
- Sørensen, G. (1999). Sovereignty: Change and Continuity in a Fundamental Institution. *Political Studies*, Vol. 47, issue: 3, 590-604.
- Trivedi, N. (2021). Pillar Two substance-based carve-out – "To be, or not to be". Retrieved from <https://ssrn.com/abstract=3864705>.
- Wahyuni, A. T., & Anggoro, A. W. (2018). Assessment of the Potential Benefit of Implementation of Country by Country Report to Tackle BEPS in Indonesia. *Prosiding Simposium Nasional Keuangan Negara 2018*, 1273-1286. <https://jurnal.bppk.kemenkeu.go.id/snkn/article/view/265>.