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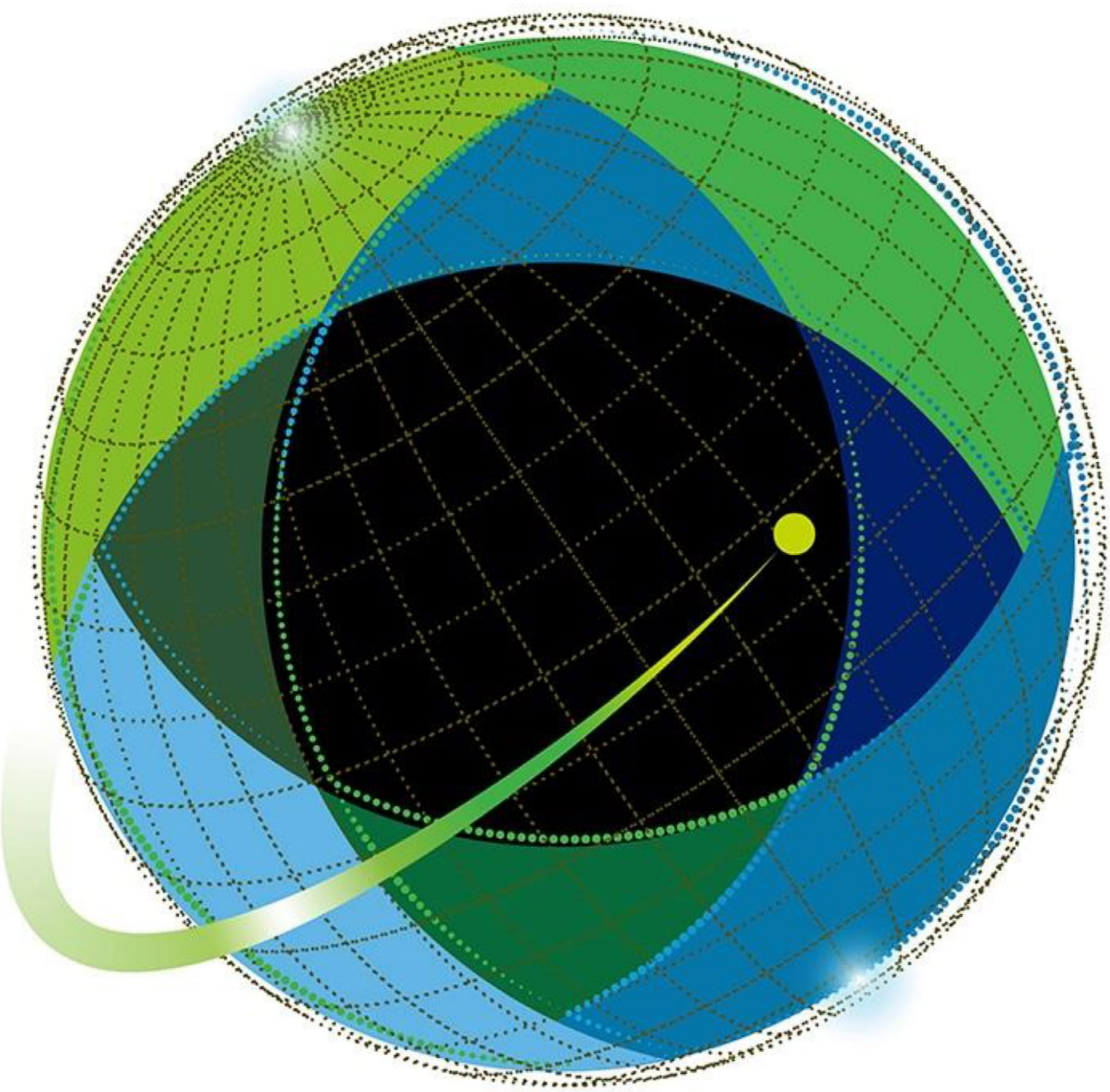

Accessing the transitional safe harbour

Pillar Two in Australia: from policy to practice

MAKING AN IMPACT THAT MATTERS since 1845

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Accessing the transitional safe harbour

Despite the political headwinds the OECD's Pillar Two framework continues to face, Pillar two is enacted legislation in Australia. In-scope groups must therefore continue their preparation to meet Australia's Global Minimum Tax and Domestic Minimum Tax obligations. Most groups intend to elect into the Transitional Safe Harbour for eligible jurisdictions, which provides welcome compliance relief when compared to performing a full GloBE computation. In this article of Deloitte's Pillar Two in Australia series, we reflect on relevant aspects such as the 'Qualified' Financial Statements and 'Qualified' Country-by-Country Report that are critical to ensure that sought-after Transitional Safe Harbour access.

Introduction

Australia's domestic Pillar Two legislative package (i.e., the 'Taxation (Multinational — Global and Domestic Minimum Tax) Act and Rules 2024) was substantively enacted on 23 December 2024. Whilst enactment was late in comparison to other members of the OECD Inclusive Framework (IF), the legislation applies retrospectively to in-scope groups for financial year (FY) starting on or after 1 January 2024.

Australian HQ groups

For in-scope Australian headquartered groups, the consolidated financial statements (CFS) will require the Pillar Two position to be disclosed as a separate income tax line item. Having a robust and audit-proof methodology aimed at assessing the group's potential exposure to Pillar Two top-up taxes is therefore important. The expected application of the Transitional Safe Harbour (TSH) to the FY in question is generally the first step taken by groups when performing this assessment.

Foreign HQ groups

Foreign headquartered groups with December-end FYs are already halfway in their 'second' Pillar Two year. If such groups are headquartered in jurisdictions that substantially enacted domestic Pillar Two legislation from 2024, the CFS of those groups should have already reported the group's Pillar Two position. It should be noted that if such groups have Australian subsidiaries (or Australian joint ventures), lower-tier CFS (and potentially even stand-alone FS) also require Pillar Two disclosure/ reporting. The work performed in relation to the Pillar Two disclosure/ reporting in the foreign group's CFS can generally be used for local purposes as well, although materiality levels might deviate.

Compliance and reporting

Pillar Two tax (information) returns are broadly required to be lodged by in-scope groups within 18 months of the end of their first FY within the rules (and within 15 months of the end of FYs thereafter), although certain foreign jurisdictions require lodgements this calendar year. In that sense, the cycle of tax provisioning first, tax returns thereafter is similar to that of traditional corporate income taxation.

The Transitional Safe Harbour

It is broadly recognised that "full" Pillar Two computations are complex and elaborate, as these require stand-alone entity computations relying on numerous data points and prescribed adjustments set out in the Australian legislative package and informed by OECD commentary. Against this background, the TSH provides for a simplified jurisdictional computation to ease into these full computations and is available for the first three transitional years. A MNE Group can successfully elect into the TSH for a jurisdiction by meeting at least one of three prescribed tests, discussed below.

TSH tests

The **de-minimis test** is satisfied if a jurisdiction has less than EUR 10m of revenue and less than EUR 1m profit before tax (PBT) as per the MNE Group's Country-by-Country Report (CbCR). A similar de-minimis provision exists within the full Pillar Two computation (albeit that test requires a "full" calculation of GloBE revenue and income and averages those figures over a number of years).

The **simplified effective tax rate (ETR) test** is satisfied if a jurisdiction's ETR is at least equal to the transitional rate (15% for FYs beginning in 2023 & 2024, increasing by 1% per annum thereafter). The ETR is calculated by dividing a jurisdiction's Simplified Covered Taxes (broadly the total amount of the current and deferred taxes from the 'Qualified' FS amended for any uncertain tax positions) by its PBT.

The **routine profits test** is satisfied if a jurisdiction's Substance-based Income Exclusion (SBIE) exceeds its PBT. The SBIE amount should also be calculated within the full Pillar Two computation for jurisdictions with insufficient ETRs, as the SBIE amount lowers the Excess Profit in relation to which the top-up tax is calculated. This test is always satisfied for jurisdictions that have negative or zero PBT recorded in the CbCR.

A 'once-out-always-out' principle applies: when a jurisdiction fails the TSH for any given year (i.e., none of the test are satisfied), it is no longer allowed to elect into the TSH for that jurisdiction in the future regardless of whether any test is satisfied. This way, MNE Groups gradually roll into their full Pillar Two computations.

Alternative TSH treatment

Certain categories of entities are subject to specific provisions within the context of the TSH. For example, Stateless Constituent Entities (such as tax transparent trusts and partnerships) are excluded from using the TSH altogether and Joint Ventures (JVs) and their JV Subsidiaries require a separate TSH assessment from the MNE Group (using slightly different data sources). Therefore, a Pillar Two entity classification exercise is generally necessary to determine the perimeter of entities which would have access to the TSH, as this information will ultimately also be required when populating the GloBE Information Return (GIR).

The Australian DMT generally applies to entities, partnerships and trusts that are controlled/consolidated by an in-scope group, or at least 50% owned and equity accounted by such group.

TSH and tax provisioning

From a tax provisioning perspective, it is important to note that the tested FY's CbCR might not yet be completed prior to the provisioning (as a CbCR generally has a lodgement deadline of 12 months after the FY concluded). Using historical CbCR data to perform TSH testing requires judgement on the predictability of the proxy data and might in certain circumstances be unsuitable from an audit perspective (e.g., due to material one-off transactions, reorganisations, etc.) and thus trigger the need for more bespoke and updated assessments.

Qualified Country-by-Country Report and Financial Statements

A prerequisite for using the TSH is that its two primary data sources – i.e., the CbCR and FS – are both 'Qualified', which is assessed per jurisdiction. For a CbCR to be Qualified, it has to be based on Qualified FS which are generally a narrower subset of accounts than what is potentially allowed per CbCR guidance. For TSH purposes the key criteria is maintaining consistency of data, both within an entity and across entities in the same jurisdiction, to preserve the integrity of using CbCR data as a blunt proxy for the GloBE rules.

01

Qualified financial statements

The Qualified FS could broadly be described as the consolidation package used to prepare the CFS or the statutory FS prepared in accordance with an authorized/acceptable accounting standard. It should be noted that OECD BEPS Action 13 Country-by-Country reporting (which has been adopted in Australia) also allows regulatory financial statements and/or financial data from internal management reporting as well as the use of different data sources amongst jurisdictions – neither are allowed from a Pillar Two perspective.

02

Consolidated reporting

OECD BEPS Action 13 also contemplates that reporting will – in principle – occur on an aggregate basis at a jurisdictional level. However, where the jurisdiction of the UPE has a system of taxation for corporate groups which includes consolidated reporting for tax purposes, as is the case for Australia, and the consolidation eliminates intra-group transactions at the level of individual line items, CbC reporting groups may prepare the CbCR using consolidated data at the jurisdictional level. This would have to be indicated in Table 1 of the CbCR and applied consistently across the years.

03

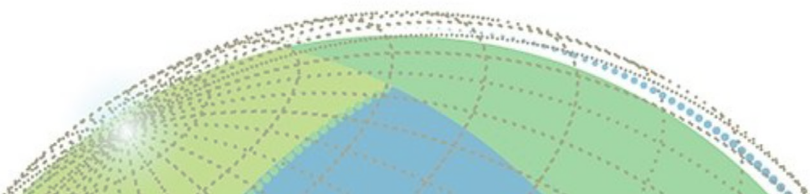
Consider adjustments

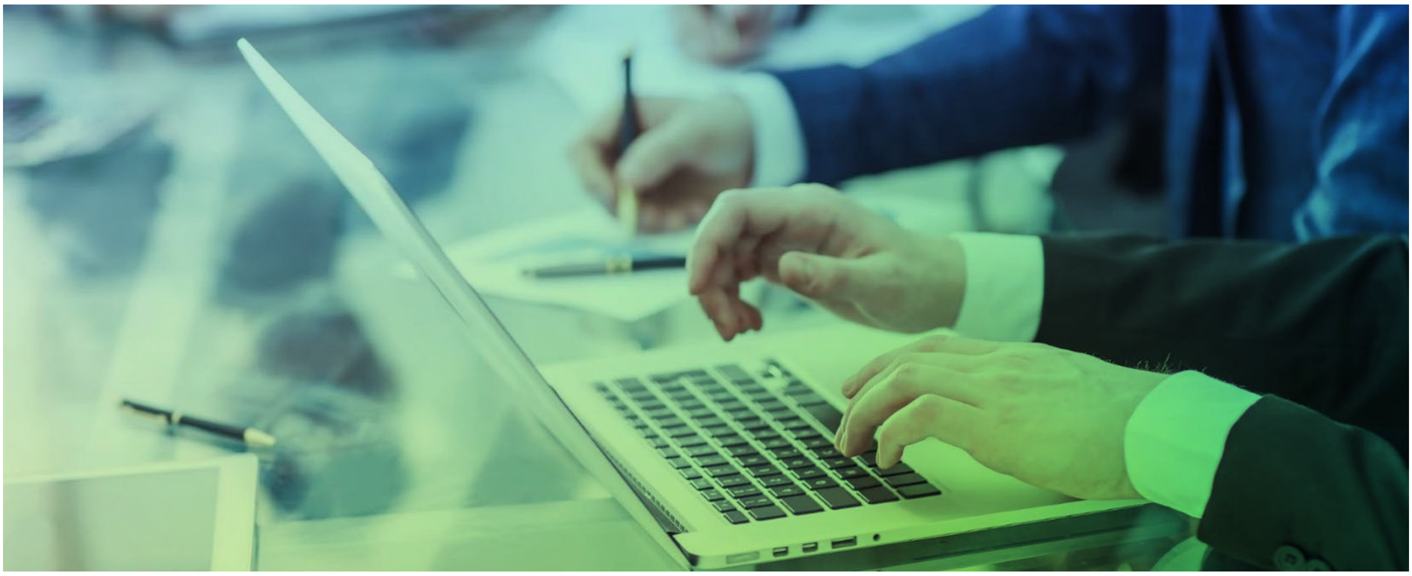
One of the key aspects when considering Qualified status is whether any 'adjustments' are performed. The OECD commentary to the Pillar Two rules states that making adjustments to the data drawn from the Qualified FS underlying the CbCR would generally disqualify a jurisdiction from using the TSH (even if such adjustment could make the data more reflective of the actual tax treatment, as would be the case with post-year end transfer pricing adjustments). This position is less clear when an MNE Group applies certain adjustments to the stand-alone FS of the consolidation package which do in fact reconcile to both the CbCR and CFS. Regardless, carefully documenting the CbCR process and use of the underlying FS is advised.

04

Purchase price accounting

Lastly, the OECD commentary puts forward additional requirements regarding whether purchase price accounting (PPA) is allowed to be included. Only if the CbCRs for FYs beginning after 31 December 2022 have included PPA adjustments (and potentially certain amendments are made in respect of goodwill impairments) will the consistent reporting condition be satisfied such that MNE Groups can take PPA into account in future CbCRs without jeopardising Qualified status.





Adjustments to Profit Before Tax and Simplified Covered Tax

Compared to a full GloBE computation, the TSH provides for substantial relief in the amount of data sources and required adjustments, however, some adjustments to PBT and Simplified Covered Taxes do remain. For example, a Net Unrealised Fair Value Loss in relation to ownership interests must be excluded from PBT if that loss exceeds € 50m in a jurisdiction. As most corporate income tax regimes exempt unrealised fair value profit and losses on equity (and follow principles of realisation instead), allowing a Net Unrealised Fair Value Loss within PBT would inflate the ETR. By contrast, the inclusion of unrealised FV gains could deflate a jurisdiction's ETR for TSH purposes, yet not necessarily cause a group to have a top-up tax under the full GloBE rules.

Hybrid arbitrage arrangements

One of the potentially more burdensome adjustments to be monitored for all MNE Groups are those involving hybrid arbitrage arrangements (HAAs). The OECD describes HAAs as arrangements designed to arbitrage differences in either the source of financial information or the difference between local tax versus accounting treatment that produce inconsistencies contrary to the purpose of the GloBE Rules. Three HAAs exist, being (i) the deduction / non-inclusion (DNI) arrangement, (ii) the duplicate loss arrangement and (iii) the duplicate tax recognition arrangement.

The category of what constitutes a DNI, duplicate loss or duplicate tax recognition arrangement could be quite wide in practice given the broad drafting of this anti-abuse rule. For example, a DNI arrangement requires a Constituent Entity to incur an expense in its Qualified FS with the counterparty Constituent Entity either not including a commensurate increase in income in its Qualified FS or not reasonably to be expected to incur a commensurate increase in its taxable income. Therefore, it appears that intercompany financing – even in a purely domestic context – provided by an entity that offsets interest income against a carry forward loss in certain circumstances or an intragroup expense that is potentially eliminated upon consolidation, might technically be captured. If the HAA DNI is triggered, the expense must be excluded from PBT (lowering the simplified ETR).

The processes to monitor and capture HAAs might not be readily available. Material HAAs should already be considered in a group's tax provisioning process.

All HAAs entered into after 15 December 2022 are within scope of these rules but note that 'altering' arrangements before this date could also trigger these rules (e.g., changing the accounting treatment, but also transferring or amending the arrangement itself).

Concluding remarks

Having a carefully documented CbCR process in place is increasingly important as the CbCR has been elevated from a mere transparency and risk assessment report to serving as source for determining whether top-up taxes might actually be due.

Secondly, ensuring that the Pillar Two requirements to obtain Qualified status per jurisdiction are met in addition to the existing BEPS Action 13 requirements for the CbCR might necessitate additional work for MNE Groups from both a data source and a content perspective.

Lastly, it should be noted that local tax authorities and auditors will now have to consider the CbCR and its underlying FS as part of their audit of the (C)FS tax line item which should separately disclose any Pillar Two top-up taxes.

Contacts

Amelia Teng
Partner
+61 3 8486 1118
amteng@deloitte.com.au

David Schultz
Partner
+61 2 9322 3620
dschultz@deloitte.com.au

Robin Tulp
Manager
+61 4 4720 0090
rotulp@deloitte.com.au

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