

PILLAR TWO AND TAX CREDIT EQUITY INVESTMENTS

OVERVIEW

As the world economy has become more globalized and digitalized, there is a widespread perception that many companies have shifted their income into countries with lower tax rates. In response, the Organisation for Economic Co-operation and Development (OECD) and G-20 created the OECD/G-20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) in 2015. On Oct. 8, 2021, more than 135 Inclusive Framework countries “joined a two-pillar solution to reform the international taxation rules and ensure that multinational enterprises pay a fair share of tax wherever they operate and generate profits in today’s digitalized and globalized world economy.”¹ The purpose of the second of the two pillars (Pillar Two) is to ensure that companies are taxed in each jurisdiction in which they do business at an effective tax rate of at least 15%.

Pillar Two would establish the Global Anti-Base Erosion (GloBE) rules. The GloBE rules have three main components: the Income Inclusion Rule (IIR), the Qualified Domestic Minimum Top-up Tax (QDMTT), and the Undertaxed Payment Rule (UTPR). In concert, these three components are intended to ensure that large Multinational Enterprises (MNEs) have a minimum effective tax rate of 15% in each jurisdiction in which they operate. Large MNEs are organizations with annual group revenue exceeding €750 million (currently about \$780 million) in at least two of the four fiscal years immediately preceding the tested fiscal year.² An MNE’s effective tax rate in a given jurisdiction is determined by dividing tax expense (the numerator) by pre-tax income (the denominator). More specifically, the effective tax rate is “equal to the sum of the Adjusted Covered Taxes of each Constituent Entity located in the jurisdiction divided by the Net GloBE Income of the jurisdiction for the Fiscal Year.”³ Both the numerator and the denominator are based on a standardized financial

1 OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris, <https://www.oecd.org/tax/beeps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm>, p. 3.

2 OECD (2021), *Model Rules*, Article 1.1.1, p. 8. Certain Large MNEs are excluded under Article 1.5.1. Excluded MNEs are:

- (a) a Governmental Entity;
- (b) an International Organisation;
- (c) a Non-profit Organisation;
- (d) a Pension Fund;
- (e) an Investment Fund that is an Ultimate Parent Entity; or
- (f) Real Estate Investment Vehicle that is an Ultimate Parent Entity.

3 OECD (2021), *Model Rules*, Article 5.1.1, p. 28.

accounting base, such as GAAP or IFRS, with important adjustments to each.⁴ To the extent that the MNE's effective tax rate in a given jurisdiction is less than 15%, it would owe a "top-up" tax to either that jurisdiction (if that jurisdiction has enacted a QDMTT), the jurisdiction of a parent entity (if that jurisdiction has enacted an IIR), or (via the UTPR) other jurisdictions in which it has a taxable presence.

The impact of the global minimum tax would be felt by multinational corporations operating in the United States with respect to their U.S. income because the top-up tax would be collected either by the U.S. (in the unlikely event the U.S. enacts a QDMTT) or by other jurisdictions in which they operate that have adopted Pillar Two; in the latter case, that top-up tax would be collected under the IIR or UTPR frameworks by those countries that have adopted Pillar Two.

TAX CREDIT EQUITY INVESTMENTS

TAX CREDIT EQUITY ISSUE

An issue for many multinational corporations and the U.S. development community is how general business tax credits generated from equity investments are treated under Pillar Two and whether they are included or excluded when calculating an MNE's effective tax rate. More specifically, companies need to assess whether, under GloBE, tax credit equity investments, which include low-income housing, historic, new markets and renewable energy tax credits, could contribute to lowering their effective tax rate below 15%. If general business tax credits generated from equity investments are included and if the company's effective tax rate falls below 15%, then the company would generally be subject to a top-up tax equal to the shortfall. This would eliminate some or all of the economic value of an MNE's tax credit equity investments.

CALCULATION OF EFFECTIVE TAX RATE

As noted above, effective tax rate is calculated on a jurisdictional basis by dividing Adjusted Covered Taxes by Net GloBE Income. The GloBE Income or Loss of each Constituent Entity⁵ is the Financial Accounting Net Income or Loss determined for the Constituent Entity for the Fiscal Year, adjusted for certain items.⁶ The Financial Accounting Net Income or Loss of each Constituent Entity is analyzed on a consolidated basis. As such, any tax credit equity investments which are consolidated would cause the income, loss, and associated taxes and tax credits of such investments to be included in the effective tax rate calculation, generally lowering Adjusted Covered Taxes and bringing the effective tax rate closer to, or below, the 15% minimum tax rate.

⁴ We do not discuss these adjustments except as specifically noted.

⁵ A "Constituent Entity" is any separate business unit of an MNE Group that is included in the Consolidated Financial Statements of the MNE Group for financial reporting purposes.

⁶ OECD (2021), *Model Rules*, Article 3.1.1, p. 15.

EQUITY METHOD OF ACCOUNTING EXCLUSION

The GloBE Income or Loss of a Constituent Entity **excludes** certain types of gain or loss, including Excluded Equity Gain or Loss. As defined in Article 10, this term includes “profit or loss in respect of an Ownership Interest included under the equity method of accounting.”⁷

The equity method exclusion directly references the exclusion of profit or loss but does not specifically reference tax expense, benefits, or credits. However, Article 4.1.3(a) requires a reduction to Covered Taxes of a Constituent Entity in “the amount of current tax expense with respect to income excluded from the computation of GloBE Income or Loss under Chapter 3.”⁸ By logical extension, tax benefits and credits generated by an equity investment should be excluded in the same way, and for the same reason, that pre-tax profit and loss and tax expense associated with such investments are excluded. Therefore, all such items should be *excluded* from both the calculation of the income derived from a standardized financial accounting base and the effective tax rate.

ACCOUNTING FOR TAX CREDIT INVESTMENTS

The Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 323 Investments - Equity Method and Joint Ventures provides guidance on the accounting for investments under the equity method. Generally, investments in entities that generate general business tax credits, notably low-income housing tax credits (LIHTCs), renewable energy tax credits, historic tax credits and new markets tax credits, are structured using passthrough entities such as partnerships and limited liability corporations. The preparer of the financial statements is required to evaluate if the investment should be consolidated. If the investment is not consolidated, then it is generally accounted for using a form of the equity method of accounting. Consequently, all its pre-tax and tax items should be excluded from the Pillar Two calculation. The proportional amortization method, as codified under ASC 323-740 as a subtopic of the equity method, is currently only available for LIHTC investments and is widely used. Hypothetical liquidation at book value (HLBV), widely used for renewable energy investments, is discussed in ASC 323-10-35-27 to ASC 323-10-35-28 and ASC 323-10-55-48 to ASC 323-10-55-57. Both the proportional amortization method and HLBV accounting should fall within the equity method of accounting exclusion.

⁷ OECD (2021), *Model Rules*, Article 10.1.1, p. 56. – Definition of Excluded Equity Gain or Loss:

Excluded Equity Gain or Loss means the gain, profit or loss included in the Financial Accounting Net Income or Loss of the Constituent Entity arising from:

- a) gains and losses from changes in fair value of an Ownership Interest, except for a Portfolio Shareholding;
- b) profit or loss in respect of an Ownership Interest included under the equity method of accounting; and
- c) gains and losses from disposition of an Ownership Interest, except for a disposition of a Portfolio Shareholding.

⁸ OECD (2021), *Model Rules*, Article 4.1.3, p. 23. The Commentary clarifies that it makes no difference whether the equity investment is in a tax opaque or tax transparent entity. (OECD (2022), Commentary, Article 3.2.1(c), paragraph 51, 53.)

JOINT VENTURES

While investments accounted for under the equity method of accounting are generally excluded in determining a MNE's effective tax rate, if the investment entity were to meet the definition of a Joint Venture, it would be necessary to analyze the impact of the Joint Venture rules of Article 6.4, described below.

In general, Joint Ventures are business enterprises that are jointly owned by two or more persons or entities. Because the enterprise is not controlled exclusively by one person, its accounting results are not consolidated on the balance sheet of any of its owners. Instead, the financial results of joint ventures are commonly reported by MNE groups using the equity method.⁹

As stated by OECD officials, Article 6.4 was intended to prevent MNEs from forming joint ventures in low-tax jurisdictions and invoking the equity method exclusion to avoid the Pillar Two tax that would otherwise be imposed on the income of such ventures. To prevent this, Article 6.4 extends the GloBE rules to entities in which the ultimate parent entity of an MNE group ("UPE") owns 50% or more of the ownership interests. Such Joint Ventures are required to determine the top-up tax amount at the Joint Venture level and allocate any resulting top-up tax to a constituent entity within the MNE group.¹⁰

Assuming, arguendo, that Article 6.4 applies to a tax credit investment, it is necessary to analyze the impact of Article 7.1. Article 6.4.1(a) says that Chapters 3 to 7 of the rules apply to a Joint Venture as if the Joint Venture is the UPE of a separate MNE Group. Article 7.1.1 and Article 7.1.2 apply to a UPE that is a tax transparent entity and have the effect of reducing the GloBE Income or Loss of a UPE, including a Joint Venture treated as a UPE, in two circumstances that are relevant here: first, under 7.1.1, if the Joint Venture has income and the Joint Venture's owner is subject to tax on the full amount of such income at a nominal rate of at least 15%; second, under 7.1.2, the Joint Venture has a loss and the loss is available to reduce the taxable income of the Joint Venture's owner.¹¹ Article 7.1 seems intended to ensure that, in the case of tax-transparent entities, Article 6.4 is confined to the purpose described above, viz., to prevent MNEs' shielding income from Pillar Two tax by forming entities in low-taxed jurisdictions and excluding the income from such entities under the equity method exception.¹²

The OECD commentary to Article 7.1 states that the nominal rate is the statutory rate applicable to the holder on its share of income.¹³ The rule does not refer to an effective tax rate and the commentary specifically states

9 OECD (2022), *Tax Challenges Arising from the Digitalisation of the Economy—Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, OECD, Paris, <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf>, Article 6.4, paragraph 83, p. 152.

10 OECD (2022), *Commentary*, Article 6.4, paragraph 84, pp. 152-153.

11 "Income" and "loss" are determined in the same way income is determined for other Pillar Two purposes, that is, generally using GAAP or IFRS.

12 OECD (2022), *Commentary*, Article 7.1.1, paragraph 5, p. 159

13 OECD (2022), *Commentary*, Article 7.1.1, paragraph 12, p. 160.

that no effective tax rate calculation is required.¹⁴ Our understanding is that this was a deliberate policy choice intended to obviate the need for entities to consider the particular facts and circumstances, and specifically the particular tax attributes, of each holder of an ownership interest. On this basis, if a U.S. tax transparent entity has a profit in a given year for GAAP, its investor would be treated as meeting the nominal rate test, the tax transparent entity would be treated under Article 7.1.1 as having zero GloBE Income, and the equity method exclusion of Article 10 would (continue to) effectively apply. This result is consistent with the observation made above: Article 6.4 was intended to prevent MNEs from shielding income from Pillar Two tax by forming entities in low-taxed jurisdictions and excluding the income from such entities under the equity method exception, and Article 7.1.1 would, in the case of tax transparent entities, confine Article 6.4 to that abusive situation.

If a U.S. tax transparent entity generates a loss for U.S. GAAP purposes, the Joint Venture would again have zero GloBE Income or Loss per Article 7.1.2, effectively restoring the equity method, since U.S. owners may use the losses.¹⁵

In sum, the Joint Venture rule would not change the result that would otherwise apply to tax credit investments that come under the equity method exclusion.

STATEMENTS BY OECD AND U.S. TREASURY CONSISTENT WITH THE ABOVE

On April 25, 2022, the OECD hosted a public consultation meeting to discuss the comments provided on the Implementation Framework. During this meeting, the OECD Secretariat addressed several questions that had been submitted. Of note was the following question about the exclusion of the tax effects of income and losses excluded under the equity method exclusion:

The provisions of Article 4.1.3(a) of the GloBE Rules exclude the current tax expense with respect to income excluded from the computation of GloBE Income or Loss under Chapter 3. The Commentary includes an example that indicates that the rule applies to taxes attributable to income from an Entity accounted for using the equity method. Losses from an Entity that do not count under the equity method are also excluded from the computation of GloBE Income or Loss. Are the tax effects of those losses also excluded from the determination of the Covered Taxes? (Question #2 addressed by the OECD Secretariat)

¹⁴ OECD (2022), *Commentary*, Article 7.1.1, paragraph 15, p. 161.

¹⁵ OECD (2022), *Commentary*, Article 7.1.2, paragraph 23, p. 162. Even if a U.S. Flow-through Entity were treated as having a GloBE Loss for the year, Article 4.1.5 should not apply since the Joint Venture (a tax transparent entity) would not accrue any deferred tax asset under U.S. GAAP. In any event, Article 4.4.1(e) does not allow accrual of a deferred tax asset with respect to the generation of tax credits (OECD (2022), *Commentary*, Article 4.4.1, paragraph 80, 103.)

Although Article 7.1 operates to reduce GloBE Income or Loss of a UPE, or a Joint Venture treated as a UPE, there is no requirement that such amounts be included in the GloBE Income or Loss of another entity. In other words, Article 7.1 does not reverse the carveouts in Articles 3.2.1 and 4.1.3(a). Again, this is consistent with the observation that Article 7.1 operates to rein in Article 6.4's circumscription of the equity method.

The OECD Secretariat responded, consistent with what was noted above, that when the equity method applies to investments, according to the relevant accounting standard, (a) the income or loss associated with those investments is excluded from the GloBE Income or Loss and (b) consistent with this, all tax effects resulting from such investments should be excluded from the effective tax rate computation. The Secretariat also emphasized, in what seemed to be a reference to the proportional amortization and HLBV methods noted above, that this analysis should apply to investments accounted for under different variants of the equity method.

On May 5, 2022, where she gave remarks to the D.C. Bar Association, Assistant Secretary for Tax Policy Lily Batchelder stated:

“My team has worked with the OECD to clarify the treatment of general business credits under the minimum tax in the Commentary to the Model Rules and in recent OECD public statements. We are confident that the value of many of our general business credits is preserved under the OECD rules, and we have established a process with the OECD for working towards additional clarifications. For example, we have heard concerns about the potential impact of other countries’ UTPRs from some taxpayers that invest in projects that give rise to the Low-Income Housing Tax Credit, certain renewable energy credits, and the New Markets Tax Credit. But because of the way those investments are structured and accounted for, the income or loss and the income tax consequences of those investments typically will be excluded from the effective tax rate calculation, so those credits generally should not be impacted by UTPRs.”¹⁶

WHERE TO GO FROM HERE?

Given how much rides on the analysis set forth above, and given that Pillar Two – including the IIR and UTPR – will be implemented separately by internal legislation in over 100 countries, additional guidance from the OECD is needed to confirm this analysis.

Specifically, that guidance should confirm that:

1. profits, losses, tax expense, tax benefit and tax credits attributable to investments accounted for under the equity method are excluded from the calculation of an MNE’s effective tax rate,
2. the equity method encompasses all its variations, including the proportional amortization and HLBV, and

¹⁶ U.S. Department of the Treasury “Remarks by Assistant Secretary for Tax Policy Lily Batchelder for the D.C. Bar Association,” May 5, 2022. <https://home.treasury.gov/news/press-releases/jy0767>. These comments were echoed in ones she made on May 20, 2022, at a Tax Council Policy Institute conference. At that conference, she stated that LIHTC, renewable energy tax credits, and NMTC should not be problematic under Pillar Two because of the investment structure and accounting treatment.

3. the results just noted are not changed by the Joint Venture rules as long as either (a) the Joint Venture has income and the direct or indirect owners of the Joint Venture are subject to tax at a nominal rate of at least 15% tax, without regard to any tax credits or attributes available to the UPE, or (b) the Joint Venture has a loss and the direct or indirect owners of the Joint Venture is entitled to use that loss.