M&A Tax Talk

Understanding Pillar Two's impact on M&A

The OECD Pillar Two rules

The Organisation for Economic Cooperation and Development's ("**OECD**") Global Anti-Base Erosion project, colloquially referred to as "Pillar Two" or "GloBE," represents the most fundamental shift in the global tax landscape in a generation. Broadly speaking, the aim of this effort is to impose a global scheme of minimum taxation on large multinational enterprises, no matter where they are headquartered or in which jurisdictions they conduct their businesses.

At the heart of the Pillar Two rules are two taxing provisions that apply in order to "top-up" a Multinational Enterprise ("**MNE**") Group's effective tax rate in a given jurisdiction to the 15-percent minimum rate. The first, the Income Inclusion Rule ("**IIR**") applies on a top-down basis, saddling the Ultimate Parent Entity ("**UPE**"), or, in other cases, an Intermediate Parent Entity, with top-up tax to the extent its subsidiaries in a given jurisdiction are undertaxed. The second mechanism, the Undertaxed Profits Rule ("**UTPR**"), applies to the extent the top-up tax is not imposed via the IIR. Where the UTPR applies, the top-up tax amount is allocated amongst all the jurisdictions that have enacted UTPR legislation. Regardless of which provision applies, the top-up tax amount is the same; all that differs is the party that is ultimately liable and the jurisdiction that is entitled to collect this revenue.

The Model Rules also provide for a third taxing mechanism, the Qualified Domestic Minimum Top-up Tax ("**QDMTT**"), that allows the source country to have the first bite at the apple when it comes to collecting the top-up tax. While QDMTTs may deviate from the OECD Model Rules in some respects, the top-up tax collected under the QDMTT in many cases is expected to closely align with that that would otherwise be collected an IIR and/or UTPR.

The members of the OECD's Inclusive Framework have agreed that, if they choose to implement the Pillar Two Rules, they will do so in a manner consistent with the OECD's Model Rules. To date, the OECD Model Rules have been adopted in some form by over 50 countries.[i]

Impact on M&A: An overview

One of the most novel and fundamental features of the GloBE Rules[ii] is their reliance on financial accounting rules to determine both the "GloBE Income" and "Adjusted Covered Taxes" of members of the MNE Group, and ultimately whether those members are subject to some form of top-up tax.[iii] While income and taxes are derived from the MNE Group's consolidated financial statements (or, under some QDMTTs, the local statutory accounts), in practice taxpayers deal with complex data requirements in order to perform the calculations and reporting that are necessary under the rules. The GloBE Rules then go further, adjusting the amounts derived from the financial accounts in many respects, including specific provisions that apply in the M&A context.

Another key element of the Pillar Two framework is the aggregation of income and taxes among all entities within a jurisdiction.[iv] This has the practical effect of creating *de facto* consolidation regimes in any jurisdiction subject to one (or more) of the top-up taxes.

Both of these aspects create special challenges in the M&A space, often in ways that even seasoned tax professionals may not be accustomed to. A brief overview of just a few of these issues follows.

GloBE Income, covered taxes, and M&A

While the calculations under the Pillar Two rules can be challenging even in the ordinary course, further complications can arise when an entity leaves or joins a group.

From a buyer's perspective, first, and perhaps foremost, the GloBE Rules disregard the effect of purchase accounting adjustments in determining future GloBE Income[v] [in a stock acquisition (see below)]. This can have a negative impact on GloBE Income in future years, as amortization or depreciation from Target's assets may not be deducted.

In certain cases, if the acquisition gave rise to a local tax step-up (such as in the case of an IRC section 338(h)(10) election), the rules may either treat the acquisition of Target as an asset acquisition (and thus allow for the purchase accounting adjustments to be taken into account), or, alternatively, provide for notional "GloBE-only" deferred tax assets.[vi] While the reversal of this deferred tax asset may be taken into account over time as it reverses, the initial recording of the asset could give rise to Top-up Tax in the year of the transaction. Conversely, where a GloBE-only "step-up" occurs without a corresponding tax basis increase, the resulting deferred tax liability may be subject to future recapture.[vii] The relative benefit (or potential risk) of each of these outcomes for Pillar Two purposes will depend on a number of factors, such as the nature of the assets, the local tax rate, and the applicable accounting standards. Further complications arise when layering on U.S. tax concepts, such as IRC section 754 elections. Taxpayers would be well advised to model out alternative acquisition structures to identify the most effective outcome under the GloBE Rules. While recent political developments have created additional uncertainty as to the future application of the GloBE Rules to U.S.-parented groups,[viii] the rules are currently enacted law in many jurisdictions and continue to apply as of this time.

Because of these complexities, the Buyer may wish instead to purchase assets instead of the shares of Target to avoid an adverse outcome under the GloBE Rules. If Seller is also subject to the GloBE Rules, however, it may be incentivized to sell the shares of Target, because gain from the disposition of an ownership interest is specifically carved out from GloBE Income (aside from portfolio shareholdings).[ix] The disparate outcomes of various deal structures under the GloBE rules as applied to Buyer and Seller create another point of consideration in negotiations and raise the potential for additional tax friction.

Diligence and post-acquisition impacts under GloBE

Pillar Two's aggregation of income and taxes within jurisdiction may in many cases lead to issues similar to those that arise in the context of tax consolidation regimes. While these considerations may be familiar to M&A practitioners, widespread adoption of Pillar Two will increase both

Private equity insights

Private equity sponsors should carefully consider the impact of Pillar Two's global minimum tax rules on M&A transactions, particularly as these rules introduce new layers of complexity and uncertainty into cross-border deal structuring. One challenge is the effect of Pillar Two on the tax efficiency of traditional holding company structures, which have historically utilized entities formed in low-tax jurisdictions to enhance after-tax returns and facilitate tax-efficient exits. The QDMTT, IIR, and UTPR rules generally require that multinational enterprise groups pay at least a 15 percent effective tax rate on their global profits, potentially reducing the benefits of tax planning considerations involving holding companies or intellectual property located in low-tax jurisdictions.

Private equity sponsors should carefully consider the potential for double taxation or mismatches in the recognition of income and taxes paid, particularly when transactions occur across jurisdictions with different Pillar Two implementation timelines or interpretations. The rules' reliance on financial accounting concepts, and the lack of clarity in certain areas—such as the treatment of reorganizations and certain partnership transactions—further complicate deal modeling and due diligence. Private equity sponsors should also consider the risk that previously negotiated tax stabilization or investment agreements may be overridden by QDMTT, potentially triggering disputes under international investment agreements and reducing certainty for cross-border investments.

their frequency and importance. Further, while countries are generally expected to align their local legislation with the OECD Model Rules, issues of tax administration, including which entities within the MNE Group are liable to pay the tax, are largely left to the discretion of local legislators and tax authorities. This not only increases the complexity of compliance, but creates traps for Buyers subject to the rules.

Diligence challenges

On the diligence front, the complexity of the GloBE Rules are likely to place additional pressures on tax diligence teams. Buyers may need to assess whether Target(s) are expected to be "low-taxed" under the GloBE rules, and how Target's effective tax rate will impact Buyer's jurisdictional ETR if Buyer has existing subsidiaries in the same country as Target. This fact pattern could be difficult to ascertain given the first Globe Information Return ("GIR") is not required to be filed until 18 months after year end (i.e., in June 2026 for calendar year 2024). As a result, diligence procedures may be performed on Pillar Two computations performed for modeling and/or financial statement purposes, creating inconsistency in data provided during diligence. Additional complications may arise from differences in accounting standards between Buyer and Seller groups, differences in fiscal year ends, and other factors.

The Pillar Two rules also introduce new tax attributes that should be assessed pre-acquisition. As noted above, the exclusion of purchase accounting may give rise to "GloBE-only" carrying values of assets, and "GloBE-only" deferred tax assets and liabilities that will need to be managed post-acquisition. Additionally, Target may already be saddled with its own specific GloBE attributes from earlier transactions that occurred prior to the sale.

Finally, the GloBE Rules provide special transition rules that can apply to adjust asset carrying value and deferred tax assets in certain contexts. Importantly, these provisions apply to transactions that take place after November 30, 2021, and before an entity becomes subject to the GloBE Rules.[x] Even though the GloBE Rules are effective in many jurisdictions today, there are a number of reasons why Target may not yet be subject to the GloBE Rules, including application of various safe harbors or because the Seller group is not within scope of the rules at all, because it is wholly domestic or below the €750million revenue threshold, for example. In the latter case, the Selling group may not have considered or managed Pillar Two exposure or attributes at all, creating a particular challenge for prospective Buyers that are within scope of the Rules.

Tax risk

The sheer number of different compliance regimes, coupled with the consolidated nature of the Pillar Two rules, may create significant additional tax risk in the M&A space. As an initial matter, when an entity subject to GloBE joins or leaves a group, the portion of its income and taxes that are taken into account by the acquiring and disposing groups are determined based upon what is reflected in each group's respective consolidated financial accounts with respect to Target.[xi] In most cases, this means that items arising in each ownership period should not impact the other party's respective GloBE Income and Covered Taxes.

The more significant risk arises from the manner in which a country might designate which entities are liable for the top-up tax. Imagine the following example:

> Seller owns OpCo1 and OpCo2, both located in Country X. Country X has adopted a QDMTT; therefore, if the Seller group is low-taxed in Country X, it will owe a top-up tax to Country X. Assume further that Country X imposes this top-up tax on each member of the MNE Group located in Country X (e.g., joint and several liability, ratably based on income, etc.).
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> Buyer purchases OpCo1 on July 1 (assume both Buyer and Seller use a calendar fiscal year). For the period January 1 through June 30, Seller would be high-taxed in Country X; however, after and unrelated to the sale, OpCo2 recognizes a significant deferred tax benefit that pushes the Seller group's Country X ETR below 15 percent, resulting in top-up tax due for Country X.

Because OpCo1 in this example was a member of Seller's group for a portion of the year, and top-up tax is due for that year, Country X may impose top-up tax on OpCo1, even though the events giving rise to the top-up tax occurred after the sale. This creates a practical concern since the seller is unlikely to allow diligence on retained entities nor control operations of these entities. This may result in the necessity for additional contractual protections in the purchase agreement.

Conclusion

Pillar Two has greatly increased the complexity of cross-border tax. M&A teams may need to adapt existing tax strategies and practices to a new and dynamic ruleset, as well as develop new approaches to tax, in order to navigate the current tax environment.

End notes

[i] Notably, the United States has not adopted any of the Pillar Two rules.

[ii] All citations herein refer to the OECD Model Pillar Two rules: OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS,* OECD, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm.

[iii] Art. 3.1.2.

[iv] Art. 5.1 and 5.2.

[v] Art. 3.1.2 and 6.2.1(c).

[vi] Art.6.2.2 and 4.4.

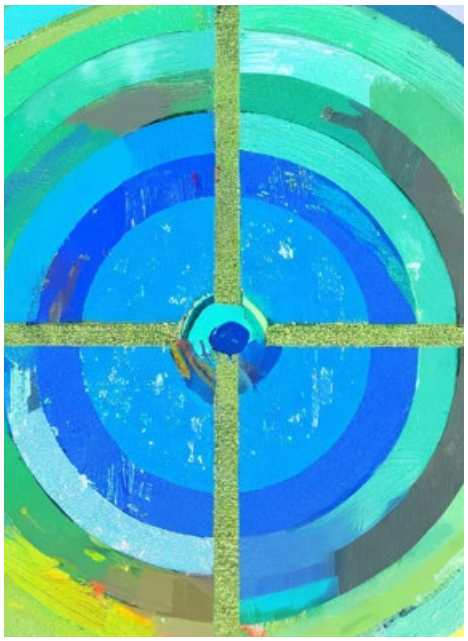
[vii] Art. 4.4.4.

[viii] *See* https://www.canada.ca/en/department-finance/news/2025/06/g7-statement-on-global-minimum-taxes.html.

[ix] Art. 3.2.1(d).

[x] Art. 9.1.2 and 9.1.3.

[xi] Art. 6.2.1(a) and (b).



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