

OECD releases Pillar Two 15% minimum effective tax rate Model Rules

20 December 2021

In brief

The OECD released the long-awaited Pillar Two 15% minimum effective tax rate Model Rules (see [here](#)) on 20 December, just days before the expected release of a draft EU Directive on minimum taxes. As set out in the [8 October 2021 Statement](#) by the OECD/G20 Inclusive Framework (IF), these Model Rules are the first of three expected sets of guidance: the Model Rules; an explanatory Commentary, expected in January; and a more detailed Implementation Framework, expected in the middle of 2022 at the earliest. These Model Rules cover the income inclusion rule (IIR) and undertaxed payments rule (UTPR), collectively referred to as 'GloBE.' More detail on the other part of Pillar Two, the subject to tax rule (STTR) will not be made public until 2022.

It has been reiterated that the aim is for Pillar Two to be brought into law in 2022, to be effective in 2023, with the UTPR to come into effect in 2024.

In detail

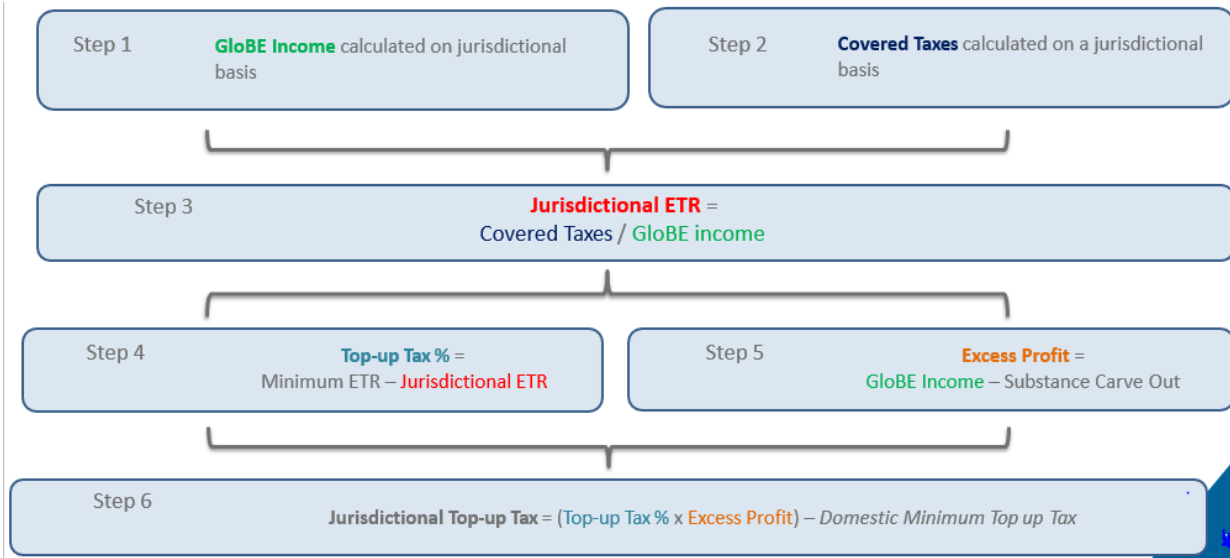
Background

There are now 137 IF Members that have signed up to the 8 October Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, with Mauritania having joined the IF and signed up to the Statement on 4 November.

Pillar Two - Model Rules

The Model Rules provide more details, fleshing out the political agreement. However, the Commentary, originally meant to be released at the same time as the Model Rules, will provide some background and examples, which would help clarify some of the complex concepts and language in the Model Rules. As to the actual mechanics of the rules, we will have to wait until mid-2022 for the detailed implementation rules. However, a public consultation event on the implementation framework will be held in February 2022 and on the Subject to Tax Rule in March 2022, according to the press release of the OECD of 20 December 2021.

The OECD has used this graphic to describe the broad steps and organisation of the Model Rules. In addition, there are detailed rules on mergers and acquisitions, tax neutrality and distribution regimes, administration, transitional rules and definitions.



Not every entity will be in scope (see, excluded entities below), and some businesses and/or jurisdictions may, effectively, not be subject to GLoBE under safe harbors referenced in the Model Rules – although the shape, not to mention the detail, of those will only become clear with the Implementation Framework in 2022.

However, we do now know more detail, and here, in summary, are some of the areas in which there is more clarity since [our previous Alert of 8 October 2021](#):

- **Scope** - MNEs with annual global consolidated revenues above €750m for at least two of the last four fiscal years immediately preceding the tested fiscal year (some transitional rules for single entities on becoming groups).
- **Excluded entities** - While retaining reference to government bodies, international organizations, and non-profit organizations, the funds exemption has been expanded. GloBE won't apply to pension funds nor, where they head up groups, investment funds or real estate investment vehicles. Constituent entities that are largely investment or ancillary vehicles and that are 95% owned directly or indirectly by excluded entities also will be excluded. Other investment entities are subject to special rules which treat them separately from other entities in a jurisdiction, with elections for them to be treated as transparent or to apply a taxable distribution methodology.
- **Parent entity applying IIR** - Parent entity applying IIR - The ultimate parent entity (UPE) is primarily responsible for applying IIR as the collection mechanism for the top-up tax (TPT). However, if the UPE jurisdiction does not apply IIR or another Qualified Income Inclusion Rule, or the UPE is an excluded entity, then responsibility falls to the next highest level Intermediate Parent Entity (IPE) that has a controlling ownership interest, and so on down the chain. If the MNE Group includes a sufficiently Partially-Owned Parent Entity (POPE: where >20% interest is held outside the group), the obligation to apply the IIR is wholly or partly pushed down to this POPE or a POPE further down the chain. There is an offset mechanism to ensure there is no double counting.
- **Top-up tax** - The jurisdictional TPT amount is the difference between the 15% GLoBE tax rate and the effective tax rate (ETR) applied to an amount of excess profit equal to net GloBE income minus the substance-based income exclusion for that jurisdiction. The de minimis exclusion treats this TPT amount as zero if, averaging the current and two prior years, both GloBE revenue is ≤ €10m and GloBE income is ≤

€1m (or a loss). Safe harbour rules will be developed to provide an election for a zero TPT amount in certain other cases as part of the Implementation Framework.

- **Allocation of TPT** - Jurisdictional TPT is allocated to constituent entities in the jurisdiction according to their contributions to aggregate GloBE income so that IIR is then applied to the relevant parent's allocable share according to the ownership interest.
- **Nature of UTPR charge** - Where there is remaining TPT after the IIR has been applied, such that the UTPR backstop kicks in, the adjustment or additional cash tax expense can be achieved in the manner each jurisdiction decides, e.g., denial of a deduction, an additional tax, a reduction in any allowance for equity, or deemed income (reversing a related party expense). The total UTPR amount is allocated among implementing jurisdictions under a formula that is based on the relative proportion of employees and tangible assets in each jurisdiction. Importantly, under this formula, there is no requirement that an entity in a UTPR jurisdiction actually makes deductible payments to a low-taxed affiliate.
- **Effective tax rate** - For each jurisdiction, the ETR is calculated as the **Adjusted covered taxes** divided by **Adjusted net GloBE income**, derived from entity-level financial information used in consolidated financial statements.
- **Adjusted covered taxes and deferred taxes** - Any tax on an entity's income or profits (including tax on distributed profits) and any taxes imposed in lieu of a generally applicable income tax (including tax on retained earnings and corporate equity) are considered covered taxes. The adjustments operate as follows: take the current tax expense as per the financial accounts, add tax accruals in profit before tax (PBT) per the accounts plus deferred tax expense or income per the accounts (recast at 15% if deferred tax items have been booked at a higher statutory rate). Additional adjustments will have to be made, including adjustments for tax on income that is excluded from the computation of GloBE income and adjustments for taxes with respect to uncertain amounts. Taxpayers can disclaim a deferred tax liability which is not expected to reverse within five years. However, if the taxpayer does not disclaim and the liability doesn't reverse in that time, a recalculation will be required (potentially adding additional top-up tax to a preceding taxable year). It seems clear from the Model Rules that deferred taxes are a key part of the overall minimum tax calculation. In addition to a five-year limit on deferral, the Model Rules set forth a list of items that will not be subject to this limitation, including cost recovery allowances on tangible assets.
- **Adjusted net GloBE income** - GloBE income will need to be calculated for each constituent entity in the jurisdiction. GloBE income is calculated as PBT, but with numerous required or elective adjustments. For example, certain disallowed expenses are required to be reversed, and intra-group transactions must be adjusted to comply with the arm's length standard. Elections are provided to permit stock-based compensation to be accounted for under the relevant income tax rules (rather than applying financial accounting concepts). In addition, an election is provided to permit a taxpayer to apply the 'realization principle' for assets and liabilities that are subject to fair value or impairment accounting.
- **Substance based carve-out** - MNEs will get a carve-out on income for 5% of the carrying value of their tangible assets and payroll, with a transition period of ten years that offers an exclusion of 8% of tangible assets and 10% of payroll in 2023, gradually declining to 5% in 2033 (par. 9.2 of the Model Rules). Eligible payroll costs include "employee compensation expenditures (including salaries, wages, and other expenditures that provide a direct and separate personal benefit to the employee, such as health insurance and pension contributions), payroll and employment taxes, and employer social security contributions." Eligible tangible assets include items located in a jurisdiction, like property, plant, equipment, natural resources, a lessee's right to use tangible assets, and certain government licenses, including ones to exploit natural resources. The carve-out doesn't apply to property that is held for sale, lease or investments,

nor tangible assets that are used to generate a company's international shipping income — such as ships and other maritime equipment.

- **GILTI compliance with Pillar Two** - For US-headquartered groups, or intermediate holding companies in the United States, the question of whether the US minimum tax (known as Global Intangible Low-Taxed Income or GILTI) is a 'compliant Pillar Two' regime remains unanswered. Without such protection, subsidiaries of US-owned businesses could be subject to the UTPR. The 8 October Statement indicated that determination of whether a regime was compliant with Pillar Two would rely on several factors, of which the most important would be if under that regime the ETR calculation was made on a per jurisdiction basis, which GILTI currently does not do. Final resolution of this issue likely will not occur until, at the earliest, the outcome of proposed legislative changes in the US becomes clear.
- **Administration** - Each constituent entity (or a designated local entity for the jurisdiction) will have 18 months for the first transitional year then 15 months to file a standardised GloBE Information Return in its jurisdiction unless it notifies the tax administration there that the UPE (or designated filing entity for the group) has filed such a return in a jurisdiction that has an information sharing agreement in place with that first jurisdiction.

EU action

Despite the fact that the OECD will only be providing more clarity on the interpretation of the Model Rules in a Commentary and more detailed implementation rules in the coming months, the European Commission is intending to publish a draft Directive on Minimum Taxes on 22 December. The Commission has already announced that the EU rules will differ from the IIR, in order to be compatible with the EU Treaty Freedom of Establishment rules – with the result that the IIR will not top up to the home country, but in the country of each relevant subsidiary.

The takeaway

For the first time, taxpayers have a clearer outline of the Model Rules – although still with much more detail to be provided next year. What is also clear, however, is how complex the rules will be, and how difficult they will be to comply with. The seventeen pages of new defined terms demonstrate the novelty of these rules, especially around the calculation of the tax base derived from financial accounting numbers. Furthermore, the jurisdictional and entity level (as opposed to business unit) calculations may not be straightforward, as many taxpayers' IT systems are not configured to collect data in the manner described in the Model Rules.

While a multitude of issues still need further clarification, companies are urged to address how to organize for compliance – bearing in mind, of course, that further clarity may only come with the Implementation Framework in mid-2022. For this exercise, modelling will also be pivotal. Indeed, the treatment of historical losses and other tax assets (especially existing on or before 30 November 2021), the use of incentives and preferential tax regimes, the impact of the inclusion of certain deferred taxes under taxes covered, and the application of the substance based carve-out are only some of the elements that require specific attention when modelling the impact of the Model Rules.

The stated timeline for Pillar Two remains very ambitious, with enactment in late 2022 (after the Implementation Framework is published) and an effective date of 1 January 2023. Realistically, it seems hard to imagine national governments clearing this through their legislative processes, drafting regulations, designing forms and systems for that date – but, equally, the political pressure, at least in Europe, remains very strong.

The potential impact of some of these provisions will need detailed consideration and as more details emerge, including with the explanatory Commentary, we will publish an in-depth Bulletin soon thereafter.

See also

- Policy on Demand: [Will Morris on new Pillar Two rules](#)

Let's talk

For a deeper discussion of how the international corporate tax framework might affect your business, please contact:

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