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Pillar 2 Watch Out: Is there a US Sandwich in Your Structure?

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US MNEs should review their org chart to identify US sandwich entities held through foreign entities located in jurisdictions that will have an IIR in effect in 2024. US sandwich entities may lead to significant additional top-up tax exposure and compliance costs, say KPMG practitioners.

As a result of acquisitions, tax planning, or other anomalies, many US-based multinational enterprises (MNEs) have a "US sandwich structure" somewhere in their org chart. A US sandwich structure is where a US-parented group holds a lower-tier US entity or branch (collectively referred to as the "US sandwich entity") through one or more foreign intermediate entities (including a foreign partnership or disregarded entity). Even if the US sandwich entity is insignificant or dormant, the Pillar 2 impact could be quite significant if a foreign intermediate entity is in a jurisdiction with an Income Inclusion Rule ("IIR") in effect for 2024.

The OECD/Inclusive Framework should clarify the Pillar 2 rules to remove the disproportionate impact discussed in this article, but whether and when such clarification may be provided is uncertain. Accordingly, this article is a call to action for US-based MNEs to:

1. Closely review their org chart to identify all US sandwich entities;
2. Determine the Pillar 2 impact of any accelerated compliance obligations and top-up tax exposures; and
3. Evaluate remediation options.

For calendar year companies, these steps should be completed before year-end to avoid a potentially significant cliff effect.

Importantly, even an accidental and insignificant US permanent establishment (PE) can cause a US MNE to go over the cliff and suffer the negative consequences discussed below. For example, an accidental PE could arise from business travelers visiting the US headquarters or from a "work from anywhere" policy. This hair trigger only underlines the need for US MNEs to understand the consequences of a US sandwich

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structure and for the OECD/Inclusive Framework to urgently clarify the Pillar 2 rules to remove such disproportionate and unexpected outcomes.

It is also important to recognize that this is not just a "US issue"; MNEs headquartered in other countries that do not implement an IIR in 2024, which could include China, India and Singapore, will also be affected by this issue.

What Is Pillar 2 Impact of a US Sandwich Structure?

A US MNE that holds a US sandwich entity through a foreign intermediate entity that is subject to an IIR in 2024 faces several unfavorable Pillar 2 impacts, ranging from more compliance, at the very least, to material top-up tax at its worst.

At a minimum, the MNE must calculate the effective tax rate (ETR) for the *entire* US jurisdiction in 2024 under the Transitional Country-By-Country Reporting (CbCR) Safe Harbor (TCbCSH). As currently drafted, the TCbCSH is performed on a jurisdictional basis taking into account the income and taxes of all Constituent Entities (CEs) in a jurisdiction, rather than just those CEs within the scope of a Pillar 2 charging provision (here, the CEs owned through intermediate entities subject to an IIR). While not entirely clear, many US MNEs have assumed that, absent a US sandwich structure, they will not be required to perform a TCbCSH calculation for the US in 2024 because no Pillar 2 charging provision would apply in respect of US income in 2024. A US sandwich structure, however, makes certain that the US MNE will be required to perform the TCbCSH calculation for the US in 2024 and satisfy the related compliance burden, including completing Section 2 of the GloBE Information Return (GIR) dealing with "Jurisdictional Safe Harbors and Exclusions." If the MNE group satisfies the TCbCSH in 2024, the impact of the US sandwich entity appears limited to this compliance burden.

If the US income is not eligible for the TCbCSH in 2024, the impact snowballs. Now, a full Pillar 2 ETR calculation is required for the US in 2024, and the entirety of the GIR will have to be completed with respect to the US income. For large US MNEs, this could entail hundreds of pages of compliance. Further, under the current Model Rules, the Transition Year for the US will be accelerated to 2024 because a jurisdiction's Transition Year is the first year a jurisdiction is within the scope of the full GloBE rules.
If the full Pillar 2 ETR for the US is less than 15%, top-up tax could be owed. This exposure is at least proportionate to the size of the US sandwich entity and, for most US MNEs, will be immaterial. By way of example, assume a US MNE owns a US sandwich entity through a UK intermediate entity and the US fails the TCbCSH in 2024. If total US GloBE Income is $100 and total US Adjusted Covered Taxes are $10, the total US Top-up Tax Amount would be $5. If the US sandwich entity only has $1 of the $100 of US GloBE income, the UK owner would only be required to pay $0.05 of top-up tax under the UK IIR ($5 of US Top-up Tax * ($1 of GloBE Income from US sandwich entity / $100 total US GLoBE Income). The balance ($4.95) goes uncollected on account of the Transitional UTPR Safe Harbor.

The more significant consequence may be that a single US sandwich entity accelerated the Transition Year for the entire US group to 2024. If the US MNE generates material US credit carryforwards in 2024 (be they R&D credits, FTCs, or Corporate Alternative Minimum Tax credits), accelerating the Transition Year in respect of the US could lead to material future top-up tax. The Pillar 2 rules are more favorable in respect of certain attributes that arise before the Transition Year. A prime example of this is deferred taxes related to credit carryforwards. If a credit carryforward is generated before the Transition Year, deferred tax expense (capped at 15%) from using the credit is included in the numerator of the full Pillar 2 ETR calculation in the year the credit is applied to reduce tax, offsetting (at least partially) the reduction to current tax expense. In contrast, using a credit carryforward that was not generated prior to the Transition Year generally will not give rise to deferred tax expense for Pillar 2 purposes, leading to lower ETRs. If the Transition Year for the US had not been accelerated to 2024 (because the US sandwich entity did not exist or because the TCbCSH was met for the US in 2024), credit carryforwards generated in 2024 (and potentially 2025) would have benefited from the favorable transition rules.

In summary, a US sandwich entity leads to, at the very least, more compliance burden. If the TCbCSH is not available, that burden will be amplified (i.e., full Pillar 2 ETR calculation) and there could be material future top-up tax on account of the accelerated Transition Year. Most impacted will be US MNEs that both fail the TCbCSH in the US in 2024 and generate material US credit carryforwards in 2024 and 2025.

Are Remediation Options Available?

Hopefully. First and foremost, affected companies should seek clarification of the Pillar 2 rules. An insignificant sandwich entity, or even just an accidental PE, should not trigger such disproportionate consequences. The authors understand that both the OECD Secretariat and the US Treasury Department are aware of these issues. Future guidance could ameliorate them by providing that an insignificant sandwich entity will not force a full Pillar 2 ETR calculation or accelerate the Transition Year. At a minimum, the jurisdictional approach to determining the Transition Year could be replaced with an entity-by-entity approach that determined the Transition Year based on when top-up tax may first be collected in respect of an entity's income, at least in appropriate fact patterns. Given everything on the OECD's plate, whether such guidance is prioritized or forthcoming at all will depend on the perceived magnitude of the sympathetic cases. Thus, it is critical for MNEs with this issue to engage with Treasury and the OECD.

Another approach that *may* be more in a taxpayer's control is to eliminate the sandwich structure by moving the sandwich entity out from under intermediate entities that are subject to an IIR. If the US sandwich entity is dormant or otherwise has no activities, an alternative solution could be to convert the entity to an LLC, which may make it a "stateless" entity for Pillar 2, rather than one that is considered located in the US. However, to avoid the cliff effect, this restructuring must be completed before an IIR applies to US income, which for calendar year companies means before yearend. Although rarely preferred, sandwich structures often linger in org charts for a reason, tax or otherwise, which may make it impractical and, in some cases, impossible, to eliminate the structure before yearend.

Where Do I Start?

The first step is to thoroughly review the group's org chart to identify all US sandwich entities (and US PEs) held through foreign entities located in jurisdictions that will have an IIR in effect in 2024, including for example Canada, Japan, the UK, and all EU member states. The second step is to determine whether the TCbCSH applies to limit the magnitude of the compliance burden and the potentially disastrous substantive tax impact of accelerating the Transition Year.