KPMG

Spotlight on:

Pillar 2 – Key Considerations for Transparent & Hybrid Fund Vehicles

Introduction – the basics

Pillar Two is an OECD initiative which implements a global minimum tax rate of 15% with the aim of preventing entities shifting profits to low or no-tax jurisdictions. At a broad level, where the effective tax rate of an entity (as computed under specific rules) is less than 15%, there are various mechanisms in place to collect additional tax to bring it up to an effective tax rate of 15%.

The rules, which are complex, are in force in Ireland for in-scope entities with fiscal years beginning on or after 31 December 2023. An Irish tax resident entity should only potentially be in scope of the rules where it is part of a multi-national (MNE) group or a domestic group which has consolidated revenue exceeding €750m for at least two of the preceding four fiscal years. Importantly, the term "entity" is broadly defined and captures:

- Any legal arrangement of whatever nature or form that prepared separate financial accounts; or
- Any legal person other than an individual

Consequently, a partnership or similar entity, such as a common contractual fund ("CCF"), which prepares separate financial statements would be considered an entity for Pillar Two purposes and could be in scope of the rules, notwithstanding that the tax transparency means such vehicles do not otherwise pay tax in Ireland.

However, there are a range of vehicles which are entirely outside the scope of the rules. For example, "investment funds" (as defined) can be considered completely outside the scope of the two main collection mechanisms however, in order to be so considered, there are prescriptive criteria which need to be satisfied.

Where a fund vehicle is nevertheless in-scope of the rules, if it is considered to be fiscally transparent in both its jurisdiction of formation and from the perspective of its investors, it can be treated as a Tax Transparent Entity for Pillar Two purposes such that the income of the entity is allocated away from the entity to the investors. In certain circumstances where a partnership or similar entity is not regarded as tax transparent from the perspective of any investor, an election can be made where conditions are satisfied to achieve broadly the same outcome as if it were transparent from an investor perspective. Such an election can ultimately protect the tax neutrality of these vehicles.

Jorge Fernandez Revilla
Partner, Head of
Asset Management,
KPMG in Ireland
jorge.revilla@kpmg.ie

Gareth Bryan
Partner, Asset
Management Tax,
KPMG Ireland
gareth.bryan@kpmg.ie

Philip Murphy
Partner, Head of
Asset Management Tax,
KPMG Ireland
philip.murphy@kpmg.ie

> **"a partnership or similar entity, such as a common contractual fund ... could be in scope of the rules, notwithstanding that the tax transparency means such vehicles do not otherwise pay tax in Ireland"**
>
> Gareth Bryan, Partner, Tax, KPMG in Ireland

The key considerations in assessing whether a fund vehicle is in scope are to determine:

Q1 Does the vehicle meet the requisite conditions to be considered an "investment fund" and if so, does it fall within the scope of the Excluded Entity definition?

Q2 If the vehicle is not an Excluded Entity, is it part of an MNE group or domestic group?

Q3 If so, does the group exceed the consolidated revenue threshold? and

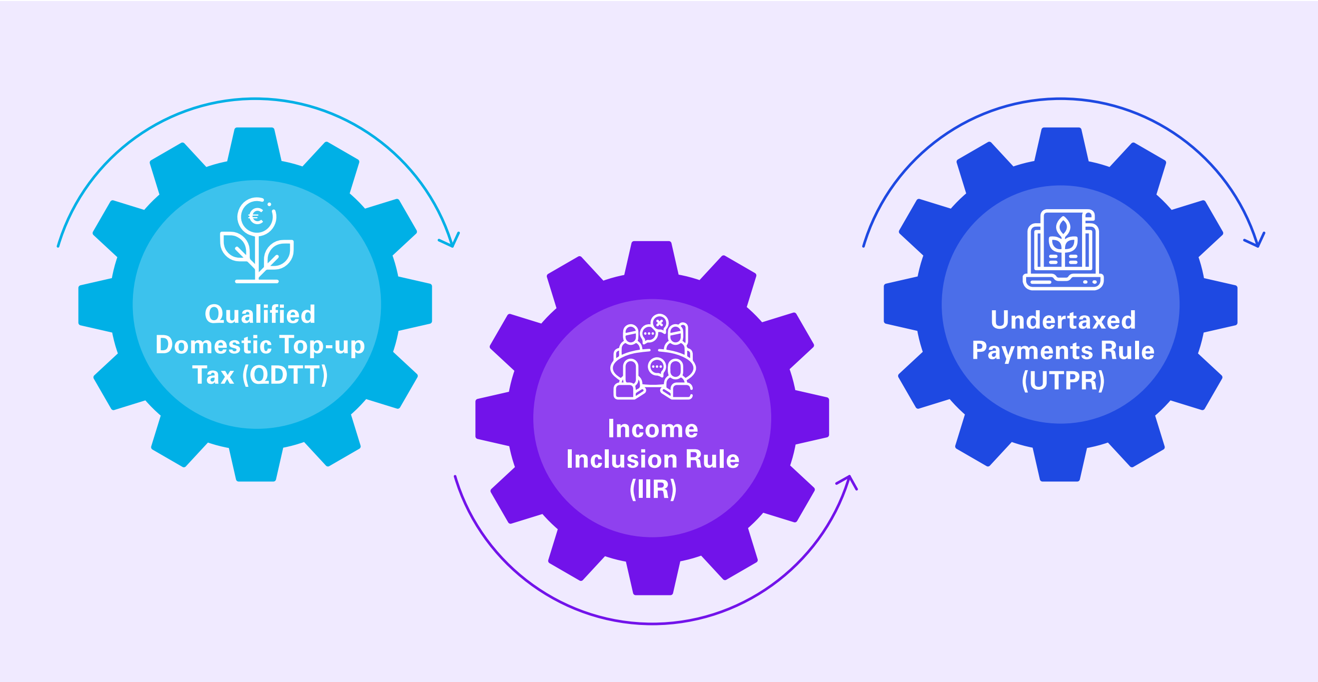
Q4 If so, is the vehicle treated as a Tax Transparent Entity for Pillar Two purposes (or can it elect to be so treated); if not, could a Taxable Distribution Method election be made?

It is important to note that not all fund vehicles will be regarded as investment funds for the purposes of the rules, so a case-by-case analysis is necessary to determine whether there is sufficient basis to regard the fund as outside the scope of Pillar Two. Furthermore, even where a fund is considered outside the scope of the rules, its revenue may need to be taken into account in determining whether any other entity which it is part of a group with exceeds the revenue thresholds. Where a vehicle is in scope of the rules, it may have additional compliance obligations even where it does not have any additional tax obligation, which may give rise to an additional administrative burden collating the data required.

> **"Where a vehicle is in scope of the rules, it may have additional compliance obligations even where it does not have any additional tax obligation"**
>
> Gareth Bryan, Partner, Tax, KPMG in Ireland

Collection of Pillar Two Taxes

There are three mechanisms under which tax is collected under the Pillar Two rules:



The Qualified Domestic Top-up Tax (QDTT) requires that those entities in the MNE group which are located in a jurisdiction that has adopted the Pillar Two rules but which would otherwise have an effective tax rate of less than 15%, pay additional tax in that jurisdiction. This rule ensures that the income of these entities is taxed at least at the minimum rate of 15%.

The Income Inclusion Rule (IIR) requires a parent entity pay a top-up tax on the income of its low-taxed constituent entities (i.e., those entities in the MNE group with an effective tax rate of less than 15% in which it has a direct or indirect ownership interest). This rule ensures that the income of these entities is taxed at least at the minimum rate of 15%. The rule can only apply where the parent entity is located in a jurisdiction that has implemented the Pillar Two rules. Generally, a parent entity should not have an IIR liability where the entities in the MNE group in which it has a direct or indirect ownership interest are located in a jurisdiction that has adopted the Pillar Two rules as the QDTT collection mechanism should ensure that their effective tax rate is at least 15%.

The Undertaxed Payments Rule (UTPR) acts as a backstop to the IIR and QDTT and applies to payments made to low-taxed entities within an MNE group. Where there are entities in the MNE group with an effective tax rate of less than 15% (taking account of any IIR paid in respect of those profits), UTPR requires that additional tax (equalling, in aggregate, 15% of those entities profits) is effectively borne be group members in jurisdictions that have implemented UTPR. This is to be done by denying tax deductions or imposing an additional charge on the in-scope group members. The UTPR charge is allocated across the group based on the proportion of tangible assets and employees in each jurisdiction that has implemented the UTPR. This rule ensures that the income of these entities is taxed at least at the minimum rate of 15%. Generally, a group member in a jurisdiction which has implemented UTPR should not have a UTPR charge where all other entities in the group are located in a jurisdiction that has adopted the Pillar Two or are owned directly or indirectly by entities located in a jurisdiction that has adopted the Pillar Two as the QDTT and IIR collection mechanisms should ensure that the effective tax rate is at least 15%.

Scoping – is the vehicle an Excluded Entity?

Where a fund vehicle is considered both an investment fund and Excluded Entity for the purposes of the rules, it will be completely outside the scope of the Pillar Two rules without any administration required on an ongoing basis. Therefore, most fund vehicles will first assess whether they can fall within the relevant definitions, which include each of the following:

A An investment fund that is an ultimate parent entity (and is therefore considered an Excluded Entity);

B An entity which is 95%+ owned by or through an Excluded Entity, subject to certain conditions in relation to the activity of the entity; and

C Any entity which is 85%+ owned by or through an Excluded Entity, where the entity derives substantially all of its income from dividends or gains.

The application of these tests can therefore be broadly split between entities which are the primary investor facing / aggregation vehicles (where (a) is likely more relevant) or which are part of fund complexes (where (b) and (c) are likely more relevant). It is worth noting for completeness that certain real estate investment vehicles can also be regarded as Excluded Entities where conditions are satisfied.

> “Where a fund vehicle is considered both an investment fund and Excluded Entity ... it will be completely outside the scope of the Pillar Two rules”
>
> Gareth Bryan, Partner, Tax, KPMG in Ireland

Investor facing / aggregation vehicles

Exemption from IIR

In order to be considered an Excluded Entity and outside the scope of the alternative collection mechanism (specifically, the income inclusion rule) the fund vehicle cannot be consolidated on a line-by-line basis into any other entity. In assessing this, there is also a deemed consolidation test (i.e. it is necessary to consider if line-by-line consolidation would be necessary if the investor in the vehicle prepared consolidated financial statements). Although many funds are widely held or there are multiple investors such that they would never need to be consolidated, there are circumstances whereby a fund may need to be consolidated into an investor (e.g. where there is a significant investor or if the manager is seeding the fund for any reasonable amount of time). Where it is possible to conclude that the vehicle is the ultimate parent entity, it is then necessary to ascertain if it falls into the relevant definition of an investment fund, which requires the fund to have all of the following characteristics:

- it is designed to pool assets (which may be financial and non-financial) from a number of investors (some of which are not connected);
- it invests in accordance with a defined investment policy;
- it allows investors to reduce transaction, research, and analytical costs, or to spread risk collectively;
- it has a main purpose of generating investment income or gains, or protection against a particular or general event or outcome;
- investors have a right to return from the assets of the fund or income earned on those assets, based on the contributions made by those investors;
- the entity or its management is subject to a regulatory regime in the jurisdiction in which it is established or managed (including appropriate anti-money laundering and investor protection regulation); and
- it is managed by investment fund management professionals on behalf of the investors.

Many investment funds should meet the above criteria however, there are circumstances where the criteria may not be clearly met. For example, a fund-of-one which is designed as such may not be able to satisfy the criteria in relation to the pooling of assets from a number of investors.

Exemption from QDTT

Where a fund entity meets the above conditions but is not an ultimate parent of the group, it will not qualify to be treated as an Excluded Entity for the purposes of IIR and UTPR. However, it should be treated as an Excluded Entity for QDTT purposes. Thus an investment fund resident in Ireland should be exempt from Irish QDTT though its investors may be subject to IIR (and other group members could be subject to UTPR) in respect of its income, depending on how Pillar Two has been implemented in the jurisdiction of its investor(s)).

This is one of the special rules that apply to a category of entities known as investment entities and which includes investment funds.

Vehicles which are part of fund structures

“Where entities are part of a fund complex but are not themselves investment funds … they might nonetheless be outside the scope of the rules”

Gareth Bryan, Partner, Tax, KPMG in Ireland

Where entities are part of a fund complex but are not themselves investment funds, there are two different scenarios under which they might nonetheless be outside the scope of the rules. The key points in the context of these two scenarios are:

- In tracing whether the respective 85% / 95% rules are satisfied, it is necessary for any intermediate entities which are being traced through to themselves be considered Excluded Entities. For example, if there is an investment holding vehicle, the shares of which are exclusively held by a master holding company which is held by an investment fund, it is necessary for both the master holding company and the investment fund to be regarded as Excluded Entities in their own right;
- Although the 85% / 95% tests allow tracing through intermediate entities, it is not possible to trace through certain entities which have been established to invest on behalf of pension funds;
- The 95% test only applies where the entity operates exclusively (or almost exclusively) to hold assets or invest funds for the benefit of an excluded entity or carries out activities ancillary to those performed by the Excluded Entity;
- The 85% test only applies where substantially all of the income of the entity is derived from dividends or gains that are excluded when calculating the income for Pillar 2 purposes.

Where there are entities which are not themselves investment funds or if there are investment funds which are consolidated into other investment funds, it will therefore be important to ensure that (i) the vehicle meets the relevant criteria to allow it rely on the 85% / 95% test and (ii) that any tracing through a fund structure is done in accordance with the specific rules, as it will not be possible to trace through certain entities (albeit where the sole investor is a feeder fund or pension fund, a look through approach may be possible).

What if a fund is not an Excluded Entity?

If a fund vehicle or any entity in a fund structure is not an Excluded Entity, it will potentially be in scope of the rules. In order to ascertain this, the key consideration is whether the entity is a part of a group, and the accounting consolidation position is critical in determining this. At its most basic level, the concept of a group is determined by reference to the consolidated financial statements prepared in accordance with an acceptable accounting standard (includes IFRS and a range of local GAAPs, including GAAP of any EU Member State), where the entity is consolidated on a line-by-line basis.

However, there are a few additional points that need to be considered when determining the group for Pillar Two purposes:

- If an investor or other equity holder is not required to prepare consolidated financial statements, there is a deemed consolidation test which must be applied i.e. it is necessary to consider the position in the event the investor / equity holder was required to prepare consolidated financial statements;
- If an entity is excluded from the consolidated financial statements solely based on its size (in the context of materiality) or on the basis it is held for sale, it is nonetheless required to be included in the group; and
- There are specific rules under which joint ventures should be included in the group, where they are at least 50% owned by a group and accounted for in the group consolidated financial statements further to the equity method.

There are also additional rules which can apply to permanent establishments however they are unlikely to be relevant to most fund structures.

Once the applicable group is determined, it is then necessary to consider whether the consolidated group revenue exceeds the €750m threshold.

Determination of consolidated revenue threshold

The basic test is whether the consolidated revenue of the group exceeds €750m in two of the preceding four fiscal years. The threshold amount is increased or decreased on a pro-rata basis where a relevant accounting period end is more or less than 12 months. Any revenue attributable to a vehicle or entity that is specifically excluded from the scope of Pillar Two (e.g. an Excluded Entity) nonetheless needs to be included in ascertaining whether the threshold has been exceeded.

Jurisdictional blending

Another special rule applicable to investment entities (and hence investment funds) relates to how tax is computed and allocated under Pillar Two. In general, Pillar Two applies a methodology known as jurisdictional blending which requires that the Pillar Two effective tax rate calculations be done by taking all of the income of, and taxes paid by, the members of the same MNE group that are resident in the same jurisdiction together in a single, joint calculation. Where the effective tax rate is below 15% and, as a result, additional tax is due, the amount to be paid by each entity is essentially based on a pro rata allocation to each of the group members. This could easily result in a disproportionately high or low allocation of Pillar Two taxes to a particular entity relative to what it would have paid if assessed independently.

However, a special rule applies to investment entities (and hence to investment funds) whereby the effective tax rate is to be calculated separately from the effective tax rate of the jurisdiction in which it is located. These rules do not apply where the investment entity is a Tax Transparent Entity (or is treated as one by election) or where the Taxable Distribution Method applies to it (discussed on the following page). If there is more than one investment entity located in the same jurisdiction, a joint calculation is done in respect of all of the investment entities.

> "If a fund vehicle or any entity in a fund structure is not an Excluded Entity, it will potentially be in scope of the rules"
>
> Gareth Bryan, Partner, Tax, KPMG in Ireland

Treatment of partnerships and similar vehicles

If a fund vehicle or any entity in a fund structure is in-scope of the rules and is not an Excluded Entity, it may come within special provisions for Flow-through Entities and Tax Transparent Entities.

An entity is a Flow-Through Entity to the extent it is fiscally transparent with respect to its income, expenditure, profit or loss in the jurisdiction where it was created unless it is tax resident and subject to tax on its income or profit in another jurisdiction. For this purpose, an entity is treated as fiscally transparent under the laws of a jurisdiction, if that jurisdiction treats the income of that entity as if it were earned directly by the investors rather than the entity itself such that the entity is not subject to tax in that jurisdiction on its income. Thus, in Ireland a partnership or a CCF will generally be treated as a Flow-Through Entity.

The Pillar Two Rules will treat a Flow-Through Entity that is a member of an MNE group (but not the ultimate parent entity of the group) as a Tax Transparent Entity to the extent that it is also treated as fiscally transparent in the jurisdiction in which its owners / investor are located provided that that it does not have a place of business in the jurisdiction where it was created and its income is not attributable to a permanent establishment.

Where this treatment applies, the income of the Tax Transparent Entity is allocated to its investors / owners in accordance with their ownership interests. Consequently, no QDTT should arise for the fund entity on its own account in the jurisdiction where it is established; instead, the income of the fund entity should be allocated to the jurisdiction of the investor for Pillar two purposes (and so should be included in the investors' QDTT calculations, if applicable). Practically, this means that an Irish fund vehicle such as an ILP or CCF should not be subject to any taxes in Ireland further to Pillar Two provided each investor recognises the ILP / CCF as transparent for tax purposes in their jurisdiction of residence.

Reverse-Hybrid Entities

If the jurisdiction of the investor does not treat a Flow-Through Entity as fiscally transparent such that it is not a Tax Transparent Entity, that entity should be treated as Reverse-Hybrid Entity and a stateless entity.

A Reverse-Hybrid Entity (or a Tax Transparent Entity that is the ultimate parent entity of the group) does not have its income re-allocated to its investors (as a Tax Transparent Entity would). However, as a stateless entity, by definition there is no jurisdiction to impose and collect a QDTT. Therefore, the income of a Reverse-Hybrid Entity should be subject to taxation under the Pillar Two rules in the jurisdiction of the investor under IRR (where applicable) and / or under UTPR. Practically, this means that Irish tax should not arise for Pillar Two purposes in the context of an ILP or CCF even where it is not regarded as tax transparent from the perspective of any investor.

It should be noted a that fund vehicle might be treated as a Tax Transparent Entity with respect to some investors and a Reverse-Hybrid Entity in respect of others; this will depend on how each investor sees the vehicle for tax purposes, which can be a complex determination in itself.

Tax transparency election

The Pillar Two Rules permit an entity to elect to treat an investment entity in which it is invested and which is not a Tax Transparent Entity as if it were one provided: (i) the investor is subject to tax in its jurisdiction of tax residence under a mark-to-market or similar regime based on the annual changes in the fair value of its ownership interest in the entity; and (ii) the tax rate applicable to the owner / investor with respect to that income equals or exceeds the Minimum Rate (viz. 15%). The election applies for five-years once made.

Where this election is made, it means that even if the jurisdiction of the investor does not treat a fund vehicle in which it is invested as fiscally transparent, the fund vehicle will be treated as a Tax Transparent Entity with respect to that investor.

We note that, in addition to including an investment fund (discussed above), an investment entity also includes an insurance investment entity (being an entity that would qualify to be an investment fund except that it is established in relation to liabilities under an insurance or annuity contract and is wholly-owned by an entity that is regulated as an insurance company). Consequently, a tax-transparency election can also be made with respect to an insurance investment entity.

Taxable distribution method election

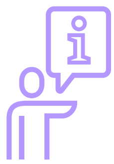
The Pillar Two Rules permit an entity (which is not itself an investment entity) to elect to apply a regime known as the Taxable Distribution Method to its investment in an investment entity. The election can only be made when the owner / investor can be reasonably expected to be subject to tax on distributions from the entity at a tax rate that equals or exceeds the Minimum Rate (viz., 15%). The election applies for five-years once made.

Under the Taxable Distribution Method, distributions and deemed distributions made by an investment entity of its income are included as part of the income of the owner / investor for Pillar Two purposes. The income of the owner / investor is also increased by taxes incurred by the investment entity but the owner / investor also gets to take these taxes into account in its Pillar Two calculations.

In addition, the income of the owner / investor is also increased by its share of the investment entity's undistributed income (net of taxes) of the investment entity which arose in the third year prior to the current year and which has not been distributed by the investment entity in the meantime.

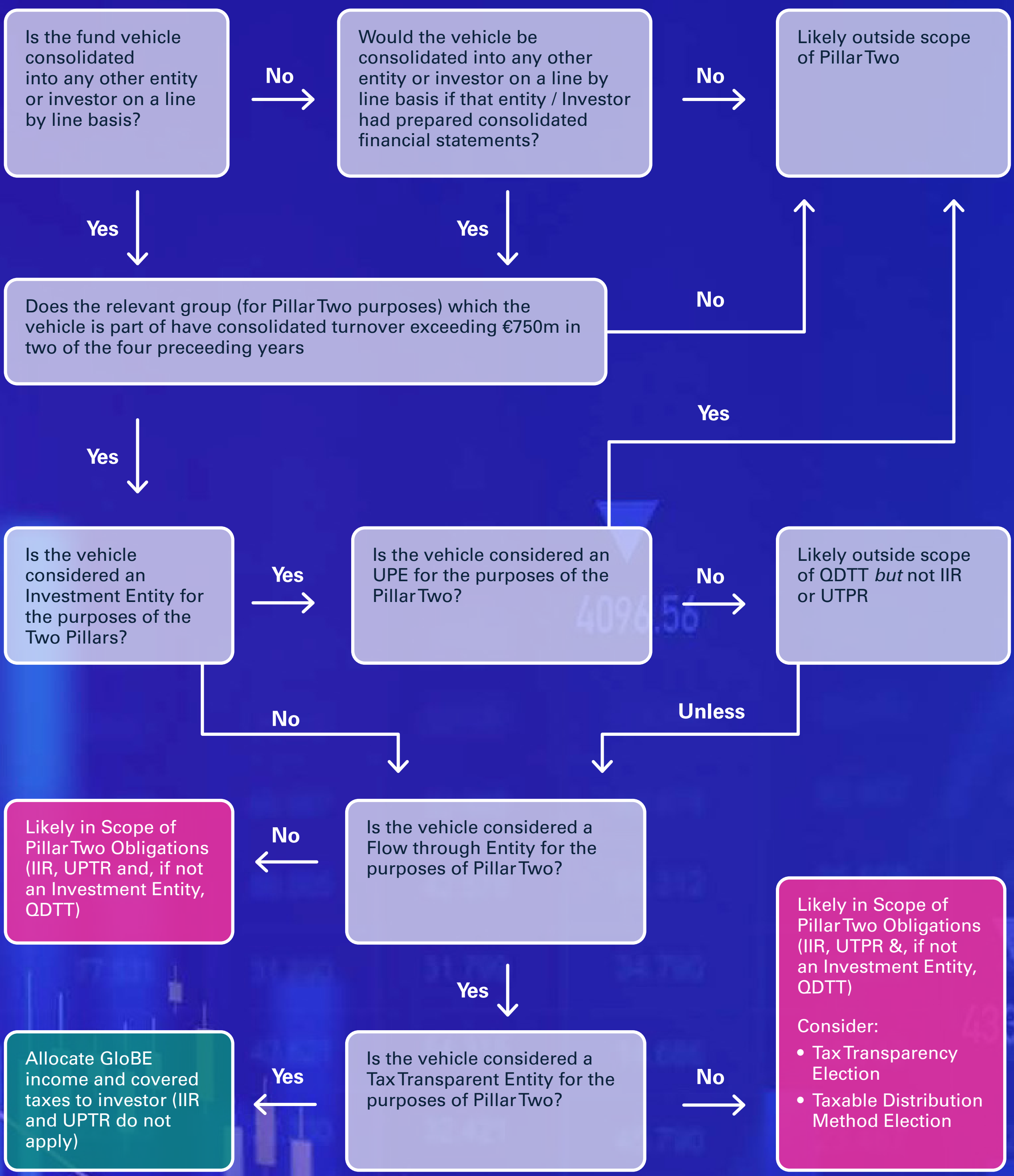
Consequently, if the jurisdiction of the investor does not treat a partnership or similar entity as fiscally transparent and a Tax Transparency election cannot be made, the investor could make this election so long as the fund vehicle is an investment entity and the investor can be reasonably expected to be subject to tax on distributions from the fund vehicle at a tax rate that equals or exceeds 15% (as computed under the Pillar Two Rules).

Where this election is made, it means that the income of the investment entity is allocated away from the entity and instead is only included for Pillar Two purposes at the level of the owners / investors.



We note that a taxable distribution method election can also be made with respect to an insurance investment entity.

Investment Entity Decision Tree



Other considerations

The most recent Finance Act included a legislative amendment to remove standalone investment undertakings from the scope of Ireland's QDTT. As a result, where an investment undertaking, such as a unit trust, investment limited partnership, or common contractual fund is not a member of any consolidated group it may fall outside the scope of Ireland's QDTT, even where its revenues are above €750 million.

Furthermore, it is expected that updated guidance will shortly be published by Irish Revenue which clarifies that sub-funds of umbrella funds can be regarded as separate entities for the purposes of the rules where they prepare separate financial statements.

Key considerations for fund structures

The key considerations for funds and their underlying structures can be broken down into a number of net points:

01 Fund vehicles are not automatically outside the scope of the rules, notwithstanding that there is a carve out for investment funds. In order to be considered fully outside the scope, it is necessary to consider if the fund may be consolidated into any investor, in addition to whether it meets the relevant criteria to be an "investment fund" as defined for the purposes of the rules. It may be challenging in practice for fund-of-one type arrangements to qualify for exclusion;

02 It is possible for vehicles held by investment funds to be considered outside the scope of the rules in their own right, however it is necessary to understand the profile of each entity in the ownership chain of the structure and also whether specific conditions are satisfied by the vehicle;

03 Where an investment fund or vehicle in a structure does not fall outside the scope of the rules by virtue of the fund focused exclusions, the accounting consolidation position is crucial to understand the group for Pillar Two purposes and whether it is in scope.

04 There are specific nuances applicable in the context of partnerships and similar fiscally transparent entities which can give rise to additional considerations for in scope groups.

Where fund vehicles do not fall outside the scope of the rules, the additional compliance burden that can arise should not be underestimated. In addition, in some cases funds will need to understand how investors treat the fund – either from an accounting consolidation perspective or in the context of whether the investor categorises the fund as opaque or transparent for tax purposes. This may require additional information from investors as part of onboarding in certain instances, which will need to be incorporated into the subscription process for new funds.

We can assist with assessing any or all of the contents of this document in the context of specific structures, providing any required technical accounting input as part of the analysis, in addition to advising on the optimal approach to adopt.

Notes


00:00:15:04

Contact us

Jorge Fernandez Revilla
Partner, Head of
Asset Management,
KPMG in Ireland
jorge.revilla@kpmg.ie

Gareth Bryan
Partner, Asset
Management Tax,
KPMG Ireland
gareth.bryan@kpmg.ie

Philip Murphy
Partner, Head of
Asset Management Tax,
KPMG Ireland
philip.murphy@kpmg.ie

kpmg.ie

Produced by: KPMG's Creative Services. Publication Date: July 2025. (11615)