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US International Tax Alert

New OECD document provides additional detail on implementing Pillar Two, outlines process to determine if local implementation is "qualified"

On June 17, 2024, the OECD/G20 Inclusive Framework on BEPS ("OECD Inclusive Framework" or IF) published further administrative guidance on the implementation of the Pillar Two global minimum tax rules, together with details of the processes for determining that jurisdictions' local implementations of the Pillar Two rules are "qualified."

The Pillar Two global minimum tax rules have been agreed by more than 140 members of the OECD inclusive framework. Jurisdictions are in the process of implementing rules in domestic legislation, which apply starting in January 2024.

Components of the Pillar Two rules

The IF's Pillar Two model rules, applicable to large multinational groups with annual consolidated group revenue of at least €750 million, will result in "top-up" tax amounts to bring the overall tax on profits in each jurisdiction where a group operates up to a 15% minimum effective tax rate. The key components are: qualified domestic minimum top-up taxes (QDMTT), which allow jurisdictions to charge any top-up taxes due in respect of local profits; the income inclusion rule (IIR) under which parent company jurisdictions apply the top-up tax rules on a top-down basis; and the undertaxed profits rule (UTPR), which will apply as a secondary (backstop) rule where the other rules have not been fully applied.

New guidance

The guidance will be incorporated into the OECD's commentary to the model rules at a future date. There are also a number of additional examples which will be included in the OECD's published examples illustrating the application of the model rules.

The new guidance covers the following distinct areas:

- Recapture of deferred tax liabilities
- Divergences between Pillar Two basis and accounting carrying values
- Allocation of cross-border current taxes
- Allocation of cross-border deferred taxes
- Allocation of profits and taxes in groups including flow-through entities
- Treatment of securitization vehicles

Recapture of deferred tax liabilities

The model rules include a deferred tax liability (DTL) recapture rule, which requires the benefit of some DTLs (for example, in relation to intangible fixed assets) that are taken into account in the Pillar Two calculations, to be tracked and then recaptured if they do not reverse within five years.

Some businesses raised questions about whether it would be necessary to track DTLs on an item-by-item basis. The latest guidance sets out approaches on how to apply the deferred tax recapture rule in practice. For example, group entities will be permitted to track DTLs on a "general ledger account" basis. Simplified tracking approaches can also be permitted on a less-detailed "aggregate DTL category" basis (that is, two or more general ledger accounts within the same balance sheet or sub-balance sheet account) where the composition of the category does not include assets that are likely to be subject to DTL recapture. Certain general ledger accounts cannot be aggregated with other accounts, including: non-amortizable intangible assets, including goodwill; intangibles with an accounting life of more than five years; related party receivables and payables; and "swinging accounts" where net asset and net liability positions can arise at different points in the life of the relevant assets/liabilities. General ledger accounts, which would always only generate deferred tax assets, are also generally excluded from an aggregate DTL category.

DTLs that would otherwise be covered by an exception to the recapture rule (for example, DTLs in respect of tangible fixed assets) will become subject to recapture if tracked as part of a general ledger or aggregate DTL category.

The default method for calculating the amount of the recapture of liabilities within an aggregate DTL category is last-in, first-out (LIFO). In some circumstances groups may choose to use the first-in, first-out (FIFO) method. Where an aggregate DTL category contains only short-term DTLs that will reverse within five years, entities can benefit from a simplification to remove the need for tracking. Guidance is also provided on the methodology for determining whether any reversals are attributable to DTLs that arose before the group came within the scope of Pillar Two.

The guidance also includes a clarification on the exceptions to the recapture rule: DTLs associated with cost recovery allowances on leased property will be within the scope of the exception if the leased property is a tangible asset.

Divergences between Pillar Two basis and accounting carrying values

Several areas in the model rules require an entity to determine its Pillar Two income or loss by reference to values that may differ from the carrying values reflected in the financial accounts used to prepare the consolidated financial statements. Examples include: pension accruals; stock-based compensation; intra-group asset transfers accounted for at cost; elections to use the realization method in lieu of fair value accounting; and adjustments following acquisitions or disposals of entities. The guidance provides clarifications on how the total deferred tax adjustment amount should be calculated using Pillar Two (global anti-base erosion or "GloBE") carrying values in these areas. The guidance also clarifies the limited extent to which such divergences are taken into account for the purposes of applying the transition rules. The substance-

based income exclusion continues to be calculated using accounting carrying values.

Importantly for taxpayers that prepare consolidated financial statements using US GAAP, the guidance provides that, in the context of an intragroup cross-border transfer of assets, the transferor will take into account an arm's length value of the asset for GloBE purposes rather than at cost.

Allocation of cross-border current taxes

Under the model rules, covered tax amounts included within the financial accounts of a "main entity" but relating to the profits of its permanent establishment generally are allocated to the permanent establishment jurisdiction for effective tax rate calculation purposes. Some jurisdictions allow for "cross-crediting," that is, foreign taxes paid on one source of income can give rise to foreign tax credits that can be used against income arising in a different jurisdiction. The existing guidance on cross-crediting is significantly expanded and sets out a formulaic mechanism for determining the allocations of covered tax amounts to each permanent establishment where cross-crediting rules apply to the main entity. The mechanism uses a four-step process, together with allocation keys, to apportion amounts. Modifications apply where cross-crediting involves taxable distributions and/or is applied by reference to separate "baskets" of foreign income. The same principles also apply in respect of the cross-crediting of taxes on controlled foreign corporations (CFCs) (other than taxes arising under a "blended CFC tax regime" such as global intangible low-taxed income (GILTI), for which specific guidance issued in February 2023 remains applicable) and also hybrid and reverse hybrid entities.

Allocation of cross-border deferred taxes

Expanded guidance is provided on the principles relevant to allocating deferred taxes between group entities where a deferred tax balance in the financial accounts of one entity arises due to the income of a different Pillar Two entity. The guidance focuses on deferred tax associated with CFC rules and sets out a formulaic five-step approach for calculating the Pillar Two reallocation of associated deferred tax amounts of a parent to its CFC. Several numerical examples are given that illustrate the interaction with deferred tax from credits for the underlying tax of the CFC itself, requirements to recast deferred tax amounts to 15% and/or the passive income limitation. The guidance states that the same principles will also apply to allocation of similar deferred taxes from a main entity to permanent establishments, and from parent entities to hybrid and reverse hybrid entities.

The new guidance also expands existing commentary that sets out a "substitute loss carry-forward DTA" mechanism to address situations where a parent entity has a current-year domestic tax loss that is used against current-year foreign CFC income with a corresponding carryforward of excess foreign tax credits. In the new guidance, this mechanism is extended to situations involving permanent establishments, hybrid entities and reverse hybrid entities, and also to similar situations involving the interaction of domestic tax losses brought forward and foreign tax credits.

Allocation of profits and taxes in groups including flow-through entities

Additional guidance has been released on the allocation of profits and taxes to and from "flow-through entities" (broadly, entities that are treated as transparent in their jurisdiction of creation). The guidance addresses situations where a flow-through entity is itself directly held by another flow-through entity. In such cases, classification of entities as "tax transparent" or "reverse hybrids," and reallocations of profits and taxes, generally will be determined by the tax law of the jurisdiction of the entity closest in the ownership chain that is itself not a flow-through entity (the "reference entity"). The guidance includes examples where the ultimate parent of a group is a flow-through entity, or where there is a minority interest in a flow-through entity. The guidance also confirms how CFC taxes that were initially attributable to a flow-through entity should be treated under the general reallocation rules for flow-through entities.

The definition of a hybrid entity has been expanded such that an entity can be treated as a hybrid entity by reference to its tax treatment in the jurisdiction of an *indirect* owner, enabling in some circumstances for taxes paid by the indirect owner to be allocated to the hybrid entity. An entity can also be treated as a hybrid entity if its local tax jurisdiction does not have a corporate income tax regime. The guidance also sets out circumstances where taxes paid by an *indirect* owner in respect of a reverse hybrid entity are allocated to the reverse hybrid.

Treatment of securitization vehicles

Additional guidance has been issued on the treatment of groups with special purpose vehicles used for securitization transactions. The guidance notes the importance for the sector that securitization entities remain "bankruptcy remote." Where a special purpose vehicle meets the guidance's definition of a securitization entity (including having non-group investors), jurisdictions can exclude these entities from the scope of their QDMTTs. However, the "switch-off rule" would apply such that a group with an excluded securitization entity would not benefit from the QDMTT safe harbor for that jurisdiction. Alternatively, jurisdictions may choose to design their QDMTTs so that any QDMTT top-up tax liabilities in respect of securitization entities are imposed on other group entities located in the same jurisdiction, in which case the QDMTT safe harbor would remain available for that jurisdiction.

The IF will consider issuing further administrative guidance to address issues associated with securitization entities, for example, hedging arrangements.

Qualified status under Pillar Two

The Pillar Two global minimum tax rules incorporate an agreed rule order, which prevents a jurisdiction from levying top-up tax in respect of low tax profits where those profits have already been subject to top-up tax under "qualified" rules in another jurisdiction. A separate question-and-answer document published by the IF describes agreed processes for common assessment of the "qualified" rules status of jurisdictions' implementations of domestic minimum top-up tax rules, IIRs, and UTPRs.; as well as assessing whether a jurisdiction's QDMTT satisfies the additional criteria for the QDMTT safe harbor to apply.

A simplified transitional qualification mechanism will apply initially based on an implementing jurisdiction's self-certification. An implementing jurisdiction will provide the IF with information on the main features of their (draft or enacted) legislation. If the rules contain some minor inconsistencies, a jurisdiction can still make a self-certification where these are expected to be addressed within an agreed timeframe. If no questions are received from other IF jurisdictions, or if any such questions are resolved, the rules will be recorded on the OECD website as having transitional qualified status. If questions cannot be resolved and a required level of opposition is reached ("consensus minus one" where all or all but one of the reviewing jurisdictions have agreed that the self-certification should be rejected) then the jurisdiction's rules will not have transitional qualified status. If the rejection requirements are not reached, the jurisdiction's rules will have transitional qualified status, but they will also be prioritized for early full legislative review under the peer review process. All implementing jurisdictions will be required to respect any transitional qualified status.

A full peer review process will be introduced, involving both a full legislative review of whether domestic legislation achieves outcomes consistent with the model rules, and ongoing monitoring to ensure that a jurisdiction's rules are applied in practice and administered consistently with the model rules. Any loss of transitional qualified status as a result of a peer review will not be retrospective but will only apply for accounting periods that begin on or after the date that the status changes.

Next steps

The IF will continue to release further agreed guidance. It is expected that future guidance will include the treatment of hybrid arbitrage arrangements in the main Pillar Two rules.

The IF also continues its work on mechanisms to resolve disputes related to differences of interpretation (including between tax authorities) of the Pillar Two rules.

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