KPMG

Inclusive Framework BEPS Agreement

Administrative Guidance of Pillar Two under BEPS 2.0

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On 2 February 2023, the OECD published the Administrative Guidance on the GloBE Rules of Pillar Two under BEPS 2.0. The OECD's press release on the release of the Administrative Guidance can be accessed via this link.

The Administrative Guidance covers five aspects of the GloBE Rules, namely (1) Scope, (2) Income & taxes, (3) Application of GloBE Rules to insurance companies, (4) Transition and (5) Qualified Domestic Minimum Top-up Taxes.

We highlight below some of the issues addressed in the Administrative Guidance. Please note the below is not an exclusive list of issues of interest.

The Administrative Guidance on the GloBE Rules

Notable issues addressed in the Administrative Guidance

Some of the most notable issues addressed in the Administrative Guidance are:

1. Deemed consolidation rule (Articles 1.2.2 and 10.1)

The GloBE Rules do not only apply to MNE groups which have prepared consolidated financial statements with annual group revenue of EUR750 million or more but also to a collection of entities (related through ownership or control) which would meet the above revenue threshold if they had been treated as a group and required to prepare a set of consolidated financial statements. A question of particular concern to the investment fund industry is whether investment funds, their investees and investment managers would be caught by this deemed consolidation rule, given the nature of their control relationships, and treated as a composite group for GloBE purposes.

The Administrative Guidance clarifies that the deemed consolidated rule will not require the preparation of consolidated financial statements in a case where the Authorized Financial Accounting Standard explicitly permits non-consolidation. For example, the consolidation exemption for investment funds under HKFRS 10 will be respected and the deemed consolidation rule does not apply. However, unconsolidated investment arrangements used by say, wealthy families to invest in various businesses could be caught by the deemed consolidation rule. The two illustrative examples in the Administrative Guidance set out the cases in which the deemed consolidation rule does not apply (i.e. where an investment entity is covered by IFRS 10) and would apply (i.e. where a privately held investment holding company is not covered by IFRS 10).

2. Excess Negative Tax Carry-forward (Articles 4.1.5 and 5.2.1)

The GloBE Rules contain a provision, in Article 4.1.5, which could lead to the imposition of GloBE top-up tax in a year in which a GloBE loss arises. The Administrative Guidance now adapts the application of Article 4.1.5. Rather than imposing top-up tax in a GloBE loss year, an Excess Negative Tax Expense amount is calculated and carried forward. This would then reduce the effective tax rate (ETR) of a subsequent profitable year, potentially leading to the payment of further top-up tax at that time.

The same mechanism is used to avoid the possibility of top-up tax rates higher than 15% by modifying the application of Article 5.2.1. In a year where the GloBE ETR is determined to be negative in a jurisdiction, an Excess Negative Tax amount is calculated and carried forward. This would reduce the ETR in a later year.

3. Equity gain or loss inclusion election (Article 4.1.3(a))

Under the GloBE Rules, profits or losses accounted for under the equity method of accounting are excluded from the ETR denominator and current tax expense on such profits is excluded from the ETR numerator. However, the GloBE Rules do not explicitly provide for the exclusion of any current tax benefit arising from losses (as such losses reduce taxable income in the owner's jurisdiction but not its GloBE income) accounted for under the equity method.

In this regard, the Administrative Guidance provides an election to remedy the distortive effects of a loss that is accounted for under the equity method (and therefore removed from the denominator of the ETR calculation) but nevertheless reduces Adjusted Covered Taxes because the loss is deductible for local tax purposes. More specifically, in-scope entities can make a 5-year election to include gains, profits and losses earned via equity method accounted investments (and other Ownership Interests) in GloBE income, subject to certain exclusions for items not subject to tax. Where this election is made, all associated current and deferred tax expenses and benefits are included in Adjusted Covered Taxes.

4. Excluded equity gain or loss and hedges of foreign equity investments (Article 3.2.1)

The GloBE rules provide that gains/losses on the disposal of (non-portfolio) equity interests will be excluded from GloBE income. The exclusion also extends to fair value gains/losses on such equity interests, and profit/loss from ownership interests which are subject to equity method accounting. To the extent that such equity interests are denominated in a currency different from the functional currency of the holding entity, the MNE group may choose to use hedging instruments. The Administrative Guidance provides a 5-year election to treat gains/losses on the hedging instruments themselves as also being excluded gains/losses.

5. Simplification for short-term portfolio shareholdings (Article 3.2.1)

The GloBE Rules provide a GloBE income exclusion for dividend income from equity interests that are not short-term portfolio holdings (i.e. less than 10% ownership interests and holding for less than one year). This then places a burden on in-scope MNEs to prove equity holding periods. As a simplification, the Administrative Guidance now provides a 5-year election to include all dividends in GloBE income. The election is open to all MNE groups but it is expected that it will largely be used by insurance companies.

6. Design of the Qualified Domestic Minimum Top-up Taxes (QDMTT) (Article 10.1)

The Administrative Guidance reiterates that in order for a jurisdiction's minimum tax to qualify as a QDMTT, it must provide for outcomes consistent with the GloBE Rules, which generally requires that any variations in the QDMTT should not produce a lower tax liability when compared with the GloBE Rules. In addition, the Administrative Guidance identifies elements of a QDMTT that would need to be identical with the GloBE Rules and certain other elements that may vary.

For example, variations from the GloBE Rules may be permissible where particular GloBE provisions would be 'redundant' in light of the jurisdiction's tax system (e.g. where a country's Corporate Income Tax (CIT) rules do not provide a tax deferral for reorganizations, the corresponding Chapter 6 GloBE Rules can be omitted from that jurisdiction's QDMTT). In addition, certain variances from the GloBE Rules which would systematically increase the tax liability under the QDMTT can be acceptable, (e.g. lowering or dropping the Substance-based Income Exclusion (SBIE) provided for under the GloBE Rules).

The Peer Review process will undertake a detailed and case-by-case evaluation of the QDMTT rules proposed by a jurisdiction, considering such alongside the domestic CIT rules, to see if omission/adaptation of any GloBE provisions is acceptable.

There are also some notable clarifications on the overall operation of the QDMTT:

- The Administrative Guidance reinforces that a QDMTT can be based on an accounting standard that differs from the one used in the consolidated financial statements of the Ultimate Parent Entity (UPE), assuming the accounting standard is of an "Acceptable" or "Authorised" nature.

- The Administrative Guidance clarifies that the QDMTT ETR numerator for the relevant jurisdiction would not include taxes paid by a shareholder of an entity located in such jurisdiction under a controlled foreign corporation (CFC) regime that would otherwise be allocable to such subsidiary under the GloBE Rules. Such rule would also apply in respect of any taxes paid by an owner of a permanent establishment located in such jurisdiction. Instead, the relevant CFC regime may give a credit for a QDMTT imposed on the CFC. As such, this would give the QDMTT imposing jurisdiction priority taxing rights over all others. Where CFC rule applying jurisdictions land in practice on this crediting point will be an area of intense interest going forward.

- The QDMTT developed by a jurisdiction needs to include the safe harbours developed by the OECD. Otherwise, an MNE would be forced to perform complex calculations for purposes of calculating tax liability under the QDMTT, which they are excused from if the GloBE Rules applied.

- A qualified QDMTT must be imposed on 100% of the tax-up tax calculated for local constituent entities (CEs). It cannot be limited to the ownership percentage of the UPE in those CEs. As such, QDMTT could lead to more top-up taxes than if the IIR at the UPE level applied in such jurisdiction.

- Elections under the GloBE Rules generally need to be provided for under a QDMTT, with certain exceptions (e.g. where the elections are irrelevant in the context of the local CIT law). An MNE group would need to make the same elections for QDMTT and GloBE rule purposes.

- A QDMTT must apply the same transition rules provided for under the GloBE Rules or otherwise the QDMTT will not reliably provide for outcomes consistent with the GloBE Rules.

The members of the Inclusive Framework on BEPS have not yet agreed on a QDMTT safe harbour and work will continue on its development. In its absence, QDMTT reduces the amount of top-up tax that arises under the GloBE Rules (i.e. a credit mechanism) while a safe harbour would switch this to an exemption mechanism. Practically, in the absence of a QDMTT safe harbour, MNEs may be required to compute the ETR for a given jurisdiction twice: first for purposes of the QDMTT (potentially using the local accounting standard) and again for purposes of the IIR/UTPR (using the consolidated financial accounting standard of the UPE).

Other issues addressed in the Administrative Guidance

Apart from the above issues, the Administrative Guidance also addresses or clarifies the below issues.

No.	Topic	Article	Description
Scope			
1	Currency conversion	1.1, 1.2, 3.1.3, 4.6.1, 4.6.4, 5.5.1, 6.1.1, 9.3.2, 10.1	The GloBE Rules include various monetary thresholds expressed in Euro. In addition to the group revenue scope threshold (EUR750m), further examples are the de minimis jurisdiction rule (EUR10m revenue and EUR1m profit/loss), and the material competitive distortion between certain accounting standards and IFRS (EUR75m). The Administrative Guidance provides for an annual rebasing of thresholds in non-euro currencies using the average foreign exchange rate in the month of December as quoted by the European Central Bank.
2	Consolidated deferred taxes amounts	4.1.1	The Administrative Guidance clarifies that deferred tax expense with respect to a CE should be included in the Deferred Tax Adjustment Amount, even when the expenses are recorded in the MNE group's consolidated financial accounts, rather than the financial accounts of individual CEs.
3	Clarifying the definition of "excluded entity"	1.5.2	The GloBE Rules provide for an extended definition of excluded entity. The definition also includes an entity, 95% held by an excluded entity, which holds assets (or invests funds) for the excluded entity; or which carries out functions ancillary to those of the excluded entity. An example might be an investment holding vehicle held by an (excluded) investment fund. The Administrative Guidance confirms that the 95% held entity can qualify as excluded entity where it **both** holds assets (invests funds) **and** performs the ancillary functions.
Income and taxes			
4	Excluded dividends – Asymmetric treatment of preference shares	3.2.1	The Administrative Guidance places a limitation on the GloBE income exclusion for dividends from (non-portfolio) equity interests. This is intended to deal with 'accounting mismatches' in relation to intra-group financing. For example, take the case where Co A holds preference shares issued by related party Co B. Co A accounts for this as equity, while Co B accounts for this as debt financing (though for local tax purposes, Co B may still treat it as equity).

			The Co B accounting treatment of dividend payments as interest, which would be followed by the GloBE income computation, would reduce the ETR denominator and raise the ETR – this is seen to be prone to GloBE tax planning. In consequence, the Administrative Guidance clarifies that Co A must be treated as receiving interest for GloBE purposes (i.e., conform recipient treatment to the accounting treatment of issuer Co B). This thereby limits the use of the GloBE dividends exclusion. To the extent that other forms of financing instruments are bifurcated by Co B into debt and equity elements there would be a proportional decrease in the amount treated as excluded dividends by Co A.
5	Treatment of debt releases	3.2.1	The Administrative Guidance excludes debt release-related income, booked to the accounts, from GloBE income. Conditions apply, including that the income must be exempt from domestic tax and the debt release must occur in the context of corporate rescue.
Transition			
6	Asset carrying value & deferred taxes under transition rules	9.1.3	The Administrative Guidance provides additional clarity on how Article 9.1.3 is meant to be applied. The Administrative Guidance deals with both the case where an intra-group transfer is booked at cost at the level of the acquiring CE and the case where it is booked at fair value. Starting with the case where the transfer is booked at cost, it is noted that a deferred tax assets (DTA) could be recognised at the level of the acquiring CE. This could be because the acquiring CE's local jurisdiction recognises a higher base cost for tax purposes, for example where the transfer consideration was higher than the historic cost at which the transfer was booked. The Administrative Guidance provides that recognition of this DTA for GloBE purposes is dependent on tax being paid, by the disposing CE, on the gain on the transfer. To the extent that the gain is taxed at 15% (or above) the acquiring CE can recognize the DTA at 15%; lower levels of tax on the gain will lead to a proportionate reduction in the quantum of DTA that can be recognized. Where no tax is imposed on the transfer gain then no DTA can be recognised for GloBE purposes. Where tax losses at the level of the disposing CE mitigate the tax actually paid on the gain, a DTA may still be recognizable at the level of the acquiring CE. In the alternative case where an intra-group transfer is booked at fair value at the level of the acquiring CE, the same considerations are in play. The tax applied to the gain at the level of the disposing CE is to be considered. Treatment at the level of the acquiring CE is 'equalized' with the treatment that would have applied to a transfer booked at cost. The GloBE carrying value at acquiring CE is reduced to cost and (assuming tax is paid on the disposal gain) a DTA is recognised at the level of the acquiring CE.
7	Applicability of Article 9.1.3 to transactions similar to asset transfers	9.1.3	The Administrative Guidance details a series of transaction types, similar to asset transfers, which are to be covered by the Article 9.1.3 provisions. In addition to asset sales, this covers certain capital leases, licenses and prepayments of royalties/rents, transfers of assets through the sale of a controlling interest, and total return swaps transferring an underlying asset to the accounts of an acquiree. It also covers entity tax residence migration leading to tax or accounting basis step up, and asset value adjustments arising from fair value accounting. The latter two transactions are regarded as deemed transfers happening 'within the same entity'.

What's next

The released guidance represents the first tranche of Administrative Guidance on the GloBE Rules, with further guidance to be issued in the future. Highlighted below are the areas for which the released guidance highlights that further guidance is at least under consideration:

- Treatment of acquirer for intra-group asset transfers
- Further guidance on equity investment inclusion election
- Further guidance on the operation of QDMTT, including:
  - Design features including the threshold for material competitive distortions, permanent establishment income allocation, jurisdictional blending, treatment of investment entities and transparent entities;
  - Allocation of QDMTT liability amongst entities in a jurisdiction;
  - Identification of 'benefits' to taxpayers which would invalidate 'qualified' status;
  - Information collection/exchange arrangements; and
  - QDMTT safe harbour

It is expected that a revised version of the GloBE Rules Commentary (originally released on 14 March 2022) incorporating the Administrative Guidance would be released later in 2023.

The OECD's news release on the Administrative Guidance also indicated that the Inclusive Framework expects to finalise the model provisions for the Subject to Tax Rule and the related multilateral instrument to assist in its implementation.

Hong Kong business considerations

- While the Administrative Guidance has provided some much-needed and welcomed clarifications on certain issues relating to the application of the GloBE Rules (e.g. the deemed consolidation rule does not apply to investment funds exempted from preparing consolidated accounts under HKFRS 10 and a cash GloBE top-up tax will not be imposed in a year with a GloBE loss under Article 4.1.5), the Administrative Guidance also adds to the complexity of the GloBE Rules in certain aspects (e.g. a "transfer of asset" under Article 9.1.3 is not limited to a sale of an asset but can also refers to a variety of transactions such as a capital lease that is accounted for as a purchase of an asset and a prepayment of royalty or rent where the licensee/lessee capitalizes and amortizes the asset in its financial accounts and the transitional provision in Article 9.1.3 will apply to those transactions).

  In-scope Hong Kong business groups will need to get themselves familiar with the detailed rules set out in the Administrative Guidance in order to be able to perform an accurate assessment of the potential impact of the GloBE Rules on them and to apply the GloBE Rules correctly.

- The HKSAR Government has earlier indicated that it plans to implement a domestic minimum top-up tax (DMTT) although there is not a definite implementation timeline. The final design features of the QDMTT safe harbour will be highly anticipated as they would probably affect the design of the DMTT in Hong Kong. It is expected that the government will launch a consultation on the Pillar 2 implementation in Hong Kong in the first half of 2023, and the design of and the related tax compliance issues of the DMTT in Hong Kong could form part of that consultation.

Contacts

Global Tax Policy Leadership Group

David Linke
Global Head of Tax & Legal Services
E: David.Linke@kpmg.co.uk

Grant Wardell-Johnson
Global Tax Policy Leader and Chair
E: Grant.WardellJohnson@kpmg.co.uk

Manal Corwin
Americas Regional Tax Policy Leader
E: mcorwin@kpmg.com

Vinod Kalloe
EMA Regional Tax Policy Leader
E: kalloe.vinod@kpmg.com

Conrad Turley
Asia Pacific Regional Tax Policy Leader
E: conrad.turley@kpmg.com

Chris Morgan
Responsible Tax Project Leader
E: christopher.morgan@kpmg.co.uk

Regional contacts

John Timpany
Head of Tax, Hong Kong SAR
E: john.timpany@kpmg.com

Ivor Morris
Hong Kong SAR BEPS 2.0 Project Leader
E: ivor.morris@kpmg.com

Anita Tsang
Hong Kong SAR Tax Policy and Knowledge Management Director
E: anita.tsang@kpmg.com

kpmg.com/cn/socialmedia