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Tax Insights

Pillar Two: OECD releases further materials

Snapshot

On 17 July 2023, the OECD released new guidance regarding the OECD/G20 Two Pillar Solution. This coincides with the G20 Finance ministers meeting and the OECD Secretary General's Tax report.

The pieces of guidance on Pillar Two are:

- Further Pillar Two Administrative Guidance (Administrative Guidance);
- Revised GloBE Information return (GIR); and
- Subject to tax Rule provisions (STTR).

A public consultation document on Pillar One Amount B (Amount B consultation) was also released, relating to the baseline wholesale distributors. More to follow on this consultation in an Australian context.

Key takeaways for Australian entities in relation to Pillar Two

- With no draft legislation yet available this guidance is the most up to date framework by which groups in scope can assess the potential impacts of the rules which are set to commence for income years beginning from 1 January 2024. Given the extensive nature of the enquiries required to comply with the rules, which will include a domestic minimum tax in Australia, the guidance is useful in providing some clarity on unresolved interpretational issues as well as the expected final form of the GloBE Information Return which will need to be disclosed 18 months after the first year of application.

- The updated GIR contains over 30 pages of data points to be completed at an entity and jurisdictional level for all entities that are consolidated in the accounts of the parent. However, this updated GIR contains a 5 year transition period for jurisdictions that do not have a top up tax payable which should significantly reduce (but not eliminate) the degree of disclosures required. The GIR remains a significant compliance burden and will be required regardless of whether top up tax is payable and there is no de minimis exemption. Australian headquartered groups with relatively small offshore footprints could still be impacted for example.

- The guidance on design options for a 'Qualified Domestic Minimum Top-up Tax' (QDMTT) are important. The permitted choices for allocation of taxes between jurisdictions and sharing of top up tax liabilities will be a key consideration for Australia as our QDMTT is designed.

- For groups with material tax credits the Pillar Two rules can pose a significant change in tax effect. A chapter in the guidance is dedicated to dealing with marketable and transferrable tax credits which are of particular importance to groups with US entities. This guidance follows the prior February 2023 guidance that clarified the position for carry forward credits which can be relevant in the Australian R&D space.

- Guidance on currency conversion indicates that groups that do not currently maintain a system of translation to presentational currency with sufficient granularity will nevertheless be required to undertake Pillar Two calculations in the presentational currency. This highlights the potentially significant compliance exercise ahead of many Australian groups in scope of these rules.

Impacted entities are multinational groups with global consolidated turnover of EUR 750 million and above. Australian multinationals in scope will also be subject to the Australian QDMTT. These rules apply from income years from 1 January 2024, although Australia has yet to release draft legislation giving effect to this policy announcement.

Components of the Pillar Two rules

The OECD model rules apply to large multinational groups with annual consolidated group revenue of at least EUR 750 million and have the following key components:

- An income inclusion rule (IIR) applies on a top-down basis such that tax due is (in most cases) calculated and paid by the ultimate parent entity to the tax authority in its country. The tax due is the "top-up" amount needed to bring the overall tax on the profits in each country where the group operates up to the minimum effective tax rate of 15%.

- The undertaxed profits rule (UTPR, sometimes referenced as the undertaxed payments rule) will apply as a secondary (backstop) rule in cases where the effective tax rate in a country is below the minimum rate of 15%, but the income inclusion rule has not been fully applied. The top-up tax is allocated to countries which have adopted the undertaxed profits rule based on a formula, and is to be implemented by countries either by denial of a deduction for payments or by making an equivalent adjustment.

- The OECD model rules also allow for countries to introduce a qualified domestic minimum top-up tax (QDMTT) aligned with Pillar Two. Under a QDMTT, top-up taxes in respect of any low-taxed profits of a group's entities in that country are payable domestically, rather than to other countries under the income inclusion or undertaxed profits rules.

The Pillar Two framework also includes a standalone subject to tax rule (STTR), a model treaty provision to allow developing countries to impose limited additional taxation on some cross-border payments between connected companies where the recipient is subject to a nominal corporate income tax rate below 9%. The STTR takes priority over the IIR, UTPR, and QDMTT, and any STTR amounts paid are intended to be creditable under those rules.

Additional safe harbors

Agreement has been reached on two additional "safe harbors."

Under a transitional UTPR safe harbor, no top-up tax will be payable under the UTPR in respect of any undertaxed profits of a business in its ultimate parent entity country if that country applies a nominal statutory corporate income tax rate of at least 20%. This is a temporary safe harbor and will defer the application of the UTPR to such profits until 2026 (i.e., for years beginning on or before 31 December 2025).

A permanent QDMTT safe harbor will allow businesses to elect to prepare a single QDMTT computation for a country. Where the safe harbor applies, no additional top-up tax will arise under the IIR or UTPR. Although QDMTTs must be consistent with the OECD model rules, some design features may vary.

In order for the QDMTT safe harbor to apply, the domestic minimum tax must not only be "qualified," but the domestic legislation must also meet an additional set of safe harbor standards. QDMTT calculations are to be prepared using the accounting standard of the consolidated financial statements of the ultimate parent entity (in line with the OECD model rules, and unless it is not reasonably practicable to do so). Alternatively, QDMTT countries can require businesses to use the local financial accounting standard if specified conditions are met, including that all constituent entities located in the country prepare financial accounts based on the local standard. Businesses will not have the option of choosing which accounting standard to use. QDMTT computations must also be consistent with the computations required under the OECD model rules subject to required/specified permitted variations.

Where a business has elected to apply the QDMTT safe harbor for a country, it will still be required to complete the relevant sections of the information return, but will do so using the calculations undertaken for QDMTT purposes.

These safe harbors will be available in addition to the existing transitional country-by-country reporting (CbC) safe harbor.

Additional administrative guidance

Further administrative guidance, including examples, has been released to clarify the interpretation and operation of the OECD model rules.

Guidance has been provided in respect of currency conversion, including:

- Pillar Two calculations and the information return should generally be prepared using the presentational currency of the ultimate parent entity's consolidated financial statements. Any amounts required to prepare the Pillar Two calculations that are not already translated into this currency should be translated based on the foreign currency translation rules of the relevant accounting standard used to prepare the consolidated financial statements.

- Countries can determine their own translation rules to convert the amount calculated in the information return to the currency in which the top-up tax will be paid.

- Pillar Two thresholds (including the EUR 750 million revenue threshold for applying the rules) expressed in a country's domestic legislation in a non-EUR currency, will be rebased annually using the average foreign exchange rate for the December month of the previous fiscal year.

Additional guidance has been issued in respect of the treatment of tax credits. Qualified refundable tax credits are considered to be broadly equivalent to government grants and therefore treated as income under the Pillar Two rules, provided the credits are refundable (i.e., payable as cash or cash equivalent) within four years. "Marketable transferable tax credits" (broadly, tax credits which can be transferred to an unrelated party and meet specific legal transferability and marketability criteria) are considered to have similar features and will also be treated as income, irrespective of whether they are refundable. Other tax credits that do not meet the criteria to be qualified refundable tax credits or marketable transferable tax credits will be treated as reducing tax. Additional guidance has also been issued in respect of "qualified flow through tax benefits," including an alternative timing rule based on proportional amortization accounting.

Further guidance has been provided in respect of the substance-based income exclusion, including in respect of "eligible employees" and "eligible tangible assets" who/that spend time outside of the country of the constituent entity which is the employer/asset owner. A threshold test will apply such that the full payroll/tangible asset carve-out can be claimed if the employee/asset spends more than 50% of the time in the location of the constituent entity. Where 50% or less of the time is spent in the location, the constituent entity will only be entitled to claim a share of the carve-out amount in proportion to the time spent in the location. Additional guidance has been provided on a number of other areas, including confirmation that businesses do not have to claim the maximum allowable amount, e.g., if substantial compliance work would be needed.

Additional guidance has been issued in respect of QDMTTs, including in respect of the application of the rules to specific types of entities (e.g., joint ventures, minority-owned constituent entities, stateless constituent entities, flow through entities). Although there is no requirement for QDMTT countries to use the information return for domestic QDMTT reporting purposes, countries can choose to do so.

Information return

Following an earlier public consultation launched in December 2022, the OECD inclusive framework has developed the standardized information return to be filed by businesses within the scope of the OECD model rules. The information return will include a comprehensive set of data points required for a tax authority to evaluate the correctness of a business's calculation of its top-up tax liabilities in each country. The information return includes sections on: the business in general, including a summary table with a high-level overview of the application of the rules in each country, e.g., stating the range in which the effective tax rate and amount of top-up tax payable falls; the corporate structure; application of jurisdictional safe harbors and exclusions; detailed calculations of amounts of Pillar Two income and losses, adjusted covered taxes, and effective tax rates; and the allocation of top-up tax liabilities.

The information return framework includes a "transitional simplified jurisdictional reporting framework" that will apply to the first five reporting years of the regime (i.e., returns for fiscal years beginning on or before 31 December 2028). Where the conditions are met, a business can elect to report the majority of the required data for a country on a net/aggregated basis, rather than for each constituent entity. This transitional simplification is available for countries where no top-up tax liability arises, or where a top-up tax liability does arise but does not need to be allocated to individual constituent entities (e.g., because all top-up tax arising in respect of that country would be payable under the IIR of the ultimate parent entity country). Businesses that elect to report jurisdictional data are expected to have an accounting system that facilitates a jurisdictional approach. Countries have the option in certain circumstances to not apply simplified jurisdictional reporting in their QDMTTs. The OECD inclusive framework will consider whether any such simplifications could apply on a permanent basis.

The deadline for filing an information return is 15 months after the fiscal year end, extended to 18 months for the first year in which a group is in scope. An information return will typically be filed centrally with the tax authority of the business's ultimate parent entity. Sections of the information return will then be shared with tax authorities of countries in which the business has constituent entities. Countries with top-up taxing rights, including under a QDMTT, will be provided with the parts of the information return that relate to the detailed computation of the relevant top-up tax amounts. Other countries will receive the information return's general information and corporate structure sections. In situations where the centralized filing mechanism does not apply, e.g., in the absence of a qualified information exchange agreement between two tax authorities, any resulting local filing obligations will be limited to the same information the local tax authority would have received through the centralized filing mechanism.

The OECD inclusive framework is exploring the possibility of developing other administrative mechanisms to facilitate further coordination and consistent application of the global minimum tax rules, e.g., a coordinated framework for further information requests and coordinated risk assessment activities.

Subject to tax rule

The OECD inclusive framework has released the model articles and commentary for the treaty-based STTR for some intragroup payments.

Where the STTR is included in a double tax treaty, the payment country will be permitted to charge tax on gross amounts of payments if the income is subject to tax in the recipient's country at a nominal tax rate below 9%. (The nominal rate is the statutory tax rate applicable to the type of income received, as amended by any "preferential adjustments," e.g., a full or partial exemption or exclusion from income.) This additional taxing right will be limited to the difference between the 9% STTR minimum rate and the nominal tax rate, less any existing taxing rights of the source country, e.g., withholding taxes.

Inclusive framework countries that apply nominal corporate income tax rates below 9% have made a political commitment to implement the STTR into their double tax treaties with developing country members when requested to do so. Developing countries are defined as those with a gross national income per capita in 2019 of USD 12,535 or less.

The STTR applies to the following types of payments: interest, royalties, payments for distribution rights, insurance or reinsurance premiums, financing fees, rent for the use of equipment, and payments for services. Other than in respect of interest and royalties, the STTR does not apply if the income in the hands of the recipient does not exceed costs incurred plus an 8.5% mark-up threshold. The rules do not apply where the income is paid by an individual, or is received by an individual or certain defined classes of entities such as pension funds or non-profit organizations.

The STTR applies to payments between connected parties (defined based on whether there is common control, or alternatively common direct or indirect participation of more than 50%). A targeted anti-avoidance rule will prevent the use of intermediaries to avoid the STTR.

Tax will be assessed annually following the end of each fiscal year (an "ex-post annualized charge") and will apply if the aggregate amount of payments made by the group from one country to the group in the other country exceeds a materiality threshold (EUR 250,000 per annum for countries with a GDP of less than EUR 40 billion, and EUR 1 million otherwise).

Next steps

Many countries are in the process of implementing the OECD model rules in their domestic legislation and the IIR and QDMTTs will begin to apply from 2024 in some countries, with the UTPR expected to apply no earlier than 2025.

The additional administrative guidance on the IIR, UTPR, and QDMTT will be incorporated into a revised version of the commentary to the OECD model rules that will be released later in 2023. The OECD will continue to release further agreed guidance on an ongoing basis.

A framework of qualifying (bilateral or multilateral) competent authority agreements, and IT-solutions to support the exchange of information returns between tax authorities, including a dedicated XML schema, is being developed by the OECD.

A multilateral instrument will be available to facilitate the implementation of the STTR within relevant existing double tax treaties. This will be open for signature from 2 October 2023. Alternatively, the STTR can be implemented into treaties individually through bilateral negotiations.

Pillar Two remains a complex set of rules looking at countries' tax regimes and incentives, and their interactions with each other. The OECD inclusive framework will continue to address the remaining open technical, compliance, and implementation issues.

If you wish to discuss Pillar Two we encourage you to reach out to our specialists to have a conversation about how Deloitte can help you prepare.

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Contacts

Amelia Teng

Partner

Tel: +61 3 8486 1118

amteng@deloitte.com.au

David Letos

Partner

Tel: +61 3 9671 6734

dletos@deloitte.com.au

Cameron Harris

Director

Tel: +61 2 9322 7651

charris@deloitte.com.au

Drew Ng

Director

Tel: + 61 3 9671 8061

drng@deloitte.com.au