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Tax Alert

Pillar Two - Global Minimum Tax - Administrative guidance

February 2023

International Tax

OECD releases Pillar Two administrative guidance

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 harbors 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**

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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 authorized financial accounting standard because there is no statute or regulation that requires it to prepare consolidated financial statements in accordance with an authorized 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 authorized 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 authorized accounting standard and that record their investments at fair value as an instance where the deemed consolidation rule will not apply, because the authorized 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, 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, including the following notable matters:

- In case of a transaction between Constituent Entities of an MNE Group, the arm's length principle applies irrespective of whether the MNE Group accounts for transactions between Constituent Entities at the disposing Constituent Entity's carrying value rather than based on fair value. *Further work will be undertaken by the IF to address potential double taxation issues without imposing undue compliance burdens*;
- Treatment of net investment hedges as Excluded Equity Gain or Loss should be at the election of the MNE Group. A Filing Constituent Entity may make a Five-Year Election to treat foreign exchange gains/losses reflected in a Constituent Entity's Financial Accounting Net Income or Loss as an Excluded Equity Gain or Loss. As a result, any taxes arising on the foreign exchange gains described in the preceding sentence shall be treated as a reduction to Covered Taxes;
- A financial instrument issued by one Constituent Entity and held by another Constituent Entity in the same MNE Group must be classified as debt or equity consistently for both the issuer and holder for computation of their GloBE Income or Loss. In case of any inconsistent classification, the classification adopted by the issuer should be applied by the issuer and the holder for GloBE purposes;
- Certain cases and conditions are provided in order for a debt release included in the Financial Accounting Net Income or Loss to be excluded from the computation of a Constituent Entity's GloBE Income or Loss;
- A special rule is provided for carry-forward of Excess Negative Tax Expense.

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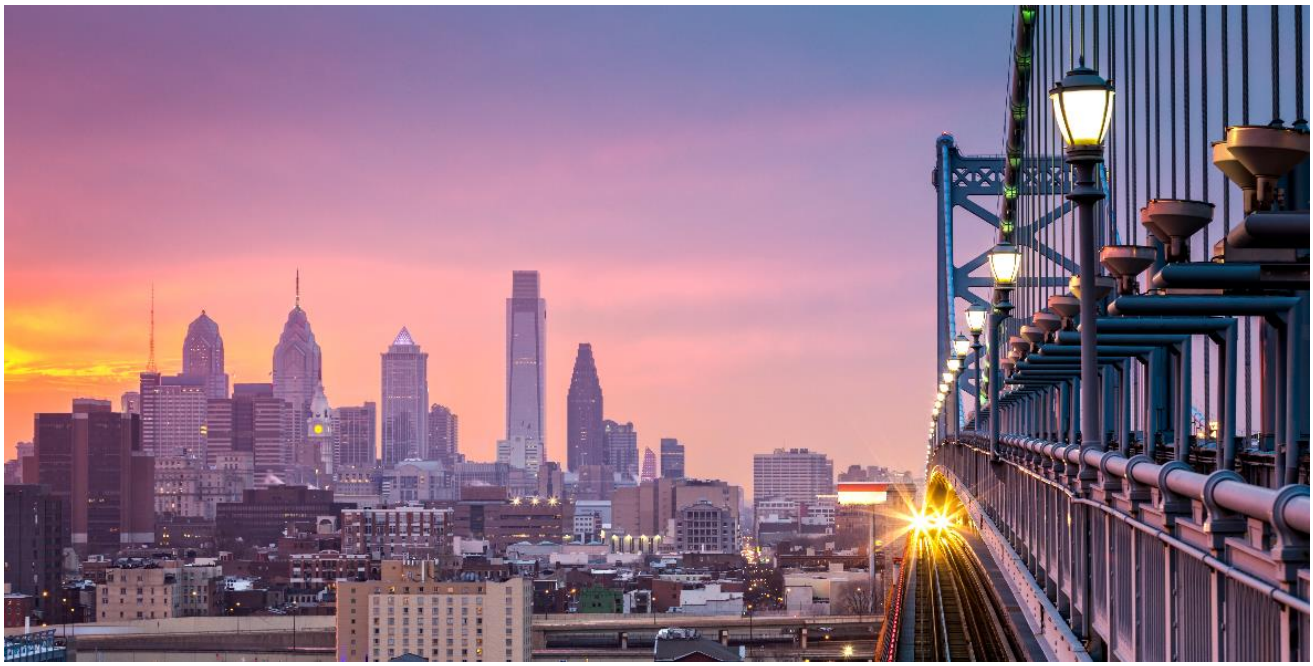
Transition rules

The guidance resolves the ambiguity around DTAs associated with credit carryforwards that arise 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 carryforwards 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 utilized 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 carryforwards.

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.



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Qualified domestic minimum top-up tax ("QDMTT")

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 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.

Several rules 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 QDMTT purposes, with the effect that the QDMTT jurisdiction has the primary right to tax income under the QDMTT arising therein.
- A QDMTT should contain safe harbors that align with the safe harbors agreed under the GloBE rules, including the transitional CbC safe harbors contained in Dec-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 harbor, the effect of which would be to eliminate any residual IIR or UTPR when the QDMTT safe harbor applies.

Looking ahead

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

- *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;*
- *Japan has submitted a draft legislation to implement IIR to align with OECD Pillar Two which is expected to be passed by the Diet in March 2023;*
- *It was announced in the Singapore Budget 2023 on 14 February 2023 that Singapore intends to implement Pillar Two measures in 2025 as well as a QDMTT;*
- *The Vietnam Government is giving serious consideration to domestic laws and policies to reflect the inevitable global trend and may soon put practical measures in place.*

Taxpayers should prepare by analyzing whether they may have substantive tax liabilities under the new rules and how they will comply with these new global obligations.

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