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US International Tax Alert

New OECD guidance addresses Pillar Two incentives and administration

On January 15, 2025, the OECD/G20 Inclusive Framework (IF) released the latest package of materials related to the 15% global minimum tax on multinational corporations ("Pillar Two" or "GloBE"). The guidance (hereafter, the "January 2025 AG") addresses the application of the Article ("Art.") 9 transition rules to certain deferred tax assets (DTAs) arising prior to the application of the GloBE Rules.

In addition, the OECD released the list of countries whose IIR and/or QDMTT legislation has so far been transitionally qualified for purposes of interacting with other countries' Pillar Two legislation.

Finally, the OECD has provided a revised final GloBE Information Return (GIR) that serves as the basis for reporting under Pillar Two along with administrative guidance related to the GIR under Art. 8. This GIR supersedes an earlier release from July 2023.

This alert addresses the guidance under Art. 9.1.2 and related provisions. The updates to the GIR and list of qualified regimes will be addressed in a future alert.

Overview of Pillar Two

The Pillar Two global minimum tax rules have been agreed to by more than 140 members of the OECD IF. Jurisdictions are in the process of implementing rules in domestic legislation, which largely apply for fiscal years beginning after December 31, 2023, or 2024, depending on the jurisdiction and top-up tax.

The guidance with respect to the GloBE Rules forms part of the "common approach." Under the common approach, countries are not required to adopt the GloBE Rules, but if they choose to do so, they agree to implement and administer the rules in a way that is consistent with the outcomes provided for under the Pillar Two Model Rules ("Model Rules") released in December 2021, and any subsequent guidance agreed to by the IF.

The publication of the January 2025 AG follows the release of the Model Rules in December 2021 and related Commentary in March 2022, rules for safe harbors and penalty relief released in December 2022, and Administrative Guidance released in February 2023, July 2023, December 2023, and June 2024. Consolidated commentaries including all guidance through December 2023 were released in April 2024.

Pillar Two consists of two interlocking domestic rules that together make up the GloBE regime. The Income Inclusion Rule (IIR) imposes top-up tax on a parent entity with respect to the low-taxed income of a member of its multinational entity (MNE) group (a constituent entity or CE). The Undertaxed Profits Rule (UTPR) denies deductions or requires an equivalent adjustment to the extent the low-tax income of a constituent entity is not subject to tax under an IIR. Countries also have the option to adopt a "qualified domestic minimum top-up tax" (QDMTT), as defined in the Model Rules and further clarified in subsequent administrative guidance. The QDMTT is credited against the top-up tax liability otherwise owed under an IIR or the UTPR (rather than treated as an additional Covered Tax), except where the QDMTT qualifies for the QDMTT Safe Harbour, in which case no IIR or UTPR may apply. Where a jurisdiction's QDMTT qualifies for the QDMTT Safe Harbour, taxpayers in that jurisdiction may still be subject to an IIR and/or UTPR if the "Switch-off" rule applies. The Switch-off rule prevents a taxpayer from claiming the benefit of the QDMTT Safe Harbour when certain aspects of the local QDMTT render it inapplicable to one or more of the MNE Group's constituent entities within that jurisdiction. In such cases, the QDMTT will continue to function as a credit against IIR/UTPR top-up tax liability.

A Transitional Safe Harbour based on Country-by-Country Reporting ("Transitional CbCR Safe Harbour"), provided in December 2022, allows MNE Groups to apply a simplified approach in lieu of the full GloBE Rules for up to the first three years of GloBE, when the jurisdiction meets one of three separate tests: the Simplified ETR Test, Routine Profits Test, or *De Minimis* Test.

While the GloBE Rules and related commentaries and administrative guidance are intended to be adopted uniformly by implementing jurisdictions, it is ultimately local legislation that will apply to charge one or more of the Pillar Two top-up taxes.

The January 2025 AG

The January 2025 AG addresses the application of Art. 9.1.2 and related rules, as well as the Transitional CbCR Safe Harbour, to certain DTAs and deferred tax liabilities (DTLs) arising from arrangements with General Governments.[1] The guidance is intended to be a clarification of the existing application of Art. 9.1.2.

The January 2025 AG provides that the limitation in Art. 9.1.2 applies to certain DTAs generated in a transaction that takes places after November 30, 2021; future work may address incentives and benefits that are offered when the GloBE Rules are in effect.

Background

Under Art. 9.1.1 of the Model Rules, the DTAs and DTLs reflected or disclosed in a constituent entity's financial accounts prior to the first year the MNE Group is subject to a top-up tax (the Transition Year) are generally taken into account in determining Adjusted Covered Taxes under Art. 4.4. This general rule is subject to two anti-abuse rules in Art. 9.1.2 and 9.1.3.

[1] Art. 10.1 defines General Government as "the central administration, agencies whose operations are under its effective control, state and local governments and their administrations."

Under Art. 9.1.2 of the Model Rules, a pre-Transition Year DTA is excluded from GloBE if it arose “from items excluded from the computation of GloBE Income or Loss under Chapter 3” and was generated in a transaction occurring after November 30, 2021 (the period between November 30, 2021, and the Transition Year is referred to here as the “Transition Period”).

Separately, for purposes of determining whether a jurisdiction satisfies the Simplified ETR Safe Harbor, Simplified Covered Taxes (*i.e.*, the numerator of the ETR fraction for Transitional CbCR Safe Harbour purposes) are the current and deferred taxes reflected in the Qualified Financial Statements, after eliminating uncertain tax positions.

DTAs not reflected or disclosed under the Authorised Financial Accounting Standard: Currently Art. 9.1.1 provides that “the impact of any valuation adjustment, or accounting recognition adjustment with respect to a deferred tax asset is disregarded” in determining whether a DTA is taken into account under GloBE. The January 2025 AG clarifies that this only applies where the DTA has not been recognized due to insufficient future taxable income; it does not apply to a DTA that cannot be reflected or disclosed under the relevant accounting standard (except as provided under paragraph 51.2 of the Commentary to Art. 6.2.1 or the Commentary to Art. 9.1.3, both of which provide guidance in which the carrying value under the Authorised Financial Accounting Standard and GloBE may diverge, and deferred taxes are computed based upon the GloBE carrying value).

Clarification of “items excluded from the computation of GloBE Income or Loss under Chapter 3”: The guidance clarifies that, for purposes of Art. 9.1.2, “items excluded from the computation of GloBE Income or Loss under Chapter 3” include both items specifically excluded under Ch. 3 (such as Excluded Equity Gain or Loss), as well as “non-economic expense or losses for tax purposes,” such as depreciation expense in excess of an asset’s cost.

The guidance further clarifies that Art. 9.1.2 does not apply to tax credit carryforward DTAs not otherwise excluded under the January 2025 AG (see below), or to any “GloBE-only” DTAs that arise from the exclusion of purchase accounting adjustments and provided for in the June 2024 AG (related to the exclusion of purchase accounting adjustments).

When a transaction is deemed to occur under Art. 9.1.2: The guidance provides that Art. 9.1.2 applies to a DTA disclosed in the financial accounts as of the Transition Year, even if the underlying transaction itself occurred after the Transition Year.

Definition of “Transaction” for arrangements with governments: The January 2025 AG primarily addresses the extent to which Art. 9.1.2 applies to DTAs arising from agreements reached with General Governments that otherwise would have provided attributes taxpayers could carry into the Transition Year under Art. 9.1.1.

As noted above, the guidance specifies that Art. 9.1.2 can apply to a transaction that occurs after the Transition Year if the relevant DTA is disclosed in the financial accounts for the Transition Year. “Transaction” for purposes of Art. 9.1.2 is interpreted broadly and includes any “agreement, ruling, decree, grant, or similar arrangement with a General Government,” as well as any

modification to an existing arrangement. These arrangements will be subject to Art. 9.1.2 if the arrangement provides the taxpayer with a credit or other relief (such as a tax basis step-up) that does not arise independently of the arrangement. A tax credit or other relief arises independently of the arrangement (and therefore would not be disallowed under Art. 9.1.2) if no critical aspect of the relief relies on government discretion.

The guidance provides three examples of arrangements that result in a DTA excluded under Art. 9.1.2:

1. A DTA attributable to a governmental arrangement concluded or amended after November 30, 2021, that provides the taxpayer with a credit or other relief that does not arise independently of the arrangement (hereafter "Governmental Arrangement DTAs");
2. A DTA attributable to an election or choice that was exercised or changed after November 30, 2021, and that retroactively changes the treatment of a transaction in determining its taxable income in a tax year for which an assessment by the tax authority was already made ("Retroactive Election DTAs"); and
3. A DTA or DTL arising from the difference between tax basis and accounting carrying value of an asset or liability if the tax basis was established pursuant to a corporate income tax enacted by a jurisdiction that did not have a pre-existing corporate income tax and that was enacted between November 30, 2021, and the Transition Year ("Initial Asset Step-up DTAs").

Art. 9.1.2 excludes from Art. 9.1.1 a DTA arising from a loss carryforward in a jurisdiction that did not have a pre-existing corporate income tax, *but only to the extent the loss arose more than five fiscal years prior to the effective date of such newly enacted income tax law*. Losses arising within five years of the effective date of such corporate income tax are not subject to Art. 9.1.2 and therefore may give rise to a DTA that is taken into account under Art. 9.1.1.

The guidance clarifies that the reversal of any DTA excluded under Art. 9.1.2 and described in the January 2025 AG may not be counted as an "Other Tax Effect" for purposes of applying the exception to Art. 9.1.3 (relating to intercompany asset transfers in the Transition Period).

Exclusion of deferred tax expense for Transitional CbCR Safe Harbour: The January 2025 AG also excludes deferred tax expense from Simplified Covered Taxes under the Transitional CbCR Safe Harbour if such expense arises from the reversal of a Governmental Arrangement DTA, a Retroactive Election DTA, or an Initial Asset Step-up DTA (subject to the amount allowable during the Grace Period, below).

Exception for DTAs during the Grace Period: The guidance provides an exception to the application of Art. 9.1.2 (and the exclusionary rule for Transitional CbCR Safe Harbour) for the DTAs described above during the "Grace Period." The Grace Period is defined as either:

1. For deferred tax expense attributable to Governmental Arrangement DTAs and Retroactive Election DTAs, all Fiscal Years beginning on or after January 1, 2024, and before January 1, 2026 (but not including a Fiscal Year that ends after June 30, 2027); or

2. For deferred tax expense attributable to Initial Asset Step-up DTAs, all Fiscal Years beginning on or after January 1, 2025, and before January 1, 2027 (but not including a Fiscal Year that ends after June 30, 2028).

The maximum amount of deferred tax expense allowed during the Grace Period (the "Grace Period Limitation") is limited to 20% of the amount of the DTA originally recorded in the financial accounts and taken into account at the lower of the 15% Minimum Rate or the relevant domestic rate. The Grace Period Limitation applies to the sum total includible in Simplified Covered Taxes in the Transitional CbCR Safe Harbour and Adjusted Covered Taxes in the GloBE Rules (*i.e.*, taxpayers may not take into account 20% of the DTA in Safe Harbor and an additional 20% in full GloBE).

Within the Grace Period Limitation, the amount of deferred tax expense taken into account in a given year is based upon the accounting methodology and terms of any governmental arrangements in place as of November 18, 2024. That is, a taxpayer may not change their accounting procedures or renegotiate the terms of any arrangement in order to accelerate the amount of deferred tax expense allowed under the Grace Period Limitation.

Finally, the Grace Period Limitation does not apply to:

1. Governmental Arrangement DTAs where the arrangement is concluded or amended after November 18, 2024;
2. Retroactive Election DTAs where the election was made after November 18, 2024; or
3. Initial Asset Step-up DTAs where the corporate income tax was enacted after November 18, 2024.

DTAs arising in these circumstances are fully excluded from both Simplified Covered Taxes and Adjusted Covered Taxes.

Interaction with QDMTT Safe Harbour: Jurisdictions are not required to adopt the revisions to Art. 9.1.1 and 9.1.2 from the January 2025 AG into their QDMTT legislation in order for the legislation to qualify for the QDMTT Safe Harbour; however, if a jurisdiction omits these rules, it is subject to the QDMTT Switch-off rule. As a result, MNE Groups operating in that jurisdiction and who have recorded or disclosed a Governmental Arrangement DTA, a Retroactive Election DTA, or an Initial Asset Step-up DTA may not apply the QDMTT Safe Harbour and may be subject to an applicable IIR and/or UTPR.

Potential financial statement impacts of January 2025 AG

The January 2025 AG constitutes new information that should be considered in the reporting period that includes the issuance date. Accordingly, for many entities, this new information was received in a period after the balance sheet date, but before the issuance of the financial statements. Such entities should consider the disclosure requirements in ASC 855-10-50-2, which states:

> Some nonrecognized subsequent events may be of such a nature that they must be disclosed to keep the financial statements from being misleading. For such events, an entity shall disclose the following:

a. The nature of the event
b. An estimate of its financial effect, or a statement that such an estimate cannot be made.

In assessing the impact, entities should consider the following:

- The January 2025 AG may result in a change in tax law in the reporting period that includes the issuance date to the extent a jurisdiction automatically incorporates OECD guidance into enacted tax law. Conversely, many jurisdictions will have to formally adopt the January 2025 AG through a change in tax law. ASC 740-10-25-47 requires a change in tax laws or rates to be recognized in the reporting period that includes the date of enactment.
- The disallowance of all or a portion of the deferred tax expense associated with Governmental Arrangement DTAs, Retroactive Election DTAs, or Initial Asset Step-up DTAs may increase top-up taxes for the 2024 tax year and future years. In addition, the January 2025 AG might impact deferred taxes if an entity elected to consider the impact of Pillar Two in the valuation allowance assessment of regular tax DTAs. See Deloitte's Financial Reporting Alert 24-1 Frequently Asked Questions About "Pillar Two" for more information.

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