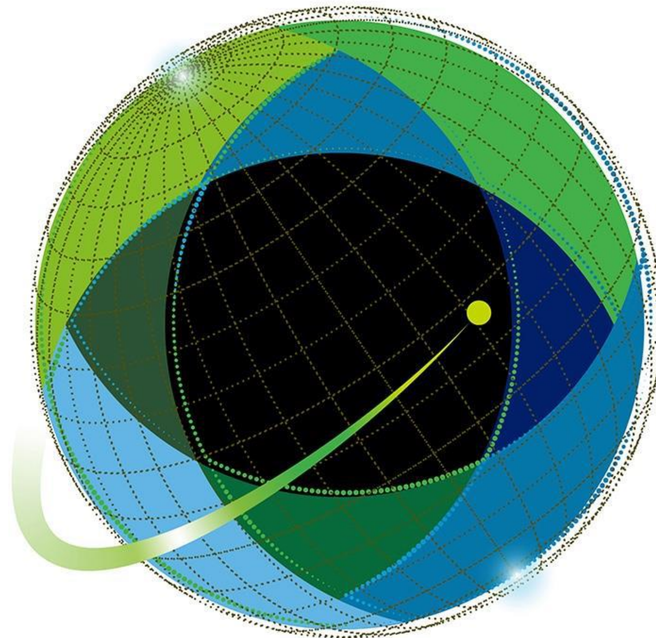

Pillar Two - Challenges for the Natural Resources Industry

On May 31st, 2023, the Netherlands published the legislative bill including the Memorandum of Understanding in respect of its domestic implementation of the G20/OECD Inclusive Framework's global minimum tax rules (also known as "Pillar Two" or global anti-base erosion ("GloBE") rules). The bill has been accepted by the Second Chamber on October 26th and on December 19th by the First Chamber. Pillar Two poses both uncertainties and challenges for natural resources companies due to the industry specific characteristics (such as tax incentives and industry-specific taxes).

Background

The OECD's Pillar Two Model Rules, on which both the Dutch legislation and the EU directive (Council Directive (EU) 2022/2523) are based, are applicable to multinational entity ("MNE") groups with an annual consolidated revenue of EUR 750 million or more in at least two of the four preceding fiscal years. Domestic groups that meet this revenue threshold are also in scope under the Dutch Pillar Two Rules. The aim of the Pillar Two Rules is to impose a jurisdictional-level minimum taxation of at least 15% on groups that are within scope.

The jurisdictional Effective Tax Rate ("ETR") calculation, which is based on stand-alone figures, comprises of the so-called aggregated 'Covered Taxes' of the group entities within a jurisdiction, divided by the sum of the so-called 'GloBE-income' of the group entities within that jurisdiction. When the ETR does not meet the required minimum rate of 15%, an additional top-up tax is levied to ensure a jurisdictional-level minimum taxation on profits of 15%.

For more background information on these proposed rules, we refer to our previous Pillar Two tax alerts for the public consultation and for the legislative bill implementing the EU directive.

ETR of natural resources companies

The definition of Covered Taxes is broadly defined to include taxes imposed on a Constituent Entity's income or profits as well as taxes that are functionally equivalent to such income taxes and taxes on retained earnings and corporate equity. As this is a rather broad definition, uncertainty may still exist with regard to the qualification of specific, less orthodox or generic taxes.

For natural resources companies, the question as to what taxes on income and/or profits are considered to be covered taxes is particularly important in view of the industry-specific taxes levied. For example, natural resources companies operating in the Dutch upstream sector are, as holders of exploration and/or production licenses, generally subject to State Profit Share, a Mining Act levy of 50% on profit resulting from Dutch mineral production activities.

It could be questioned whether such tax which is levied in addition to a generally applicable corporate income tax are considered to be Covered Taxes and thus affect the ETR positively. The same question applies with respect to similar foreign industry-specific taxes levied on profits and their effect on the respective foreign ETR's.

In this regard, the OECD Commentary on the GloBE rules state that taxes imposed on the net income from specific activities, such the exploration and production of oil and gas, irrespective of whether or not they apply in addition to a generally applicable corporate income tax, would also fall within the general definition of a 'Covered Tax'. Furthermore, the OECD Commentary states that the definition of 'Covered Taxes' would also include a separate levy that is imposed on the net income or profits from natural resource extraction activity.

Natural resource levies that are closely linked to extractions, for example, those that are imposed on a fixed basis or on the quantity, volume or value of the resources extracted rather than on net income or profits, would however not be treated as Covered Taxes except where these taxes are levied in lieu of a generally applicable corporate income tax.

Incentives

Within the natural resources industry, it is not uncommon for local governments to offer certain tax incentives to companies in order to attract foreign investments. An important consequence of the Pillar Two Rules is that jurisdictions will reconsider their existing incentives regime as essentially jurisdictions may no longer be willing to grant incentives to the extent that they may result in a jurisdictional ETR of MNE or domestic groups of less than 15%, as a compensating top-up tax is then levied to ensure an overall minimum taxation on profits that amounts to 15%. Some jurisdictions consider the introduction of so-called Qualified Refundable Tax Credits as defined under the Pillar Two Rules to ensure alignment with the new system. These credits as well as other incentives may be treated as increasing the GloBE Income, rather than reducing the element of Covered Taxes, leading to a less significant decrease in ETR than credits that decrease the Covered Taxes.

Timing differences

Based on the Pillar Two Rules, deferred taxes as a result of timing differences are in principle included in the ETR calculation. However, certain adjustments have to be made that can be of importance to natural resources companies, as they affect the extent to which deferred taxes are included in the ETR calculation.

An important adjustment in this regard is the so-called recapture rule. The recapture rule limits allowable timing differences relating to deferred tax liabilities to those which will reverse within five years. Otherwise, the ETR and/or top up tax in the fifth preceding accounting period will be recalculated.

Investments of natural resources companies generally have a long recovery period. Furthermore, local tax rules could allow for accelerated depreciations. This could create significant timing differences which would exceed a five-year period. The recapture rule might therefore impose a risk for natural resources companies, as deferred tax expenses might not be taken into account sufficiently, which negatively impact the ETR calculation and lead to additional top-up taxes due.

However, there are exceptions to this recapture rule. For natural resources companies, the following exceptions would be especially relevant. No recapture is required in respect of deferred tax liabilities arising on:

- Cost recovery allowances on tangible assets, which may include natural resources, such as mineral deposits, timber, oil and gas reserves, and exploration and evaluation assets.
- Costs of a license or similar arrangement for the exploitation of natural resources, where this entails significant investment in tangible assets.
- Decommissioning expenses incurred with regards to certain types of assets upon reaching the end of their useful life.

Although these exceptions to the recapture rule provide for important categories of deferred tax liabilities for natural resources companies that therefore do not need to be monitored for recapture, natural resources companies will need to understand the potential impact of the recapture rule and exceptions to those rules and how this may impact their tax position. In addition, companies should also take into account that, to the extent that the deferred tax expense is calculated using a (statutory) tax rate of 15% or more, the deferred tax expense must be recast at 15%.

Losses

Within the initial exploration phase, loss-making periods are relatively common within the natural resources industry. In this regard, when an MNE or domestic group becomes subject to the Pillar Two rules for the first time, it will be important to determine the deferred tax impact of those pre-GloBE tax losses in combination with applicable transition rules in order to avoid additional top-up taxes being due over these timing differences.

Furthermore, during years in which the GloBE rules have been enacted, certain adjustments are required in respect of losses in relation to the deferred tax calculation.

For loss-making periods in jurisdictions that do not levy corporate income taxes, and in which hence commercially no deferred tax assets or liabilities would be formed, a simplified loss offsetting regime may be used by applying the so-called “GloBE loss election”. The GloBE loss election is a simplification which is especially useful for jurisdictions that do not impose corporation tax. In general, this election simplifies the Pillar Two deferred tax calculation by only taking the effect of losses into account rather than the full range of timing differences. Also, the transition rules related to pre-GlobE deferred tax attributes are seemingly disregarded if a GloBE loss election has been made.

Next steps

The Netherlands has already published the legislative bill and Memorandum of Understanding to implement Pillar Two into the Dutch legal system. The implementation deadline is set on December 31st, 2023, and as already mentioned, both Dutch legislative Chambers have accepted the proposal, meaning that only the signature of the King and a publication in the official journal are required before the bill is legally enacted. On a global level, more and more jurisdictions are currently issuing (draft) legislation implementing Pillar Two.

Therefore, taxpayers that are active within the natural resources industry will need to understand how their tax position may be impacted by these Pillar Two rules going forward. Our team of industry specialists is of course happy to assist in performing that assessment.

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