Inclusive Framework BEPS Agreement

Update on Pillar 2 agreement – December 2021

Policy Perspectives update

KPMG Global Release: Executive Summary

On 20 December 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting, involving 137 countries, released Model Globe Rules under Pillar 2. The document contains 70 pages, 15 of which are definitions, that are the rules for a Global Minimum Tax at 15% for Multi-national Enterprises (MNEs) with a turnover of more than €750 million. It is anticipated that a document providing further commentary on the rules will be released early next year. The model rules released on 20 December differ from the original Blueprint on Pillar 2 from October 2020 in significant ways.

The adoption of the new rules is based on a ‘common approach’ which means that jurisdictions are not required to adopt the rules, but if they choose to do so, they will implement the rules consistently with the model.

The rules are due to be brought into law in each participating jurisdiction through domestic law changes in 2022, to be effective in 2023 for the Income Inclusion Rule (IIR), and 2024 for the Under-Taxed Payments Rule (UTPR).

The IIR imposes top-up tax on a parent entity with respect to low taxed income of a Constituent Entity. The UTPR denies deductions or provides for a similar adjustment for group entities to the extent that there is top-up tax that has not been taxed under the IIR.

The determination of whether top-up tax is required, either through the IIR or the UTPR, is based on a complex calculation of the Effective Tax Rate (ETR) for a jurisdiction. The Model Rules use modified deferred tax calculations for the timing differences and the treatment of losses.

There is an elective substance based carve-out which may reduce the profits that are subject to top-up tax. This is based on the level of payroll and the carrying value of certain tangible assets, within a jurisdiction. The rules also provide for a Domestic Top-up Tax where countries can impose a specific tax in their own jurisdiction to lift the ETR on certain profits, excluding those that are subject to a substance-based exclusion, to the minimum rate of 15%.

There are exclusions for Pension Funds, Government, International and Non-Profit Organizations as well as Investment Funds and Real Estate Investment Vehicles that are Ultimate Parent Entities.

It is proposed that there will be certain Safe Harbor rules, although these have yet to be developed.

Also excluded from this Pillar 2 package are the proposals for a Subject to Tax Rule which is proposed to apply to certain payments including interest and royalties where the nominal tax rate on a payment falls below a minimum rate of 9%. The final scope of these rules is yet to be determined and expected in early 2022.

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The Pillar 2 rules apply blending on a jurisdiction-by-jurisdiction basis. The US Administration has proposed modifications to their rules on Global Intangible Low Taxed Income or GILTI, which are currently based on global blending. The Model Rules provide that "consideration will be given to the conditions under which the US GILTI regime will co-exist with the GloBE Rules, to ensure a level playing field".

Work on Pillar 1, which deals with new rules on the allocation of a portion of residual profit of MNEs with initially a turnover of greater than €20 billion and profit before tax margins above 10% of revenue to market jurisdictions is progressing and announcements are expected in 2022. These rules and the Subject to Tax Rule will require modifications to tax treaties anticipated to occur through a Multi-lateral Instrument.

What's New

This Model has added a new concept of domestic top-up tax. This allows a jurisdiction to introduce a rule, which effectively duplicates the Model for top-up tax, but ensures that the tax is collected by that local jurisdiction and is not ceded to another jurisdiction under either the IIR or the UTPR. Assuming low-tax jurisdictions take this path, it may reduce the complexity of the rules in many circumstances while achieving the goal of the Pillar 2 project of providing a floor for tax competition.

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Scope of the Global Minimum Tax

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Pillar 2 deals with new Global Anti-Base Erosion (or GloBE) or Global Minimum Tax rules. The agreed global minimum tax rate is 15%.

Revenue threshold

Generally, the GloBE rules apply for an MNE where consolidated group revenue exceeds €750 million. This is determined by looking at the consolidated financial statements. An entity located in one jurisdiction which has a permanent establishment in another jurisdiction is also deemed to be a group when applying the test.

Test years for consolidated revenue threshold

There is a four-year test period determining whether the threshold is met. Generally, if revenue of €750 million is exceeded in two of the previous four fiscal years the threshold is met. Where two groups merge, the test is deemed to be met if the sum of the revenue of each group meets the €750m threshold. There are also special rules for demergers.

Excluded entities

Certain organizations, entities or arrangements are excluded from the GloBE rules. Government Entities, which do not carry on a trade, International Organizations and Non-profit Organizations and Pension funds are fully excluded. In addition, Investment Funds are excluded, but only when they are the Ultimate Parent Entity of an MNE Group. Certain holding vehicles owned by these excluded entities are also themselves excluded, as discussed in Section 8.

Exclusions – international shipping

There is an exclusion for international shipping income and certain related income. This applies to both the transportation of passengers and cargo but does not include income from transportation in inland waterways of the same jurisdiction. To qualify for the exclusion, the Constituent Entity must demonstrate that the strategic or commercial management of all ships concerned is effectively carried on from within the jurisdiction where the Constituent Entity is located.

What's New

The Pillar 2 Blueprint provided a threshold test based on the current year and the immediately preceding year. This Model provides for a four-year test period.

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Income inclusion rule

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Top-down approach & Intermediate Parents

The GloBE rules are designed to ensure that large MNEs pay a minimum level of tax on the income arising in each jurisdiction in which they operate. To this end, and as explained further in Section 5, the rules calculate the ETR imposed on the MNE in each jurisdiction. Where the ETR in a jurisdiction falls below 15% these rules determine an amount of top-up tax for each constituent entity in the jurisdiction.

The IIR is the primary rule to impose this top-up tax. Under the IIR a parent entity within the MNE group will pay tax, in its jurisdiction of tax residence, in respect of its allocable share of the top-up tax of a low-taxed Constituent Entity. In this regard the IIR bears similarities to Controlled Foreign Corporation (CFC) rules.

Under the top-down approach, priority is given to the parent entity at the highest point in the ownership chain. Therefore, in a multi-tiered structure, where the ultimate parent entity (UPE) of the MNE group is subject to a qualified IIR (i.e., one conformant to the GloBE rules design), it will pay the IIR tax in respect of the top-up tax of a low-taxed Constituent Entity, rather than an intermediate parent entity. Where the UPE is not subject to a qualified IIR, IIR taxing rights will ‘drop’ down to the jurisdiction of the intermediate parent entity beneath it, to the extent it applies a qualified IIR and so on down the chain of ownership.

Split ownership rules

An exception to the top-down rules can apply where a low-taxed Constitutent Entity has a significant (i.e., more than 20%) minority interest holder outside the MNE group. The split-ownership rules apply to address the potential for leakage that would result from simply subjecting the UPE’s allocable share of the low-taxed Constituent Entity to IIR tax.

For example, take the case where the UPE has a 75% ownership interest in an intermediate parent entity, and the latter has a 100% ownership interest in a low-taxed Constituent Entity. In this case, the IIR taxing rights would ‘drop’ to the jurisdiction of the intermediate parent entity, assuming the latter applies a qualified IIR. This is termed a ‘partially-owned parent entity’. The effect of the rule is that 100% of the top-up tax is subject to IIR tax at the level of the partially owned parent entity, rather than 75% of top-up tax being taxed at the level of the UPE. The rules provide that the allocable share of higher-tier parents (e.g., 75% share of the UPE in this case) will be reduced to the extent IIR tax is imposed by lower tier parents (i.e., down to zero in this case).

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Under-taxed payments rule

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Situations where UTPR applicable and top-up tax calculation

The UTPR operates as a backstop to the IIR, to be applied where insufficient top-up tax is collected under the IIR. Importantly, the UTPR also serves the purpose of ensuring low-tax income in the UPE jurisdiction is subject to tax at the minimum rate. Central to the application of the UTPR is the determination of the Total UTPR top-up tax amount. This is an aggregate ‘pool’ of all the top-up tax of low-taxed Constituent Entities, across the MNE group, which is not adequately taxed by an IIR or otherwise excluded.

An important rule, in this regard, references the UPE’s ownership interest in a low-taxed Constituent Entity. If the UPE has a 75% ownership interest in a low-taxed Constituent Entity, and the IIRs applied at the level of group parents (including partially owned parent entities) tax the full 75% of the low-taxed Constituent Entities’ top-up tax, then for UTPR purposes the low-taxed Constituent Entities’ top-up tax will be reduced to zero (despite 25% of the top-up tax remaining untaxed). If this is not the case (e.g., group parents subject 74% of the potential 75% to IIR, as the 1% holder is not an IIR-applying jurisdiction), then the top-up tax is not reduced to zero. Instead, the top-up tax for UTPR purposes is reduced by the amount subject to IIR (e.g., 26% remains). These core rules are accompanied by special rules.

In the case of a JV, for example, the top-up tax ‘ceiling’ for UTPR is the UPE ownership interest in the JV (e.g., 50% of JV top-up tax). For investment entities within a group, the UTPR does not apply.

Denial of a deduction or other mechanism

The total UTPR top-up tax is allocated over jurisdictions in which the MNE has Constituent Entities, and which have adopted the UTPR into law (UTPR jurisdictions). It is left open to UTPR jurisdiction tax authorities how they go about ensuring that the Constituent Entities in their jurisdiction have an additional cash tax expense equal to the allocation for the fiscal year. It could be by way of denial of tax deductions (of any type) or equivalent adjustment, e.g., deemed taxable income or a new tax. It remains to be seen what guidance the Commentary provides on the allocation of the UTPR burden over the Constituent Entities in a jurisdiction. To the extent that top-up tax allocations cannot be imposed immediately, they can be carried forward for imposition in a later year in the same jurisdiction.

Allocation key for UTPR

The allocation mechanism for the total UTPR top-up tax takes into account the relative 'substance' of Constituent Entities in UTPR jurisdictions. A given jurisdiction's UTPR percentage (i.e., the share they are allocated of the total UTPR top-up tax) is determined by calculating (i) the jurisdiction's number of employees as a proportion of the total employees in UPTR jurisdictions, and (ii) the carrying value of the tangible assets in the jurisdiction as a proportion of the total carrying value of tangible assets in all UPTR jurisdictions. Each of these proportions is given a 50% weighting in determining the UTPR percentage.

Employee numbers and tangible assets are evaluated largely in the same manner as for CBCR, though employees will be treated as located in the jurisdiction of a Permanent Establishment to the extent the separate Permanent Establishment accounts include the relevant payroll. An important feature of the allocation key is that if a UTPR jurisdiction does not fully use the top-up tax rights allocation made to them for a given fiscal year, then their UTPR percentage is reduced to zero for subsequent periods until the amount from the previous years has been imposed. This would mean that a UTPR jurisdiction is incentivised to impose UTPR top-up tax allocations expeditiously, to avoid loss of allocations in future years which would otherwise be shared amongst other jurisdictions.

What's New

The UTPR mechanism in the final rules is very different from the Blueprint. The Blueprint UTPR rules were much more limited, with deduction denials focused on related party payments from high-tax Constituent Entities, and with top-up tax dealt with separately for each low-taxed Constituent Entity. The final rules provide countries with more avenues for imposing the UTPR tax and incentivise them to do so expeditiously. Notably, the final rules provide for a domestic top-up tax presenting an opportunity for a country to 'tax back' in its own jurisdiction.

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Covered taxes

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Taxes on income and adjustments

The top-up tax rate for a jurisdiction is determined as the total adjusted covered taxes for the Constituent Entities in a jurisdiction, divided by the net income of the jurisdiction. The starting point for Constituent Entity adjusted covered taxes is the current tax expense accrued in the Constituent Entity financial accounts in respect of covered taxes, as subject to various adjustments. This makes it important to understand (i) the meaning of covered taxes and (ii) the nature of the various adjustments.

Covered taxes are defined to include taxes recorded in respect of a Constituent Entities' net income, as well as taxes in lieu of a corporate income tax (e.g., withholding tax on foreign income), taxes imposed under eligible distribution tax systems and on retained earnings and corporate equity (e.g., Zakat in Saudi Arabia).

The adjustments made to the current tax expense number include reductions for amounts related to excluded income (e.g., non-portfolio dividends), and exclusions for uncertain tax positions, certain refundable tax credits, accrued taxes not paid within 3 years. There is also an adjustment for certain deferred tax.

Specific provisions also deal with post-filing adjustments to Constituent Entities covered tax liabilities; this can trigger recalculation of prior year ETRs and top-up tax amounts.

Allocation of taxes between Constituent Entities

In arriving at the number for Constituent Entity adjusted covered taxes it is necessary allocate some covered taxes from one Constituent Entity to another.

For example, withholding taxes suffered by a recipient Constituent Entity and recorded in its accounts, will be allocated to the distributing Constituent Entity as its covered tax. Specific provisions cover Constituent Entity to Constituent Entity allocations for Permanent Establishments and hybrid entities (both treated as Constituent Entities) as well as in relation to CFC and transparent entity taxes. CFC and hybrid entity allocations are capped in order to reduce the effect of the transfer of passive assets from a high taxed jurisdiction into that jurisdiction.

Deferred tax to address timing difference

As noted above, a key step in arriving at the number for Constituent Entity adjusted covered taxes is the adjustment for deferred tax. This is intended to address the ETR volatility that would otherwise arise due to accounting (book) to tax differences. Carry forward tax losses are also effectively dealt with by means of deferred tax assets (DTAs). While the calculation of the number for inclusion in Constituent Entity adjusted covered taxes starts with the CE's accounting deferred tax expense accrued, there are a number of adjustments required.

Deferred tax expense must be recast at the 15% rate (where recorded at a rate in excess). Also, where a deferred tax liability, including in Constituent Entity adjusted covered taxes, does not reverse within 5 years (i.e., the tax is not paid by that time), then this must be reversed out (or the Constituent Entity can choose not to include in covered taxes in the first instance).

However, for a prescribed list of deferred tax liabilities specified this 5-year reversal rule does not apply. DTA valuation adjustments and deferred tax remeasurements due to corporate income tax rate changes are generally disregarded. There are also special transitional rules for deferred tax attributes existing when an MNE comes within the scope of GloBE.

There is also a special 'alternative' regime that can be used (on election) in lieu of these deferred tax provisions. It provides for the calculation of a deemed DTA for certain losses at the minimum rate and its carry forward for inclusion in adjusted covered taxes. This may be particularly relevant for no/low tax jurisdictions.

R&D Credits

On the specific area of R&D tax credits, practice differs across countries on whether refunds are granted – some allow for refunds and others do not. For those providing for refunds, some limit these to smaller enterprises which may not be in scope of GloBE. It remains to be seen to what extent countries might, in response to GloBE, update their R&D credit provisions so that they can be treated as an increase to GloBE income, rather than as a reduction to Covered taxes, so allowing for a higher ETR calculation. It may be that some countries conclude that a shift to R&D grants is the better approach. Further details may be forthcoming on release of the Commentary or through the consultation process.

What's New

The Pillar 2 Blueprint provided for a system of loss and excess tax carry forwards and credits to address the timing difference issue. This has now been replaced with the adjusted deferred tax accounting approach.

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Effective Tax Rate – Normal Cases

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The GloBE rules prescribe that the ETR of the MNE Group for a jurisdiction with Net GloBE Income is calculated for each Fiscal Year. The ETR of the MNE Group for a jurisdiction is equal to the sum of the Adjusted Covered Taxes of each Constituent Entity located in the jurisdiction (numerator) divided by the Net GloBE Income of the jurisdiction for the Fiscal Year (denominator). For the purposes of this rule, each Stateless Constituent Entity shall be treated as a single Constituent Entity located in a separate jurisdiction.

Calculation of Net GloBE Income

The Net GloBE Income of a jurisdiction for a Fiscal Year is the positive amount, if any, computed in accordance with the following formula:

Net GloBE Income = GloBE Income of all Constituent Entities from that jurisdiction - GloBE Losses of all Constituent Entities from that jurisdiction.

GloBE income of each Constituent Entity is defined as the financial accounting net income or loss determined for the Constituent Entity for the Fiscal Year adjusted for certain specific items. Adjusted Covered Taxes and GloBE Income or Loss of Constituent Entities that are Investment Entities are excluded from the determination of the Effective Tax Rate and the determination of Net GloBE Income. The top-up tax percentage for a jurisdiction for a Fiscal Year is the positive percentage point difference, if any, between 15% (the Minimum Rate) and the ETR.

The Excess Profit for the jurisdiction for the Fiscal Year is the positive amount, if any, between the Net Globe Income minus the Substance based Income Exclusion. The Substance based Income Exclusion is discussed in Section 7. The Jurisdictional Top-Up Tax for a jurisdiction for a Fiscal Year is the positive amount, if any, equal to the Top-Up Tax Percentage times the Excess Profit less any Domestic Top-up Tax and plus any Additional Top-up Tax arising from certain adjustments such as prior year increases.

There is a de minimis exclusion. Upon request and subject to conditions, the top-up tax for the Constituent Entities located in a jurisdiction is deemed to be zero for a Fiscal Year if, for such a Fiscal Year:

(a) the Average GloBE Revenue of such jurisdiction is less than EUR 10 million; and

(b) the Average GloBE Income or Loss of such jurisdiction is a loss or is less than EUR 1 million.

Additionally, there are other special adjustments, most notably for stock-based compensation expense and the treatment of certain “refundable tax credits”. As relevant to stock-based compensation, the Model Rules allow Constituent Entities to make an election (that applies to all Constituent Entities in a jurisdiction) to substitute the amount allowed as a deduction in the computation of its taxable income for the amount expensed in its financial accounts. The intent of this rule seems to be to prevent top-up tax arising in respect of book-to-tax differences associated with stock-based compensation plans.

With respect to refundable tax credits, the Rules provide that qualified refundable tax credits (generally refundable tax credits paid as cash or cash equivalents within four years) be treated as income, whereas other refundable tax credits are instead treated as offsets to tax expense. Although the Rules do not explicitly address government grants, such grants would generally be included in GloBE Income based on general financial accounting principles.

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Effective Tax Rate – special cases

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The Model Rules adjust the calculation of the GloBE ETR to account for certain special circumstances.

Constituent Entities joining and leaving a group

Under the Model Rules, special provisions apply when an entity (target) becomes or ceases to be a Constituent Entity of an MNE Group. In general, a target is treated as a member of a group in an acquisition year if any portion of its assets, liabilities, income, expenses, or cash flows are reflected on a line-by-line basis in the consolidated financial statements of the UPE for the year. In the acquisition year, only the target's income and taxes that are reflected in the UPE's consolidated financial statements are considered for GloBE purposes.

The target's income and taxes (during the acquisition year and all succeeding years) is determined using the historical carrying value of its assets and liabilities.

For purposes of applying the deferred tax accounting rules:

a) Deferred tax items, except for certain losses, that transfer from the disposing MNE Group to the acquiring MNE Group are taken into account by the acquiring MNE Group as if the acquiring MNE Group controlled the target when those deferred items arose;

b) From the perspective of the disposing MNE Group, the target's deferred tax liabilities are deemed to have fully reversed (as relevant to the 5-year reversal requirement for deferred tax liabilities);

c) From the perspective of the acquiring MNE Group, the target's deferred tax liabilities are treated as arising in the acquisition year, and if the deferred tax liability does not reverse within 5 years of the acquisition year, it is treated as a reduction to covered taxes in the recapture year, rather than the year the deferred liability arose.

Transfers of assets and liabilities and certain reorganizations

In the case of a disposition of assets and liabilities, the disposing entity will include the gain or loss on the disposition in its GloBE Income or Loss and the acquiring entity will determine its GloBE Income or Loss using the carrying value of the assets and liabilities under the accounting standard used in the UPE's consolidated financial statements. The intent seems to be to align, for GloBE purposes, the amount realized by the disposing entity with the acquiring entity's adjusted carrying value for financial accounting purposes. Note that, for these purposes, the Model Rules treat an acquisition or disposal of a controlling interest in a Constituent Entity as a disposal of the assets and liabilities if the target's jurisdiction taxes the transaction as a deemed transfer of assets and liabilities.

The disposing entity's GloBE Income or Loss generally will exclude any amount realized as part of a "GloBE Reorganization", and the acquiring entity will inherit the disposing entity's carrying values of the acquired assets and liabilities.

A GloBE Reorganization is generally a transfer of assets and liabilities such as a merger, demerger, liquidation, or similar transaction where (i) the consideration for the transfer is in whole or significant part equity interests issued by the acquiring entity (or the target entity in the case of a liquidation); (ii) the disposing entity's gain or loss on the assets is not taxed in whole or in part; and (iii) the tax laws of the jurisdiction of the acquiring entity requires the acquiring entity to compute taxable income using the disposing entity's tax basis in the assets. If certain non-qualifying consideration is received pursuant to the GloBE Reorganization, however, the disposing entity's GloBE Income or Loss will include the associated gain or loss and the acquiring entity's carrying value will be adjusted consistent with local tax rules.

Additionally, an election is available that would allow a Constituent Entity to make certain adjustments and use the fair value of assets or liabilities on a go-forward basis.

Multi-Parented MNE Groups

If two MNE Groups combine their consolidated financial statements based on an agreement between their UPEs that they operate as a single MNE Group (Multi-Parented MNE Group), the Model Rules treat all the Constituent Entities, except excluded entities, as members of one group. This includes any entity consolidated on a line-by-line basis with the Multi-Parented MNE Group or otherwise controlled by one of the MNE groups.

Notwithstanding any combination agreement between the UPEs, the Model Rules provide that such Multi-Parented MNE Groups will have two UPEs that must each apply the IIR with respect to each's Allocable Share of the Top-Up Tax of Low-Taxed Constituent Entities. With respect to the UTPR, all the Constituent Entities located in an implementing jurisdiction are to apply the UTPR, taking into account all relevant members of the Multi-Parented MNE Group. Finally, both UPEs must submit the GloBE Information Return, unless a single Designated Filing Entity is appointed.

Treatment of Flow-Through Entities, Hybrids and JVs

The manner in which the GloBE Rules apply to a MNE Group's investment in flow-through entities, hybrids, and JVs depend in the first instance on whether the financial results of such entity are consolidated with those of the MNE Group, rendering such entity a Constituent Entity.

The financial accounting net income or loss and covered taxes of an entity that is not a Constituent Entity are generally excluded from the application of the GloBE Rules to the MNE Group. However, they may nevertheless be taken into account under the special rules described below in respect of JVs if the UPE holds, directly or indirectly, at least 50% of the ownership interests of such entity, and the results of such JV are included in the financial statements of the MNE Group under the equity method of accounting, subject to certain exclusions.

The financial accounting net income or loss (and the corresponding covered taxes) of a Constituent Entity that is fiscally transparent in its or its owner's jurisdiction are allocated to a particular jurisdiction (of a permanent establishment thereof, as applicable) based on the tax treatment of the entity in its jurisdiction and in the jurisdiction of each Constituent Entity-owner.

The allocation of the financial accounting net income or loss and covered taxes of a such an entity is done separately for each ownership interest in the entity because the treatment of such entity as transparent or not may vary across jurisdictions of its Constituent Entity-owners.

For example, the income and taxes of a tax transparent entity (i.e., an entity treated as fiscally transparent in its jurisdiction as well as that of its owner) are generally assigned to the jurisdiction of such owner while the income and taxes of a reverse hybrid entity are treated as stateless and tested separately.
Additionally, the GloBE Income or Loss and covered taxes of a hybrid entity are generally allocated to the hybrid entity, including any covered taxes contained in the financial accounts of a Constituent Entity-owner of a hybrid entity in respect of income or loss of the hybrid entity.

As referenced above, where the entity is not a Constituent Entity but qualifies as a JV, special rules apply to the income and taxes of the JV and its consolidated subsidiaries ("JV subsidiaries" and together, a "JV group"). Under the final rules, a Top-Up Tax for each member of the JV group would be computed by hypothetically treating the JV group as a separate MNE group of which the JV is the UPE.A Parent Entity holding (directly or indirectly) ownership interests in a member of the JV group would apply the IIR with respect to its allocable share of the top-up tax of such member (in accordance with the general IIR rules).

The UPE's allocable share of the top-up tax of all members of the JV group (the "JV Group top-up tax") would then be reduced by the amount of top-up tax included by a Parent Entity under an IIR, and any remaining amount of JV Group Top-Up Tax would be added to the total UTPR Top-Up Tax and allocated to members of the MNE Group in accordance with the general rules.

What's New

The Pillar 2 Blueprint provided a simplified IIR approach for a JV group whereby the ETR for the JV group would have been calculated as a whole based on the equity method income arising from, and the proportionate share of income taxes accrued by, the JV group. The final rules do not allow for worldwide blending with respect to a JV group and instead require the group be treated as a separate MNE and calculate Top-up Tax with respect to each JV group member.

Details of the de minimis exclusion are new and combine the CBCR proposal with the low profit exclusion.

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Substance-based Income Exclusion

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The GloBE rules provide for a substance carve-out based on the return to payroll and tangible assets. The effect of the substance carve-out is to allow a jurisdiction to continue to offer tax incentives that reduce taxes on routine returns from investment in substantive activities. The use of payroll and tangible assets is to assist both labor and capital-intensive industries.

Calculating the Substance-based Income Exclusion

The payroll component is based on determining the payroll costs of employees of the relevant MNE entity. A wide concept of employees is adopted and must include independent contractors who are natural persons or employed by an employment company whose daily activities are directed by the MNE entity, but not employees of a corporate contractor providing goods or services.

The rules look to where the activities of an employee take place and not the location of the employer. Payroll costs (apart from payroll costs capitalized into tangible assets) are also widely defined and include employee benefits, certain pension fund payments and related taxes.

The tangible asset component is based on the carrying value in the Financial Accounts (with certain safeguards) of plant, property, equipment, land use rights and land (excluding land held for development). There are special rules for self-constructed assets, natural resources, and leased assets which aim at equivalent treatment.

The amount of the Substance-based Income Exclusion is the sum of a percentage applied to the payroll and tangible asset components. For the payroll component, the percentage starts at 10% and declines by 0.2 percentage points per year for the first 5 years to 9%, and then by 0.8 percentage points per year to reach 5% after 10 years. For the tangible asset component, the percentage starts at 8% and declines by 0.2 percentage points per year for 5 years to reach 7% and then by 0.4 percentage points for 5 years to also reach 5% after 10 years.

Applying the Substance Income Exclusion

The Substance-based Income Exclusion is subtracted from the local profit (Net Globe Income) in a jurisdiction to produce an Excess Profit. This Excess Profit is multiplied by the top-up tax Percentage being the difference between the 15% minimum rate and the ETR for the local jurisdiction (without adjustment for the carveout). This product gives the top-up tax Amount which is taxed either through the IIR or the UTPR. A Substance-based Income Exclusion amount that is not utilized cannot be carried forward or back.

By way of example, say that an MNE’s Constituent Entity in Country A has payroll of €100, a carrying value of tangible assets of €200, financial accounts profits of €100 and tax paid of €10. Assume that when profits are adjusted for the GloBE rules, the Net GloBE Income remains as €100, and the covered taxes remain as €10. The ETR is 10% (€10/€100). The substance-based income exclusion is calculated as €26 (applying

10% and 8% to payroll and assets for year 1, respectively). Excess profits are consequently €74 (€100 – €26). Applying the 5% (15%-10%) top-up tax rate to the Excess Profit yields top-up tax of €3.70, which is taxed through the IIR and/or UTPR. This could be reduced to nil if a Domestic Top-up Tax was applied by Country A.

What's New

The determination of the local ETR is based on the Net Globe Income and not just the Excess Profit when calculating top-up tax. The way in which the Substance Income Exclusion operates means that in most cases some portion of the tax concessions granted in a jurisdiction are likely to be 'taxed back'. Where the local ETR is less than 15%, and if the substance exclusion does not carve-out 100% of the profits in the jurisdiction, then a portion of the benefit will be taxed in another jurisdiction, either through the IIR or the UTPR. These rules provide for Domestic Top-up Tax which allows a jurisdiction to impose tax that would otherwise go to an IIR or UTPR jurisdiction.

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Investment Funds

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Scope

The GloBE rules provide for several categories of Excluded Entities ranging from Governmental Entities to Non-profit organizations and Pension Funds. This list of Excluded Entities specifically also includes Investment Funds and Real Estate Investment Vehicles that are the UPE. The rationale for the Investment Funds exclusion is found in the widely recognized principle of tax neutrality for investment funds.

An Investment Fund is an entity or arrangement (i) that is designed to pool assets from a number of investors, (ii) that invests with a defined investment policy, (iii) allows investors to reduce transaction, research or analytic costs or to spread risk collectively, (iv) is aimed at generating investment income and/or gains or protect against a particular event or outcome, (v) where investors have a right to return from the assets of the fund or income earned on those assets, based on contributions made by the investors, (vi) where the fund is subject to the regulatory regime for investment funds in its jurisdiction of establishment or management and (vii) where the fund is managed by fund management professionals on behalf of the investors.

Vehicles owned by Excluded Entities

The GloBE rules recognize that Investment Funds may use special purpose vehicles to hold assets or to make certain investments that therefore become part of the Fund infrastructure and should be treated as part of the Excluded Entity.

To this end, the rules prescribe that Excluded Entities include entities that (i) are at least 95% owned (directly or indirectly) by Excluded Entities, operate (almost) exclusively to hold assets of investment funds (pure holding vehicles) and only carry out activities that are ancillary to the activities of the Investment Fund, or (ii) are at least 85% owned (directly or indirectly) by Excluded Entities provided that substantially all of the entity's income is Excluded Dividends or Equity Gain or Loss.

Treatment of Investment Funds with an MNE

The GloBE rules recognize that Investment Funds may use special purpose vehicles to hold assets or to make certain investments that therefore become part of the Fund infrastructure and should be treated as part of the Excluded Entity. To this end, the rules prescribe that Excluded Entities include entities in a manner similar to the above.

Other issues

The hope is that the 2022 Commentary will provide further details and guidance for situations where (i) an Investment Fund holds a controlling stake in an MNE Group that otherwise exceeds the consolidated revenue threshold (€ 750m) and (ii) is an Investment Fund is controlled by a Constituent Entity of an MNE Group that is not an Excluded Entity. The Model Rules offer the option for a Filing Constituent Entity to not treat an Entity as an Excluded Entity.

What's New

The Model Rules specifically lists Real Estate Investment Vehicles as Excluded Entities and furthermore clearly define special purpose vehicles that are covered under the Excluded Entity definition.

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Administration

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Filing obligations

A GloBE Information Return needs to be filed by either the Constituent Entity in a jurisdiction or a Designated Local Entity acting on its behalf. There is an alternative whereby the Ultimate Parent Entity or a Designated Filing Entity can lodge a return if they are located in a jurisdiction that has a Qualifying Competent Authority Agreement in place for that Reporting Fiscal Year.

The GloBE Information Return needs to be lodged within 15 months of the GloBE Reporting Year.

The information contained in the return will be in a standard form which is to be developed but would include:

- Identification of the Constituent Entities and their location;
- The overall corporate structure of the MNE Group;
- Information necessary to compute the Effective Tax Rate for each jurisdiction, the top-up tax for each Constituent Entity and members of a JV Group;
- The allocation of top-up tax to the IIR and the UTPR;
- Record of any elections made;
- Other information agreed as part of the GloBE Implementation Framework.

There is an ability for local administrations to modify the information, filing and notification requirements. Local sanctions, penalties and confidentiality provisions will apply.

Administrative Guidance will be developed which will be subject to any requirements of domestic law.

Safe Harbors

The Model Rules include essentially a placeholder for the future development of "Safe Harbors", which are intended to reduce the administrative burden of the GloBE Rules on MNEs Groups.

The to-be-developed Safe Harbor is elective, applies on a jurisdictional basis, and, assuming the MNE is eligible, has the effect of reducing the top-up tax for the relevant jurisdiction to zero in the eligible year. No detail is provided on how the Safe Harbor will be calculated, but possibly it will be based on a simplified jurisdictional effective tax rate calculation, such as leveraging country-by-country reporting information. Notably, even if an MNE is eligible for the Safe Harbor in a jurisdiction and makes the election, it would still be required to supply additional information to certain tax authorities if requested to do so within 36 months of the filing of the GloBE Information Return.

It is envisioned that the Safe Harbors will be finalized as part of the development of the GloBE Implementation Framework.

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Implementation process and timeline

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In early 2022, the OECD will release the Commentary relating to the model rules and address co-existence with the US Global Intangible Low-Taxed Income or GILTI rules. This will be followed by the development of an Implementation Framework focused on administrative, compliance and co-ordination issues relating to Pillar Two.

The Inclusive Framework is also developing the model provision for a Subject to Tax Rule, together with a multilateral instrument for its implementation, to be released in the early part of 2022. A public consultation event on the implementation framework will be held in February and on the Subject to Tax Rule in March.

Agreement	Adoption into Law	Implementation
1 July 2021 – Agreement by 130 countries in the IF to a new international tax framework **October 2021 –** Detailed implementation plan for both pillars **20 December 2021 –** Agreed GloBE rules released for Pillar Two	**Early 2022** – release of Commentary on GloBE rules **February 2022** – Public Consultation on Implementation Framework **March 2022** – Public Consultation on the STTR **Mid 2022** – A model treaty provision to give effect to the STTR together with Commentary will be developed as will a multilateral instrument to faciliatate adoption of the STTR **End of 2022** – Finalisation of the Implementation Framework	**2023** – According to the Executive Summary, the effective date for implementation of Pillar Two is envisaged by 2023 with deferral of implementation of the UTPR rules for 12 months

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Ten points on what tax leaders need to do

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The GloBE rules can have significant impact on the ETR of MNE Groups, and it is expected to result in many different implementation challenges, as well as an increase of the administrative burden for MNE Groups that are in scope of the rules, particularly in the context of the yearly ETR and top-up tax calculations based on a jurisdictional blending.

1. **Undertake a high-level evaluation of how the rules could potentially impact the MNE**

   This may involve the use of KPMG Assessment Tools and review of the MNE's Group Structure. While the Safe Harbor rules have yet to be developed, a delineation can be drawn between entities that will clearly exceed the minimum ETR threshold and those that may not. It will also involve an assessment of whether a structure is likely to involve Excluded Entities or how certain tax concessions might operate. It should be remembered that the position of various entities can change signficantly from year to year. It should also be noted that full jurisdictional blending is not required in some cases.

2. **Understand the potential systems issues in collating data**

   Some information will be available through regular accounting information and some will need additional information to be gathered (for example, the extended definition of payroll, which includes certain types of independent contractors for the purpose of determining the Substance-based Exclusion Income).

3. **Ensure that there is strong liaison between tax teams and accounting teams on information**

   Because much of the information required is based on accounting data and delineations, particularly in relation to Deferred Tax, there is a need to ensure that data is available at the right level of granularity and integrity or robustness. In addition, the treatment and/or allocation of certain items of income or costs (including taxes) under the GloBE rules may differ from the accounting treatment in the financial accounts. The GloBE rules as outputs will also have accounting implications.

4. **Consider a more detailed assessment model**

   After an intitial evaluation provided above in 1-3, a more detailed assessment is likely to be appropriate to determine potential additional GloBE tax liabilities and the potential exercise of elections available. KPMG has a tool which can accommodate this more detailed assessment. This can be used to refine consideration of any elections.

   Also, any transaction between Constituent Entities located in different jurisdictions that is not recorded in the financial accounts consistent with the arm's length principle must be adjusted to be consistent with that principle.

5. **Inform Board and Management Committees of the potential financial and administrative impact of the new GloBE rules**

   Ensure that your budget has included additional funds for compliance costs, and that those within the organization that need to know are aware of the potential information gathering exercises to help stream-line this process.

6. **Establish Tax Control Framework for GloBE**

   The GloBE rules may result in an increase of the overall effective tax rate of an MNE group and therefore can have a significant cashflow and financial statements impact. Non-compliance can result in a higher level of scrutiny from the tax authorities, higher (tax) costs as well as brand and potential reputational damage. The MNE board's tax governance needs to include a robust tax control framework that ensures compliance with these new rules.

7. **Whether a central, regional or hybrid approach is going to be adopted for dealing with GloBE**

This will depend on the organization, but it is likely that some decentralization will be required based on the need for local information.

8. Monitor how individual countries are reacting to GloBE and consistency of application

This includes amendments to introduce Domestic Top-up Taxes or Alternative Minimum Taxes, IIR and UTPR rules. Some countries may change tax-based incentives to grants and other forms of subsidy to better accommodate the rules.

While the rules seek to involve a consistent framework, there may be differences in how they are applied to domestic entities. The potential co-existence of GILTI rules is likely to present differences in application. The EU may well introduce additional elements that extend or 'clarify' the GloBE rules in comparison to other jurisdictions.

9. Consider future tax disclosures and interaction with the GloBE rules

There are an increasing number of disclosure regimes, both private and public, and early consideration of how they intersect is important. These include CBCR, GRI 207 and EU Public CBCR in addition to the GloBE rules.

10. Consider any secondary impacts for customers and investee communications

There may be many secondary effects for MNEs, including customer credit profiles, cash-based evaluations of investments and dealing with minority interests. Consideration of these impacts needs to be part of an implementation plan.

More information

The following KPMG resources are available to help you keep pace with developments on an ongoing basis.

Webcast: the path ahead for BEPS Pillar 1 and 2 implementation	KPMG Tax Policy Perspectives	KPMG TaxNewsFlash Subscription	KPMG Future of Tax

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