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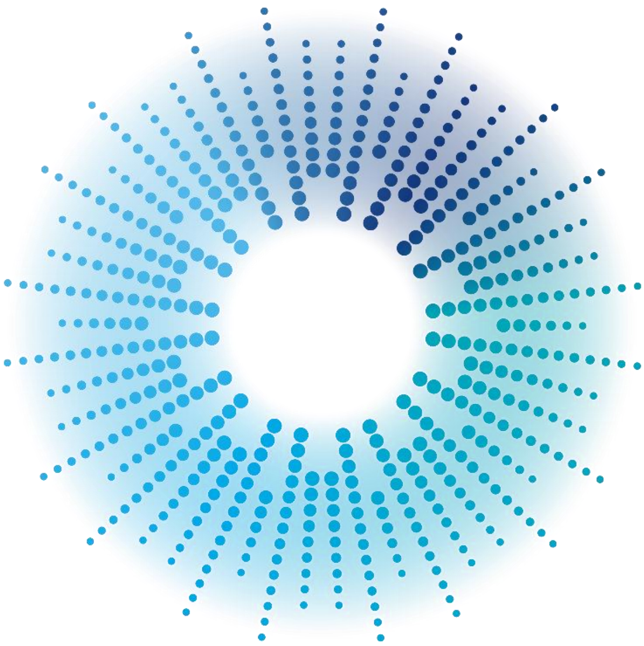

Tax Insights

OECD inclusive framework publishes Pillar Two global minimum tax model rules

Snapshot

On 20 December 2021, the G20/OECD Inclusive Framework on BEPS ("inclusive framework") published *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)* ("model rules"). This follows on from the *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, agreed by more than 135 of its members on 8 October 2021.

Since 2017, the 141 member countries of the inclusive framework have developed a "two-pillar" approach to address the tax challenges arising from the digitalisation of the economy: addressing nexus and profit allocation challenges ("Pillar One") and global minimum tax rules ("Pillar Two").

Income inclusion rule and undertaxed payments rule (GloBE)

The main income inclusion rule and its "backstop," the undertaxed payments rule, are designed to ensure that large multinational groups pay corporate income taxes at a minimum level of 15% in every country in which they operate. Countries are not required to introduce the rules, but the model rules provide a template for adoption in domestic law in a consistent and coordinated way. The model rules consist of chapters on:

- Scope;
- Income inclusion rule and undertaxed payments rule;
- Computation of '"GloBE income or loss" (tax base);
- Computation of "adjusted covered taxes;"
- Computation of effective tax rates and top-up tax;
- Corporate restructurings and holding structures;
- Tax neutrality and distribution regimes;
- Administration;
- Transition rules; and
- Definitions.

Scope

Large multinational groups with annual consolidated group revenue of at least EUR 750 million (approx. AUD 1.19 billion) in at least two of the four immediately preceding fiscal years are in scope of the rules.

Limited exclusions apply for investment funds/real estate investment vehicles (that are ultimate parent companies), pension funds, governmental entities, international organisations, and nonprofit organisations. The rules can apply to subgroups controlled by such excluded entities.

Income inclusion rule (main rule)

The **income inclusion rule** applies on a top-down basis such that in most cases any tax due is calculated and paid by the ultimate parent company to the tax authority in its country. The tax due is the "top up" amount required to bring the overall tax on the profits in each country where the group operates up to the minimum effective tax rate of 15%.

If the ultimate parent company is in a country that has not implemented the income inclusion rule, the next intermediate holding companies in the ownership chain calculates and pays top up taxes in respect of their low-taxed subsidiaries. Notwithstanding the top-down approach, "partially-owned parent entities" apply the income inclusion rule in respect of their low-taxed subsidiaries to take into account minority interests.

Undertaxed payments rule (secondary rule)

The **undertaxed payments rule** applies as a secondary (backstop) rule in cases where the effective tax rate in a country is below the minimum rate of 15%, but the income inclusion rule has not been fully applied. The undertaxed payments rule can also apply to low-taxed profits in the ultimate parent country.

The top up tax is allocated to countries which have adopted the undertaxed payments rule based on a formula:

50% x (number of employees in a country applying the undertaxed payments rule/number of employees in all undertaxed payments rule) plus 50% x (total net book value of tangible assets in a country applying the undertaxed payments rule/total net book value of tangible assets in all undertaxed payments rule countries).

The top-up tax is implemented either by denial of a deduction for payments or by making an equivalent adjustment.

Groups that are newly expanding internationally are exempt from paying top up tax under the undertaxed payments rule for up to five years. Such groups must have entities in no more than six countries and the net book value of their "international" tangible assets must not exceed EUR 50 million (excluding tangible assets in the country with the most tangible assets).

Calculating the effective tax rate (ETR)

The rules apply on a jurisdictional-blending basis. The annual effective tax rate calculation required for **each country** takes into account the total covered taxes, profits, and losses attributable to all of the group companies ("constituent entities") in that country, as calculated under specific Pillar Two rules.

A group can elect to apply a de minimis exclusion for countries with revenues of less than EUR 10 million and profits of less than EUR 1 million (as calculated under the model rules and based on the average of the current and two previous fiscal years).

Computation of GloBE income or loss (tax base)

The starting point for the tax base is the **accounting net income (or loss) of each constituent entity** as used in the preparation of the ultimate parent company's consolidated financial statements (before any consolidation adjustments eliminating intra-group transactions).

Adjustments are made to calculate the GloBE income or loss (i.e., tax base) for each constituent entity, including in respect of:

- Net taxes expense (including covered taxes);
- Dividends;
- Equity gains/losses (e.g., arising from the disposal of shares);
- Revaluation method gains/losses;
- Gains/losses from transfers of assets/liabilities as part of a "GloBE reorganisation;"
- Asymmetric foreign currency gains/losses;
- Policy disallowed expenses (e.g., bribes);
- Prior period errors and changes in accounting principles;
- Accrued pension expenses; and
- Intragroup financing expenses without a commensurate increase in taxable intragroup income of a counterparty.

A number of elections may also be made including to:

- Substitute the amount expensed in financial accounts for the tax deduction available locally for share-based (stock-based) compensation;
- Determine gains and losses on a realisation basis for assets and liabilities subject to fair value or impairment accounting;
- Apply the consolidated accounting treatment to eliminate income, expense, gains, and losses between constituent entities in a tax consolidated group in the same country; and
- Carry back and offset a net gain from immovable property to previous periods where a net asset loss arose from immovable property in that country.

Transfer pricing adjustments are required where amounts are not consistent with the arm's length principle.

International shipping income is excluded from the tax base due to the global prevalence of tonnage tax regimes that are not based on profits.

There are also specific adjustments for financial services businesses, such as considerations for policy returns to shareholders and taxes thereon for insurance companies, considerations for insurance reserves and to take account of equity movements in relation to Additional Tier 1 Capital for regulated banking businesses.

Computation of adjusted covered taxes

The starting point to calculate the adjusted covered taxes is the current tax expense accrued in the constituent entity's net income (or loss), as used in the preparation of the parent company's consolidated financial statements (before any consolidation adjustments eliminating intragroup transactions).

Adjustments are then required, to reduce the effects of temporary differences on the volatility of effective tax rates (see below in respect of deferred taxes).

Covered taxes taken into account for the purposes of the model rules are:

- Taxes on a constituent entity's income or profits (or on its share of another constituent entity's income or profits) recorded in the financial accounts of the constituent entity;
- Taxes under an eligible distribution tax system, e.g., where tax in excess of 15% is generally payable only on distribution (or deemed distribution) of profits to shareholders;
- Taxes in lieu of corporate income tax; and
- Taxes levied by reference to retained earnings and corporate equity.

Both domestic and foreign taxes imposed on the company's profits are included, e.g., taxes paid under controlled foreign company (CFC) rules further up the ownership chain are taken into account when determining the covered taxes for the country in which the CFC is located.

Any additional top-up tax arising in respect of prior period recalculations is added to the top of tax payable in the current year.

Deferred tax mechanism to address temporary differences

The "Total Deferred Tax Adjustment Amount" for each constituent entity is calculated using the deferred tax expense in its financial accounts as a starting point. If the deferred tax expense is calculated using a tax rate of 15% or more, the deferred tax expense must be recast at 15%.

A number of exclusions are required, including in relation to:

- A deferred tax expense with respect to items excluded from the computation of the model rules tax base;
- Movements in deferred tax expenses accrued relating to "uncertain tax positions" and distributions from a constituent entity;
- Impact of a valuation/accounting recognition adjustment of a deferred tax asset;
- The deferred tax expense on re-measurement due to a change in the domestic tax rate; and
- Deferred tax expense on the generation and use of tax credits.

Further adjustments are required in respect of losses including: a reduction for a loss deferred tax asset not recognised because recognition criteria are not met and to recast at 15% a deferred tax asset attributable to a loss under the model rules that has been recorded at a lower rate.

A recapture rule limits allowable timing differences to those which will have reversed within five years. Otherwise the effective tax rate/top up tax in the fifth preceding accounting period will be recalculated, but any incremental top-up tax payable in the current accounting period.

No recapture is required in respect of deferred tax liabilities arising on:

- Tangible assets;
- Costs of a government lease/license for use of immovable property/exploitation of natural resources;
- Research and development expenses;
- Decommissioning and remediation expenses;
- Fair value accounting on unrealised net gains;
- Foreign currency exchange net gains;
- Insurance reserves/insurance policy deferred acquisition costs;
- Gains from the sale of local tangible property reinvested in tangible property in the same country; and
- Amounts accrued as a result of accounting principle changes in respect to the above.

Where a net "GloBE Loss" has been calculated for an accounting period in a country, a group may elect to calculate a simplified "GloBE loss deferred tax asset" rather than undertake the detailed calculations for that country. An amount equal to 15% of the value of the loss as calculated under the model rules is then available for offset against future profits in that country.

Substance-based income exclusion

A **substance based income exclusion rule** reduces the amount of profit from the calculation of additional top up taxes due, intended to represent a fixed return for substantive activities.

The carve-out has two components:

- A payroll component equal to a 5% mark-up on payroll costs (including salaries, health insurance, pension contributions, employment taxes, and employer social security contributions) of eligible employees (including independent contractors) performing activities in the country; and
- A tangible asset component equal to a 5% mark-up applied to the carrying value of tangible assets located in the country including property, plant and equipment and natural resources.

A transition period applies during the first ten years of the rules, during which 8% of the carrying value of tangible assets and 10% of payroll is initially excluded, declining gradually over the period to 5% in 2033.

Computation of effective tax rate and top-up tax

The effective tax rate of each country is calculated by aggregating the tax base and adjusted covered taxes for all constituent entities in the same country. The top up tax percentage is the difference between the effective tax rate in the country and the 15% minimum rate.

Top up tax payable for a low tax country = Top up tax percentage x Combined tax base of constituent entities located in the country less substance-based income exclusion

Countries that adopt the rules are not required to introduce domestic top-up taxes on their own resident taxpayers, but may choose to do so. Any such domestic minimum top up tax paid to the local tax authority and calculated in an equivalent manner to the model rules reduces the amount of top up tax payable in respect of the low tax country (as long as the country does not provide ‘any related benefits’).

The remaining top up tax is assigned to individual constituent entities in the low tax country in proportion to their net income as calculated under the model rules, in order to determine the top up tax amounts payable by parent entities.

Other components of the rules

Additional rules are also set out in respect of corporate restructurings, including mergers, demergers, group members joining and leaving a group, and transfers of assets and liabilities.

Specific rules apply to permanent establishments, tax transparent entities, stateless entities, investment entities, investment funds/real estate investment vehicles, joint ventures, multiparented (including dual listed) groups, cooperatives, and minority-owned entities, as well as in respect of deductible dividend and distribution regimes.

Transition rules

Existing tax attributes, including losses, reflected/disclosed in the financial accounts of a constituent entity in the first year during which the rules apply are taken into account in the effective tax rate calculations. Deferred tax assets/liabilities are capped at the lower of 15% or the applicable domestic tax rate. (A deferred tax asset recorded at a lower rate may be taken into account at 15% if it is attributable to a loss as calculated under the model rules.) Deferred tax assets arising from items excluded from the model rules tax base computation and which arise in a transaction after 30 November 2021 are excluded.

Deferred tax assets/liabilities in respect of acquired assets (other than inventory) transferred between constituent entities after 30 November 2021 and before the group is within the scope of the rules, are based on the disposing entity's carrying value.

Compliance and administration

The OECD will develop a "GloBE Implementation Framework" consisting of administrative rules, guidance, and procedures to facilitate coordinated implementation of the model rules. Businesses will be required to prepare a "GloBE information return" which will include:

- Information on group members, including tax identification numbers;
- Information on the corporate structure of the group;
- Information necessary to compute the effective tax rate for each country and the top up tax of each group member, as well as the allocation of top up tax to each country; and
- A record of elections made under the model rules.

A standard template will be developed. Returns must be filed no later than 15 months after the last day of the accounting period, extended to 18 months in respect of the group's first return.

The ultimate parent company (or an appointed group member) will file the return with its local tax authority, who will then exchange the agreement with other tax authorities where a qualifying competent authority agreement is in place. Each constituent entity located in a country applying the model rules will need to notify its local tax authority of the group member filing the return and in which country it is located. Group members located in a country which has adopted the rules but does not have the necessary exchange relationships in place will be required to file a copy of the return with their local tax authority. Group members can appoint another constituent entity located in the same country to file and/or submit notifications on their behalf. Domestic laws will apply with respect to penalties and the confidentiality of information.

Safe harbours may be considered to reduce the number of countries for which detailed effective tax rate calculations are required. The design of any safe harbours will be included in the "GloBE Implementation Framework," if agreed.

Next steps

The model rules will be supplemented by commentary, to be released in early 2022. The GloBE Implementation Framework for administration, compliance, and coordination will follow, with a public consultation event in February 2022. The OECD will also address coexistence with the US global intangible low-taxed income (GILTI) rules in early 2022. The income inclusion rule is expected to take effect from 2023. The inclusive framework statement of October 2021 stated that the undertaxed payments rule would be deferred by one year to 2024.

The model treaty article for a subject to tax rule will be released in early 2022, along with a multilateral instrument for its implementation. A public consultation event will be held in March.

Comments

The OECD model rules published on 20 December 2021 mark a key point in the development of the global international tax framework. The Pillar Two rules are as much about governments holding other governments to certain tax standards as they are about multinationals, and reflect the desire by many countries to remove corporate tax as a factor in countries' competition for investment. To achieve this in the age of globalisation, the Pillar Two model rules (the primary income inclusion rule and the secondary undertaxed payments rule) introduce fundamental changes, including creating a harmonised global tax base in order to compare effective tax rates and take into account differences in domestic corporate tax regimes. The result is inevitably extremely complex. The rules provide for a mix of accounting and tax concepts, including the up-to-now speciality subject of deferred tax, and will, in effect, require large businesses (broadly those in the scope of country-by-country reporting) to keep a third set of books for Pillar Two calculation purposes. This complexity is highlighted by the 15 possible elections that groups can make, some of them on a by-country basis, in order to try to simplify the calculations.

The tight timetable for completion and publication of the model rules means that there are other key components of the Pillar Two minimum tax approach still being worked on by the inclusive framework. These include a detailed commentary to be released in early 2022 and draft treaty clauses for the priority "subject to tax rule" for some intragroup payments from developing countries to low-tax countries. There also may be treaty clauses to implement (and ensure consistency regarding) the income inclusion and undertaxed payments rules later in 2022. It is intended that the income inclusion rule will take effect in 2023. The European Commission intends to publish a draft directive on 22 December 2021 to implement Pillar Two in the European Union.

Many businesses have been concerned at the lack of opportunity for broad public consultation on the development of the model rules, and while some specific industry issues have been addressed (such as Additional Tier 1 Capital for regulated banks) it is likely that other points of specific detail will cause concern. The inclusive framework does plan to consult in 2022 on a GloBE Implementation Framework that will develop administrative rules, guidance, and procedures to facilitate coordinated implementation.

The new rules will require a step-change for groups in scope in terms of global tax compliance - including understanding the rules, accessing data, performing and processing the calculations, understanding accounting treatments, and adjusting for changes in prior periods as well as filing additional Pillar Two calculation returns and notifications.

Businesses will be particularly concerned at the suggestion that there will need to be "notifications" made to all tax authorities as this has proved particularly onerous and inconsistent between jurisdictions in relation to country-by-country reporting requirements (with perceived limited additional benefit for tax authorities). It also will be essential for governments to conclude competent authority agreements to share Pillar Two returns swiftly to prevent the need for costly local filing of Pillar Two returns in multiple countries, with potential associated confidentiality risks. The Forum on Tax Administration has said that one of their priorities for tax authorities for 2022 is the effective implementation of both Pillar One and Pillar Two.

A number of key big-picture questions remain. Firstly, will the US GILTI regime be adapted so as to be considered a coexistent regime with the Pillar Two rules? If so, US parented groups would continue to apply GILTI (as modified) rather than the income inclusion rule under Pillar Two. This will be addressed by the inclusive framework in 2022, but requires, as a minimum, US domestic law changes to make GILTI operate on a country-by-country basis. Secondly, how will governments in low-tax countries respond to the Pillar Two rules? A likely response for some, perhaps many, countries will be to increase tax rates to 15% for large multinationals, and the Pillar Two rules anticipate this with allowance for domestic minimum tax regimes to enable tax to remain in the country with the economic activity. Unless significant and effective safe harbours can be agreed (which has not been the case to date), the price for achieving the political objective of a global minimum rate will be expensive compliance for all large multinational businesses, regardless of the countries in which they operate.

Australian perspective

Some particular matters to consider from an Australian perspective:

- Australia has a comprehensive CFC regime that applies Australian tax concepts to attribute certain amounts of passive and 'tainted' income back to Australia. The model rules are complementary to existing CFC regimes so the GloBE calculation will be an additional compliance obligation for Australian headquartered multinationals. However, additional top up tax under the GloBE rules is likely to be limited to low-taxed active income (i.e., income that has not otherwise been subject to tax under the CFC rules).

- Income that is subject to the Australian CFC provisions will be taxed in Australia (generally at 30%) with a foreign income tax offset, as appropriate. By contrast, income subject to the GloBE rules will be taxed in Australia at the difference between 15% and the effective tax rate in the relevant foreign country.

- The GloBE rules are also expected to overlay existing anti-avoidance rules such as the 'targeted integrity rule' that denies deductions for related party interest if taxed at 10% or less. Unlike the targeted integrity rule, the Pillar Two top up tax takes account of withholding taxes but it appears that the targeted integrity rule would continue to take precedence to any GloBE top up, meaning there is a potential for double tax if both rules do not co-ordinate.

- The model rules contain a definition of Multi-parented MNE Groups that includes dual-listed arrangements and stapled structures that will be relevant in Australia.

- For inbound (foreign controlled) Australian companies their role may be limited to supplying information to its parent given the 'GloBE information return' obligation rests with the parent, provided the parent country adopts the Income Inclusion Rule.

- The OECD has indicated that the income inclusion rule is expected to take effect from 2023. This will require that the Australian legislated form of the model rules are passed into law in Australia, noting that the Parliamentary calendar in 2022 will be affected by the election.

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