The intersection of Pillar Two and M&A tax

Fit for Pillar Two series

The ***Fit for Pillar Two*** series aims to help tax teams of multinational enterprises (MNEs) within the scope of Pillar Two prepare for the upcoming wave of international tax changes by putting theory into practice. In this series, Christian Athanasoulas, the Global Head of International Tax and M&A Tax, KPMG International and Tax Practice Leader — Services, KPMG in the US provides his insights and draws on experiences from professionals across KPMG member firms worldwide. Articles in the ***Fit for Pillar Two*** series will build upon each other and are designed to guide companies through the phases of Pillar Two readiness.

Background

As multinational enterprises (MNEs) continue to navigate the evolving landscape of global taxation, the intersection of Pillar Two with mergers and acquisitions (M&A) transactions presents unique challenges and opportunities. This article, the third in our series, explores how Pillar Two interacts with M&A activities — focusing on acquisitions, dispositions, joint ventures and carve-outs.

Understanding the impact of Pillar Two on M&A transactions is crucial. Pillar Two introduces a global minimum tax rate of 15 percent that significantly affects M&A activities. Companies engaging in acquisitions or dispositions must consider how these transactions will influence their effective tax rate, deal terms and compliance obligations.

The impact of Pillar Two is not limited to situations in which target group revenues already exceed the 750 million euros (EUR) threshold and are therefore in-scope of Pillar Two rules. An M&A transaction could also lead to the creation of a Pillar Two in-scope group if the newly combined group has revenues exceeding the EUR750 million threshold (subject to the two out of the proceeding four years test).

Conversely, a transaction could also take a group out of Pillar Two's scope if it involves the disposition of part of the group and group revenues drop below the EUR750 million threshold. Finally, Pillar Two can also be relevant in transactions where the resulting group may not breach the EUR750 million threshold if revenue forecasts suggest that the group will exceed it in future years.

Given the various ways in which Pillar Two can be relevant for a transaction, deal teams must always be aware of its presence and potential impact.

Pillar Two's impact can be felt across many transaction types and end-to-end across a deal's lifecycle — starting from the pre-deal stage, when companies need to consider what impact the proposed transaction will have on their Pillar Two profile. It will also be increasingly important from a sell-side perspective that all relevant Pillar Two information has been collated and readily available to the purchaser.

In tax due diligence, Pillar Two introduces a suite of new reporting obligations that will need to be reviewed to ensure compliance, as well to consider the various tax attributes within the target group and their Pillar Two impact. As deals are negotiated, additional consideration of warranties and indemnities included in the agreement will be needed, as well as ensuring that information rights exist for future Pillar Two compliance obligations.

In a post-deal world, any restructuring or integration planning and the potential Pillar Two impact will need to be considered. In particular jurisdictions, the direct tax implications of mergers and acquisitions may be highly significant amid diverse taxation principles and/or associated tax benefits. Consequently, it's crucial to meticulously consider the interplay between local regulations and Pillar Two to prevent unintended consequences.

Finally, reporting obligations arising under Pillar Two as a result of the transaction will require timely disclosure of relevant information to meet these obligations.

In conclusion, it's hard to ignore Pillar Two's potential impact on M&A transactions. Deal teams will need a strategic approach that considers both the immediate and long-term tax implications of Pillar Two. By understanding the complexities and leveraging strategic responses, companies can navigate the intersection of Pillar Two and M&A tax effectively. This proactive approach can not only mitigates potential risks but also positions companies to capitalize on opportunities arising from the global minimum tax landscape.

Q&A insights

Q1. How has Pillar Two impacted organizations' evaluations of contemplated transactions and their associated tax due diligence procedures?

Before a deal, it's essential to determine if the target company is subject to Pillar Two. This involves assessing whether the acquisition will lead to additional Pillar Two obligations for the acquirer. Understanding the target's jurisdictional tax profile is crucial, as it influences the global minimum tax's applicability. This assessment should include a review of the target's operations, revenue streams and existing tax strategies to identify potential exposure to Pillar Two rules.

From a seller's perspective, relevant Pillar Two information should be made available to the purchaser. When vendor due diligence is prepared, a section setting out the historical profile of the target from a Pillar Two perspective should always be included and should consider:

I. Whether the target is subject toPillar Two as a standalone group/part of the vendor's group/not subject to Pillar Two.

II. Any target entities responsible for the Pillar Two liabilities/filings in general (e.g., Partially Owned Parent Entities (POPEs), entities liable to Qualified domestic minimum top-up tax (QDMTT), etc.)

III. Pillar Two treatment of any intragroup transfers during the transitional period (from 30 November 2021) and any associated Pillar Two exposure.

IV. Specific arrangements in relation to any partially owned entities, joint ventures and permanent establishments which can significantly complicate the analysis.

V. Any changes in the group composition in the last four financial years, including where the group has been formed as a result of an acquisition.

From a valuation perspective, Pillar Two tax assumptions and risks should be incorporated within any financial model, and the impact of Pillar Two factored into the effective tax rate (ETR) forecasting. The top-up tax due under Pillar Two can be material and have a potential deal valuation impact. It's important to note that different buyer profiles could lead to different future cash tax-rate considerations, providing a competitive advantage for bidders that would not bring the target or themselves into the scope of Pillar Two as a result of an acquisition.

When structuring the transaction, the design can significantly influence tax efficiency, particularly in intragroup asset transfers and financing arrangements. It's crucial to align these steps with Pillar Two requirements to help optimize tax outcomes.

For instance, structuring the transaction to maximize the use of tax attributes such as losses or credits can mitigate the impact of the global minimum tax. Similarly, potential tax benefits associated with goodwill or other tax figures may not be permissible under Pillar Two, which could negatively impact the ETR following the transaction. Consideration should also be given to the timing of the transaction, as this can affect the applicability of certain tax rules and exemptions.

Brazil provides an example of the complex interaction between Pillar Two and existing tax rules. The model rules generally do not recognize any accounting adjustments from purchase accounting. Consequently, goodwill and fair value step-ups of assets/liabilities recorded due to a business combination will not impact Pillar Two calculations. However, Brazil's legislation allows the acquirer in a business combination to amortize and deduct goodwill and fair value step-up for income tax purposes if the acquired entity is merged into the buyer (or vice-versa) and certain conditions are fulfilled. This amortization is not permitted to affect Pillar Two calculations, which can significantly influence the ETR.

The relevance of this effect is noteworthy on its own, but further complications may arise. Brazil's common practice of utilizing a two-step structure — first acquiring a legal entity and then merging it at book value to achieve goodwill and step-up deductibility — can present additional challenges. As detailed in the June 2024 Administrative Guidance (AG), such a merger can generate Pillar Two specific deferred tax assets (DTAs) that may immediately impact the ETR and reduce the tax benefit associated with the goodwill and step-up amortization.

Q2. What additional risks does Pillar Two introduce into the deal process and what options can organizations take to ensure they have the necessary protections?

Pillar Two creates significant new drafting considerations for transaction participants when finalizing agreements. As a starting point, Pillar Two effectively introduces a new tax on in-scope groups, making it important to ensure that Pillar Two taxes (QDMTT, top-up tax, etc.) are adequately defined in the contract.

Pillar Two rules are unique in that they can impose a tax on entities in relation to other entities' profits. For example, a buyer may face liability for a top-up tax due from prior ownership. Pillar Two taxes thus need to be defined appropriately so that tax liability impacts the appropriate party post-transaction. Furthermore, it's vital to secure access to detailed financial and tax data from the seller to ensure compliance with Pillar Two reporting requirements.

Sale and purchase agreements should include sufficient warranties and indemnities to address Pillar Two risks. This might involve obtaining warranties regarding the accuracy of Pillar Two sensitive balances and any Global Anti-Base Erosion (GloBE) elections made.

Additionally, consider including specific indemnities for potential Pillar Two liabilities that may arise post-transaction. For example, reflecting an unforeseen tax refund for prior years in the sale and purchase agreement might be challenging. If warranties and indemnities are not available, consideration could be given to obtaining a specific tax insurance policy to cover historical Pillar Two risks. However, these policies could be more expensive and require a more detailed underwriting process than warranties and indemnities in practice.

Revising previous corporate arrangements, including existing shareholder agreements and earlier sale and purchase agreements, might be needed. Pillar Two rules may result in tax liabilities for the invested entity, leading non-related shareholders to question who should bear that burden.

Q3. What key items should organizations consider post-deal as they move past a transaction, from both an integration and compliance standpoint?

Post-deal integration can affect tax planning under Pillar Two. Companies must assess how restructuring after the transaction might lead to additional tax burdens and ensure that aligning the combined entity's tax strategy does not inadvertently trigger additional tax liabilities.

Companies should also consider the impact of integration on existing tax attributes and ensure that these are preserved where possible. It's important to model potential Pillar Two impacts post-transaction, considering jurisdictional blending and other factors that might affect the tax rate, such as the GloBE elections to be made or changed for the future.

This includes analyzing the impact of Pillar Two on cash-flow projections and ensuring sufficient liquidity is available to meet any additional tax obligations. Companies should also consider the impact of Pillar Two on their overall capital structure and financing arrangements.

Strategic responses to Pillar Two include evaluating the availability of transitional safe harbors that can provide temporary relief from certain Pillar Two obligations. This requires gathering data such as country-by-country reporting (CbCR) information and ensuring compliance with safe harbor criteria. Leveraging these safe harbors can allow companies to adjust their tax strategies in response to Pillar Two. Companies should also consider the impact of safe harbors on their overall tax planning and ensure that they are utilized effectively.

Additionally, companies should consider measures to optimize the minimum tax rate across jurisdictions, such as shifting high-taxed income to low-tax jurisdictions or exploiting losses through jurisdiction blending. This may involve restructuring operations, revisiting transfer pricing policies, or exploring alternative financing arrangements to achieve a more favorable tax position. Companies should also consider the impact of these measures on their overall business strategy and ensure that they are aligned with their long-term objectives.

It's important to maintain a sharp focus on all compliance and reporting obligations associated with Pillar Two. Collecting the necessary information to compute GloBE income on a jurisdictional basis requires extensive data from accounting and finance teams — which in a newly created group may come from multiple data sources or enterprise resource planning (ERP) systems.

For example, among Japanese companies — which are generally seen as having a decentralized global tax governance structure — the introduction of Pillar Two highlights the need for data management by the Japanese parent company and its involvement in local tax analysis for significant transactions. As a result, an increasing number of Japanese multinationals are reviewing their global tax governance structure and fine-tuning it in terms of various taxes beyond Pillar Two, including Japanese controlled foreign corporation (CFC) rules.

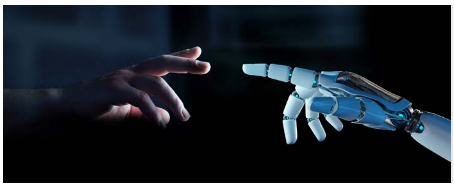
KPMG observations

1. Pillar Two's impact should be considered early in the deal process as it can determine the focus of any tax due diligence work, tax structuring and sales and purchase agreement (SPA) negotiations.
2. Combining a target business with an existing business in a jurisdiction might jeopardize applicable transitional safe harbor reliefs.
3. Gathering the necessary information to evaluate Pillar Two positions in the target business can be challenging throughout the deal, especially post-deal when coordination with the vendor may be necessary for Pillar Two compliance.
4. Assess the target business in terms of Pillar Two impacts on its tax benefits, as well as potential tax benefits that may result from the M&A transaction itself.
5. Evaluate relevant previous arrangements with third parties that might be affected by the acquisition and subsequent structuring due to Pillar Two.

Enabling technology

KPMG Digital Gateway — Powered by Microsoft Azure, KPMG Digital Gateway, is a single platform cloud-based solution that gives you access to the full suite of KPMG Tax technologies.

KPMG' BEPS 2.0 Automation Technology (KBAT) is a cloud-based tool designed to help evaluate, monitor, compile, track, calculate, analyze, report and comply with Pillar Two obligations, through integration with the KPMG Digital Gateway platform.



KPMG BEPS 2.0 tracker — Hosted on Digital Gateway, BEPS Pillar Two content providing access to announcements, justification status information and jurisdiction contacts.

Stay tuned for the next informative article in our Fit for Pillar Two series as KPMG specialists delve deeper into compliance and reporting.

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