Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)

The Pillar Two Rules in a Nutshell

The Pillar Two Model Rules (also referred to as the "Anti Global Base Erosion" or "GloBE" Rules), released on 20 December 2021, are part of the Two-Pillar Solution to address the tax challenges of the digitalisation of the economy that was agreed by 137 member jurisdictions of the OECD/G20 Inclusive Framework on BEPS and endorsed by the G20 Finance Ministers and Leaders in October. They were developed by delegates from all Inclusive Framework member jurisdictions and agreed and approved by consensus.

The Pillar Two Model Rules are designed to ensure large multinational enterprises (MNEs) pay a minimum level of tax on the income arising in each jurisdiction where they operate. The rules run to about 45 pages with another 15 pages of definitions. They are drafted as model rules that provide a template that jurisdictions can translate into domestic law, which should assist them in implementing Pillar Two within the agreed timeframe and in a co-ordinated manner.

Overview

The Pillar Two Model Rules consist of 10 chapters. Chapter 1 addresses questions of scope. Chapters 2-5 contain the key operative rules. Chapter 6 deals with mergers and acquisitions. Chapter 7 provides special rules that apply to certain tax neutrality and existing distribution tax regimes. Chapter 8 deals with administration, Chapter 9 provides for rules on transition and Chapter 10 contains definitions. As a general matter, the Pillar Two Model Rules have been designed to make sure they accommodate a diverse range of tax systems, including different tax consolidation rules, income allocation, entity classification rules etc., as well rules for specific business structures such as joint ventures and minority interests. As such, many of the specific provisions of the Pillar Two Model Rules will not apply to all jurisdictions or each individual in-scope MNE.

Taxpayers that either have no foreign presence or that have less than EUR 750 million in consolidated revenues are not in scope of the Model Rules. In addition, the Pillar Two Model Rules do not apply to government entities, international organisations and non-profit organisations (preserving domestic tax exemptions for sovereign, non-profit and charitable entities), nor do they apply to entities that meet the definition of a pension, investment or real estate fund (preserving the widely shared tax policy of not wishing to add an additional layer of taxation between the investment and the investor). These entities are excluded even if the MNE group they control remains subject to the rules.

Taxpayers in scope of the rules calculate their effective tax rate for each jurisdiction where they operate, and pay top-up tax for the difference between their effective tax rate per jurisdiction and the 15% minimum rate. Any resulting top-up tax is generally charged in the jurisdiction of the ultimate parent of the MNE. A de minimis exclusion applies where there is a relatively small amount of revenue and income in a jurisdiction. The Pillar Two Model Rules also contemplate the possibility that jurisdictions introduce their own domestic minimum top-up tax based on the GloBE mechanics, which is then fully creditable against any liability under GloBE, thereby preserving a jurisdiction's primary right of taxation over its own income.

The key operative rules that set out the calculation and charging provisions are contained in Chapters 2-5, and discussed in more detail below.

Taxpayers that have engaged in mergers or acquisitions during the year also need to consider the rules in Chapter 6. Chapter 7 contains a number of special rules that apply to a relatively narrow range of taxpayers subject to tax neutrality or existing distribution tax regimes.

Chapter 8 provides an internationally co-ordinated approach to administering the rules. This includes a standardised information return to facilitate the co-ordination of compliance and reduce burdens on taxpayers, as well mechanisms to avoid duplicative reporting and the scope to release co-ordinated guidance on the application of the rules in practice. Chapter 8 also provides for the possibility of safe harbours that would reduce administrative burdens, where particular operations of an MNE are almost certain to be taxable above the minimum rate. The final design of any safe harbours, as well other aspects of administration, compliance and co-ordination will be developed further in consultation with business and stakeholders, and reflected in the Implementation Framework to be released in 2022.

The transition provisions in Chapter 9 take existing tax attributes into account, including all pre-existing tax losses, to simplify the application of the rules and reduce compliance burdens when an MNE first comes into scope of the Pillar Two Model Rules. It also has a limitation of the application of the UTPR when an MNE is in its initial phase of expanding abroad. The transition rules also provide a phased introduction of the rules through a gradual reduction of the substance-based income carve-out over the first ten years of Pillar Two.

Finally, Chapter 10 sets out the necessary definitions, and the rules for determining where an entity is located for the purpose of applying the calculations in Chapters 2-5, which are needed to give effect to the jurisdiction-by-jurisdiction approach.

As noted in the Preamble to the Pillar Two Model Rules, consideration will be given to the conditions under which the US Global Intangible Low-Taxed Income (GILTI) regime will co-exist with the GloBE rules, to ensure a level playing field.

Key Operative Rules

Chapters 2-5 set out the key operative provisions that every in-scope MNE would apply. An MNE can apply the rules in the following steps (see also Fact Sheets):

- **Calculate the effective tax rate**: Chapters 3 and 4 identify the pools of low taxed income on a jurisdictional basis. They do this by calculating the income (or loss) under Chapter 3, and the tax attributable to that income under Chapter 4; and
- **Calculate the top-up tax**: Where there is low taxed income in a jurisdiction, the resulting top-up tax calculation is done under the rules in Chapter 5; and
- **Determine the liability for the top-up tax**: If top-up tax is owed, the charging provisions in Chapter 2 apply. These provisions describe which entity within the MNE will be liable for top-up tax in respect of low taxed income arising in a jurisdiction.

Calculation of the effective tax rate

In order to know if top-up tax is owed, rules are needed to calculate the Effective Tax Rate (ETR) in each jurisdiction where the MNE operates. This requires first a calculation of the income, and second a calculation of the tax on that income.

Under Chapter 3, the income (or loss) is calculated based on financial accounts, which provides a base that is harmonised across all jurisdictions. Certain adjustments are needed to better align the financial accounts with tax purposes. These have been kept to a minimum and are made where necessary to reflect common permanent differences, such as to remove most dividends and equity gains so that the minimum tax does not apply to such income, or to remove expenses disallowed for tax purposes such as bribes and to correct prior year errors. There is also an exclusion for international shipping income.

Under Chapter 4, the tax attributable to that income is calculated. It includes income taxes, defined in a way to provide consistent and flexible recognition across a wide range of tax systems, but does not include non-income based taxes such as indirect taxes, payroll and property taxes. Rules are also provided to allocate income taxes which are charged as a withholding tax or following the application of a Controlled Foreign Company (CFC) regime (which are allocated to the entity that earned the underlying income). The treatment of qualified refundable tax credits (i.e. tax credits that are refundable within four years) aligns with their current characterisation and treatment for accounting purposes.

Chapter 4 also sets out rules for addressing temporary differences, which arise when income or loss is recognised in a different year for financial accounting and tax. Rules are needed to address this given that the Pillar Two Model Rules rely on the financial accounts for calculating the income (or loss). Given that most businesses already use deferred tax accounting to reconcile differences between financial accounting and tax results, the Pillar Two Model Rules leverage these existing accounting principles to simplify compliance. Certain adjustments are made to the existing deferred tax accounts to protect the integrity of

the Pillar Two Model Rules. For example, the credit for deferred tax liabilities is capped at the minimum rate in order to prevent any excess tax sheltering unrelated income. The rules also include a recapture mechanism that adjusts for certain deferred tax liabilities that have not reversed (i.e. the tax has not actually been paid) within five years. These rules should mean that minimum tax generally will not be owed by reason of a timing difference. In addition, because tax losses are tracked through deferred tax accounts, the deferred tax accounting rules enable the carry-forward of attributes resulting from tax losses. For businesses that do not wish to apply deferred tax accounting rules in a jurisdiction, an election is available instead to apply a simplified methodology whereby GloBE losses are effectively carried forward.

Calculation of the top-up tax

Once the effective tax rate is calculated (i.e. the tax divided by the income, and aggregated on a per jurisdiction basis), Chapter 5 then determines how much top-up tax is owed. The rate of tax owed is the difference between the 15% minimum rate and the ETR in the jurisdiction. That top-up tax percentage is then applied to the GloBE income in the jurisdiction, after deducting a substance based income exclusion. The substance based income exclusion reduces the exposure to the minimum tax and is calculated as a percentage mark-up on tangible assets and payroll costs. Finally, if a jurisdiction has a domestic minimum tax that is consistent with the Pillar Two Model Rules, such domestic tax is credited against any Pillar Two minimum tax liability.

Determination of the group entity liable for the top-up tax

A liability to top-up tax for a member of an in-scope MNE group arises under two types of provisions contained in Chapter 2. The primary rule is the Income Inclusion Rule (IIR). Under the IIR, the minimum tax is paid at the level of the parent entity, in proportion to its ownership interests in those entities that have low taxed income. Generally, the IIR is applied at the top, at the level of the ultimate parent entity, and works its way down the ownership chain. Rules are also provided to allow the IIR to be applied by a parent entity in which there is a significant minority interest, to minimise leakage of low taxed income.

A backstop is needed to ensure the minimum tax is paid where an entity with low taxed income is held through a chain of ownership that does not result in the low-taxed income being brought into charge under an IIR. This backstop is the UTPR. This rule works by requiring an adjustment (such as a denial of a deduction) that increases the tax at the level of the subsidiary. The adjustment is an amount sufficient to result in the group entities paying their share of the top-up tax remaining after the IIR. The share of the top-up tax is calculated based on a formula, in proportion to the relative share of assets and employees. This helps to ensure the rule is administrable, but also attaches the adjustment to entities that are most likely to have the capacity to pay the required amount of top-up tax.

The same calculations under Chapter 5 are applied whether the top-up tax is being charged under the IIR or the UTPR, to ensure co-ordinated outcomes. However, given that there will typically be subsidiaries in several different jurisdictions, the UTPR requires a higher level of administrative co-operation, which underlines the importance of the standardised information reporting requirements contained in Chapter 8. It is also one of the reasons the UTPR is a backstop rather than the primary rule.

Fact Sheets

The fact sheets illustrate the key steps that an MNE might go through in order to determine its liability under the Pillar Two Model Rules. The fact sheets set out five key steps: starting with whether the MNE is within scope of the rules; working through the mechanics of a jurisdictional ETR calculation in order to determine the amount of any top-up tax that may be due; and finally to determine the jurisdiction where such tax is payable. These steps correspond to the provisions on scope and the key operative rules described above.