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US Multinationals Need a Plan for Pillar Two Dispute Resolution

Skadden's David Farhat and Eman Cuyler explain how OECD Pillar Two rules can lead to multilateral disputes and what US multinationals can do to prepare.

Proper international tax planning for US multinational enterprises in 2024 and beyond requires a close eye on the OECD's Pillar Two rules, which are fast becoming a reality in many jurisdictions.

Designed to address the tax challenges presented by the digitalization of economies, Pillar Two rules mandate that MNEs with an annual consolidated revenue of more than 750 million euros ($809 million) are subject to a minimum effective tax rate of 15% in each jurisdiction where they operate, regardless where they are domiciled.

Although many Organization for Economic Cooperation and Development jurisdictions are marching forward with implementation of Pillar Two, the US still isn't on board. As such, MNEs will likely be subject to the minimum tax provisions in other countries where they operate regardless of the US position.

A few areas of potential dispute could arise under Pillar Two, as well as certain steps US MNEs can take to prepare for, and comply with, these rules.

Potential Disputes

As Pillar Two becomes effective, several questions remain unanswered. For instance, the OECD contemplates that Pillar Two rules will be implemented in a consistent manner across all jurisdictions. But because these rules must be enacted through domestic legislation, inconsistencies in drafting, interpretation, and application can be expected, which will likely lead to various multilateral disputes.

US MNEs are in a peculiar position if the US doesn't shift its stance. US MNEs already face several minimum tax rules including global intangible low-tax income, the base erosion and anti-abuse tax, and the corporate alternative minimum tax, which aren't consistent with Pillar Two requirements.

In the absence of US action to conform its international tax landscape with these rules, there is potential for double taxation due to top-up taxes under Pillar Two in certain foreign jurisdictions.

In addition, Pillar Two requires a robust information exchange system, which can potentially lead to double taxation due to slow, ineffective, or lack of proper coordination between jurisdictions.

Resolution Difficulties

Pillar Two disputes will be difficult for US MNEs to resolve through traditional international dispute resolution models, such as mutual agreement procedures pursuant to income tax treaties or international arbitration under investment treaties, because they are multilateral. The more jurisdictions are around the table, the harder it is to reach consensus.

Relying on existing dispute resolution models alone may not be a sufficient solution for US MNEs, as it isn't clear whether disputes related to the Pillar Two rules will be covered under existing US income tax treaties. Although the OECD issued a public consultation document assessing various dispute prevention and dispute resolution frameworks, there are no current clear binding methods to resolve these disputes.

Next Steps

In light of the many outstanding questions and constantly evolving international tax landscape, here are a few considerations for MNEs.

Monitor developments. MNEs should consistently monitor global developments related to Pillar Two and other international tax developments. Although the exact date of Pillar Two implementation will vary by jurisdiction, over 30 jurisdictions, including the EU, South Korea, and Japan, formally adopted Pillar Two, while other countries are actively introducing proposed or draft legislation.

Instead of adopting the Pillar Two rules, some countries are considering other avenues such as enacting a corporate income tax within the scope of Pillar Two. Bermuda, for example, enacted a first-ever 15% corporate income tax in December 2023.

Long-term roadmap is required. The complexities of these provisions mandate that US MNEs have a long-term operational plan in place. It should include modeling out potential scenarios, calculating potential Pillar Two exposure, and determining which entities in the group are in scope of these rules.

Any plan must consider reassessing organizational structure, including whether legal entity simplification or operational changes are appropriate to minimize tax exposure and compliance cost. It also must consider the impact of Pillar Two on existing tax structure including transfer pricing, cost-sharing arrangements, intellectual property and research and development locations, as well as acquisitions.

C-suite engagement isn't optional. Pillar Two ushers in a host of new challenges that are expected to impact everything from fundamental business operations to information exchange, technology plans, mergers and acquisitions strategies, and supply chain efficiency. These can't be handled solely by tax departments—they require extensive engagement and support from the executive teams and other stakeholders. Moreover, the potential tax and reputational cost could be significant for certain MNEs, which merit C-suite attention.

Familiarity with dispute prevention and resolution mechanisms is vital. While the OECD is considering supplementary dispute resolution mechanisms, familiarity with existing international tax dispute resolution options such as mutual agreement procedures or the International Compliance Assurance Program can't be overlooked to proactively mitigate and manage potential audits and disputes.

Binding dispute prevention mechanisms, including bilateral and multilateral advance pricing arrangements, should be considered to mitigate incidence of double taxation related to certain issues such as transfer pricing methods.

Transfer pricing certainty is increasingly important as the new Pillar Two rules sit on top of the current framework. As disputes under Pillar Two arise, US MNEs will be in a much better position if they don't also have to deal with transfer pricing adjustments, which will lead to more disruption.

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