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Tax Insights

OECD releases Pillar Two administrative guidance

Snapshot

On 2 February 2023, the OECD/G20 Inclusive Framework on BEPS (inclusive framework) released a package of technical and administrative guidance ("administrative guidance") related to the 15% global minimum tax on multinational corporations known as Pillar Two (or the global anti-base erosion ("GloBE") rules). The guidance was agreed by consensus of all 142 countries and jurisdictions in the OECD/G20 inclusive framework and forms part of the "common approach." Under the common approach, 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 the Pillar Two model rules and any subsequent guidance agreed by the inclusive framework.

The publication of the administrative guidance follows the release of the Pillar Two model rules in December 2021 and commentary in March 2022, as well as rules for safe harbours and penalty relief released in December 2022. The newly released administrative guidance will be incorporated into a revised version of the commentary that is expected to be released later in 2023.

Pillar Two consists of two interlocking domestic rules that together make up the GloBE regime:

a) An income inclusion rule (IIR), which imposes a top-up tax on a parent entity in respect of the low-taxed income of a member of its multinational entity (MNE) group (a constituent entity); and

b) An undertaxed profits 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.

Countries also have the option to adopt a "qualified domestic minimum top-up tax" (QDMTT) as defined in the model rules and further clarified in this administrative guidance.

The administrative guidance covers over two dozen topics, addressing those issues that members of the inclusive framework identified as most pressing. The guidance includes topics relating to the scope of companies that will be subject to the GloBE rules, the method for allocating global intangible low-taxed income (GILTI) among the subsidiaries of a US MNE for purposes of determining their effective rates under the GloBE rules, transition rules that will apply in the years before the global minimum tax applies, and guidance on QDMTTs that countries may choose to adopt.

The administrative guidance consists of five chapters:

- Chapter 1: Scope
- Chapter 2: Income & taxes
- Chapter 3: Application of GloBE Rules to insurance companies
- Chapter 4: Transition
- Chapter 5: Qualified Domestic Minimum Top-up Taxes

Scope

The GloBE rules apply to MNE groups that consolidate on the parent entity's financial statements. The definition of "consolidated financial statements" in the model rules includes financial statements that an entity would prepare if it were required to prepare such statements.

The administrative guidance clarifies the scope of the "deemed consolidation" test provided in the GloBE rules. Specifically, the guidance provides that the deemed consolidation rule applies when an entity does not prepare financial statements under an authorised financial accounting standard because there is no statute or regulation that requires it to prepare consolidated financial statements in accordance with an authorised accounting standard (e.g., a privately held corporation). The deemed consolidation rule applies to treat a group as a consolidated group if:

a) The parent entity were required to prepare financial statements under law or regulations; and

b) The applicable accounting standard required consolidation.

Notably, the rule does not deem a group to consolidate where entities are not required to consolidate under the authorised accounting standard. As explained in the administrative guidance, "the test does not change the content of the accounting standard but rather asks whether a consolidation group would have existed if the application of the standard was compulsory." The guidance specifically mentions entities that are treated as investment entities under the authorised accounting standard and that record their investments at fair value as an instance where the deemed consolidation rule will not apply, because the authorised accounting standard does not require consolidation of the investments on a line-by-line basis in this situation.

The additions to the commentaries on the scope of the GloBE rules also address ancillary technical issues such as currency conversion and when certain entities may be treated as excluded entities.

Income and taxes

The administrative guidance addresses several issues relating to GloBE income or loss and covered taxes, many of which are particularly relevant to US MNEs:

- Clarification on the treatment of GILTI:
    - The guidance confirms GILTI is a CFC tax that is allocated to one or more CFC jurisdictions.
    - The guidance provides an allocation formula for GILTI and other "blended CFC tax regimes" whereby the CFC tax is allocated to low-tax entities based on the difference between that jurisdiction's effective tax rate (ETR) under the GloBE rules and the CFC tax rate (i.e., 13.125% for GILTI), and the amount of income as determined under the CFC regime (i.e., tested income in the case of GILTI) earned in that entity. This rule applies through 2025 (for calendar-year groups), at which point the inclusive framework will assess whether to allow a special allocation method for blended CFC tax regimes.
    - GILTI and other CFC taxes, including subpart F, are not taken into account under a QDMTT.
- The guidance addresses an issue under US GAAP for sales of assets between group members. Regardless of how the group accounts for such transfers, for GloBE purposes the selling entity determines its gain or loss on an arm's length basis. The administrative guidance, however, does not expressly address the carrying value of the transferred asset for GloBE purposes in the hands of the acquiring entity. Rather, the administrative guidance notes that further guidance may address the potential for double taxation.
- A new "substitute loss carry-forward DTA [deferred tax asset]" addresses foreign tax credit carry forwards from years where credits cannot be utilised because of a domestic loss that offsets controlled foreign corporation (CFC) income, such as can occur in the case of an overall domestic loss and subsequent recapture under US Internal Revenue Code section 904(g).
- A new election adds back "qualified flow-through tax benefits of qualified ownership interests," which is intended to address tax benefits that are derived from certain equity structures, such as the low-income housing tax credit and certain other "green" credits in the US, including those that were included in the Inflation Reduction Act enacted in 2022. Under this regime, tax credits and other tax benefits derived from certain flow-through entities are removed from the owner's covered taxes, up to the amount of the owner's investment in the entity.

Transition rules

The guidance resolves the ambiguity around DTAs associated with credit carry forwards that arises because of an apparent tension between articles 9.1.1 and 4.4.1(e).

- Article 9.1.1 states that, generally, DTAs that exist before the GloBE rules come into effect are taken into account once the rules apply (subject to a 15% limitation).
- Article 4.4.1(e), however, provides that any DTA associated with tax credit carry forwards is excluded from adjusted covered taxes.

The guidance states that all DTAs (disregarding the impact of valuation allowances and accounting recognition adjustments) are taken into account under article 9.1.1 and thus can be utilised to increase covered taxes in post-effective date GloBE years (including those DTAs relating to credits), other than any DTAs subject to articles 9.1.2 and 9.1.3. A special formula is provided for applying the 15% limitation to DTAs arising from credit carry forwards.

The guidance also clarifies various aspects of the article 9.1.3 transition rule. Under article 9.1.3, if a constituent entity transfers assets (other than inventory) to another constituent entity of the same MNE

group after 30 November 2021 and before the commencement of a transition year (the pre-GloBE period), the transferee will determine its basis (GloBE carrying value) based on the carrying value of the transferor and determine any DTAs arising from that transfer on that basis. The policy intention of article 9.1.3 is to disallow either a carrying-value step-up or the creation of a DTA, either of which would permit a taxpayer to receive a tax benefit in the post-GloBE period with respect to a transaction in the pre-GloBE period that was taxed below the minimum rate.

- For example, where the income on the transfer in the pre-GloBE period is not taxed, under article 9.1.3 the transferee entity may neither:

  a) take a stepped-up carrying value in the transferred asset for GloBE purposes that otherwise would have permitted the acquiring entity to reduce post-GloBE income through increased depreciation or amortisation; nor

  b) create a DTA in the acquiring entity that could then be carried into the post-effective date period and achieve the same effect by creating a tax expense in post-GloBE years, as the DTA would be reversed.

- However, to the extent tax was paid on the transfer, either by the selling entity, a local consolidated group, or by another constituent entity under the principles of article 4.3 (e.g., CFC taxes and taxes on permanent establishment income), the buyer may establish a DTA following the sale in such cases based on the amount of tax paid, subject to the 15% limitation under article 9.1.1.

- The term "transfer" is interpreted broadly to include any transaction that has a similar effect to a transfer, including fully paid-up leases/licenses, sales of controlling interests, prepayments of royalties, total return swaps, and migrations between jurisdictions that result in basis step-ups.

Qualified Domestic Minimum Top-up Taxes (QDMTTs)

A QDMTT need not follow the detailed rules applicable to the IIR and the UTPR described in the model rules and related commentary, but a QDMTT must be implemented and administered in a way that is consistent with the outcomes provided for under the GloBE rules. The administrative guidance contains further guidance on QDMTTs to assist tax administrations in determining whether a minimum tax will be respected as a QDMTT. Specifically, with respect to each chapter of the model rules, the administrative guidance identifies the degree to which a QDMTT must conform to or can vary from the requirements of such chapter. For example, whereas only companies with more than EUR 750 million (approx. AUD 1.1 billion) of turnover are in scope under the model rules, a QDMTT can apply to companies with less revenue, but the threshold cannot be set above EUR 750 million (approx. AUD 1.1 billion).

Several rules with respect to QDMTTs are worthy of note:

- Article 4.3.2(c) of the model rules provides that covered taxes included in the financial accounts of a constituent entity's direct or indirect constituent entity-owners under a CFC tax regime are allocated to the constituent entity that earned the income giving rise to the CFC inclusion. This rule is turned off for purposes of the QDMTT, with the effect that the QDMTT jurisdiction has the primary right to tax income under the QDMTT arising in its jurisdiction.

  From an Australian perspective this may result in two sets of rules – CFC taxation and a QDMTT – applying in tandem to Australian taxpayers that are subject to CFC tax. Whilst it could be expected that any QDMTT paid should be creditable against a CFC liability this will require close attention in the legislative drafting phase as a consequential amendment, and may impact an Australian taxpayers' franking profile.

- A QDMTT should contain safe harbours that align with the safe harbours agreed under the GloBE rules, including the transitional CbC safe harbours contained in the December 2022 guidance.

- A QDMTT need not contain a "substance-based income exclusion" (SBIE) based on payroll and assets in a jurisdiction but, if it does include one, it cannot be more generous (but can be less generous) than the SBIE in the model rules.

Under the model rules, a QDMTT results in a credit against either an IIR or a UTPR. In certain circumstances a credit resulting from the application of the QDMTT may eliminate any further top-up tax under an IIR or a UTPR. That may not always be the case, due in part, for example, to the fact that a QDMTT may be determined by reference to a local financial accounting standard, as opposed to the financial accounting standard of the ultimate parent entity. The administrative guidance explains that the inclusive framework will undertake further work on developing a QDMTT safe harbour, the effect of which would be to eliminate any residual IIR or UTPR when the QDMTT safe harbour applies.

Looking ahead

Jurisdictions around the world are moving forward with the adoption of Pillar Two.

Most notably, South Korea has passed legislation implementing Pillar Two beginning in 2024.

The EU unanimously approved a directive in December 2022 that requires member states to transpose Pillar Two into domestic law by the end of 2023, with an effective date of 2024 for the IIR and 2025 for the UTPR.

The UK also has proposed legislation to take effect on the same timeline.

In October 2022, the Australian Government released a consultation paper to seek views on how Australia can best engage with the two-pillar solution, including the Pillar Two Model Rules and Commentary. It is expected that draft legislation will be released during 2023 for consultation.

Other countries have announced intention to follow suit. Taxpayers should prepare by analysing whether they may have substantive tax liabilities under the new rules and how they will comply with these new obligations around the world.

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