Analysis

Pillar Two: the consequences of staggered global implementation

Speed read

With sufficient momentum behind the OECD's Pillar Two project to introduce a global minimum tax, the initiative appears to be on the cusp of becoming a reality. Despite attempts to coordinate implementation to a global schedule, countries are adopting the rules in a timeframe that suits their legislative cycle and/or political imperative. Due to the interlinking nature of the rules, this staggered implementation cycle will create perverse outcomes for groups with a presence in early and late adopting jurisdictions.

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As domestic legislation is laid out to implement the OECD Pillar Two project, a complex picture is beginning to emerge. Groups that have a presence in delayed or even non-implementing jurisdiction in combination with early adopting jurisdictions will need to understand the interaction between the different layers of the rules and the various timelines for implementation. While a coordinated roll-out of rules was once an aspiration, the reality is anything but.

Interlinking rules

By way of recap, the main components of Pillar Two are the GloBE rules which include the income inclusion rule (IIR) and the undertaxed profit rule (UTPR). They aim to ensure that large multinational groups pay a minimum effective tax rate (ETR) of at least 15% on profits in every jurisdiction in which they operate. This is achieved by allowing countries to impose top-up taxes in situations where an MNE is taxed below the minimum rate. Pillar Two also includes the subject to tax rule (STTR), which is expected to apply in priority to the GloBE rules. However, the detailed workings of the STTR are yet to be published and so we have put this rule to one side for the purpose of this article.

The agreed rules also provide countries with the option to create a 'qualified domestic minimum top-up tax' (or QDMTT for short). A QDMTT is a minimum tax that is incorporated into the domestic law of a jurisdiction, and broadly computed in the same way as the Pillar Two rules. Although a QDMTT is not a 'covered tax' for the purposes of the GloBE rules – and so is not taken into account in the calculation of the ETR – it is deducted from the top-up tax allocated to a jurisdiction. The result is that a country can avoid a top-up tax being charged by other jurisdictions under the GloBE rules on profits derived from that country by introducing a QDMTT.

Implementation timelines

The landmark global agreement in October 2021 saw OECD Inclusive Framework members sign up to the Pillar Two rules. The agreement set a target implementation date for the IIR to be effective in 2023, with the UTPR due in 2024. It should be noted that jurisdictions are not required to adopt the rules, so in reality there has always been some discretion around the timetable.

The detailed workings of the rules have been published in stages, with the governing framework of the rules released in December 2021, followed by commentary in March 2022. Both of which were augmented by details of the safe harbour in December 2022 and administrative guidance published in February 2023. Despite the fragmented publication of the rules and guidance some jurisdictions have remained committed to the original timetable; however, this ambition is not shared globally. As a result, there is significant variation in the implementation timeline for the introduction of the IIR, QDMTT and UTPR.

> The staggered timeline may have a notable effect on a group's exposure to the minimum tax

The UK is one jurisdiction on track to (just) meet the original target of bringing the rules into effect in 2023. Finance (No. 2) Bill 2022/23 contains the UK legislation to implement the multinational top-up tax (effectively the IIR), taking effect for MNEs with fiscal years beginning on or after 31 December 2023 once it receives royal assent this summer. The UK rules also include a QDMTT; however, the government has not yet published clauses to implement the UTPR. There still remains time to implement the UTPR within the next UK legislative cycle, although the delay in publication provides UK policy makers with more time to observe implementation of the rules in other jurisdictions.

EU implementation is, for the most part, in sync with the anticipated timeline. In December 2022, the EU reached unanimous agreement to introduce a Directive implementing the Pillar Two rules with the IIR expected to become effective on or after 31 December 2023 and the UTPR becoming effective on or after 31 December 2024. Despite the Directive, transposition into domestic legislation remains sparse, with only a few member states publishing domestic implementing rules. Those that have done so include Germany, Ireland, the Netherlands, and Sweden. The Directive also provides opportunity for delayed adoption in certain EU member states if no more than twelve ultimate parent entities (UPEs) of in-scope groups are located in the member state. This means some smaller member states may choose to elect to delay implementation for up to six years, prolonging the agony of fragmented implementation until at least 2029.

Elsewhere, South Korea is committed to joining the first wave of implementation. Although more detailed rules are expected, the governing legislation anticipates implementation of not only the IIR and a QDMTT but also (and somewhat surprisingly) the UTPR from 1 January 2024.

It seems unlikely that the coordinated timeline for implementation will be met in other countries. Singapore and Hong Kong, for example, have already signalled that they will introduce the IIR and a QDMTT to take effect for fiscal years starting on or after 1 January 2025. More jurisdictions are likely to follow in this second phase of implementation. Not only does this allow time to draft legislation, but it also provides the ability to observe (and potentially learn from) the roll-out in other jurisdictions.

Last week, the Crown Dependencies also expressed an intention to introduce the IIR and a domestic minimum tax for in-scope groups from 2025. The wording of the press release, however, permits Jersey, Guernsey and the Isle of Man sufficient flexibility to adjust their approaches in the light of progress on implementation elsewhere. Resource limitations in smaller jurisdictions may mean they simply opt to implement a minimum tax which provides sufficient coverage to not cede taxing rights and some protection against a future blacklisting by the EU. Finally, there are other jurisdictions that have not published any information on their implementation plans and may simply never legislate the rules.

Implications of staggered implementation

The staggered timeline may have a notable effect on a group's exposure to the minimum tax. It will affect which jurisdiction holds the primary taxing rights and where the associated compliance obligations will arise. We will walk through a few examples to illustrate the implications for groups with a presence in early and late adopting jurisdictions.

Before we move on to our examples, we should acknowledge the potential effect of the transitional safe-harbour rule. This rule will help alleviate the administrative burden of complying with the GloBE rules in the early years of implementation (broadly up to fiscal years beginning in 2026) by treating the top-up tax due in some low-risk jurisdictions as zero. Where the safe-harbour applies, it will remove the need for detailed GloBE calculations for the given jurisdiction. This may reduce the impact of some of the issues in the examples that we discuss below, but it will not be a universal panacea.

1. Taxing rights may shift between jurisdictions

Our first example is simply designed to demonstrate how the right (or obligation) to impose tax under the IIR might shift between jurisdictions as a result of staggered implementation.

The right (and obligation) to collect the top-up tax through the IIR is generally granted to the jurisdiction of the UPE of the multinational group. In circumstances where the UPE jurisdiction has not implemented an IIR either because it is delayed or it has no intention of introducing the rules, the right/obligation to apply an IIR is conferred upon the next jurisdiction(s) in the ownership chain in which a constituent entity is located (referred to as an 'intermediate parent entity' in the GloBE rules) and which has implemented the new rules. But an IIR implemented by that jurisdiction will, of course, only apply to low-taxed profits of entities that are owned directly or indirectly by the relevant intermediate parent entity.

Take an example of a Hong Kong parented group with an intermediate UK holding company that in turn holds a number of subsidiaries in low tax jurisdictions (see figure 1). The Hong Kong entity is the UPE, however as it will not apply the IIR until 2025, taxing rights under the IIR in 2024 are conferred upon the UK company as an intermediate parent entity in relation to low-taxed entities within the group that

Figure 1: Taxing rights may switch between jurisdictions

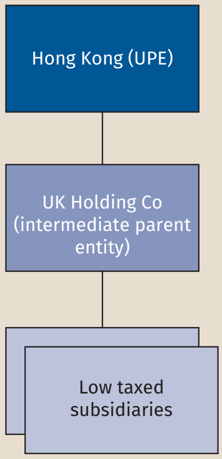
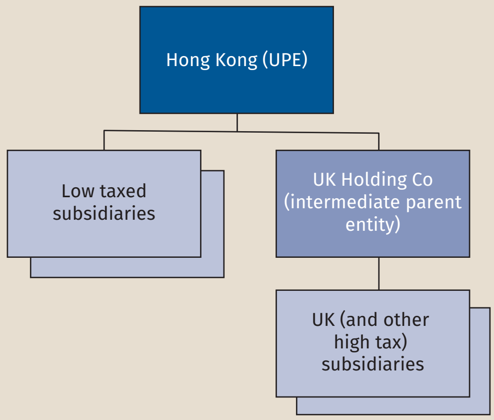


Figure 2: Reorganised group with an intermediate parent entity located in an early adopting jurisdiction



are owned directly or indirectly by the UK company.

By having an intermediate company in an early adopting jurisdiction, the group will need to comply with UK IIR rules, making any relevant top-up tax payment in respect of low taxed subsidiaries in the UK and reporting in line with UK procedures. When the IIR is implemented in Hong Kong in 2025, the right to impose the top-up tax in relation to the profits of the low-taxed subsidiaries will switch to Hong Kong. The group will then need to prepare calculations and meet compliance obligations under Hong Kong's procedures rather than the UK.

For the most part this will be a compliance headache to manage. It may be ameliorated to an extent if the group is able to appoint a designated filing entity to file GloBE information returns, and so avoid the need to change the entity that files its GloBE return. It is noteworthy that the issue only arises in relation to low-taxed subsidiaries in group structures that are owned directly or indirectly by the intermediate holding company located in an early adopting jurisdiction. If the group structure is flattened (see figure 2) so that the UPE in the late-adopting jurisdiction directly holds the low-tax subsidiaries the issue disappears. Whether this type of reorganisation is feasible will of course depend upon the circumstances. Any benefit is likely to be temporary – lasting only until the jurisdiction of the UPE introduces an IIR or

Figure 3: Late adopting jurisdictions may be brought into scope

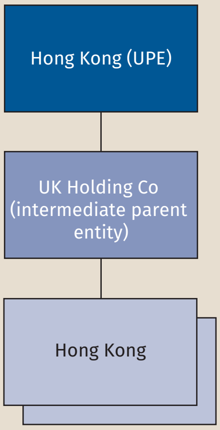
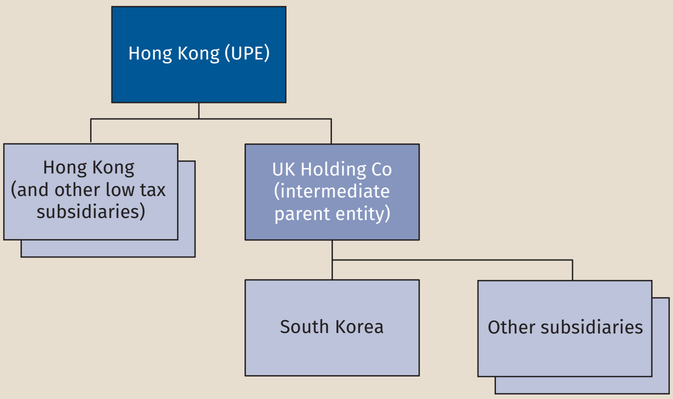


Figure 4: The long-arm of the UTPR



the UTPR is implemented in the jurisdiction in which any constituent entity in the group is located.

2. Unexpected parts of the group may be brought into the scope of rules

The next example uses the basic premise of the previous example but adds in a Hong Kong subsidiary into the group (see figure 3). As before, the UK holding company will be an intermediate parent entity during 2024. The UK company will pay top-up tax under the IIR in respect of low-taxed profits in its subsidiaries. The early adoption by the UK means that an ETR calculation will have to be undertaken for each jurisdiction in which any subsidiary of the UK company is located. In our example, this will include Hong Kong (even though Hong Kong will not implement the IIR until 2025) and the ETR calculation for Hong Kong will include all group entities, including those which are not direct or indirect subsidiaries of the UK company (in our case, including the Hong Kong UPE).

The top-up tax implications may be limited, but this result might come as a surprise to groups that had anticipated jurisdictions with delayed implementation would provide some respite from the compliance obligations. Notwithstanding the compliance burden of the ETR calculation and potential IIR exposure, it is worth noting tax authorities in implementing jurisdictions where the group has a presence will receive all of the information contained within the GloBE information return (which sets out how the top-up tax has been calculated in every jurisdiction).

Once again, if the group structure is flatter, without the use of intermediate holding companies, and with all companies located in a given jurisdiction within a coherent sub-group, early adoption by one jurisdiction would not bring another jurisdiction into scope of the ETR calculation prematurely.

3. The long-arm of the UTPR

The UTPR will bite in circumstances where the top-up tax has not been collected under either a QDMTT or an IIR. As we have mentioned above, South Korea currently plans to implement the UTPR from 2024. If South Korea continues with its plans, it will have the ability to tax low-taxed profits in multinational groups that contain South Korean entities until the relevant jurisdictions introduce an IIR or QDMTT.

In our third example (figure 4), South Korea will collect tax in respect of low-taxed profits in Hong Kong and other low-taxed subsidiaries held by the UPE. The other subsidiaries held by the UK will not be subject to the UTPR as they are held by an entity that imposes an IIR. The precise manner and timing of the tax charge will depend upon how South Korea implements the UTPR.

The mechanics of the Pillar Two framework may create perverse outcomes during the initial phases of implementation

There remains some uncertainty about widespread adoption of the UTPR, especially in light of the appetite for QDMTTs (ultimately rendering the rule somewhat redundant). As it currently stands, however, the UTPR remains more than a theoretical risk due to South Korea's plan to bring the rule in one year earlier than the coordinated schedule. Although the UTPR bounty would ordinarily be shared amongst other jurisdictions that have implemented a UTPR, based on the existing schedule, South Korea will be the sole beneficiary in 2024 unless and until other jurisdictions follow suit. Diplomatic efforts may yet change this course, but if not, South Korea could take on a new, albeit temporary, role as a global tax collector.

Conclusion

Staggered implementation means a more complex picture is emerging than was originally anticipated under the coordinated timetable. As we witnessed under the first BEPS programme, differences in the policy making cycle and differing appetite and even ability to make changes means fragmentation in global implementation was perhaps inevitable. The implication here is that the mechanics of the Pillar Two framework may create perverse outcomes during the initial phases of implementation. For groups that have not started their Pillar Two planning (and there are some), now is the time to face the music and understand how the timing of the rules will affect the tax and reporting exposure. ■

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