Pillar Two Model Rules published on 20 December 2021, and EU Pillar Two Directive proposed on 22 December 2021

On December 20th the OECD published detailed model legislation (“Model Rules”) for the project commonly known as “Pillar Two”, to assist in the implementation of a landmark reform to the international tax system. The reform is intended to ensure that Multinational Enterprises (“MNEs”) will be subject to a minimum 15% tax rate from 2023 onwards. The Model Rules serve as a template for domestic rules for jurisdictions that agreed on the Two-Pillar Solution. The OECD aims that these rules are brought into domestic legislation during 2022 and should start becoming effective as from 2023.

Shortly after the publication of the Model Rules, the European Commission (“EC”) published a proposal for an EU Directive ensuring implementation of Pillar Two on 22 December 2021 (the “Directive”). The EU Member States will need to unanimously agree in order for the Directive to be adopted. Once implemented by the Member States, the Directive should come into effect in the entire EU on 1 January 2023.

Overview

The Model Rules (also referred to as “GloBE” rules) are designed to ensure large MNE’s pay a minimum level of tax on the income arising in each jurisdiction where they operate.

The Model Rules provide that taxpayers in scope of the rules have to calculate their effective tax rate for each jurisdiction where they operate, and pay a ‘Top-up Tax’ for the difference between their effective tax rate per jurisdiction and the 15% minimum rate. If the domestic effective tax rate is lower than the 15% minimum rate and therefore the Top-up Tax is owed, the Top-up Tax is generally charged in the jurisdiction of the ultimate parent of the MNE under the Income Inclusion Rule (“IIR”). Where the IIR is not sufficiently effective, an Under Taxed Payments Rule (“UTPR”) should apply. The final part of the Pillar Two solutions is the so-called subject to tax rule (“STTR”). The STTR will be a treaty-based rule, which should allow certain source jurisdictions to impose a limited withholding tax on certain related party payments subject to tax below a minimum rate. However, this rule requires a multilateral instrument, for which public consultations are expected to start in March 2022. The instrument should be ready by mid-2022.

The aim is that the Model Rules will be converted into domestic law in the various jurisdictions during 2022. The IIR should become effective starting from 2023 and the UTPR from 2024 onwards.

Only the Model Rules have been published to date. Further explanatory commentary to the rules is expected to be published by the OECD early next year.

In detail – the Pillar Two / GloBE rules

For a MNE to determine the liability under the Model Rules, the following steps have to be followed.

Step 1: Determine whether the MNE is "in scope"

To determine whether a MNE is in scope of the Model Rules, a MNE should have more than EUR 750 million in consolidated revenues in at least two of the four preceding fiscal years, and have a foreign presence. There are a few carve-outs for "Excluded Entities" that are not in scope of the Model Rules such as:

» Government entities
» International organizations and non-profit organizations
» Pension funds, investment funds and real estate investment funds

Step 2: Determine the ETR

In order to determine if any Top-up Tax is due, the ETR of a MNE should be determined on a aggregated and per jurisdiction basis where the MNE is active. In order to determine the ETR, the 'GloBE income' (basis) and the 'GloBE tax' should be determined.

Step 2a: "GloBE Income"

The GloBE Income (or loss) is in principle determined on the basis of the net income as reported in the financial accounts. Further, certain adjustments are made to that income, in order to better align the financial accounts with the requirements from a tax perspective. The OECD kept these differences at a minimum and they typically reflect common permanent book-to-tax differences. For example qualifying dividends and capital gains derived from shareholdings in subsidiaries are in principle removed from the GloBE Income.

Step 2b: "GloBE Tax"

The next step is to calculate the GloBE Tax, being the tax attributable to the GloBE Income. According to the Model Rules, the tax to be taken into account should equal the current tax expense accrued in the financial accounts. Taxes covered under current tax expenses are generally taxes on income and equity, and derivatives thereof (e.g. similar taxes that are only levied upon distributions). Further, certain adjustments have to be made, for example for taxes accrued as an expense in the earnings before taxation or deferred taxes.

Step 2c: "ETR"

The ETR can be determined by dividing the aggregated GloBE Income in the jurisdiction by the aggregated GloBE Tax of all MNE entities (and permanent establishments) in the relevant jurisdiction as calculated under the proposed rules.

Step 3: Determine the "Top-up Tax"

Once the ETR is calculated for the relevant jurisdiction, the next step is determining the Top-up Tax. This requires the determination of the Top-up Tax Rate, which is the percentage difference between the 15% minimum rate and the lower ETR in the jurisdiction. The Top-up Tax Rate is then multiplied with the amount of 'excess profits' in the jurisdiction. Excess profits are the GloBE Income (or loss) less a substance based carve out, being 8% of the carrying value of tangible assets and 10% of payroll costs in the jurisdiction. The substance based carve out exclusion percentages are both

reduced to 5% over a period of 10 years. The optional de minimis exclusion that had previously been announced has been maintained in the Model Rules. Jurisdictions may opt to not apply the GloBE rules to jurisdictions where a MNE has revenues of less than EUR 10 million and profits of less than EUR 1 million.

An example of how the Top-up Tax should be determined:

» GloBE Income (on a jurisdictional basis) = 1 million
» GloBE Tax = 100k
» ETR = 10% (1 million / 100k)
» Top-up Tax Rate = 5% (15% minimum rate -/- 10% ETR)
» Substance based carve out = 400k (percentage of jurisdictional tangible assets and payroll costs)
» Excess profits = 600k (GloBE Income of 1 million less Substance based carve out of 400k)
» Top-up Tax = 30k (5% over excess profits)

Step 4: Allocation of the Top-up Tax due under the "IIR and UTPR"

The Top-up Tax is allocated to jurisdictions under the following two provisions:

Primary rule: Income Inclusion rule (IIR)

The primary rule is the IIR. The IIR means that the Top-up Tax is in principle paid at the level of the ultimate parent entity in proportion to its ownership. If the jurisdiction of the ultimate parent entity does not apply the IIR, the next 'top entity' in line may levy the IIR (top-down).

Secondary rule: Under Taxed Payment Rule (UTPR)

The secondary rule is the UTPR, which is intended to serve as a backstop to the primary IIR. The UTPR applies if low-taxed income is not being sufficiently picked-up under the IIR. The UTPR should be applied by the other implementing jurisdictions. Such adjustment could be in the form of e.g. a denial of deduction, or the recognition of deemed income, resulting in an increase of the tax due in the other jurisdictions. The rules provide that any remaining low-taxed income is divided under an allocation key that is based on an implementing jurisdiction's relative share of tangible assets and employees (on a 50/50 basis). It appears that it is not relevant whether the entities actually make deductible payments to a low-taxed group entity. Instead, all tax deductible payments made in a jurisdiction, including payments made to third parties, may potentially be denied under the UTPR in order to increase the jurisdictional ETR to the required minimum level.

Administration of the Model Rules

Each constituent entity – or a designated local entity on its behalf – should file a standardized GloBE information return in its jurisdiction of residence with its local authority. The return should be filed within 15 months from the end of the relevant financial year, but for the first return a longer 18 month period would apply. The other MNE entities that are subject to the Model Rules should file a notification with their local authority, notifying which constituent entity has filed the return. If no information sharing agreement is in place between the jurisdiction of the filing constituent entity and the jurisdiction where a notification should be made, then the standardized

information return should in principle also be filed in the latter country.

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It is currently not clear whether the US minimum tax generally known as Global Intangible Low-Taxed Income or ("GILTI") is fully compliant with the Model Rules, although it is reiterated that the OECD/G20 Inclusive Framework on BEPS agreed that consideration will be given to the conditions under which the GILTI regime will co-exist with the GloBE Rules. Further guidance is expected in early 2022, when the OECD will release its commentary on the application of the GloBE Model Rules. In the event that the GILTI rules will not be fully compliant, subsidiaries of US MNEs or holding entities might be subject to the UTPR. Based on the OECD's statement of 8 October, this question would be dependent on several items, the most important one being that GloBE applies a per-jurisdiction blending mechanism whilst GILTI currently does not.

EC's proposal for an EU Pillar Two Directive

Two days after the publication of the Model Rules, the EC proposed a Directive for the implementation of Pillar Two in the EU. The publication of the proposed Directive does not come as a surprise, as the EC had already announced its intention in its roadmap of 18 May 2021, titled "Business taxation for the 21st century", although the publication two days after the publication of the Model Rules is expeditious to say the least. The European Parliament and European Economic and Social Committee will still need to be consulted and give their opinion. Thereafter, EU Member States will need to unanimously agree on the adoption of the Directive in order for it to enter into force. Next, the EU member states will have to implement this Directive into their domestic legislation, of which the targeted effective application date is 1 January 2023.
Unanimous agreement within the EU seems more realistic, given that all EU Member States but Cyprus have signed on to the OECD initiative and Cyprus has expressed broad support of the OECD efforts. The EC's expectation that the Directive will receive the required unanimous consent on this basis is also explicitly noted in its press release. The Directive seems to closely follow the Model Rules published on 20 December 2021.

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Whilst we realize this note likely falls on deaf ears in the current political climate, we call on EU policy and lawmakers to reconsider whether this Directive is necessary at this stage and instead focus on implementing the Pillar Two Model domestically. Given the mechanics of Pillar Two, we are generally of the view that frontrunning these rules in a harmonized way in the EU through a Directive may be premature. Although Pillar Two does not have a mandatory character, it enjoys a broad global consensus between the IF member jurisdictions, who collectively represent more than 95% of global GDP. As such, it seems likely that the Model Rules will quickly gain traction globally. If sufficient jurisdictions adopt domestic versions of the Model Rules, not only should the envisaged global minimum rate of 15% quicky become a fact for many in-scope MNEs, it should also cause an incentive for other jurisdictions to implement these rules. The Model Rules allow jurisdictions to introduce their own domestic minimum Top-up Tax based on the GloBE mechanics, fully creditable against any liability under GloBE, thereby preserving

a jurisdiction's sovereignty to tax income with a sufficient nexus to it.

Whilst the desire to have an EU Pillar Two Directive can be explained by the EU's tireless efforts to further harmonize taxation within the EU, implementing these developments as one EU block may not only prove unnecessary – as illustrated above – but may also pose a potential risk. If the Model Rules turn out to enjoy less consensus than the number of signatories leads to suspect, then the EU may effectively put itself in a competitive disadvantage by harmonizing these rules in a Directive. Moreover, EU Directives, including changes to EU Directives, require anonymous approval from all EU Member States. Amending EU Directives - once adopted - is very difficult, time consuming and in practice therefore rare. This means that future circumstances that may justify amendments, such as progressive insights on how the Pillar Two rules will work out in practice or a lesser than anticipated global adoption, cannot be swiftly taken into account by EU Member States individually. By contrast, domestic implementations of the GloBE Model Rules rather than an EU Directive, should enable EU jurisdictions to better adjust the implementing rules to the rapidly changing global economic and political developments.

Finally, if the Directive is indeed unanimously adopted in the EU, this begs the question whether the Anti-Tax Avoidance Directive (ATAD 1 and ATAD 2) will still be necessary in its current form. With tax legislation becoming more complex each year and taxpayer administration, tax compliance and systems reaching (or exceeding) peak capacity, reconsidering the necessity of this complex set of anti-abuse legislation in favor of a global Two Pillar system would be most welcome.

What should you do?

It is recommended that MNEs determine whether they are in scope of the GloBE rules. If so, it is recommended to already start identifying the ETR under the GloBE rules on a country-by-country basis. If the ETR is below 15% in particular jurisdictions, further actions might be necessary.

Let's talk

The press release of the OECD can be read here.
The Pillar Two Model Rules can be read here.

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