Tax Incentives Under a Side-by-Side System

By Brian Jenn

On January 5, 2026, the Organization for Economic Cooperation and Development's (OECD) Inclusive Framework (IF) on base erosion and profit shifting (BEPS) IF at last released guidance implementing the June 2025 G7 agreement regarding the status of the U.S. tax system within the Pillar 2 Framework. Under the side-by-side approach reflected in the G7 statement and the new IF guidance (the "Side-by-Side Guidance")[1], a multinational enterprise (MNE) Group may elect to apply a new Side-by-Side Safe Harbor for taxable years beginning after January 1, 2026, if its ultimate parent entity (UPE) is located in a jurisdiction with a Qualified Side-by-Side Regime. An MNE Group that elects the Side-by-Side Safe Harbor would avoid the application of any under-taxed profts rule (UTPR) or income inclusion rule (IIR) to the income of any member of the MNE Group. An electing MNE Group would not, however, escape the application of qualified domestic minimum top-up taxes (QDMTTs) in jurisdictions where its members operate.

It is of course intended that the U.S. tax system would constitute a Qualified Side-by-Side Regime, and both Treasury officials and Congressional policymakers have generally applauded the Side-by-Side Guidance, which effectively implements the notion of global intangible low-taxed income (GILTI) "coexistence" (or GILTI grandfathering) that the first Trump Administration negotiated for and that was acknowledged in the IF's 2020 Pillar 2 Blueprint. That said, the Side-by-Side Guidance does come with some strings attached, particularly related to how the U.S. and foreign jurisdictions may modify their tax systems to incentivize taxpayer behavior. This column focuses on those strings and what they could mean for the evolution of the international tax system.

Qualified Side-by-Side Regimes

A Qualified Side-by-Side Regime generally must include an eligible domestic tax system and an eligible worldwide tax system. An eligible domestic tax system must include (i) a 20% statutory tax rate (including subnational corporate income taxes) and (ii) a QDMTT or a corporate alternative minimum tax (CAMT). An eligible worldwide tax system must include (i) a comprehensive tax regime applicable to all corporations on foreign income, including both active and passive income and (ii) mechanisms to address BEPS risks. The Side-by-Side

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Guidance indicates that a regime could satisfy the requirement related to BEPS risks by having rules to prevent cross-crediting of foreign tax credits between active and passive income or having rules that effectively create low- and high-tax foreign tax credit baskets.

Both an eligible domestic tax system and an eligible worldwide tax system must also entail no material risk that in-scope MNE Groups headquartered in the jurisdiction will experience effective tax rate (ETR) outcomes below 15%. In particular, with respect to the domestic tax system, there should be no material risk that MNE Groups with their UPE located in the jurisdiction and in-scope of the GloBE Rules, will be subject to an ETR on their domestic operations below 15%. With respect to the worldwide tax system, there must be no material risk that in-scope MNE Groups will be subject to an ETR on their collective foreign operations below 15%. In both cases, satisfaction of this condition is evaluated based on the overall operation of the tax regime and does not preclude ETRs below 15% on some income streams if it is likely that an MNE Group would also have other, more highly taxed income streams.

The IF agreement on the Side-by-Side Safe Harbor does little to dispel questions over the future of Pillar 2.

Although the Side-by-Side Safe Harbor was developed with the United States in mind, there is a process for confirming the qualification of the U.S. tax system as a Qualified Side-by-Side Regime. Upon request by a jurisdiction, the IF will assess that jurisdiction's pre-existing tax regime (the U.S. tax system is the only one) against the eligibility criteria by the end of the first half of 2026. Thus, the U.S. tax system's status as a Qualified Side-by-Side Regime should be confirmed by July 2026. For a jurisdiction that does not currently have a Qualified Side-by-Side Regime but subsequently makes the necessary changes to its tax system, that jurisdiction may request that the IF assess its tax system in 2027 or 2028.

Limitations on the U.S. Tax System

Although tax sovereignty was the U.S. rallying cry for the Side-by-Side system, the Side-by-Side Guidance comes with some strings attached to the U.S. tax system in order to preserve its status as a Qualified Side-by-Side Regime, once initially confirmed. In particular, a jurisdiction with a Qualified Side-by-Side Regime must notify the IF if it "materially amends" its regime.[2] On receiving such a notification, the IF "will consider the best path forward."[3] The Side-by-Side Guidance lists as examples of material changes a reduction in the corporate tax rate, the repeal of a controlled foreign corporation (CFC) tax regime, and the introduction of a new income exclusion, exemption, or preferential regime, as well as a material expansion of the availability of a tax incentive or preferential regime.

The ongoing notification requirement for tax system changes raises questions about the flexibility Congress enjoys to modify the U.S. tax system without jeopardizing its status as a Qualified Side-by-Side Regime. If, for example, Congress were to materially modify the CAMT, or even if Treasury were to exercise its regulatory authority in a taxpayer-favorable way, there may be a need to notify the IF and submit those changes to its judgment, notwithstanding that the CAMT arguably lacks a sound tax policy basis to begin with. Additionally, reductions in the corporate rate—even to the 15% level President Trump had proposed as a candidate—or reductions in the FDII rate, not to mention broader changes to the U.S. tax system, could also raise issues for Qualified Side-by-Side Regime status. Ironically, these kinds of impositions on Congressional prerogative seem similar to—albeit more hypothetical than—the concerns that motivated Congress to propose the Section 899 retaliatory tax, which in turn led to the agreement on the Side-by-Side system.

Limitations on Foreign Tax Systems

One of the primary considerations of the IF in developing the Side-by-Side Guidance was to ensure that the Side-by-Side Safe Harbor does not present the opportunity for BEPS or an un-level playing field. In particular, there is a concern that significant jurisdictions could introduce incentives targeted specifically at MNE Groups that are eligible for the Side-by-Side Safe Harbor, thereby creating disparities that could lead to an unraveling of the Pillar 2 regime as MNE Groups invert to countries with Qualified Side-by-Side Regimes and other countries abandon QDMTTs. With these prospects in mind, the Side-by-Side Guidance includes some new limitations as well as some shots across the bow of countries that might be eager to differentiate themselves through tax incentives.

No CFC Tax Pushdown to QDMTTs

Unlike the top-up tax due under an IIR or UTPR, the top-up tax due under a QDMTT is calculated without any reduction for taxes paid with respect to the QDMTT jurisdiction under a CFC Regime. Although the United States had initially sought to allow jurisdictions to incorporate this CFC tax pushdown feature into their QDMTTs as a matter of tax sovereignty, there were concerns within the IF that QDMTTs would cease functioning as an effective backstop to IIRs and UTPRs in that scenario. Accordingly, the Side-by-Side Guidance provides that "the QDMTT for all MNE Groups must continue to be calculated without the pushdown of taxes on controlled foreign companies or foreign branches."[4] Jurisdictions may still wish to assess the value of having a "qualified" domestic top-up tax *versus* the value to U.S.-based multinationals of CFC tax pushdown, although the other provisions of the Side-by-Side Guidance noted below must also be taken into consideration.

No Conditional or Discriminatory Taxes

In addition to trying to reinforce QDMTTs by prohibiting pushdown of CFC taxes, the Side-by-Side Guidance takes the more far-reaching step of providing that "conditional or discriminatory" taxes imposed by a jurisdiction will not be considered Covered Taxes at all. Although this rule is situated within guidance on "Reinforcing the Effectiveness of QDMTTs," it could be read as broadly applying for purposes of determining whether any tax—not just a tax imposed by a QDMTT jurisdiction—constitutes a Covered Tax. Consequently, if a jurisdiction imposed a levy that does not apply MNE Groups that are eligible for the Side-by-Side Safe Harbor, the amount of that levy paid by MNE Groups with UPEs that are not subject to a Qualified Side-by-Side Regime would not be considered Covered Tax paid by such groups and therefore would not be considered in their global anti-base erosion (GloBE) ETR, potentially resulting in the imposition of top-up tax under an IIR or UTPR. Faced with such a harsh rule, some jurisdictions with disproportionate investment from U.S. MNE Groups, or that would like to attract such groups' investment, may elect to abandon meaningful corporate taxation altogether, or at least at the 15% level targeted under Pillar 2. In any event, the IF indicates in the Side-by-Side Guidance that it will consider further work on how this rule will be consistently applied. Such work might include dealing with situations where some MNE Groups currently enjoy tax incentive agreements that contractually bind the granting foreign government and would not be willing to elect in to an alternative tax regime.

Forthcoming Work on Related Benefits

In addition to the new rules described above, the Side-by-Side Guidance reaffirms the commitment of the IF to developing guidance that "clarifies when benefits provided by a jurisdiction must be treated as a return of tax that reduces Adjusted Covered Taxes, as well as further guidance on the identification of benefits that are related to the implementation of the GMT (Related Benefits)."[5] This statement relates to provisions of the Commentary on the Model Rules that indicate a DMTT or IIR will not be a "qualified" IIR or a QDMTT, respectively, if the enacting jurisdiction introduces benefits that are related to the implementation of the global minimum tax (GMT), referred to as Related Benefits. Although the Commentary only speaks to qualification of the DMTT or IIR, the IF appears to be considering the further step of treating certain kinds of benefits as reducing tax paid, as in the case of Code Sec. 901(i), which reduces taxes considered paid for foreign tax credit purposes by certain subsidies that are determined by reference to the amount of tax paid or the tax base. As in the case of the conditional or discriminatory taxes described above, the rules related to benefits provided by the taxing jurisdiction could have the effect of lowering an MNE Group's jurisdictional GloBE ETR, exposing it to top-up tax. The rules would not, however, be directly relevant to MNE Groups based in the U.S. or another jurisdiction with a Qualified Side-by-Side Regime, and countries catering primarily to such groups could choose to provide benefits to MNE Groups that make the Side-by-Side Safe Harbor election, possibly at the risk of losing the "qualified" status of their domestic top-up tax.

"Stocktake" in 2029

None of the measures described above ensures that countries will not adopt policies that the IF may consider as undermining the GMT. For that reason, the Side-by-Side Guidance indicates that the IF will undertake a "stocktake" pursuant to a process to be concluded by 2029. The stocktake will take into account data on the effect of the GMT and the Side-by-Side system, including the level of implementation of QDMTTs. Particular attention

will be given to "emerging competitive imbalances" and "negative trends in taxpayer behaviors" including inversions or a material increase in profits in low-tax jurisdictions without QDMTTs. Based on the stocktake, and to "facilitate ... the continued operation" of the Side-by-Side system, the IF commits to "take action to address substantial identified risks to the level playing field or BEPS."[6]

Notwithstanding the implied threat looming over the Side-by-Side system—notably set to have effect only following the 2028 U.S. elections—there seems to remain a collective action issue, in that individual countries may find it in their best interest to abandon QDMTTs or provide certain MNE Groups targeted incentives even though doing so could contribute to the adoption of new policies as part of the 2029 stocktake.

Where Goes Pillar 2 from Here?

The IF agreement on the Side-by-Side Safe Harbor does little to dispel questions over the future of Pillar 2. On the one hand, the guidance targets certain possible country reactions—including QDMTT CFC tax pushdown and conditional tax systems—that could be seen as undermining the Pillar 2 Framework, while also holding out the threat of revisiting the entire situation in 2029. On the other hand, countries that wish to cater to MNE Groups that elect the Side-by-Side Safe Harbor may have some openings to do so, particularly if they proceed without fanfare. Although it seems hazardous to guess how this dynamic will play out in the long term, it is also hard to imagine countries simply abandoning tax as a tool for attracting investment in the way that the IF would like.

ENDNOTES

1 Inclusive Framework on BEPS, "Tax Challenges Arising from the Digitalisation of the Economy—Global Anti-Base Erosion Model Rules (Pillar Two), Side-by-Side Package.

2 *Id* at 85.

3 *Id.*

4 Side-by-side guidance, p. 8.

5 *Id* at 74.

6 *Id* at 9.