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BEPS 2.0

Pillar Two: implementing a global minimum corporate tax rate

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Pillar Two: implementing a global minimum corporate tax rate

On 20 December 2021 the OECD published 70 pages of model provisions for the "GloBE" minimum tax rules, which are the main component of Pillar Two of the BEPS 2.0 project. This reflects an unprecedented degree of international co-operation on corporate tax, and puts countries in a position to move ahead with domestic implementation of the rules, which will have a pervasive effect on large businesses.

The genesis of the BEPS 2.0 project was a desire to reform the taxation of digital business models, a challenge which the original BEPS project had left unresolved. While that remains an important goal that is being addressed through Pillar One of the project, large, developed countries successfully broadened the programme of work to include consideration of minimum tax rules under Pillar Two.

This responds to long-standing concerns of those countries that their corporate tax bases are undermined by MNEs moving mobile, profitable activities to low-taxed foreign subsidiaries. Historic attempts to combat this using controlled foreign company (CFC) rules have been a mixed success, with MNEs able to respond by moving their headquarters to countries with no or more lenient CFC rules. The GloBE rules aim to put an end to this "race to the bottom" through broad global implementation of the main top-up tax rule and robust backup rules that ensure top-up tax is charged even where a group is headquartered in a non-implementing territory.

The GloBE rules are complex, and likely to have a significant impact on the international tax landscape. They will apply to a large population of businesses – over 6,000 groups meet the €750m revenue threshold – and will provoke businesses to consider changes their group structures, and countries to their tax systems, in response.

> This guide answers some of the most immediate questions about the model GloBE rules and the global context in which they are being introduced.

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Pillar Two proposals: what you need to know

Q What are the Pillar Two rules?

The main component of Pillar Two is the GloBE rules. They aim to ensure that large MNE groups pay a minimum effective tax rate (ETR) of at least 15% on profits in every jurisdiction in which they operate. This will be 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). This will apply before the GloBE rules and will give greater source taxing rights to developing countries in certain situations.

Q Who will the GloBE rules apply to?

> The GloBE rules will apply to groups with entities in more than one jurisdiction and revenues of at least €750m per annum.

This will be subject to limited exclusions:

- a de minimis, which will exclude jurisdictions where the group has revenues of less than €10m and profits of less than €1m from the GloBE calculation;
- a limited exclusion for groups in the early stages of international expansion (<€50m tangible assets overseas and operating in no more than five other jurisdictions); and
- exclusions for pension funds, investment entities, and governmental and intergovernmental organisations.

Q How will ETR be measured?

$$\text{ETR} = \frac{\text{Covered tax}}{\text{GloBE profit}}$$

Covered tax will include both current and, in some instances, deferred taxes accrued in a company's accounts. Including deferred tax reduces the likelihood that a top-up tax is imposed solely because of differences in when income and expenses are recognised under the GloBE and domestic tax rules.

GloBE profit will be based on accounting profit before tax, subject to adjustments – most significantly a participation exemption for dividends and gains derived from shareholdings of more than 10%.

Substance-based income exclusion

A formulaic substance carve out will exclude a fixed return on a group's tangible assets and payroll costs in each jurisdiction from the profits that are subject to the top-up tax. This recognises that income attributable to such physical factors is unlikely to result from profit shifting.

Pillar Two proposals: what you need to know

Q How do the GloBE rules work?

> The GloBE rules will determine an amount of top-up tax to be paid by a group.

That will be done by:

- testing the ETR paid by the group in each jurisdiction in which it operates;
- determining how much additional tax, if any, should be paid to increase each jurisdiction's ETR to 15%; and
- allocating that top-up tax to other jurisdictions.

Top-up tax will be allocated under two rules.

The main rule is the income inclusion rule (IIR). This is analogous to the controlled foreign companies (CFC) rules that many countries already apply. It will generally be applied by the home jurisdiction of the ultimate parent entity (UPE) in a corporate group and give them the right to collect all the top-up tax relating to foreign entities owned by the UPE.

There is also a backup rule – the undertaxed payment rule (UTPR). The UTPR will allocate any top-up tax that has not been allocated under the IIR. That could be top-up tax due in relation to:

- profits earned in the UPE jurisdiction, in situations where the UPE jurisdiction does not apply an ETR of at least 15%; or
- profits earned by the entire group, in situations where the UPE jurisdiction does not implement the GloBE rules.

Any top-up tax due under the UTPR will be allocated among the countries in which the group has operations in proportion to the group's payroll costs and tangible asset value in each country. Those countries will then collect the tax either by denying deductions to, or imposing a schedular charge on, group entities resident in their territory.

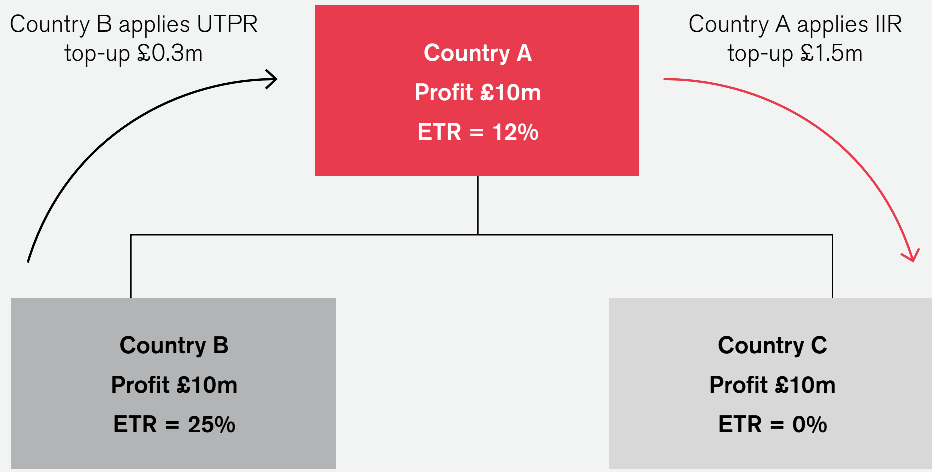
Top-up tax

Countries A and B have implemented the GloBE rules, while Country C has not

Country A charges: £10m x (15% - 0%) = **£1.5m** in respect of Country C

Country B charges: £10m x (15% - 12%) = **£0.3m** in respect of Country A

Total top-up tax = **£1.8m**



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Which countries will implement Pillar Two, and how?

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Which countries will implement Pillar Two, and how?

Q Who has signed up to Pillar Two, and what does this actually mean?

137 of 141 members of the Inclusive Framework (IF) - Mauritania joined in November - have signed up to Pillar Two. This now involves all 27 EU Member States - including Ireland, Estonia and Hungary, each of whom had previously resisted the new framework. However, it is worth considering further what "having signed up" actually means.

Pillar Two has two components:

- the GloBE rules, which ensure large groups pay a minimum effective corporate tax rate on all of their profits; and
- the subject to tax rule (STTR), which gives developing countries greater source taxing rights over certain low-taxed related party payments.

With respect to the GloBE rules, IF members have committed only to adhere to a "common approach", rather than to adopt a prescribed suite of measures in their entirety. This leaves countries with a range of options as to what implementation of the GloBE rules will look like for them (see below).

By contrast, the published statements to date have been unequivocal when it comes to the STTR, stating it is a minimum standard that must be implemented by IF jurisdictions with a nominal corporate income tax below 9% through adjustments to their bilateral treaties when requested to do so by developing IF members. Signatories to Pillar Two will not have any discretion in this regard. That said, the STTR is notable by omission from the model rules published on 20 December. Although the rule will have limited reach, we await further developments on what the final model treaty provision will look like and how it will be implemented.

Q What factors will affect how countries choose to adopt the GloBE rules?

At one end of the spectrum, it will be consistent with the agreement for a country to make no adjustments to its domestic tax law at all bar anything required to ensure that it respects the way other jurisdictions have implemented the rules (e.g.rule order and agreed safe harbours). There have already been murmurs from certain jurisdictions that this will be their preferred approach. It may be particularly attractive for countries with no corporation tax system who are happy to acquiesce in the reforms taking place elsewhere without having to undertake a domestic revolution in their own approach to taxing corporates.

Other countries may then decide to cherry-pick elements from the GloBE rules or implement in fullform. In the latter case, even a commitment to entire implementation will not necessarily result in an identical approach from each country. The commitment is simply to implement and administer the rules consistently with the Pillar Two agreement, which is a lower common denominator than might have been envisaged at the outset. For example, countries will be free to choose how to capture the top-up tax under the undertaxed payment rule (UTPR).

We expect most large developed countries, including those in the G20, will be keen to secure the additional tax revenues that Pillar Two offers and will fully implement the rules. They may also conclude it would be more attractive for groups to be subject to the IIR in their parent jurisdiction, than to face an administratively difficult patchwork of deduction denials in subsidiary jurisdictions under the UTPR. A significant majority of the world's MNEs are headquartered in those countries, so it is likely the rules will achieve good coverage of their target population.

Whether and how countries implement the rules is likely to be an evolving picture, influenced by consultations with stakeholders where governments choose to carry these out.

Which countries will implement Pillar Two, and how?

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Q How will low tax jurisdictions respond?

Pillar Two threatens the economic model of those low tax jurisdictions that rely on attracting large MNEs. Their governments will be carefully considering how exposed they are and what to do, e.g. by raising their corporate tax (CT) rates or looking for other means of competition such as employment taxes or expenditure-based credits. If Pillar Two is effective and MNEs end up paying a 15% ETR via a top-up tax, there may be little advantage to a country not charging CT if it has the administrative infrastructure to do so.

The same calculus is relevant to countries that have high tax rates, but which might be home to some MNEs that pay less than the minimum ETR because they benefit from reliefs. Those countries will be considering whether to pare back the generosity of reliefs or introduce domestic alternative minimum taxes (AMTs) to "soak up" any potential top-up tax – a possibility that the OECD model rules explicitly contemplate.

The impact of Pillar Two may be more difficult to judge for countries with low but meaningful CT rates such as Ireland. Ireland has prospered economically by attracting MNEs with its 12.5% CT rate, and initially resisted signing up to the OECD agreement before announcing an intention to raise their CT rate to 15% for the largest groups. Most of the MNEs Ireland has attracted are US headquartered though, so they are arguably less exposed to Pillar Two than they are to the US rules, which could end up being more benign. It is also possible that Ireland ends up well-placed as a location that taxes at, but not above, the minimum rate.

Q What about the US?

The US already has global intangible low-taxed income (GILTI) rules which impose a top-up tax on overseas activities of US groups. GILTI is less stringent than the GloBE rules: it applies a minimum rate of 10.5% and does so on a worldwide basis which allows tax paid in high tax countries to offset low tax profits elsewhere.

Under the Trump administration the US argued that GILTI should be considered equivalent to the GloBE rules and that the US should not be required to change its approach. The Biden administration has since proposed increasing the GILTI rate and applying the rules on a country-by-country basis, which would align it more closely with the GloBE rules. It remains to be seen whether those proposals will be enacted and if so, how they will be amended by the US Congress. However, it is virtually certain that the US will end up with rules that are different to the GloBE rules, perhaps materially so.

The model rules confirm that the OECD is continuing to consider the conditions under which the GILTI regime will co-exist with the GloBE rules.

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Which countries will implement Pillar Two, and how?

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Q When will countries adopt the GloBE rules?

> The October 2021 OECD agreement envisages that countries will start to bring the income inclusion rule (IIR) into effect in 2023. This is a challenging timetable given countries would have little more than a year to draft and enact legislation. However, from 2024 countries will be able to apply the backup UTPR to MNEs that are not subject to the IIR in their headquarter jurisdictions, so countries that want to implement the IIR will have a strong incentive to do so swiftly.

The EU will be in the vanguard of implementation. On 22 December 2021 the EU Commission published a draft Directive that will ensure that the Pillar Two rules are adopted by all Member States on a consistent basis – with a target commencement date of 1 January 2023.

While the UK government has not made any firm statements about when (or how) it will implement the rules, as one of the key players in brokering the G7 and G20 agreements that laid the ground for the reforms we expect it will act promptly. Although the UK government has indicated it will consult with stakeholders before legislating, this will be focused on implementation and administration rather than the policy choices agreed within the rules.

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Who will be impacted by Pillar Two?

Q What if our HQ jurisdiction doesn't implement the GloBE minimum tax rules?

> The October 2021 OECD/G20 agreement does not require signatory countries to implement the GloBE minimum tax rules - only to act consistently with the agreement if they do, and to recognise other countries' implementation of the rules.

We expect most large economies, including the G20 countries and the EU, to implement the rules. Those countries are home to the parent entities of over 90% of the world's MNEs which will therefore be subject to top-up under the income inclusion rule (IIR).

Some signatories to the agreement – for example countries without an existing corporate income tax system, or smaller countries that are not home to many MNEs – may choose not to implement the rules. MNEs headquartered in those countries will not therefore be subject to the IIR at parent level, however a top-up tax may still be payable. Although the rules give priority taxing rights to the parent entity, any countries that are home to intermediate holding companies in the group will be free to apply the IIR instead if the parent company jurisdiction has not exercised its taxing rights under the IIR. A further backstop rule – the undertaxed payment rule (UTPR) – will also allow implementing countries in which the group has operations to collect any top-up tax that has not been charged under the IIR.

Each group's circumstances will determine how much tax can be collected under the UTPR, however for large groups with operations in several implementing jurisdictions it is likely to be a credible backup to the IIR.

Q We don't have operations in obvious low tax jurisdictions – do we need to care?

> The GloBE tests effective tax rate (ETR) using an objective measure of taxable profit, so the fact that a group's operations are all in countries with nominal CT rates above 15% does not mean the group will not have an exposure.

An exposure could arise because of permanent differences between the domestic and GloBE tax bases, for example if the group benefits from reliefs given by a jurisdiction that are not accounted for in the GloBE profit measure.

An exposure could also arise because of timing differences, for example if income and expenses are recognised at different times under domestic and GloBE rules in a way that reduces the domestic tax paid in comparison with what would be expected under GloBE.

Groups will be able to include deferred tax expenses in their ETR calculations, which will reduce the impact of timing differences. However, in many instances if the timing difference has not unwound after five years the deferred tax will be adjusted out of the ETR calculation – referred to as "recapture" – and a top-up tax may arise. This could pose a particular problem for groups with longer-life assets that are subject to recapture, such as intangibles and goodwill.

Q What if our ETR in every country is above the minimum rate?

> Even in situations where a group's ETR is above 15% in every jurisdiction it will still need to fulfil potentially complex reporting requirements to establish that this is the case. The position in one year will also have implications for later years - for example a loss established in one year will need to be taken into account in the ETR calculation of later years - so groups will have to monitor their exposure on an ongoing basis.

The OECD is considering adopting safe harbours that will remove the need to do a full ETR calculation for jurisdictions that meet certain gateway criteria, for example a simplified ETR calculation based on CbCR data. The safe harbour proposals will be developed during 2022 as part of the OECD's work on GloBE implementation. While any features that focus GloBE on genuine low or no tax jurisdictions would be welcome, countries will be concerned to avoid leaving material gaps in the rules' coverage, and it may therefore be difficult to design safe harbours that provide a meaningful simplification. Again, groups that are within a safe harbour in one year may still need to track what their position would have been under the full GloBE calculation in case that is relevant in the future.

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Scope of the GloBE rules and application to investment funds and family offices

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Q Which group entities will be within the scope of the GloBE minimum tax rules (and to what extent)?

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Q What will the investment fund exclusion mean in practice?

Q How will family offices be treated?

Scope of the GloBE rules and application to investment funds and family offices

Q Which group entities will be within the scope of the GloBE minimum tax rules (and to what extent)?

As expected the scope of the GloBE rules turns heavily on how the parent of the group in question prepares its consolidated accounts. However, the results that the rules are intended to produce in practice are perhaps not as obvious from the face of the model text as hoped. The OECD commentary expected next year will hopefully provide additional clarity on this. In the meantime, it is possible to extract the basic scoping mechanic from the rules and we have set this out below.

Q Which entities are in scope?

An MNE group under the model rules is the collection of entities for which an ultimate parent is required to prepare consolidated accounts. "Entities" will include all legal persons (other than individuals) as well as partnerships, trusts and permanent establishments. The ultimate parent entity (UPE) will be the entity that is required to prepare the consolidated accounts, while not itself being consolidated in the accounts of an entity above it.

Whether the MNE group is then in scope will depend on whether the annual revenue in the consolidated financial statements of its UPE meets the €750m threshold, taking into account the revenue of all entities in the group. The anticipated commentary should provide more detail on how this works in practice and may well be augmented by anti-avoidance rules targeting attempts to fragment groups.

Identifying the entities that comprise a group is not the end of the story, however. An in scope MNE group then needs to identify which of its entities will be subject to the main charging provisions. Key to this will be identifying any "Excluded Entities", as these will not be subject to the main rules (although their revenue will still count towards the threshold above). Excluded Entities include certain pension funds, non-profit organisations, and investment and real estate funds.

Q What does this mean in practice?

An entity that is not consolidated with a UPE will (subject to certain narrow exceptions) neither count towards the revenue threshold, nor fall within the scope of the main charging rules. This will be particularly relevant for any entities not consolidated with their parents under the IFRS 10 Investment Entity rules.

By contrast, entities which are consolidated with an ultimate parent further up the group:

- will count towards the aggregate revenue threshold of that group; and
- may or may not fall within the scope of the main charging rules (depending on whether they are Excluded Entities).

It seems fairly clear under the consolidation rules above that, to the extent investment funds do not consolidate with their investee entities, they will not be aggregated together either for the purposes of drawing the parameters of its MNE group (and working out if the €750m threshold is met), or for the purposes of calculating the group's ETR and top-up tax.

Scope of the GloBE rules and application to investment funds and family offices

What is the investment fund exclusion?

The model rules confirm that both investment and real estate funds are "Excluded Entities". In each case, the exclusion only applies if the relevant fund is an UPE and it is therefore not a panacea for all funds wherever they may be situated in a group.

An investment fund is defined in the rules as an entity that meets all seven specified criteria set out in the rules, including being designed to pool assets from a number of investors (at least some of whom are unconnected), investing in accordance with a defined investment policy, and being subject to a relevant regulatory regime.

It is, however, likely to be helpful that exclusion also extends to asset holding entities, being entities that are either:

- at least 95% owned by other Excluded Entities and whose function is to hold assets or invest funds for the Excluded Entity's benefit or only carry out ancillary activities; or
- at least 85% owned by other Excluded Entities and whose income is substantially all dividends and gains relating to participation shareholdings.

Asset holding entities do not need to be UPEs to benefit from the exclusion.

What will the investment fund exclusion mean in practice?

The effect of the investment fund exclusion is not clear cut.

While it carves investment funds out from the "operative provisions" of the GloBE rules, it does not appear to prevent the revenue of an investment fund from counting towards the €750m threshold for a consolidated group as a whole, or to prevent entities owned by an excluded fund from being aggregated.

Elaboration in the OECD commentary on the intended result here would mitigate the remaining uncertainty on this important point.

How will family offices be treated?

Whether a family office investment vehicle is required to aggregate with its investments for the purposes of the GloBE revenue threshold and calculating ETRs and top-up tax will depend, as with other investment vehicles, on whether it consolidates those investments in its accounts.

However, family office investment vehicles are less likely to benefit from the investment fund exclusion under the model rules (although this should be confirmed on a case by case basis); given the nature of family office investment arrangements, any relevant entities are likely to only pool assets from related investors.

Family office investment vehicles may also fall outside the Excluded Entity definition if they are not themselves UPEs, i.e. where they are consolidated with an entity above them in the group (although they may still qualify as excluded asset holding entities if they are themselves held by an investment fund and meet the conditions above).

The Blueprint published in October 2020 specifically stated that the definition would not apply to unregulated investment vehicles such as family held companies, and it is likely we will see a supporting explanation regarding this in the commentary.

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Reliefs and incentives

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Will reliefs offer any benefit post-GloBE?

Q

How do the GloBE minimum tax rules treat tax reliefs and incentives?

Q

Will this provoke governments to withdraw tax reliefs?

Reliefs and incentives

How do the GloBE minimum tax rules treat tax reliefs and incentives?

The GloBE ETR calculation does not generally include adjustments for reliefs and incentives - for example enhanced deductions, tax credits or reduced rates or exemptions for categories of income.

Many incentives will therefore reduce a group's ETR in the recipient jurisdiction below the domestic nominal tax rate. If they reduce that ETR below the 15% minimum rate that will result in a top-up tax which will effectively remove some of the benefit of the incentive.

Will reliefs offer any benefit post-GloBE?

Yes.

Firstly, there are some important kinds of incentive that do not reduce a group's GloBE ETR:

- accelerated capital allowances, which provide a timing benefit that is adjusted out of the ETR calculation. (See superdeduction example on page 18); and
- fully refundable tax credits such as the UK's R&D Expenditure Credit, which are treated as akin to a grant or subsidy rather than a tax reduction. (See RDEC example on page 17).

Secondly, even where an incentive does reduce a group's GloBE ETR there can still be considerable scope for a group to benefit from it without triggering a top-up. That will especially be the case for businesses based in countries with CT rates materially above the 15% minimum – including the UK, which will have a 25% CT rate from April 2023 – and businesses with a mixture of activities, some of which benefit from incentives and some of which do not. See Patent Box example on the right.

Patent Box

The UK's Patent Box effectively taxes covered income at a reduced rate of 10%, which will lower the ETRs of groups that benefit from it.

Most claimants will have a mixture of Patent Box income (taxed at 10%) and other income (taxed at 25% from 1 April 2023). Depending on the relative size of those income streams a group may not fall below the minimum rate overall, and continue to receive the full benefit of the Patent Box.

Patent Box example

Example 1: mix of high and low taxed income

	Patent Box income (£m)	Other income (£m)	Total (£m)
Profits	30.0	25.0	55.0
Tax @ 10%/25%	3.0	6.3	9.3
ETR			16.8%
Top-up tax			-

Example 2: predominantly low taxed income

	Patent Box income (£m)	Other income (£m)	Total (£m)
Profits	30.0	5.0	35.0
Tax @ 10%/25%	3.0	1.3	4.3
ETR			12.1%
Top-up tax			1.0

Reliefs and incentives

R&D credits

The GloBE rules treat "above the line" tax credits that are fully refundable within four years, such as the UK's R&D expenditure credit (RDEC), as additions to taxable income rather than reductions in tax paid. This recognises that while such credits are delivered through the tax system they are effectively government subsidies for expenditure, and in substance akin to a government grant.

This means that receiving RDEC, which is treated as taxable income for UK CT purposes, will not reduce a group's UK ETR.

In contrast, non-refundable credits will be treated as tax incentives, and as reductions to the tax paid by the recipient group, directly reducing its ETR in the jurisdiction concerned.

Example: different effects of RDEC and non-refundable credits on ETR

RDEC

	UK CT (£m)
A. Income	50.0
B. RDEC	15.0
C. Total profit	65.0
D. Tax @ 25%	16.3
	GloBE
E. GloBE profit (C)	65.0
F. GloBE tax (D)	16.3
G. ETR (F/E)	25%

Non-refundable credit

	UK CT (£m)
A. Income	50.0
B. Non-refundable credit	15.0
C. Total profit	65.0
D. Tax @ 25%	16.3
	GloBE
E. GloBE profit (C - B)	50.0
F. GloBE tax (D - B)	1.3
G. ETR (F/E)	2.6%

Reliefs and incentives

Superdeduction

The UK provides several allowances aimed at encouraging investment in physical capital by accelerating the point at which tax relief for expenditure is given. They include:

- a 130% first year "superdeduction" for expenditure on most new plant and machinery;
- a 100% first year Annual Investment Allowance for up to £1m of expenditure on other plant and machinery; and
- a 50% first year deduction for expenditure on long-life assets.

These allowances provide timing benefits compared to both conventional writing-down allowances and accounting depreciation. The GloBE ETR calculation smooths out timing differences by looking at any deferred tax accrued in a group's accounts as well as cash tax payments. While an accelerated allowance will depress a group's cash tax payments, a commensurate deferred tax expense will be recognised in the group's accounts, reflecting that the group will receive smaller deductions (and therefore pay more cash tax) in the future. Accelerated allowances of up to 100% in the first year will not therefore reduce a group's ETR. Capital allowances for expenditure on tangible assets are one of the categories of timing difference for which deferred tax is not recaptured under the GloBE rules (see page 21), so this treatment is permanent.

Allowances that go beyond that, such as the 130% superdeduction, do not just accelerate the point at which tax deductions are available – they also uplift the amount of deductions that are given. To the extent they provide an uplift they will reduce the GloBE ETR.

Q

Will this provoke governments to withdraw tax reliefs?

> Pillar Two is unlikely to lead to wholesale removal of tax reliefs.

The policy motivations – encouraging business investment, supporting key industry sectors – for the reliefs that already exist will remain after the GloBE rules are implemented. Tax will still be an effective lever in many cases, for the reasons given above and because most taxpayers that benefit from reliefs are SMEs that do not meet the GloBE revenue threshold.

However, governments will also be concerned to avoid incurring "deadweight" cost by providing reliefs that reduce businesses' tax liabilities, only for the same businesses to suffer a compensating top-up tax elsewhere.

Governments could try to avoid this by pruning the generosity of reliefs that they assess as being particularly likely to pull groups' ETRs below the minimum. Some may go further and prevent any possibility of a GloBE top-up by introducing rules that increase a group's domestic CT liability to the minimum rate before the GloBE rules are applied.

In the longer term these complexities might reduce the relative attractiveness to governments of corporate income tax incentives and lead them to look to tax levers that are not impacted by Pillar Two, for example employment taxes, or non-tax levers such as grants.

5

Losses and timing differences

What about other kinds of timing difference?

What happens when a group makes a loss under the GloBE rules?

How does the deferred tax mechanism work?

How complex will this be to administer?

What if my group was loss-making before the GloBE rules were introduced?

Losses and timing differences

Q What happens when a group makes a loss under the GloBE rules?

Most countries allow taxpayers to offset losses against profits so that they are taxed on no more than the overall net profit that they make over time. The GloBE rules seek to achieve the same outcome but do so using deferred tax accounting.

When a group makes a GloBE loss in a jurisdiction, that loss is not carried forward and used to reduce GloBE profits in a later year.

That means there will be an apparent shortfall in tax in the later year – that year's GloBE profits will be undiminished by losses, but the tax paid under the jurisdiction's domestic tax system will be reduced on account of loss relief.

The GloBE rules address this by allowing entities to treat deferred tax expenses recognised in their accounts, including in relation to tax losses, as "covered tax" in the ETR calculation. This increases the numerator in the GloBE ETR calculation.

Q How does the deferred tax mechanism work?

In a loss-making year, an entity will recognise a deferred tax asset (DTA) in its accounts, representing the tax that will be saved by claiming loss relief in the future. That asset will have been valued using the relevant domestic tax rate - so a loss of £10m incurred in a country with a 25% tax rate will give rise to a DTA of £2.5m.

In the later year when the loss is relieved under the domestic tax system, that DTA will be reversed, producing a deferred tax expense in the entity's profit and loss account. That deferred tax expense is then taken into account under the GloBE rules when determining the entity's ETR for that year.

Importantly, the GloBE rules require deferred tax expenses to be "recast" – in other words revalued – at the 15% minimum rate. The £10m loss described above would therefore be treated for GloBE purposes as giving rise to a DTA of £1.5m. Recasting ensures that losses are valued consistently. Without it, a loss arising in a high tax environment would have a greater effect than an equal loss arising in a low tax environment, despite them both representing the same reduction in profits.

Example: Recasting DTAs

	Year 1 (£m)	Year 2 (£m)	Year 3 (£m)
GloBE profit/(loss)	(10.00)	5.00	10.00
Cash tax expense @ 25%		-	1.25
Apparent ETR		-	13%
Deferred tax expense		0.75	0.25
Final ETR		**15%**	**15%**
Calculation of DTA, "recast" at 15%:			
b/fwd	-	1.50	0.75
created	1.50	-	-
used	-	0.75	0.25
c/fwd	1.50	0.75	0.50

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Losses and timing differences

What about other kinds of timing difference?

There are many instances besides losses in which income and expenses will be recognised at different times under domestic and GloBE rules in ways that could increase or decrease a group's apparent ETR. That could, for example, be the case if a group receives accelerated capital allowances, or roll-over relief, or is taxed on a realisation basis in respect of assets that are accounted for at fair value.

The deferred tax accounting approach described above also addresses these general timing differences – groups will be able to recognise deferred tax expenses in their ETR calculations, effectively matching tax paid to taxable profits over time.

However, the rules are concerned to prevent indefinite deferral of tax and do not accommodate every timing difference. Other than for a relatively short list of exceptions, deferred tax liabilities (DTLs) are subject to "recapture". That means that if a group recognises a DTL which has not unwound (effectively, been paid in cash) after five years the deferred tax will be adjusted out of the ETR calculation in the year of recognition and a top-up tax may arise.

The timing differences excepted from recapture include those arising from capital allowances and roll-over relief in respect of tangible assets, FX gains and fair value accounting. Perhaps the most significant items that are subject to recapture are intangible assets and goodwill, which are often relieved for tax purposes in a way that differs materially from the accounting treatment.

How complex will this be to administer?

The deferred tax approach for addressing timing differences could be administratively very burdensome.

Groups will need to recast all of their DTAs and DTLs at the minimum rate and then separately track them for recapture purposes. While for some groups that will be the unavoidable price of ensuring that their ETR is measured accurately, the rules also allow groups to elect for a simplified treatment that only tracks DTAs relating to losses. This may be attractive to businesses that are confident any timing differences will not pull their ETR below the minimum rate.

What if my group was loss-making before the GloBE rules were introduced?

A similar mechanism will assist groups with losses brought forward at the point they transition into GloBE. Groups will be able to recognise DTAs or DTLs in their entities' accounts at the date they transition into GloBE, subject to recasting. In one act of deliberate simplification the model rules allow pre-existing losses of any age to be brought forward and do not impose any expiry date on the use of losses.

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6

Substance-based income exclusion

Q What is the substance-based income exclusion?

Q How much income will be excluded?

Q Who will benefit?

Substance-based income exclusion

Q What is the substance-based income exclusion?

For in scope groups, the substance-based income exclusion will exclude a fixed return on a group's tangible assets and payroll costs in a jurisdiction from the top-up tax calculation. This recognises that income attributable to such physical factors of production is unlikely to result from profit shifting.

The exclusion does not alter the ETR calculation. Instead, it reduces the amount of profit that is subject to top-up once the ETR has been determined. This effectively ensures that both the excluded income and any tax charged thereon are left out of account. If a group's profit in a jurisdiction is less than the amount of the substance exclusion then it will not suffer any top-up in respect of that jurisdiction, even if the ETR is below 15%.

Q How much income will be excluded?

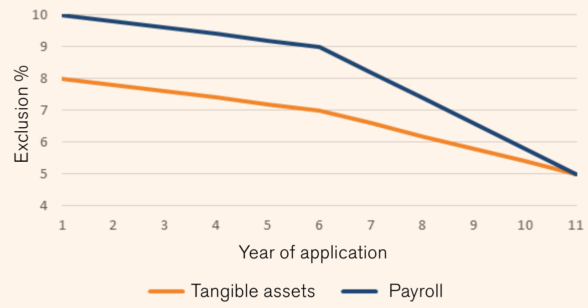
The amount excluded will be a fixed percentage of:

- the carrying value of tangible assets that a group has in a jurisdiction; and
- the payroll costs of the group's employees in that jurisdiction.

Tangible assets will not include property held for sale, lease or investment.

The percentage will initially be 8% for tangible assets and 10% for payroll. Each percentage will then reduce to 5% over 10 years.

Substance-based carve out decreases in value over time



Parent (UK)

OpCo (Hungary) **Tax rate = 9%**	**IPCo (Bermuda)** **Tax rate = 0%**
OpCo manufactures products	IPCo holds and manages the group's IP

Profit	£25m
Tangible assets	£150m
Payroll	£150m

Carve out =
(£150m + £150m) x 5% =
£15m

Top-up rate =
15% - 9% =
6%

Top-up tax =
(£25m - £15m) x 6% =
£0.6m

Profit	£50m
Tangible assets	£5m
Payroll	£5m

Carve out =
(£5m + £5m) x 5% =
£0.5m

Top-up rate =
15% - 0% =
15%

Top-up tax =
(£50m - £0.5m) x 15% =
£7.4m

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Substance-based income exclusion

Q Who will benefit?

> The substance exclusion draws a distinction between immobile physical activities, the location of which is likely to depend on a range of commercial factors, and other, more mobile activities which are arguably more susceptible to base erosion and profit shifting (BEPS).

It will be most relevant to groups that carry out asset- and labour-intensive activities such as manufacturing – one of its main proponents was Hungary, which has sought to attract manufacturing businesses with a 9% tax rate and generous incentives. In some instances, the exclusion may exclude all or a large proportion of the profits attributable to those activities from top-up, although this will become less likely as the carve out percentages taper down to 5%.

The benefit is likely to be negligible for low-taxed IP holding companies and group financing companies, which generally earn profits that are high compared to their tangible asset and payroll cost bases. While the exclusion is a welcome feature of the rules it is therefore unlikely to blunt their impact on their intended target.

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7

Subject to tax rule (STTR)

Q

What's the idea behind the STTR and why is it in the Pillar Two package?

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Which countries will be able to apply STTR, and when?

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How will the STTR work?

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How will the STTR interact with the GloBE rules?

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Subject to tax rule

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What's the idea behind the subject to tax rule (STTR) and why is it in the Pillar Two package?

> The STTR gives greater source taxing rights to countries in situations where their residents make certain payments to connected parties in jurisdictions that tax the receipt at a nominal rate below 9%. It will operate as a standalone rule from the GloBE minimum tax rules.

It was included in the Pillar Two package to satisfy the interests of the developing countries in the OECD Inclusive Framework (IF). They argued that they were exposed to base erosion involving deductible payments to low tax jurisdictions, and that the IIR alone was not an equitable response given that MNE groups would only pay top-up tax in their ultimate parent countries, which are overwhelmingly developed economies.

It applies to connected party payments of interest, royalties, and certain other payments to be decided. Detailed model provisions for the STTR are yet to be published.

Which countries will be able to apply it, and when?

> The STTR is only relevant to situations where there is an existing bilateral tax treaty. Where there is no treaty, countries are already free to impose source taxation without constraint.

The STTR is only designed for developing countries. They may invoke the STTR to amend existing bilateral tax treaties that limit their source taxing rights to below 9%, but only where their treaty partner taxes the specified payments at a nominal rate below 9%.

A developing country is defined as one with GNI per capita of no more than $12,535 – a list that includes India, China, South Africa, Indonesia and many others.

The developing countries in the IF have relatively few treaties that meet the criteria above in relation to interest and royalties, which would significantly limit the situations in which the rule would be relevant if those were the only kinds of income in scope. Those countries have therefore been arguing for a more expansive scope covering some kinds of active income, for example fees for technical services or payments in respect of distribution rights. It is unclear how the negotiations on this important point were concluded – the model rules published on 20 December only cover the GloBE rules, and the OECD has undertaken to publish a model STTR treaty provision in early 2022.

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Subject to tax rule

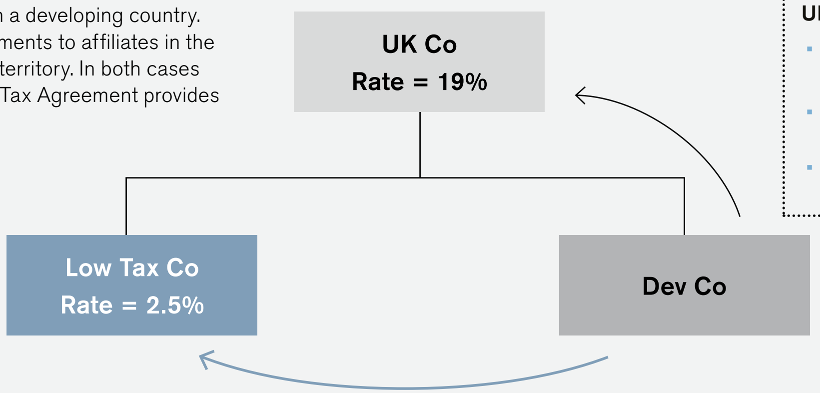
How will the STTR work?

The additional source taxing right will be limited to the difference between 9% and the nominal tax rate in the residence jurisdiction, applied on a gross basis. If the existing treaty already permits source taxation at a sufficient rate, then no additional taxing right will be available.

We expect that most countries will exercise the STTR taxing right by applying a withholding tax, but they could also do so via an annually assessed charge.

Example

Dev Co is resident in a developing country. It makes royalty payments to affiliates in the UK and in a low tax territory. In both cases the relevant Double Tax Agreement provides for nil withholding.



UK payment

- £10m royalty payment to UK
- Nominal rate exceeds the 9% minimum
- Treaty WHT rate of nil would apply

Low taxed payment

- £10m royalty payment to low tax territory
- Treaty WHT rate of nil would apply
- However, nominal rate is below the 9% minimum
- STTR therefore allows WHT of 6.5% (= 9%–2.5%)

How will the STTR interact with the GloBE rules?

Any tax paid under the STTR will be treated as a covered tax for GloBE purposes, in the same way that any other withholding tax would. It will therefore reduce the scope for the ultimate parent country to charge top-up tax under the IIR.

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