KPMG report: Pillar Two implementation package

December 21, 2022

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The OECD/G20 Inclusive Framework on BEPS (the "Inclusive Framework") on 20 December 2022 released an implementation package related to the Pillar Two Global Anti-Base Erosion (GloBE) Rules, which provide a coordinated system to ensure that multinational enterprises (MNEs) with revenues above €750 million pay at least an effective rate of 15% on the income arising in each of the jurisdictions in which they operate. The release includes three documents:

- **Safe Harbors and Penalty Relief** designed to minimize the compliance burden associated with undertaking the full GloBE effective tax rate (ETR) calculation in respect of "lower risk jurisdictions" and a transitional penalty relief regime when an MNE has taken "reasonable measures" to correctly apply the GloBE Rules;

- **GloBE Information Return** which seeks public input on the data requirements associated with complying with the GloBE Rules, the exchange of the information return, and related issues; and

- **Tax Certainty** which outlines and seeks public input on various mechanisms, including dispute prevention and resolution, for achieving tax certainty under the GloBE Rules.

The Safe Harbors and Penalty Relief document includes a Transitional Country-by-Country Reporting (CbCR) Safe Harbor that has already been agreed by the Inclusive Framework and a framework for the development of a potential permanent safe harbor. The GloBE Information Return and Tax Certainty document are both released as public consultation documents, with comments due by 3 February 2023.

Not included in this release is Administrative Guidance on many outstanding technical issues; such guidance is expected to be issued in the future on a rolling basis, with the first tranche expected in early 2023. Work is also underway on the subject to tax rule and the implementing multilateral instrument.

Safe Harbors

The Inclusive Framework's work on safe harbors responds to a longstanding concern of the business community that Pillar Two imposes unduly burdensome ETR computations on MNEs, particularly those operating in high-tax jurisdictions.

Recognizing this concern, the GloBE Model Rules (released in December 2021) included Article 8.2, which effectively served as a placeholder to incorporate to-be-developed safe harbors into the final design. In April 2022, the OECD hosted a public consultation on various potential safe harbor design options, and, in response, received hundreds of pages of comments from a variety of stakeholders, including businesses. Building on the input received during the public consultation, the Inclusive Framework has now agreed on the design of a Transitional CbCR Safe Harbor and a framework for the development of a potential permanent safe harbor.

Transitional CbCR Safe Harbor

The stated intent for the Transitional CbCR Safe Harbor is to provide relief for MNE groups in the initial years that the GloBE Rules are in force. In particular, the document recognizes that MNE groups will face considerable immediate compliance difficulties in building systems to collect the data needed for undertaking the full GloBE calculation. The Transitional CbCR Safe Harbor seeks to address this concern by reducing the circumstances in which an MNE Group will be required to undertake such calculations in respect of "lower-risk jurisdictions."

The Transitional CbCR Safe Harbor identifies "lower-risk jurisdictions" through the application of three quantitative tests, all of which leverage the MNE group's Country-by-Country Report (CbC Report). More

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specifically, for an MNE Group to qualify for the Transitional CbCR Safe Harbor in a particular jurisdiction, a jurisdiction needs to pass at least one of the following three tests:

- **De Minimis Test:** The MNE group reports total revenue of less than €10 million and Profit (Loss) before Income Tax of less than €1 million in the jurisdiction on its Qualified CbC Report for the year;

- **Simplified ETR Test:** The MNE group has a Simplified ETR equal to or greater than the Transition Rate in the jurisdiction for the year; or

- **Routine Profits Test:** The MNE group's Profit (Loss) before Income Tax in the jurisdiction on its Qualified CbC Report is equal to or less than the Substance-based Income Exclusion (SBIE) amount for entities resident in that jurisdiction, as calculated under the GloBE Rules.

In accordance with Article 8.2, the top-up for a jurisdiction that meets any one of the above tests is deemed to be zero and there is no need to undertake the full GloBE calculation in respect of that jurisdiction.

Importantly, the Transitional CbCR Safe Harbor is only available during the Transition Period, which is any fiscal year beginning on or before December 31, 2026, but not including a fiscal year that ends after June 30, 2028.

Other key definitions in applying the above tests include:

- The Transition Rate is 15% for fiscal years beginning in 2023 and 2024, 16% for fiscal years beginning in 2025, and 17% for fiscal years beginning in 2026.

- The Simplified ETR is calculated by dividing the jurisdiction's income tax expense as reported on the MNE group's Qualified Financial Statements, after eliminating any taxes that are not Covered Taxes and uncertain tax positions, by the jurisdiction's Profit (Loss) before Income Tax as reported on the MNE group's Qualified CbC Report.

- Qualified Financial Statements include the accounts used to prepare consolidated financial statements of the ultimate parent entity, separate financial statements of each constituent entity prepared using an acceptable financial accounting standard or an authorized financial accounting standard, or a more limited set of accounts used in preparing the CbC Report when the entity is not consolidated on a line-by-line basis due to size or materiality.

- Qualified CbC Report means a Country-by-Country Report filed using Qualified Financial Statements.

An MNE group that qualifies for the Transitional CbCR Safe Harbor with respect to one or more jurisdictions is still subject to the full GloBE Rules in respect of jurisdictions that do not qualify for the safe harbor. Further, for jurisdictions that do qualify, the MNE group would still have to complete the relevant sections in the GloBE Information Return that concern the application of the safe harbor in that jurisdiction, although this is significantly less compliance burden than would be required under the full GloBE calculation.

The Transitional CbCR Safe Harbor is applied on a "once out, always out" basis; meaning that if an MNE group has not applied the safe harbor with respect to a jurisdiction in a year in which it is subject to the GloBE Rules, the MNE group cannot qualify for the safe harbor for that jurisdiction in a subsequent year. This rule does not apply in circumstances when the MNE group did not have constituent entities in the jurisdiction in the previous year.

If it is determined upon audit that a taxpayer did not apply the Transitional CbCR Safe Harbor correctly, and a jurisdiction should not have benefited from the Transitional CbCR Safe Harbor for a particular year, the GloBE rules would apply fully for that year and any subsequent year.

The rules adjust the application of certain provisions in the GloBE Rules to ensure the Transitional CbCR Safe Harbor delivers its intended benefits. This includes turning off Article 4.1.5, which can result in a group

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incurring a top-up tax in respect of a jurisdiction with a loss and coordinating the application of the transitional rules included in Article 9.1. In contrast, the permanent safe harbor, discussed later in this report, would not appear to turn off Article 4.1.5.

Additional special rules apply in respect of joint ventures, certain tax neutral ultimate parent entities, investment entities and their constituent entity-owners, and net unrealized fair value losses exceeding €50 million.

Furthermore, certain entities and arrangements are excluded from the Transitional CbCR Safe Harbor, including stateless constituent entities, certain multi-parented MNE groups, jurisdictions with constituent entities that have elected to be subject to eligible distribution tax systems under Article 7.3, and, as already noted, jurisdictions that have not benefited from the Transitional CbCR Safe Harbor in a previous year.

KPMG observation

The Transitional CbCR Safe Harbor effectively provides MNEs with three short-term “outs” from having to undertake the full GloBE calculation in a jurisdiction: the De Minimis Test, the Simplified ETR Test, and the Routine Profits Test. Because all three tests rely on the CbC Report, the process (and rigor) that goes into preparing that report will have greater significance going forward, which may require groups to review their internal processes.

KPMG observation—Transition Period

For calendar year taxpayers, the Transitional CbCR Safe Harbor will generally be available for three years: 2024, 2025 and 2026. However, it is unlikely that an MNE group will qualify for the Transitional CbCR Safe Harbor in every jurisdiction in which it operates. This implies that MNE groups will still have to establish all the appropriate processes to perform the full GloBE calculation in respect of non-qualifying jurisdictions by 2024 at the latest.

In any case, the full GloBE calculation will be required in every jurisdiction once the Transition Period expires (although a permanent safe harbor, discussed later in this report, may provide some relief).

KPMG observation—Simplified ETR Test

Of the three tests, the Simplified ETR Test is most likely to deliver meaningful simplification. The source of the simplification is the ability to leverage a Qualified CbC Report for purposes of computing income and Qualified Financial Statements for purpose of computing tax expense (with no adjustments other than to eliminate taxes that are not Covered Taxes and uncertain tax positions). As a result, many of the most complex adjustments and associated tracking requirements contained in the full GloBE calculation, including, for example, recasting deferred taxes at 15% as applicable, adjustments for deferred tax assets related to tax credits, and tracking deferred tax liabilities to determine if they reverse within five years, are not required, at least in respect of eligible jurisdictions during the Transition Period.

While it may seem inconsistent for the Simplified ETR test to utilize the CbC Report for purposes of measuring income (the denominator of the ETR fraction) and the Qualified Financial Statements to measure tax expense (the numerator of the ETR fraction), this is necessary because neither measure of tax expense in the CbC Report includes deferred taxes.

Notably, particularly for US-based MNEs, there is no requirement to allocate CFC regime taxes to the underlying CFC jurisdictions as part of the Simplified ETR Test. As such, GILTI and Subpart F taxes would apparently be included in the ETR calculation of the United States for purposes of the Simplified ETR Test. Some portion of these taxes could also be allocated to foreign jurisdictions when undertaking the full GloBE calculation.

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KPMG observation—De Minimis Test

For large MNE groups, the De Minimis Test is expected to provide limited relief in the sense that it will exclude only their smallest jurisdictions.

Article 5.5 of the Model Rules already contained a permanent de minimis exclusion based on the same thresholds (i.e., revenue less than €10 million and profit less than €1 million). What is new in this transitional safe harbor is that it relies on the CbC Report to compute the MNE Group's revenue and profit, and only requires the test be applied to the current period (not the current period and two prior periods as required under Article 5.5), making it easier to apply.

KPMG observation—Routine Profits Test

The Routine Profits Test builds from the SBIE (as calculated under Article 5.3 of the Model Rules), which provides an exclusion equal to a fixed return on the payroll expense and tangible assets located in a jurisdiction.

For all but the most asset- and/or labor-intensive businesses, the Routine Profits Test is expected to deliver limited simplification in jurisdictions when a group is profitable. In addition, it will be harder to qualify each year as the fixed return applied to payroll expense and tangible assets decreases every year until hitting a 5% steady state in 2033.

However, a potentially significant benefit is that the Routine Profits Test will provide simplification for jurisdictions when a group has a loss or zero profits.

KPMG observation—Safe harbors not included in the document

One of the most requested safe harbors during the April public consultation was a Qualified Domestic Minimum Top-up Tax (QDMTT) safe harbor that would deactivate the Income Inclusion Rule (IIR) and Undertaxed Profit Rule (UTPR) in respect of jurisdictions with a QDMTT (to avoid multiple ETR calculations under different accounting standards). Though no such safe harbor was included in the document, it was highlighted that this proposal is being considered as part of the Inclusive Framework's future work.

Permanent Safe Harbor

Also included in the document is a framework for the development of a potential permanent safe harbor. The stated goal is to allow MNE groups to avoid making certain complex GloBE calculations in situations when the calculation could be simplified without altering the MNE group's GloBE outcomes or otherwise undermining the integrity of the GloBE Rules (hence, the document refers to the permanent safe harbor as the "Simplified Calculations Safe Harbor").

Like the Transitional CbCR Safe Harbor, the permanent safe harbor seeks to achieve this desired result through the application of three quantitative tests: De Minimis Test, ETR Test, and Routine Profits Test. If a jurisdiction meets any of these three tests it will qualify for the permanent safe harbor, and the current top-up tax will be reduced to zero in accordance with Article 8.2 (but any additional current top-up tax, such as that arising from a recalculation of a prior year's top-up tax or under Article 4.1.5, is not reduced).

The difference between the permanent safe harbor and the Transitional CbCR Safe Harbor is the source data that is used for purposes of applying the three tests. In particular, rather than relying on the CbC Report, the permanent safe harbor is applied using a Simplified Income Calculation, Simplified Revenue

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Calculation, and Simplified Tax Calculation. None of these terms are defined in any meaningful way in the document, leaving those details to future Administrative Guidance. The document notes that any simplification under the permanent safe harbor should: (a) provide for the same final outcomes as those provided under the GloBE Rules; or (b) not otherwise undermine the integrity of the GloBE Rules.

As with the Transitional CbCR Safe Harbor, qualifying for the permanent safe harbor on a jurisdictional basis does not excuse the MNE group from complying with group-wide GloBE requirements. The compliance requirements would be considerably streamlined for jurisdictions that qualify for the permanent safe harbor, however.

The permanent safe harbor also includes a simplified calculation for Non-Material Constituent Entities (NMCEs), i.e., entities that are not consolidated on a line-by-line basis in a group's audited consolidated financial statement solely on size or materiality grounds. This simplification would allow a group to base their GloBE calculation on data for a given NMCE (revenue and taxes) as determined in accordance with OECD CbCR guidance. The Inclusive Framework will review the methodology for this calculation to evaluate whether it undermines the integrity of the GloBE Rules no later than 2028.

KPMG observation

The permanent safe harbor is less technically developed than the Transitional CbCR Safe Harbor. The key definitions associated with applying the De Minimis Test, ETR Test, and Routine Profits Test are open for future development. For this reason, it is difficult to assess the impact the permanent safe harbor will have on compliance.

Because a stated goal of the permanent safe harbor is to not alter an MNE group's GloBE outcomes, these simplified calculations may not deviate considerably from the regular calculations or may apply in a manner when it is clear that a full GloBE calculation could only produce a higher ETR result.

While not stated explicitly, it would seem the Inclusive Framework has rejected the CbC Report as the basis for the permanent safe harbor. This likely stems from the many definitional differences between the GloBE Rules and CbCR, which were likely acceptable only on a transitional basis.

If the CbC Report is in fact deemed unacceptable for this purpose, the Inclusive Framework will likely find it challenging to identify alternative data sources or calculations that deliver meaningful simplification while at the same time satisfying the criteria established in the document to "provide for the same final outcomes" or "not undermine the integrity of the GloBE Rules."

KPMG observation—Routine Profits Test

When a jurisdiction has a GloBE loss and hence satisfies the Routine Profits Test (subject to future definitions), only the current top-up tax liability for that jurisdiction will be deemed to be zero (i.e., not the Additional Top-up Tax, including one that arises under Article 4.1.5). This is a marked difference from the Transitional CbCR Safe Harbor.

Transitional Penalty Relief

The Inclusive Framework also reached a common understanding that during the same Transition Period for which the Transitional CbCR Safe Harbor applies no penalties or sanctions should apply in connection with the filing of a GloBE Information Return when a tax administration considers that an MNE has taken "reasonable measures" for the correct application of the GloBE Rules.

The term "reasonable measures" is not defined in the document but should be understood in light of each jurisdiction's existing rules and practices. The documents suggests that "reasonable measures" should be

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considered met when a taxpayer has, in good faith, put in place the appropriate systems to understand and comply with the rule; made mistakes or errors that are reasonable in the circumstances; made errors attributable to unfamiliarity with the rules in the initial implementation period; applied the rules in a manner that reflects a reasonable interpretation of an unclear rule; or the MNE's actions do not result in a reduction of top-up tax liability in the current or future year.

KPMG observation

It is important to note that the contemplated penalty relief regime is a common understanding between Inclusive Framework members, rather than a legally binding commitment.

GloBE Information Return

The GloBE Model Rules provided for the development of a standardized GloBE Information Return ("GIR") in Article 8.1.4, covering all the data points that tax administrations will require to evaluate a taxpayer's application of the GloBE Rules. The consultation document identifies all of the information that a taxpayer could require to compute every aspect of its GloBE calculation (roughly 200 data points, per jurisdiction). The document explains that taxpayers may not be required to include all these data points (which are listed in a 56-page Annex) in its GIR and seeks input from stakeholders on the information that taxpayers should be expected to collect, retain, and report to tax administrations. The document also discusses whether it is appropriate to share the full GIR with each jurisdiction that implements the GloBE Rules and the work the Inclusive Framework is undertaking to build a centralized filing system whereby a taxpayer could file its GIR with a single tax administration that would then automatically exchange the relevant parts with other affected administrations.

The document highlights that feedback from stakeholders will play a critical role in setting the Inclusive Framework's priorities for a common information filing and exchange system.

KPMG observation

The drafting of the document hints at the expectation that the GIR should include all the data points tax administrations would require to evaluate a taxpayer's application of the GloBE Rules. This would impose a significant compliance burden on taxpayers, something we expect to be raised during the public consultation process.

The onerous data requirements contemplated in the GIR underlines the significance of the safe harbors discussed earlier in this report.

Tax Certainty

The GloBE Rules are meant to provide a consistent and coordinated basis for the global application of minimum effective tax rules through a "common approach," although it has long been recognized that there is a risk of different interpretations and disputes leading to double taxation.

The document emphasizes that the Model Rules, Commentary, and to-be-released Administrative Guidance are designed to facilitate the consistent application of the GloBE Rules. However, it also acknowledges that differences in approach may arise in the way the rules are enacted or applied across different jurisdiction.

The document approaches tax certainty through two lenses: dispute prevention mechanisms intended to prevent disputes from arising in the first place and dispute resolution mechanisms to resolve any disputes that do arise.

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Dispute Prevention Mechanisms

The document identifies the mechanisms contained in the Model Rules, Commentary, and Administrative Guidance as the primary way to prevent disputes. The most important of these mechanisms is the multilateral review process that will review a jurisdiction's implementation of the GloBE Rules to determine whether they are consistent with the Model Rules and hence recognized as "qualified." The "qualified" status is important as it will limit or modify the application of other jurisdictions' GloBE Rules. The document notes that differing interpretations of the rules could be referred to the Inclusive Framework for resolution but emphasizes that such referrals would be limited to issues of policy, not specific cases.

Second, the document suggests that jurisdictions could adopt a coordinated approach to risk assessment building on the OECD's International Compliance Assurance Program ("ICAP"). The idea is that coordinating tax administration inquiries will provide the best foundation for the rules to be applied consistently.

Third, the documents suggests that jurisdictions could provide bilateral or multilateral rulings on the treatment of certain issues through an Advance Pricing Agreement ("APA") type process. However, access to an APA-like mechanism would be necessarily limited because the legal basis for such agreements' rests on bilateral tax treaties.

Dispute Resolution Mechanisms

Recognizing that it will not be possible to prevent disputes in all cases, the document acknowledges the need for a mechanism to resolve disputes. It proposes that this could build on the basic elements of existing mutual agreement procedures (MAP), with the objective that a taxpayer could submit a request to a competent authority in a jurisdiction where an action taken by such jurisdiction could result in taxation not intended under the GloBE Rules, with that competent authority then responsible for resolving the dispute with other relevant competent authorities.

The document discusses the nature of disputes that could be covered by dispute resolution, which could be broadly defined or narrowly focused on situations when groups face double taxation, and the legal basis for resolving disputes. Here, the document outlines four legal instruments that could be used:

- A **Multilateral convention "MLC)** that would establish a common standard to interpret the GloBE Rules and provide a common framework for jurisdictions covered by the MLC to resolve disputes.
- A **Convention on Mutual Administrative Assistance in Tax Matters (MAAC)** that would allow parties to the MAAC to consult each other on disputes but would not provide taxpayers with the right to request a competent authority procedure, nor provide a legal basis for competent authorities to reach and implement a substantive agreement.
- **Bilateral tax treaties** could be used to resolve disputes between jurisdictions with a bilateral treaty, which would limit the role of taxpayers because competent authorities would have discretion over whether to initiate MAP proceedings (under Article 25(3)).
- **Domestic law provisions** could establish a reciprocal dispute resolution mechanism in the domestic law of jurisdictions implementing the GloBE Rules, though legal or constitutional constraints may limit the effectiveness of such mechanisms.

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Stakeholders are invited to provide input on all aspects of the proposed tax certainty framework, including by identifying possible scenarios when two (or more) jurisdictions implementing the GloBE Rules could interpret or apply the rules in a different manner, and other options to achieve tax certainty.

KPMG observation

There are limitations to the various dispute prevention and resolution mechanisms outlined in the document. For taxpayers, it seems clear that the best option would be for the Inclusive Framework to implement a dispute resolution mechanism through an MLC. The fact that the Inclusive Framework is exploring other options may indicate there is not sufficient appetite from Inclusive Framework members for such a mechanism.

KPMG observation

The challenges of designing the tax certainty framework are complicated by the fact that in the short run some jurisdictions are unlikely to introduce the GloBE Rules. There is an open question as to whether jurisdictions that have not implemented the GloBE Rules should play a role in the tax certainty process, for example, when disputes relate to the application of their domestic law.

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Contact us

Marcus Heyland
mheyland@kpmg.com

Kevin Brogan
kevinbrogan@kpmg.com

Seth Green
sethgreen@kpmg.com

Quyen Huynh
qhuynh1@kpmg.com

Danielle Rolfes
drolfes@kpmg.com

Alistair Pepper
alistairpepper@kpmg.com

kpmg.com/socialmedia

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