Nangia Andersen LLP

OECD announces Pillar Two Model Rules to effectuate Global Minimum Tax into Domestic Legislation

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Background

In October 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (IF) finalised a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. Pillar-two stipulates global minimum tax rate of 15% and comprises the Global anti-Base Erosion Rules (GloBE) rules.

With a view to provide guidance to the jurisdictions that agreed to the Inclusive Framework/G-2- Pillar Two framework to implement into domestic legislation a 15% minimum tax rate, the OECD on 20th December 2021 released model rules. Essentially, the rules establish the scope and set out the mechanism for the Global Anti-Base Erosion (GloBE) rules under Pillar Two.

The OECD has arranged the rules into 10 chapters, each chapter dealing with specific issues pertaining to computation of GloBE income or loss and the top-up tax, corporate restructurings and holding structures, administration and transition rules and so on.

Scope of the Globe rules

The rules have been formulated to apply to constituent entities of an MNE group with annual revenue of EUR 750 million or more in at least two of the four fiscal years immediately preceding the tested fiscal year. In case one or more of the Fiscal Years taken into account is of a period other than 12 months, for each of those Fiscal Years the EUR 750 million threshold has to be adjusted correspondingly.

Besides, certain categories of entities have been explicitly excluded from scope of the rules. These are government entities, international organizations and non-profit organizations, as well as entities that meet the definition of a pension, investment or real estate fund.

The Income Inclusion Rule (IIR)

The Ultimate Parent Entity or Intermediate Parent Entity of an MNE Group, having an ownership interest in a Low-Taxed Constituent Entity at any time during the Fiscal Year will be required to pay its share of top-up tax of that Low-Taxed Constituent Entity for the Fiscal Year.

The share of the top-up tax of a Low-Taxed Constituent Entity will depend upon the Parent Entity's Inclusion Ratio for the Low-Taxed Constituent Entity for the Fiscal Year, i.e. the ratio of (a) the GloBE Income of the Low-Taxed Constituent Entity for the Fiscal Year, reduced by the amount of such income attributable to Ownership Interests held by other owners, to (b) the GloBE Income of the Low-Taxed Constituent Entity for the Fiscal Year.

The Undertaxed Payments Rule (UTPR)

The UTPR rule stipulates that the constituent entities of an MNE Group shall be denied a deduction or be required to make an equivalent adjustment under the domestic law in an amount resulting in an additional cash tax expense equal to the UTPR Top-up Tax Amount for the Fiscal Year allocated to that jurisdiction. If such an adjustment is insufficient to produce an additional cash tax expense equal to the allocated UTPR Top-up Tax Amount, the difference shall be carried forward to the extent necessary to the succeeding Fiscal Years.

The Total UTPR Top-up Tax Amount for a Fiscal Year is the sum of the Top-up Tax calculated for each Low-Taxed Constituent Entity of an MNE Group for that Fiscal Year. However, the Top-up Tax calculated for a Low-Taxed Constituent Entity that is otherwise taken into account shall be reduced to zero if all of the Ultimate Parent Entity's Ownership Interests in such Low-Taxed Constituent Entity are held directly or indirectly by one or more Parent Entities that are required to apply IIR in the jurisdiction where they are located with respect to that Low-Taxed Constituent Entity for the Fiscal Year.

Computation of Globe Income/Loss

An MNE's income or loss shall be determined after making some adjustments to the financial accounts to align the accounts with tax purposes. Importantly, gains or losses from disposition of assets and liabilities, any asymmetric foreign currency gains, dividends, equity gains, international shipping income shall be considered in computation of GloBE income.

The Financial Accounting Net Income or Loss of a Constituent Entity that is a Permanent Establishment (PE) is the net income or loss reflected in the separate financial accounts of the PE. If the PE does not have separate financial accounts, then the Financial Accounting Net Income or Loss shall be taken as the amount that would have been reflected in its separate financial accounts if prepared on a standalone basis and in accordance with the accounting standard used in the preparation of the Consolidated Financial Accounts of the Ultimate Parent Entity.

Furthermore, GloBE Loss of a PE shall be treated as an expense of the Main Entity (and not of the PE) for purposes of computing its GloBE Income or Loss to the extent that the loss of the PE is treated as an expense in the computation of the domestic taxable income of such Main Entity and is not set off against an item of income that is subject to tax under the laws of both the jurisdiction of the Main Entity and the jurisdiction of the PE. Accordingly, the GloBE Income subsequently arising in the PE shall be treated as GloBE Income of the Main Entity (and not the PE) up to the amount of the GloBE Loss that previously was treated as an expense for purposes of computing the GloBE Income or Loss of the Main Entity.

Adjusted Covered Taxes and the Effective Tax Rate

For the computation of Adjusted Covered Taxes, the starting point is the current tax expense accrued in the financial accounts, with some specified adjustments. To determine the income taxes attributable to an MNE's constituent entities, the rules provide that the calculation includes income taxes but does not include non-income-based taxes such as indirect taxes, payroll and property taxes. Certain deferred taxes shall also be included in Adjusted Covered Taxes to address temporary book-tax timing difference.

The Effective Tax Rate of the MNE Group for a jurisdiction with Net GloBE Income is required to be computed for each Fiscal Year. The Effective Tax Rate of the MNE Group for a jurisdiction is equal to the sum of the Adjusted Covered Taxes of each Constituent Entity located in the jurisdiction divided by the Net GloBE Income of the jurisdiction for the Fiscal Year.

Top-up tax

Under the Pillar-Two, the top-up tax is first levied under the “Income Inclusion Rules” or IIR on a parent entity with an ownership interest in a low-taxed constituent entity. If any residual amount of top-up tax remains unallocated after the IIR applies, the undertaxed payments rule (UTPR) allocation mechanism comes into play.

The top-up rate i.e. the difference between the 15% minimum rate and the Effective Tax Rate (ETR) in a jurisdiction is to be applied on GloBE income after deducting a substance-based income exclusion.

The substance-based income exclusion is stipulated as the sum of 5% of the payroll costs for employees that perform activities in the jurisdiction and 5% of the carrying value of tangible assets located in the jurisdiction. Tangible assets shall include property, equipment and natural resources located in the jurisdiction, as well as a lease on rights to use tangible assets. However, the tangible asset carve-out computation shall not include the carrying value of property (including land or buildings) that is held for sale, lease or investment or the carrying value of tangible assets used in the generation of a Constituent Entity’s International Shipping Income and Qualified Ancillary International Shipping Income (i.e. ships and other maritime equipment and infrastructure).

The rules further provide for a 10-year transition period in recognition of the potential impact of the GloBE rules on existing incentives and existing investment. The Transition Period starts with a 10% carve-out for payroll costs and 8% carve-out for tangible assets, with these carve-out percentages lessening to 5% over time.

Corporate Restructurings and Holding Structures such as Joint Ventures and Multi-Parented MNE Groups

In case of a merger i.e. any arrangement where all or substantially all of the Group Entities of two or more separate Groups are brought under common control such that they constitute Group Entities of a combined Group or an Entity that is not a member of any Group is brought under common control with another Entity or Group such that they constitute Group Entities of a combined Group, the consolidated revenue threshold of the MNE Group for any Fiscal Year prior to the merger is deemed to be met for that year if the sum of the revenue included in each of their Consolidated Financial Statements for that year is EUR 750 million or more.

Also, for purposes of the GloBE Rules, the acquisition or disposal of a Controlling Interest in a Constituent Entity will be treated as an acquisition or disposal of the assets and liabilities if the jurisdiction in which the target Constituent Entity is located, or in the case of a Tax Transparent Entity, the jurisdiction in which the assets are located, treats the acquisition or disposal of that Controlling Interest in the same or similar manner as an acquisition or disposition of the assets and liabilities and imposes a Covered Tax on the seller based on the difference between the tax basis and the consideration paid in exchange for the Controlling Interest or the fair value of the assets and liabilities.

The GloBE Rules are also applicable to a Joint Venture and its JV Subsidiaries. Pertinently, the JV Group top-up tax shall be reduced by each Parent Entity's Allocable Share of the Top-up Tax of each member of the JV Group that is brought into charge under a Qualified IIR and any remaining amount shall be added to the Total UTPR Top-up Tax Amount.

In case of Multi-Parented MNE Groups, the Entities and Constituent Entities of each Group are treated as members of a single MNE Group for purposes of the GloBE Rules (the Multi-Parented MNE Group). Further, an Entity (other than an Excluded Entity) shall be treated as a Constituent Entity if it is consolidated on a line-by-line basis by the Multi-Parented MNE Group or its Controlling Interests are held by Entities in the Multi-Parented MNE Group.

The Ultimate Parent Entities of the separate Groups that comprise the Multi-Parented MNE Group shall be the Ultimate Parent Entities of the Multi-Parented MNE Group when applying the GloBE Rules.

Applicability of Deductible Dividend Regime on Ultimate Parent Entity

In computing its GloBE Income or Loss for a Fiscal year, an Ultimate Parent Entity if subject to a Deductible Dividend Regime shall reduce its GloBE Income for such Fiscal Year by the amount that is distributed as a Deductible Dividend within 12 months of the end of the Fiscal Year if the dividend is subject to tax in the hands of the dividend recipient for a taxable period that ends within 12 months of the end of the MNE Group's Fiscal Year, and the dividend recipient is subject to tax on such dividend at a nominal rate that equals or exceeds the Minimum Rate.

Importantly, if the Ultimate Parent Entity holds an Ownership Interest in another Constituent Entity subject to the Deductible Dividend Regime (directly or through a chain of such Constituent Entities), the foregoing provisions shall apply to each other Constituent Entity in the UPE Jurisdiction that is subject to the Deductible Dividend Regime to the extent that its GloBE Income is further distributed by the Ultimate Parent Entity to recipients.

Provisions applicable to Investment Entities

In case of a Constituent Entity being an Investment Entity, the Effective Tax Rate has to be calculated separately from the Effective Tax Rate of the jurisdiction in which it is located.

The Effective Tax Rate for each such Investment Entity is equal to the Investment Entity's Adjusted Covered Taxes divided by the MNE Group's Allocable Share of the Investment Entity's GloBE Income.

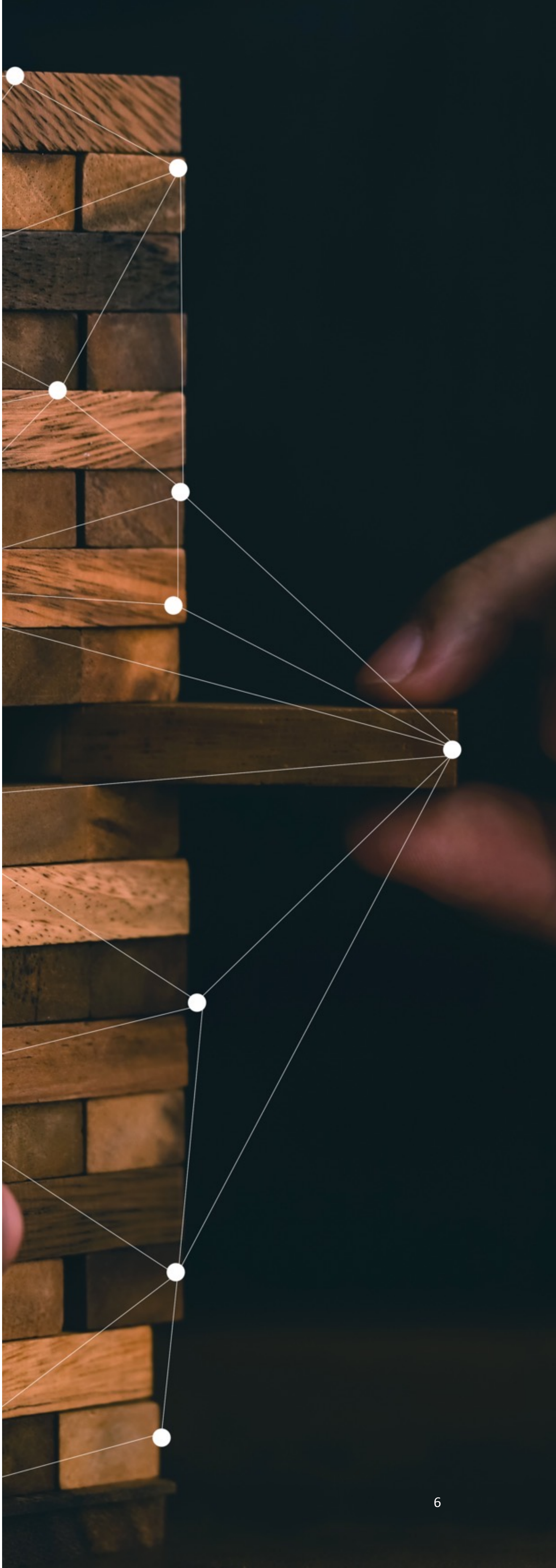
The Top-up Tax Percentage for an Investment Entity shall be the percentage point excess, if any, of the Minimum Rate over the Effective Tax Rate of the Investment Entity. If there is more than one Investment Entity located in the jurisdiction, the MNE Group's Allocable Share of the Investment Entity's GloBE Income and the Substance-based Income Exclusion determined for each such Investment Entity are combined to compute the Effective Tax Rate of all such Investment Entities.

Deferred tax accounting approach under the GloBE rules

The apprehension that income or loss may be recognised in a different year for financial accounting and tax, the GloBE rules leverage the deferred tax accounting mechanisms to adjust for such timing differences. The application of the deferred tax accounting approach under the GloBE rules incorporates several safeguards that ensure that the approach neutralises only temporary differences between tax and book, and that credit is only given for tax that will be paid within an appropriate time frame.

However, the foregoing provisions are subject to a "recapture mechanism" in respect of certain deferred tax liabilities that do not unwind within the prescribed period of five years. The recapture rule requires a deferred tax liability to be reversed to the extent it is not paid within five years from when it was first creditable under GloBE.

The five-year recapture rule does not apply to some items including cost recovery allowances on tangible assets, R&D expenses, and fair value accounting on unrealised gains.



Furthermore, there shall also be an "alternative mechanism" for carry-forward of losses in the form of a deemed tax asset that is priced at the minimum rate, particularly for MNEs that suffer losses in low tax jurisdictions.

Administration under the Pillar Two implementation

The "GloBE Information Return" shall be filed by the Constituent Entity or Ultimate Parent Entity or the Designated Filing Entity, as the case may be, in a standard template designed in accordance with the GloBE Implementation Framework.

The return shall be filed with the tax administration of the concerned jurisdiction no later than 15 months after the last day of the Reporting Fiscal Year. However, to provide transitional relief for filing obligations, the rules prescribe that return shall be filed with the tax administration no later than 18 months after the last day of the Reporting Fiscal Year that is the Transitional Year.

The return shall include all information agreed as part of the GloBE Implementation Framework and is necessary to carry out the administration of the GloBE Rules. The return shall specifically comprise information of tax identification numbers and jurisdictions of the constituent entities of the MNE Group, the overall corporate structure of the MNE group, the information necessary to compute the Effective Tax Rate (ETR) for each jurisdiction and the Top-up Tax of each Constituent Entity and also the allocation of Top-Up Tax under the IIR and the UTPR Top-Up Tax amount to each jurisdiction.

Nangia Andersen LLP's Take

The release of the Model Rules is the first significant step in the implementation of the two-Pillar solution of the OECD. The model rules essentially provide a comprehensive picture of the mechanism designed to operationalise the Pillar-Two solution.

The rules are formulated in a way that would result in most of the covered entities paying the 15 per cent tax on any low taxed income. Further, the provisions for Corporate Restructuring and Holding Structures would be of profound significance for large corporates seeking planning avenues.

As the rules are technical and involve complexities, the OECD anticipates to further release a Commentary in early 2022 to provide guidance on the interpretation of the global minimum tax rules. The OECD also states that stakeholder input will be pursued in the development of the GloBE Implementation Framework so as to ensure co-ordination and administration of the global minimum tax rules. The work on the Implementation Framework is stated to be finalised by the end of 2022.

Notably, the OECD is also in the process of developing a model treaty provision to give effect to the second prong under Pillar Two i.e. Subject To Tax Rule (STTR). It has also stated that a multilateral instrument will be developed by the IF by mid-2022 to facilitate rapid and consistent implementation of the STTR in relevant bilateral treaties.

Since the Rules are expected to come into force in 2023, most countries are likely to incorporate these Model Rules into their respective domestic laws in the year 2022 itself. Hence, taxpayers will have to proactively assess their IT systems and configurations in order to enable compliance with the Model Rules.

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