OECD Releases Pillar Two Guidance Introducing Side-by-Side Exemption for U.S. Multinationals and New Safe Harbors

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On January 5, 2026, the OECD/G20 Inclusive Framework (the "Inclusive Framework") released a package of guidance on the application of the "Pillar Two" global minimum tax rules (the "Guidance"). The Pillar Two regime generally seeks to ensure that large multinational groups ("MNE Groups") are subject to a minimum effective tax rate of 15% on income arising in each jurisdiction in which they operate. The Guidance introduces the much-awaited "side-by-side" regime for U.S.-parented MNE Groups that was announced by a statement of the G7 last June, following the removal by the U.S. Congress of the controversial section 899 "revenge tax" targeting countries that have enacted Pillar Two legislation. The side-by-side safe harbor (the "SbS Safe Harbor"), effective from January 1, 2026, largely eliminates the application of Pillar Two's top-up taxes to U.S.-parented MNE Groups. The other highlights of the Guidance include (i) an Ultimate Parent Entity-based Safe Harbor, (ii) a Substance-Based Tax Incentive Safe Harbor, (iii) a Simplified Effective Tax Rate Safe Harbor and (iv) an extension of the Transitional Country-by-Country Reporting Safe Harbor.

Side-by-Side Safe Harbor

The SbS Safe Harbor turns off Pillar Two's "top-up" taxes for eligible MNE Groups, covering both the "income inclusion rule" (the "IIR") that taxes companies on the income of low-taxed subsidiaries and the "undertaxed profits rule" (the "UTPR") that taxes all group members in UTPR jurisdictions on the income of low-taxed affiliates. The SbS Safe Harbor applies to jurisdictions that have satisfied the Inclusive Framework that their tax systems impose sufficient minimum taxation requirements on domestic and foreign income that Pillar 2 taxation is not required.

As of now, only the United States is listed as qualifying for the SbS Safe Harbor, although additional countries could seek inclusion as long as their tax regime meets the safe harbor requirements and was in place as of January 1, 2026 (taxes enacted after that date may potentially be eligible for exemption in the future).

To qualify for the SbS Safe Harbor, a jurisdiction must have (i) an "eligible domestic tax system" and (ii) an "eligible worldwide tax system" and meet certain other requirements.

An "eligible domestic tax system" is one that has a statutory corporate tax rate of at least 20% and a qualifying domestic minimum top-up tax ("QDMTT") or corporate alternative minimum tax (e.g., the U.S. CAMT regime) imposing at least a 15% tax on book income for large taxpayers. An "eligible worldwide tax system" taxes worldwide income, covering active and passive income of foreign branches and controlled foreign companies regardless of whether income is distributed to the domestic company.

The international tax regime must also have mechanics that address risks targeted by the OECD's Base Erosion and Profit Shifting initiatives, including preventing cross-crediting of taxes between high-taxed active income and low-taxed passive income. For both tests, the Guidance leaves the ability to disqualify a regime if there is a material risk that effective tax rates will be less than 15% in practice. Lower rates of taxation on certain categories of income will not necessarily violate this requirement.

The SbS Safe Harbor applies only to an MNE Group where the ultimate parent entity (the "UPE") is located in a jurisdiction qualifying for the SbS Safe Harbor (but covers all members of the group, wherever located). Non-U.S.-parented groups with a significant U.S. presence will not be eligible for the safe harbor, including any non-U.S. subsidiaries that sit under a U.S. company—at least for now.

Importantly, the SbS Safe Harbor does not disable QDMTTs enacted by countries to ensure a minimum level of taxation for entities in that country. The Guidance requires the UPE jurisdiction to provide a tax credit for subsidiary QDMTTs and prohibits pushdown of parent "controlled foreign corporation taxes" into the calculation of the QDMTT.

MNE Groups eligible for the SbS Safe Harbor will not be fully exempt from Pillar Two's tax reporting obligations but will have simplified reporting that excludes information needed for IIR and UTPR calculations. Eligible MNE Groups will also be required to apply for the SbS Safe Harbor as it will not apply automatically.

Ultimate Parent Entity ("UPE") Safe Harbor

The UPE Safe Harbor is available to an MNE Group if its UPE is located in a jurisdiction that qualifies for the UPE Safe Harbor. In that case, the "top-up" tax for the UPE jurisdiction will be deemed to be zero for purposes of the UTPR rules. In effect, the

UTPR rules will be turned off for the members of the group that are located in the UPE jurisdiction. Importantly, the UPE Safe Harbor does not disable the application of the IIR or the UTPR for the members of the group that are not located in the UPE jurisdiction. As a result, the benefits of the UPE Safe Harbor are more limited than the SbS Safe Harbor. As with the SbS Safe Harbor, the UPE Safe Harbor also does not disable the application of the QDMTTs for the members of the group that are not located in the UPE jurisdiction.

A jurisdiction would qualify for the UPE Safe Harbor if it has satisfied the Inclusive Framework that its tax system is an "eligible domestic tax system" that was in place as of January 1, 2026. As for the SbS Safe Harbor, an "eligible domestic tax system" is one that has a statutory corporate tax rate of at least 20% and a QDMTT or corporate alternative minimum tax imposing at least a 15% tax on book income for large taxpayers. In addition, the tax system must not present a material risk that groups headquartered in such a jurisdiction would be subject to tax at a rate below 15% on their domestic profits.

As of now, no jurisdiction has been recognized as qualifying for the UPE Safe Harbor, although (as for the SbS Safe Harbor) countries could seek inclusion as long as their tax regime meets the safe harbor requirements. The Guidance provides that the Inclusive Framework will assess a jurisdiction's eligibility for the UPE Safe Harbor, upon request, by the end of the first half of 2026. MNE Groups that have UPEs in jurisdictions that might qualify for the UPE Safe Harbor should monitor developments in that area.

As for the SbS Safe Harbor, eligible MNE Groups will be required to elect the benefits of the UPE Safe Harbor, as it will not apply automatically. The UPE Safe Harbor would apply to fiscal years beginning on or after January 1, 2026.

Substance-Based Tax Incentive ("SBTI") Safe Harbor

The SBTI Safe Harbor generally eliminates the "top-up" taxes that would otherwise be attributable to the use of "qualified tax incentives" in a jurisdiction, within certain limits.

This safe harbor is limited to (i) "expenditure-based" tax incentives and (ii) certain "production-based" tax incentives that are linked to substantive activities in a given jurisdiction. An "expenditure-based" tax incentive is a tax relief (such as a tax credit or super deduction) based on a portion of qualifying expenditures incurred. The Guidance lists "research and development" tax incentives as an example. A "production-based" tax incentive is a tax relief based on the amount of production or reduction in by products

(e.g., emissions) during production by the taxpayer. The tax incentives must generally be available to all taxpayers to be eligible for the safe harbor.

Under the SBTI Safe Harbor, the qualified tax incentives give rise to an adjustment to the effective tax rate of the relevant jurisdiction by increasing the "covered taxes"—but they are not included in GloBE income. As such, the treatment of a tax incentive as a qualified tax incentive may be more beneficial than the treatment as a "qualified refundable tax credit" or "marketable transferable tax credit" under the Pillar Two rules.

The benefit of the SBTI Safe Harbor remains subject to limitations, as the increase in "covered taxes" in the relevant jurisdiction is subject to a substance cap tied to the local economic activities. The substance cap that an MNE Group can use is either (i) the greater of 5.5% of the payroll costs or the depreciation and depletion expense in respect of eligible tangible assets or (ii), if a five-year election is made, 1% of the carrying value of eligible tangible assets (other than land and other non-depreciable assets).

Eligible MNE Groups will be required to apply for the SBTI Safe Harbor for a relevant jurisdiction, as it will not apply automatically. The election can be made for fiscal years beginning on or after January 1, 2026.

Simplified Effective Tax Rate ("ETR") Safe Harbor

The Simplified ETR Safe Harbor is designed to offer a permanent method of calculating a jurisdiction's effective tax rate based on consolidated financial statements with only minimal adjustments.

In cases where a "tested jurisdiction" has a "simplified ETR" of 15% or more or has a simplified loss, the "top-up" tax for that jurisdiction can, by election into the safe harbor, be deemed to be zero, and there is no requirement to prepare full Pillar Two calculations. The Simplified ETR Safe Harbor applies to fiscal years beginning on or after December 31, 2026, although jurisdictions can choose to operate it from December 31, 2025.

The simplified ETR is calculated on the basis of income and tax expense using the information in the relevant consolidated financial statements. There are certain compulsory adjustments (e.g., uncertain taxes) and certain optional adjustments (e.g. inclusion of tax credits). The notion of "tested jurisdiction" applies the calculations on a jurisdictional basis, although there are separate calculations for joint venture and minority-owned structures (consistent with the separate treatment of these in the wider Pillar Two Model Rules).

The Simplified ETR Safe Harbor has entry criteria that essentially require that the MNE Group did not have any "top-up" tax liability in the tested jurisdiction in every fiscal year beginning within 24 months before the current fiscal year. This is considered annually so that it is possible to fall outside the safe harbor despite previous eligibility. There are then re-entry criteria.

Despite its name, the Simplified ETR Safe Harbor is likely to result in some complexities since the rules are detailed, and there will almost certainly be questions and issues relevant to specific jurisdictions. Helpfully, the Transitional Country-by-Country Reporting Safe Harbor (upon which the Simplified ETR Safe Harbor is based) is being extended for a year to allow for this.

Looking Forward

The introduction of the SbS Safe Harbor is welcome relief for U.S.-parented MNE Groups, although some of the administrative reporting associated with Pillar Two will continue to apply. It is likely that some jurisdictions other than the United States will seek to qualify for the SbS Safe Harbor or the UPE Safe Harbor in the coming months, so further developments are expected. The relatively broad implementation of QDMTTs across the globe, including jurisdictions that have traditionally been low-taxed jurisdictions, has certainly played a key role towards achieving the policy objectives of Pillar Two thus far.

Looking forward, the Guidance notes that the Inclusive Framework will undertake an assessment by 2029 to review the state of the SbS Safe Harbor and the UPE Safe Harbor and ensure that the objectives of Pillar Two are preserved. As part of that review, the Inclusive Framework commits to take action to remedy risks to the level playing field or BEPS. While the Guidance reflects a significant milestone reflecting remarkable buy-in from the international community, the side by side system ultimately must be reflected in member country legislation, and it is possible that snags or delays in the implementation process could raise international tensions again. This is likely not the end.

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