



Cyprus Tax News

Overview of the OECD Pillar Two guidance on Safe Harbours and Penalty Relief

Further to our [alert](#) on the agreement of the Organisation for Economic Cooperation and Development (OECD) Inclusive Framework (IF) on the components on Pillar Two, in late December 2022, the IF released an implementation package relating to Pillar Two Global Anti-Base Erosion (GloBe) Rules, which consisted of three elements:

- Guidance on Safe Harbours and Penalty Relief;
- A public consultation document on the GloBe Information Return; and
- A public consultation document on Tax Certainty for the GloBE Rules.

It's important to note that the public consultation documents are still a work in progress and subject to change. As such, we continue monitoring the developments and will provide an update in a future tax alert.

The released [Guidance](#) provides safe harbours and simplifications that aim to reduce the compliance burden for businesses, while ensuring tax authorities have access to comprehensive information to assess top-up tax liability.

The guidance includes a transitional safe harbour, a potential future permanent safe harbour based on simplified calculations, and a transitional penalty relief. The new guidance will provide greater clarity and certainty for businesses and tax authorities alike as they navigate the implementation of Pillar Two.

Recap of the Pillar Two global minimum tax rules

The Pillar Two global minimum tax rules are designed to ensure that large multinational enterprises (MNEs) pay a minimum level of tax on the income arising in each jurisdiction where they operate. It applies to large multinational

groups with annual consolidated group revenue of at least €750 million and includes three main components, as set out below:

1. The income inclusion rule (IIR), which applies on a top-down basis and requires the ultimate parent company to pay any necessary tax 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%.
2. The undertaxed profits rule (UTPR), which acts 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 top-up tax is allocated to countries that have adopted the undertaxed profits rule based on a formula and can be implemented by denying a deduction for payments or making an equivalent adjustment.
3. The qualified domestic minimum top-up tax (QDMTT), which enables top-up taxes in respect of any low-taxed profits of a group's entity in that country to be paid to the local tax authority, instead of being paid to other countries under the IIR or UTPR rules.

Safe harbours and Transitional Penalty Relief

Transitional country-by-country reporting (CbC) safe harbour

The transitional safe harbour is a temporary measure that allows multinational businesses to exclude their lower-risk country operations from the compliance obligation of preparing full Pillar Two calculations. The safe harbour applies for years beginning on or before 31 December 2026 (but not for a fiscal year ending after 30 June 2028), providing a three-year window for most groups to take advantage of this provision.

The transitional safe harbour uses information taken from a business's Country-by-Country (CbC) report and/or financial statements to determine whether its operation in a country meets any of the following three tests:

- **De minimis test:** The business reports total revenues of less than €10 million and profit before income tax of less than €1 million for a country.
- **Effective tax rate test:** The business's simplified effective tax rate* (ETR) for a country is equal to, or greater than, the "transition rate"** for the year.
- **Routine profits test:** The business's profit before income tax in a country is equal to, or less than the "substance-based income exclusion amount," as calculated under the OECD Model Rules.

* The simplified ETR for the purposes of the effective tax rate test is calculated by dividing the country's 'simplified covered taxes by its profit before income tax as reported on the CbC report.

** The transition rate is 15% for years beginning in 2023 and 2024, increasing to 16% and then 17% for years beginning in 2025 and 2026, respectively.

If any of these tests are satisfied, the top-up tax for that country will be zero.

It is important to note that a "once out, always out" approach will apply. If a business does not apply the transitional safe harbour to a country in one year, it cannot use it for that country in a subsequent year.

There are special rules that may apply to exclude certain entities in specific circumstances, such as joint ventures, joint venture subsidiaries, entities held

for sale, flow-through entities, or entities subject to eligible distribution tax systems.

Permanent safe harbour – simplified calculations

Where an MNE's operations in a jurisdiction do not meet the requirements of a transitional safe harbour, they may still qualify for the terms of a permanent safe harbour. The report sets out a framework for the future development of permanent safe harbours that would allow MNEs to avoid some of the more complex calculations required under the GloBE rules, using simplified income, revenue, and tax calculations, which would be an alternative to the GloBE income or loss, GloBE revenue, and adjusted covered taxes calculations.

For a jurisdiction to qualify for the simplified calculations, it must pass one of the following three tests:

- The GloBE Income is equal or less than the amount of the substance-based income exclusion; or
- revenue is less than €10 million, and income (profits) are less than €1 million (i.e., that the country qualifies for the de minimis exclusion within the OECD Model Rules); or
- the effective tax rate is at least 15%.

If any of these tests are met, the top-up tax for that country will be zero.

The simplified calculations will be provided as part of a future Agreed Administrative Guidance. MNE Groups would then be able to rely on the safe harbour when calculating their ETR on a jurisdictional basis and filing their GloBE Information Return. However, to benefit from the Simplified Calculations Safe Harbour, MNE Groups must comply with the filing requirements agreed upon as part of the Administrative Guidance.

Transitional Penalty Relief

The penalty relief is intended to provide a "soft-landing" in the introduction of the GloBE Rules, recognising that MNEs are more likely to make mistakes in the initial years of the application of the rules. It is applicable during the same transitional period as the transitional CbCR Safe Harbour (i.e. for any fiscal year commencing on or before 31 December 2026, but not for a fiscal year ending after 30 June 2028).

According to the guidance, a tax administration should not impose any penalties or sanctions if it deems that an MNE has taken "reasonable measures" to ensure proper compliance with the GloBE rules. The term "reasonable measures" is not defined in the report, and it should be interpreted based on each jurisdiction's existing regulations. Tax administrations will have to evaluate whether an MNE has taken reasonable measures based on the specifics of each case. The transitional penalty relief would not be applicable to cases of avoidance, fraud, or abuse.

Concluding remarks

- It is important to note that qualifying for the CbC safe harbour or for the permanent safe harbour on a jurisdictional basis does not exempt the MNE Group from complying with group-wide GloBE requirements such as the requirement to prepare and file its GloBE Information Return.
- As the Pillar Two rules will be implemented by the end of 2023, MNE groups should start assessing the potential impact of the GloBE rules on their tax positions. Being proactive in their approach to meeting any challenges will be key to successfully implementing the Pillar Two rules.

The OECD's guidance on Safe Harbours and Penalty Relief may offer some transitional relief, but significant challenges remain. With the clock ticking, it is crucial for MNE groups to take action now.

Contact

If your business requires further support in order to navigate the tax challenges arising from the Pillar Two rules, please get in touch with our International Tax team listed below:



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