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Pillar Two: OECD Inclusive Framework global minimum tax model rules

Overview

The G20/OECD Inclusive Framework on BEPS published *Global Anti-Base Erosion Model Rules (Pillar Two)*. The key elements of these Model Rules were agreed upon and described in the *Statement on the components of global tax reform* agreed by more than 135 of its members on October 8, 2021.

On December 20, 2021 the G20/OECD Inclusive Framework on BEPS (the IF) published *Global Anti-Base Erosion Model Rules (Pillar Two)* ("Model Rules"). The key elements of these Model Rules were agreed upon and described in the *Statement on the components of global tax reform* agreed by more than 135 of its members on October 8, 2021.

Since 2017 the 141 member countries of the OECD Inclusive Framework have developed a "two-pillar" approach to address the tax challenges arising from the digitalization of the economy: addressing nexus and profit allocation challenges ("Pillar One") and the global minimum tax rules released this week as Model Rules ("Pillar Two").

Pillar Two consists of two interlocking domestic rules that together make up the Global Anti-Base Erosion (GloBE) regime:

1. An Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of the low-taxed income of a member of its MNE group (a constituent entity); and
2. An Undertaxed Payments Rule (UTPR), which denies deductions or requires an equivalent adjustment to the extent the low-tax income of a constituent entity is not subject to tax under an IIR.

The GloBE rules have the status of a "common approach" among IF members. That is, countries are not required to adopt the GloBE rules, but if they choose to do so, they agree to implement and administer the rules in a way that is consistent with the outcomes provided for under Pillar Two in light of these Model Rules and any subsequent guidance agreed by the IF. The OECD is expected to release detailed commentaries to these Model Rules in early 2022, with intended implementation of the rules by IF members in 2023.

It is expected that the European Commission will issue a draft directive for EU Member States to implement these rules in 2023 later this week.

Income inclusion rule and undertaxed payments rule: The IIR and its "backstop," the UTPR, are designed to ensure that large multinational groups pay corporate income taxes at a minimum level of 15% in every country in which they operate. The model rules consist of chapters on:

- Scope
- Income inclusion rule and undertaxed payments rule
- Computation of "GloBE income or loss" (tax base)
- Computation of "adjusted covered taxes"
- Computation of effective tax rates and top-up tax
- Corporate restructurings and holding structures
- Tax neutrality and distribution regimes
- Administration
- Transition rules
- Definitions

Scope

Large multinational groups with annual consolidated group revenue of at least EUR 750 million in at least two of the four immediately preceding fiscal years are in scope of the rules.

Limited exclusions apply for investment funds/real estate investment vehicles (that are ultimate parent companies), pension funds, governmental entities, international organizations, and non-profit organizations. The rules can apply to subgroups controlled by such excluded entities.

Income inclusion rule (main rule)

The IIR applies on a top-down basis such that in most cases any tax due is calculated and paid by the ultimate parent company to the tax authority in its country. The tax due is the "top-up" amount required to bring the overall tax on the GloBE Income in each country where the group operates up to the minimum effective tax rate of 15%.

There are special rules for situations in which the ultimate parent company is in a country that has not implemented the income inclusion rule, but there are intermediate holding companies that are in another country, as well as special rules to take into account certain situations in which there are minority interests.

Undertaxed payments rule (secondary rule)

The UTPR applies as a secondary (backstop) rule in cases where the effective tax rate in a country is below the minimum rate of 15% but the IIR has not been fully applied. *The UTPR can also apply to low-taxed GloBE Income in the ultimate parent country, even if that parent country has adopted the IIR.*

For US-parented MNEs in scope, there remains the issue of whether US GILTI will be treated as a qualifying income inclusion rule. If it is treated as a qualifying IIR, then the UTPR will not apply to the low-taxed GloBE Income of the subsidiaries of US in-scope MNEs but could still apply to low-taxed GloBE Income in the US if the effective rate with respect to US operations is less than the minimum rate of 15% as determined under the special GloBE rules described in more detail below.

To date there has been no agreement as to whether GILTI will qualify as an IIR under these rules. Current expectations are that if Congress were to raise the US GILTI rate to at least 15% (to be calculated on a country-by-country basis)

then US GILTI would be respected as a qualifying IIR by countries adopting the GloBE. If, however, Congress fails to do so, other countries might refuse to treat US GILTI as a qualifying IIR.

Under the UTPR, the top-up tax is allocated to countries that have adopted the UTPR based on a formula that takes into account both the number of employees and the net book value of tangible assets in a UTPR country compared to the total number of employees and net book value of tangible assets in all UTPR countries.

The top-up tax under the UTPR is implemented either by denial of a deduction for payments or by making an equivalent adjustment under domestic law.

Groups that are newly expanding internationally are exempt from paying top-up tax under the UTPR for up to five years. Such groups must have entities in no more than six countries and the net book value of their "international" tangible assets must not exceed EUR 50 million (excluding tangible assets in the country with the most tangible assets).

Calculating the effective tax rate

The rules apply on a jurisdictional-blending basis. The annual effective tax rate (ETR) calculation required for each country takes into account the total covered taxes, profits, and losses attributable to all of the group companies ("constituent entities") in that country, as calculated under specific Pillar Two rules.

A group can elect to apply a de minimis exclusion for countries with GloBE revenues of less than EUR 10 million and GloBE Income of less than EUR 1 million (as calculated under the Model Rules and based on the average of the current and two previous fiscal years).

Computation of "GloBE income or loss" (tax base)

The starting point for the tax base is the accounting net income (or loss) of each constituent entity as used in the preparation of the ultimate parent company's consolidated financial statements (before any consolidation adjustments eliminating intragroup transactions) subject to a variety of adjustments described in the Model Rules.

A number of elections may be made, including to substitute the tax deduction available locally for share-based (stock-based) compensation for the amount expensed in financial accounts.

Transfer pricing adjustments are required where amounts recorded in the financial accounts are not consistent with the arm's length principle.

International shipping income is excluded from the tax base due to the global prevalence of tonnage tax regimes that are not based on profits.

There are also specific adjustments for financial services businesses, such as where an insurance company pays taxes on behalf of a policyholder; in respect of timing differences for insurance reserves and deferred acquisition costs; and to provide for the deductibility and taxation of distributions in respect of Additional Tier 1 Capital for regulated banking businesses.

Computation of "adjusted covered taxes"

The starting point to calculate the "adjusted covered taxes" is the current tax expense accrued in the constituent entity's net income (or loss), as used in the preparation of the parent company's consolidated financial statements

(before any consolidation adjustments eliminating intragroup transactions). Adjustments are then required in order to reduce the effects of temporary differences on the volatility of effective tax rates. These adjustments differ from the normal tax accounting rules with respect to deferred tax assets and liabilities in several important respects, including the rate at which they are recorded, as more fully described in the Model Rules.

Substance-based income exclusion

A substance-based income exclusion rule reduces the amount of profit from the calculation of additional top-up taxes due; this reduction is intended to represent a fixed return for substantive activities.

The carve-out has two components:

1. A payroll component equal to a 5% mark-up on eligible payroll costs (including salaries, health insurance, pension contributions, employment taxes and employer social security contributions) of eligible employees (including independent contractors) performing activities in the country; and
2. A tangible asset component equal to a 5% mark-up applied to the carrying value of eligible tangible assets located in the country, including property, plant and equipment and natural resources.

A transition period applies during the first ten years of the rules, during which 8% of the carrying value of tangible assets and 10% of payroll is initially excluded, declining gradually over the period to 5% for each in 2033.

Computation of effective tax rate and top-up tax

The effective tax rate of each country is calculated by aggregating the tax base and adjusted covered taxes for all constituent entities in the same country. The top-up tax percentage is the difference between the effective tax rate in the country and the 15% minimum rate.

Countries that adopt the rules are not required to introduce domestic top-up taxes on their own resident taxpayers but may choose to do so. Any such domestic minimum top-up tax paid to the local tax authority and calculated in an equivalent manner to the Model Rules reduces the amount of top-up tax payable in respect of the low-tax country (as long as the country does not provide “any related benefits”).

The remaining top-up tax is assigned to individual constituent entities in the low-tax country in proportion to their net income as calculated under the Model rules, in order to determine the top-up tax amounts payable by parent entities.

Other components of the rules

Additional rules are also set out in respect of corporate restructurings, including mergers, demergers, group members joining and leaving a group, and transfers of assets and liabilities.

Specific rules apply to permanent establishments, tax transparent entities, stateless entities, investment entities, investment funds/real estate investment vehicles, joint ventures, multi-parented (including dual listed) groups, cooperatives, and minority-owned entities, as well as in respect of deductible dividend and distribution regimes.

Transition rules

The Model Rules contain a variety of transition rules including a rule to the effect that deferred tax assets/liabilities in respect of acquired assets (other than inventory) transferred between constituent entities after November 30, 2021 and before the group is within the scope of the rules are based on the disposing entity's carrying value. This could have special implications for US-parented MNEs that repatriate intangible property to the United States.

Compliance and administration

The OECD will develop a "GloBE Implementation Framework" consisting of administrative rules, guidance, and procedures to facilitate coordinated implementation of the Model Rules. Businesses will be required to prepare a "GloBE information return" with respect to each GloBE participating jurisdiction; this information return will include a variety of information including all information necessary to compute the effective tax rate for each country and the top-up tax of each group member, as well as the allocation of top-up tax to each country.

The ultimate parent company (or an appointed group member) will file the return with its local tax authority, which will then exchange the agreement with other tax authorities where a qualifying competent authority agreement is in place.

Safe harbours may be considered to reduce the number of countries for which detailed ETR calculations are required. The design of any safe harbours will be included in the GloBE Implementation Framework, if agreed.

Next steps

The Model Rules will be supplemented by commentary that is expected to be released in early 2022. A public consultation event in February 2022 will focus on the particular issues that will be relevant for the development of the GloBE Implementation Framework. The Implementation Framework for administration, compliance, and co-ordination will follow by the end of 2022. The OECD will also address co-existence with the US Global Intangible Low-Taxed Income (GILTI) rules in early 2022. The IIR is expected to take effect from 2023. The Inclusive Framework Statement of October 2021 stated that the UTPR would be deferred by one year to 2024.

The model treaty article for a subject-to-tax rule will be released in early 2022, along with a multilateral instrument for its implementation. A public consultation event will be held in March 2022.

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