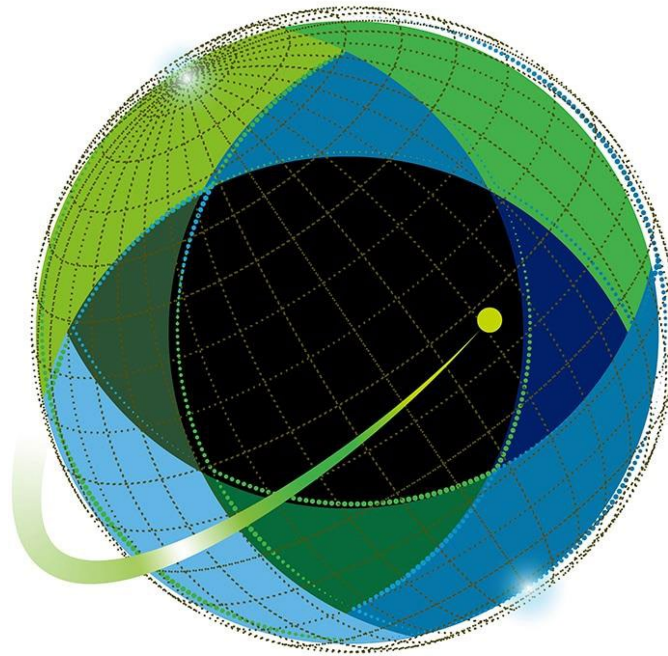

Pillar Two – Attention points for tax due diligence and transaction documentation

As the European Commission well-stated on its website on January 1, 2024: "a new era for corporate taxation in the European Union has entered into force today". The OECD/G20's plan for a global minimum tax, to ensure that multinationals pay their fair share of taxes, has entered into force in the European Union as of 2024. This article addresses certain Pillar Two related difficulties during tax due diligence and when negotiating transaction documentation.

Introduction

Pillar Two addresses base erosion and profit shifting by means of global minimum tax rules ensuring multinationals with a consolidated revenue of more than EUR 750 million ("**MNE Group**") to pay a minimum effective tax rate ("**ETR**") of 15% on profits for each country in which such MNE Group operates. In M&A, Pillar Two is a matter both seller and purchaser should be aware of when performing tax due diligence ("**DD**") and it should also be taken into account when drafting and negotiating the share purchase agreement ("**SPA**"). This article highlights certain attention points in M&A and also aims to provide further guidance.

Due diligence

In a tax DD, a historical review of the tax position of the Target takes place. With Pillar Two legislation being effective as from 2024, we increasingly notice Pillar Two issues arise in M&A transactions.

In current tax DD processes there is often a lack of sufficient Pillar Two tax calculations as per effective date at Target level to perform the detailed analysis as in a regular DD process. At this stage a tax DD process is mainly focused on:

i. Target's processes in place with respect to its Pillar Two obligations and registration/filing requirements;
ii. Transitional Safe harbour eligibility: has an appropriate analysis been performed and have jurisdictions been identified which are not able to rely on safe harbours? What is the process to monitor whether Target will be able to continue to apply these safe harbours?
iii. Historical transactions: have there been any historical intragroup restructurings or third party acquisitions and is there a Pillar Two analysis performed? Especially relevant are the transitional rules for intragroup asset transfers (for the period between November 2021 and the first year Pillar Two applies) in case a business unit is carved out from a multinational group; and,
iv. Review of the key commercial to tax adjustments and deferred tax items and its Pillar Two treatment.

For the determination of the scope of a tax DD it was already important to look at factors like the Target's tax profile, required timeframe, etcetera. In addition, for Pillar Two purposes, the revenue threshold (of EUR 750 million) should be considered and a distinction can be made between several scenarios, such as:

1. Both the Target and seller's MNE Group are not in scope of Pillar Two;
2. The Target itself (on a standalone basis) is not in scope of Pillar Two, but is part of a MNE Group that is in scope of Pillar Two; and,
3. The Target itself (on a standalone basis) is in scope of Pillar Two.

Off course, in the scenario where the Target itself on a standalone basis is in scope of Pillar Two (situation 3 above), the tax DD process should focus on identifying possible historical Pillar Two risks. However, even in the abovementioned situation 1 and 2 the historical Pillar Two risks are important.

Firstly, the tax DD process is suitable for determining the applicable charging mechanism(s) and as a consequence the (primary and secondary) Pillar Two liabilities, relevant for processing into the transaction documentation. The QMDTT is primarily due at the level of the respective Target entity, while this is different for IIR and UTPR. The IRR is paid by the ultimate parent entity in its own country. The UTPR comes into play when the IRR has not been (fully) applied at ultimate parent entity level. Both the IIR and UTPR could require seller companies to pay Pillar Two taxes which are allocable to the Target entities or even vice versa if any of the Target entities is subject to UTPR.

Secondly, post-closing the combined revenue of the purchaser and the Target may meet the revenue threshold for Pillar 2. Therefore, it is important for the purchaser to understand the implications for its Pillar Two position post-transaction, as it will affect purchasers' tax expense.

The tax DD process is primarily suitable for determining the applicable charging mechanism(s)

Transaction documentation

In this paragraph we will highlight some Pillar Two related attention points that might come up during SPA negotiations. We will distinct between two mostly used purchase price mechanisms, Completion Accounts and Locked Box.

Completion Accounts

When using a Completion Accounts mechanism, generally parties first determine an initial purchase price by estimating the equity value of the Target per the completion date. When completion occurs, the initial purchase price is paid by the purchaser to the seller. After completion, parties need to determine and reach agreement on the final purchase price, whereby any difference between the already paid (estimated) initial purchase price and the final purchase price shall be settled between parties.

In case the SPA is based on a Completion Accounts mechanism, specific Pillar Two related discussions should be minimal, as any Pillar Two taxes relating to the period up to completion should be for the account of the seller. If the purchaser is in scope of Pillar Two, any Pillar Two taxes of Target relating to the period after the date of completion should be for the account of the purchaser. Specific guidance is included in the legislation (article 6.2 OECD rules) on dealing with constituent entities joining and leaving an MNE group, for example on how to calculate the Substance Based Income Exclusion with an entity transfer during the year (by allocating 'eligible' payroll costs or tangible assets to seller and buyer group) or the amount for which the deferred tax position should carry over.

The purchaser should however be conscious of any secondary Pillar Two tax liabilities relating to the period up to completion, for which it might want to obtain an indemnity from the seller (also see below).

Locked Box

When using a Locked Box mechanism, often the most recent (audited) annual accounts of the Target are used to determine the (fixed) purchase price, whereby the economic risks and benefits are deemed to be transferred as from the balance sheet date of these annual accounts, the so-called effective date or economic date. Since the purchaser bears the economic risk as of the effective date, it generally negotiates certain protective clauses to protect itself against any value that is extracted from the Target ("leakage") in the period between the effective date and the date on which completion takes place (the "Locked Box period").

Allocation of Pillar Two Taxes in the Locked Box period

An important discussion point that might come up in a Locked Box transaction is the allocation of Pillar Two taxes of the Target attributable to the Locked Box period.

Since the Target is effectively (not legally) transferred to the purchaser as from the effective date, the commercial question arises if and to what extent a seller or purchaser should economically bear the Pillar Two taxes allocable to the Target for the Locked Box period. Subject to the parties' (commercial) positions, this discussion can become difficult to resolve.

First, the actual calculation (and allocation between parties) of the Pillar Two taxes for the locked box period may become complex quickly. For instance, due to the impact of 'jurisdictional blending', when Target is part of a group of entities within the same jurisdiction. In many situations the total Pillar Two liability (taking seller group and Target combined) may not be the same as the Pillar Two liability for seller group stand-alone and Target stand-alone as a result of the Substance Based Income Exclusion and the Top up Tax Percentage.

Secondly, the purchaser's Pillar Two position might become relevant for the allocation discussion. If the purchaser is out of scope of Pillar Two and remains out of scope after the transaction, it could hold that if the Target was already under its control as per the effective date, the Target would not have been subject to Pillar Two and hence, the purchaser should not bear any (economic) liability of such Pillar Two taxes.

Further, if the purchaser is (or after the transaction becomes) in scope of Pillar Two it could well be that if the Target would have been under purchaser's control as per the effective date, the

amount of Pillar Two taxes would differ from the situation in which the seller has Target under its control e.g., due to jurisdictional blending. For example in the situation that purchaser's ETR is way above 15% and Target's ETR is below 15%.

We note that the above considerations are subject to commercial discussions in the context of the entire transaction, but could lead to situations where both parties have to put their cards on the table during the deal negotiations and give each other information that they typically would not reveal. The positions should therefore be carefully explored and considered at an early stage by each party and further analysed during diligence.

Secondary tax liabilities

Entities within an MNE Group can be held primarily liable for Pillar Two taxes, but can also be held liable on a secondary basis for any Pillar Two taxes due by other members within the MNE Group. The scope and mechanism of this secondary liability relating to Pillar Two taxes differ per jurisdiction, as each jurisdiction has been given a certain degree of freedom to implement this in its own jurisdictional collection legislation. For example, in the Netherlands, entities located in other jurisdictions can even be held secondary liable for taxes under de Dutch Minimum Income Tax Act (Dutch QDMTT Act).
The purchaser should therefore always consider obtaining a tax indemnity for any secondary Pillar Two tax liabilities (e.g., by means of a specific or general secondary tax indemnity).

Discussions might arise in Locked Box transactions relating to the allocation of Pillar Two taxes for the Locked Box period

Tax Sharing Agreement and Assistance

Lastly, parties should include wording in the SPA relating to the termination of any tax sharing agreement in relation to Pillar Two taxes as per the effective date or completion date (depending on the purchase price mechanism and commercial positions). Parties should also strive to include wording that ensures mutual assistance and the provision of information, reasonably required to comply with their respective Pillar Two obligations.

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