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Navigating Mergers and Acquisitions in the Era of the OECD Pillar Two Model Rules

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Introduction

Tax positions have always been a part of merger and acquisition (M&A) transactions, but the Organisation for Economic Co-operation and Development's (OECD) Pillar Two Model Rules (Pillar Two) introduce a new layer of considerations. The impact on a target's effective tax rate can affect the after-tax return on the investment, impacting the valuation of transactions. It is clear, therefore, that these rules will have wide-reaching implications for M&A, reshaping strategies, and decision-making processes for companies and investors alike.

This article provides an overview of the key tax implications Pillar Two has on M&A transactions.

Overview of Pillar Two Charging Mechanisms

Pillar Two introduces a series of interlocking rules broadly set out as follows:

- Income Inclusion Rule (IIR): This rule requires the ultimate parent entity of a multinational enterprise (MNE) group to pay a top-up tax if the income of a constituent entity is taxed below the minimum rate. The tax is the top-up amount required to bring the overall tax on the profits up to the 15% effective tax rate. The amount of the top-up tax payable under the IIR and the UTPR (see below) are net of any Qualified Domestic Minimum Top-Up Tax (QDMTT), i.e., of minimum tax included in the domestic law of a jurisdiction.
- Undertaxed Payment Rule (UTPR): This operates as a backstop to the IIR, allocating top-up tax to jurisdictions where the MNE has operations if the IIR is not fully applied.
- Subject to Tax Rule (STTR): The STTR operates before the IIR and confers a primary taxing right to the source jurisdiction. It is activated where intragroup payments are made by an entity in one contracting state to a group entity in another contracting state that is subject to an adjusted nominal tax rate below the 15% minimum effective tax rate. In that case, the source state may levy a withholding tax equal to the top-up tax on the gross payment.

Key Implications for M&A Transactions

Valuations and modelling

The effective tax rate of a company will impact the after-tax cash flow of a company. Therefore, valuation models like discounted cash flow that are based on future cash flows of a company will be impacted by either a higher or lower effective tax rate.

Companies with an effective tax rate below 15% may face additional tax liabilities under the Pillar Two rules, potentially decreasing their attractiveness or influencing the price a buyer is willing to pay. The opposite may also be true whereby high effective tax rate may shelter some of the buyer's own low taxed entities in the same jurisdiction.

Other considerations for the financial model are tax reliefs and incentives. Tax incentives allowed under domestic law may not qualify as refundable tax credits under Pillar Two, which could in turn lower a group's effective tax rate below 15%. Care will need to be taken where financial modelling is dependent on certain tax reliefs and incentives being available.

For some groups, the impact of the Pillar Two rules may be even more profound than just looking at the effective tax rate. For example, where an acquisition pushes a target previously below the EUR 750 million threshold over the limit and thereby bringing the entire group within the scope of Pillar Two. In this case, the broader consequences of falling within Pillar Two will need to be considered.

Key Implications for M&A Transactions

Tax Due Diligence

The implementation of Pillar Two will pose several challenges for tax due diligence and engaging tax teams (with Pillar Two knowledge) early in the transaction process is essential for collecting data required for due diligence of Pillar Two positions, assessing potential top-up tax liabilities, estimating the economic value of potential tax attributes, and determining the transaction's pricing strategy.

It will also be important to understand the Pillar Two profile of the target and the potential application of the IIR, UTPR and STTR to understand how these rules might impact post-acquisition integration and tax planning (e.g., use of tax incentives and tax credits historically and going forward).

One other area that will need to be looked at carefully is deferred tax liabilities (DTLs). DTLs arise from timing differences between the recognition of income and expenses for accounting purposes versus tax purposes, leading to taxes being deferred to future periods. The Pillar Two rules include a mechanism whereby DTLs, if not settled within a specified period (generally five years), will be included in the effective tax rate calculation. A question arises here as to whether any tax payable under Pillar Two post-closing as a result of such inclusion should be borne by the purchaser or the seller (via contractual protections).

Tax Structuring

Deal structuring could evolve to mitigate the impact of Pillar Two. For example, buyers might consider alternative structures such as asset purchases instead of share purchases to better manage the implications of the Pillar Two rules. Consideration could also be given to prepacking assets (carve-outs), intangible property transfers, and acquisition financing structures, to mention a few.

The risks of any structuring/restructuring will need to be negotiated and allocated between the parties.

Contractual Protections

Contractual protections will be dependent on the structure of the transaction, jurisdictions involved in the transaction, and any due diligence considerations that arise. The buyers, at a minimum, would want to structure indemnities to protect their interests with regard to any top-up taxes incurred during the pre-closing period and any potential secondary tax liability, both of which may arise where an acquired target entity bears joint and several liability for the top-up tax obligations of the other seller's constituent entities.

By carefully considering Pillar Two specific indemnities, warranties, and information-sharing mechanisms, stakeholders can better navigate the Pillar Two complexities in M&A transactions.

Financing Considerations

Debt-financed acquisitions have traditionally provided tax shields via interest deductions, but the benefits of these structures could be impacted by Pillar Two where the group's ETR falls below the minimum rate due to deductions.

Integration and Post-Acquisition

MNEs may consider restructuring their operations or supply chains to optimize their global tax position under Pillar Two. This could involve, for example, reallocating functions, assets, or risks minimizing the impact of top-up taxes. Transfer pricing implications will also need to be considered with any such restructuring.

The burden and cost of any integration or restructure efforts should be considered early by both sides of any transaction (i.e., buyer and seller) so that they can be factored into the deal negotiations.

Strategic Responses to Pillar Two

To navigate the challenges and opportunities presented by Pillar Two, MNEs should consider the following strategic responses:

- Analyse the potential impact of Pillar Two on different M&A transactions. In the context of an evolving international landscape, accelerated transaction timetables, competitive M&A processes, and tax teams with limited resources (and, perhaps, limited Pillar Two experience), it is important to understand the practical challenges to carrying out Pillar Two analysis in the context of a M&A transaction and, with that, to raise potential risks to stakeholders' appropriately.
- Invest in technology and expertise to enhance the tax function's ability to manage complex compliance requirements and strategic tax planning under the Pillar Two rules.
- Review transfer pricing policies to ensure that these are aligned with the new rules to avoid unintended tax consequences.

Targets have an opportunity to pave the way for successful M&A processes, potentially outperforming competitors, by making Pillar Two information readily accessible for prospective buyers.

Conclusion

Entering into a M&A transaction with clear understanding and foresight on the impacts of Pillar Two will help pinpoint issues early and avoid any unwanted surprises.

Deloitte Middle East is able to assist clients with advice on valuations, due diligence, deal structuring and modernizing tax functions so that clients can navigate the complexities of Pillar Two to ensure maximum value of any M&A transaction.

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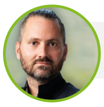
Pillar Two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