KPMG report: Administrative guidance on the GloBE rules

Issues of importance to U.S.-parented MNEs

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Introduction

The OECD/G20 Inclusive Framework on BEPS (IF) on 2 February 2023 released Administrative Guidance (AG) related to the Pillar Two global anti-base erosion (GloBE) rules, which provide a coordinated system to ensure that multinational enterprises (MNEs) with revenue above €750 million pay an effective tax rate (ETR) of at least 15% on their adjusted financial statement income arising in each of the jurisdictions in which they operate. Read ***TaxNewsFlash***

The AG adds to the expanding body of guidance that has been approved by the IF on the GloBE rules, which includes the **Model Rules** (released in December 2021), **Commentary** (released in March 2022), and **Safe Harbors** [PDF 459 KB] (released in December 2022). Various other aspects of the GloBE rules are the subject of ongoing work, including work on administration and ways to provide tax certainty regarding the operation and interpretation of the GloBE rules by multiple jurisdictions.

The AG covers 26 items in 111 pages and sets out to clarify or simplify the application of the GloBE rules. Each item of the AG includes revisions to a particular section of the GloBE Commentary. The AG reflects the consensus of all 142 jurisdictions in the IF and is not open to public comment. The released AG is noted to be an initial tranche, focused on priority issues, to be followed by further guidance throughout the year. The OECD also intends to release a revised version of the GloBE Commentary incorporating the changes made by the AG later this year.

The 26 items included in the AG are grouped into five categories:

- Scope (Article 1 of the GloBE rules)
- Income & taxes (largely Articles 3 and 4)
- Application of the GloBE rules to insurance companies (various articles)
- Transition rules (Article 9)
- Qualified Domestic Minimum Top-up Taxes (a defined term in Article 10 as relevant for various other chapters and referred to herein as QDMTTs)

Immediately below are general observations on the AG, followed by detailed descriptions of the issues of particular importance to U.S.-parented MNEs and other groups with significant U.S. operations. Capitalized terms not defined herein have the meaning given in the foregoing guidance.

General observations

Several general observations can be made on the AG content.

- **Helpful clarifications**: Many of the AG items are directed at "helping" taxpayers. These clarify the application and interpretation of the GloBE rules to avoid distortive outcomes that could otherwise arise. Examples include the AG items softening the application of Article 4.1.5, various insurance-relevant rule clarifications, clarifications on the excluded entity definitions, the treatment of currency hedges of investments in foreign operations, and clarifications of various transitional rules.

- **GloBE and accounting**: Several of the AG items might be viewed as patches to deal with quirky interactions of the GloBE rules with accounting treatments. Conceivably, some of these outcomes were not foreseen when the GloBE rules were initially drafted. Examples include the AG items on the application of the rules when historic cost is used for intra-group asset transfers and when there is an asymmetric accounting treatment of preference shares at the holder and issuer levels.

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- **Spill-over effects**: Some of the AG items are directed at resolving specific issues but conceivably could have spill-over effects. An example is the list of "events" treated as a transfer of assets for purposes of the transition period in Article 9.1.3, such as certain licenses and changes in tax residence. Do these clarifications have implications for the "in-regime" rules? Another example is the assertion that Article 3.2.3 (which requires that transactions between constituent entities (CEs) be adjusted to align with the arm's length principle) applies to transfers of assets and liabilities between CEs covered by Article 6.3.1. Before this clarification, the GloBE treatment would have followed the accounting treatment, which in some cases, including U.S. GAAP, may have recorded the transfer at historical cost. The Commentary had previously targeted the application of Article 3.2.3 at transfer pricing adjustment, which is not the case for the new AG item. What are now the new limits on the application of Article 3.2.3?

- **Legal effect of the AG**: Article 8.3.1 provides that jurisdictions must apply the GloBE rules in accordance with the AG. Furthermore, it is clear from the AG that, for a jurisdiction's Income Inclusion Rule (IIR), Undertaxed Profits Rule (UTPR) or Qualified Domestic Minimum Top-up Tax (QDMTT) to be "qualified," it must follow the AG. For AG that is released after a jurisdiction has codified the GloBE rules, this requirement to adapt to evolving AG may raise issues regarding whether the AG should be applied on a dynamic or static basis (e.g., whether to maintain its qualified status a jurisdiction needs to update its domestic law to reflect the most recent AG).

  In addition, there conceivably could be instances in which a local court determines that the AG interpretation of a provision is not supported by the wording of the rule, as incorporated into domestic law. Notably, the UK's draft GloBE legislation, released in July 2022, incorporated elements of the Commentary alongside the Model Rules. Some jurisdictions may choose a similar course, bringing elements of the Commentary, AG, and safe harbor provisions explicitly into domestic law. How jurisdictions with varying legal traditions will adapt to future AG tranches remains to be seen.

- **QDMTT design flexibility**: As detailed further below, the AG provides jurisdictions with a degree of flexibility on the design of a QDMTT, with the option to modify or omit certain provisions when these variations do not produce outcomes inconsistent with the GloBE rules. Whether a minimum tax is treated as a QDMTT will be determined by a multilateral review process (Peer Review) guided by the AG. Once a jurisdiction has designed a QDMTT that they consider should pass Peer Review, there may well be a queue of other jurisdictions seeking sign off. It is also possible that a jurisdiction would need to amend its minimum tax following review. As such, there appears to be a journey ahead for jurisdictions seeking to adopt a QDMTT.

- **Compatibility with tax treaties:** The Executive Summary of the AG notes: "Consistent with the intention of the Inclusive Framework, the GloBE rules (including the IIR and UTPR) are designed so that the imposition of top-up tax in accordance with those rules will be compatible with the provisions of the UN Model Double Tax Convention and the OECD Model Tax Convention on Income and on Capital." This statement may have been included in response to commentators challenging whether the GloBE rules are consistent with tax treaties.

Notable AG items for U.S.-parented MNEs

The AG items of greatest significance to U.S.-parented MNEs and MNEs with significant U.S. operations include guidance with respect to:

- The QDMTT
- The allocation of taxes arising under a Blended CFC Tax Regime (i.e., GILTI)
- Loss-making Parent Entities of CFCs
- The Transition Rules
- The Equity Investment Inclusion Election and Qualified Flow-Through Tax Benefits
- The Excess Negative Tax Expense administrative procedure

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- The deemed consolidation test

Detail on these items and accompanying KPMG observations are set out below.

QDMTT

The AG reiterates that, for a jurisdiction's minimum tax to qualify as a QDMTT, it must provide for outcomes consistent with the GloBE rules, which generally requires that any variations not produce a lower liability than would be expected under the GloBE rules. The AG identifies certain elements of a QDMTT that need to be identical to the GloBE rules, and other elements that may vary. Variations from the GloBE rules may be permissible when particular GloBE provisions would be redundant in light of the jurisdiction's tax system. For example, if a jurisdiction's Corporate Income Tax (CIT) does not provide tax deferral for reorganizations, the Chapter 6 GloBE rules relating to reorganizations can be omitted from a QDMTT. In addition, certain variances from the GloBE rules that would systematically increase a group's tax liability under the QDMTT are acceptable, e.g., lowering or dropping the Substance-based Income Exclusion (SBIE). The Peer Review process will include a detailed "case-by-case" evaluation of the QDMTT rules proposed by a jurisdiction, with consideration given to the domestic CIT rules, to see if the omission or adaptation of any GloBE provisions is acceptable.

The AG also includes some notable clarifications on the overall operation of the QDMTT.

- The AG reinforces that, under the Model Rules and Commentary, a QDMTT can be based on an accounting standard that differs from that used in the consolidated financial statements of the Ultimate Parent Entity (UPE) if the accounting standard is of an "Acceptable" or "Authorised" (adjusted to prevent material distortions) nature.

KPMG observation

While there are practical reasons to permit a jurisdiction to use its own accounting standard for purposes of its QDMTT (subject to certain requirements), this presents a significant compliance challenge for MNEs. In the absence of a QDMTT safe harbor, it requires taxpayers to compute two different GloBE ETRs in respect of that jurisdiction: one for purposes of the QDMTT (using the local accounting standard) and again for purposes of the IIR/UTPR (using the accounting standard of the UPE). For U.S.-parented MNEs that prepare consolidated financial statements using U.S. GAAP, this practically means undertaking GloBE ETR calculations in respect of every jurisdiction that implements a QDMTT using both local GAAP and U.S. GAAP. And this is in addition to calculations already required for regular U.S. tax purposes, such as computing tested income for purposes of GILTI.

Even if a QDMTT safe harbor emerges in future guidance that eliminates the need for the secondary GloBE ETR calculation, MNEs cannot easily begin to prepare their accounting systems and related processes until jurisdictions that intend to implement QDMTTs make known the accounting standards that will be required or permitted.

- The AG clarifies that a jurisdiction imposing a QDMTT has priority taxing rights over all others. That is, the numerator in a QDMTT ETR calculation should not include taxes paid to another jurisdiction under a CFC regime that otherwise would be allocable under the GloBE rules to a CE located in the jurisdiction. This rule also applies in respect of any taxes paid by an owner of a permanent establishment in the jurisdiction. Instead, a CFC regime may give a credit for a QDMTT imposed on the CFC.

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KPMG observation

Excluding taxes paid under CFC tax regimes from the QDMTT ETR numerator is a significant development for U.S.-parented MNEs, as this means that any tax paid under GILTI and Subpart F would not be taken into account as a Covered Tax for purposes of a QDMTT.

Effectively, a revised rule order has emerged: (1) QDMTT, (2) GILTI/Subpart F, (3) IIR, and (4) UTPR. If QDMTTs proliferate, the relevance of the allocation of GILTI taxes to foreign jurisdictions (discussed below) will be significantly reduced. In light of the new rule order, we anticipate that the United States will provide a foreign tax credit (FTC) for tax paid under QDMTTs. Such credits may not provide a tax benefit, however, because in practice many MNEs are excess credit in the GILTI basket.

- The AG provides that a QDMTT should include the safe harbors developed by the OECD, including the transitional safe harbors. Otherwise, an MNE would be forced to perform complex calculations for purposes of the QDMTT that they would be excused from under an IIR and UTPR.
- To be qualified, a QDMTT must be imposed with respect to 100% of the top-up tax calculated for local CEs; it cannot be limited to a UPE's ownership percentage in the CEs. As such, a QDMTT could lead to more top-up tax than if a UPE’s IIR applied. The AG also provides, however, that jurisdictions may choose to apply their QDMTT only to groups for which all CEs located in the jurisdiction are 100% owned by the UPE or a partially-owned parent entity (POPE) for the entire fiscal year.
- A QDMTT generally needs to include the elections under the GloBE rules, unless they are irrelevant in the context of the local CIT, e.g., the election for stock-based compensation need not be included if the local CIT limits the deduction to amounts reported under the local accounting standard. An MNE group must make consistent elections for QDMTT and IIR/UTPR purposes.
- Finally, a QDMTT must apply the transition rules to reliably provide for outcomes consistent with the GloBE rules. For example, if the same transition rule did not apply in respect of deferred taxes, the covered taxes taken into account in computing the ETR under a QDMTT and IIR would be inconsistent.

Importantly, the IF has not yet agreed on a QDMTT safe harbor, though the AG notes that work continues in this respect. In its absence, a QDMTT reduces the amount of top-up tax under the IIR/UTPR through a credit mechanism, whereas a QDMTT safe harbor would provide relief through an exemption mechanism.

Allocation of taxes arising under a Blended CFC Tax Regime (i.e., GILTI)

The IF has agreed that GILTI, in its current form, meets the definition of a Controlled Foreign Company (CFC) Tax Regime under the GloBE Rules and must be treated as such. Article 4.3.2(c) requires tax imposed under a CFC Tax Regime to be allocated from the direct or indirect CE-owner that is subject to the CFC tax to the CE through which the CFC income arose. Recognizing that this allocation is complex for “Blended CFC Tax Regimes,” such as the U.S. GILTI regime, that aggregate income, losses, and creditable taxes across jurisdictions, the AG sets out a simplified allocation that must be applied for fiscal years beginning on or before December 31, 2025, and that do not end after June 30, 2027. The IF will assess whether to allow a special allocation methodology for Blended CFC Tax Regimes for future periods.

KPMG observation

While guidance on the allocation of GILTI taxes was highly anticipated, its relevance could be limited in practice if QDMTTs, which exclude taxes paid under GILTI, proliferate. The allocation, however,

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would still be relevant in the context of the IIR and UTPR if QDMTTs do not fully insulate the MNE Group from paying tax under an IIR or UTPR.

KPMG observation

The AG states that a Blended CFC Tax Regime does not include a regime that takes into account a group's domestic income, though a Blended CFC Tax Regime may allow domestic losses incurred by the shareholder of the CFC to reduce the CFC inclusion. Under the new U.S. corporate alternative minimum tax (CAMT) regime, a domestic corporation may be subject to additional U.S. income tax based on its adjusted financial statement income (AFSI). If the domestic corporation is a U.S. shareholder of a CFC, its AFSI (i.e., the base upon which CAMT liability is determined) includes its pro rata share of CFC earnings. Based on the AG's description, it appears that CAMT taxes on CFC earnings are not eligible for the simplified allocation methodology. It remains unclear whether any portion of a taxpayer's CAMT liability is treated as a CFC Tax and, if so, how that portion would be allocated to CEs.

The portion of U.S. income tax paid under the GILTI regime that is allocated to a CE (which may be a CFC or a tested unit of a CFC, such as a branch that operates in a jurisdiction other than that of the CFC) will be calculated using the allocation formula set forth below, which considers both (1) the quantum of income in a jurisdiction as calculated under the CFC Tax Regime (i.e., the CE's tested income rather than its GloBE income) and (2) the degree to which the GloBE ETR in the jurisdiction falls below the "Applicable Rate," which is the rate at which foreign taxes would fully offset tax due under the CFC regime (i.e., 13.125% for GILTI).

The **"Blended CFC Tax Allocated to an Entity"** is determined using the following formula:

$$\frac{\textit{Blended CFC Allocation Key}}{\textit{Sum of all Blended CFC Allocation Keys}} \times \textit{Allocable Blended CFC Tax}$$

The **"Blended CFC Allocation Key"** is determined using the following formula:

$$\textit{Attributable Income of Entity} \times (\textit{Applicable Rate - GloBE Jurisdictional ETR})$$

For the above formula:

- "Allocable Blended CFC Tax" is the amount of tax incurred by the CE-owner under the Blended CFC Tax Regime. In the case of GILTI, the AG notes that this amount can be determined from the U.S. federal income tax return. In the absence of a domestic loss, it will equal "the amount of GILTI (reduced by the GILTI deduction) multiplied by 21%, less the foreign tax credit allowed in the GILTI basket."

KPMG observation

The AG does not define "the amount of GILTI" or the "GILTI deduction," but the amount of GILTI should include the gross-up for any taxes deemed paid in respect of the shareholder's GILTI inclusion under section 78 of the Code (the section 78 gross-up) and the GILTI deduction should include the deduction allowed under section 250 of the Code in respect of the section 78 gross-up. If the section 78 gross-up were not included, the Allocable Blended CFC Tax could be negative because the determination of the foreign tax credit allowed in the GILTI basket takes into account the gross-up.

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KPMG observation

Absent a domestic loss, a U.S. shareholder's Allocable Blended CFC Tax equals the amount of GILTI (gross GILTI inclusion reduced by the related section 250 deduction) multiplied by 21%, less the foreign tax credit allowed in the GILTI basket. Thus, the amount of GILTI treated as subject to U.S. tax is not reduced by any other deductions of the U.S. shareholder that are allocated and apportioned to the GILTI basket for purposes of determining the GILTI basket FTC limitation. As a result, whenever a U.S. shareholder allocates other deductions, such as interest, to the GILTI basket, it will have a positive amount of Allocable Blended CFC Tax that can be allocated to a low-taxed jurisdiction even if the U.S. shareholder's CFCs are subject to an average foreign effective tax rate in excess of 13.125%.

- "Attributable Income of Entity" is the owner's proportionate share of the income of the CFC (or relevant part thereof if the CFC is comprised of more than one CE) as determined under the Blended CFC Tax Regime. As relevant to GILTI, the AG states that the Attributable Income of the Entity can be determined from the U.S. federal income tax return and is equal to the U.S. shareholder's share of the tested income (without reduction for foreign income taxes) of the CE (which may be a CFC or a tested unit thereof).

KPMG observation

Because the GloBE rules apply on a jurisdictional basis, allocating GILTI tax will require a U.S. shareholder to allocate the tested income of each CFC among its disregarded entities and/or branches if it operates in multiple jurisdictions (giving rise to separate "tested units" under the GILTI high-tax exclusion rules of Reg. § 1.951A-2 and separate CEs under the GloBE rules). Because the definition of a CE generally corresponds to the definition of a tested unit, a taxpayer may have already determined the CFC's tested income on a CE-by-CE basis in order to apply the GILTI high-tax exclusion (as provided in Reg. § 1.951A-2) or to allocate and apportion any foreign income taxes assessed at the level of a tested unit, but this will not always be the case. When a CFC has an overall tested loss or is comprised of one or more CEs that operate at a loss, a CE of the CFC may have tested income that exceeds the net tested income of that CFC.

In calculating the tested income of a tested unit for purposes of the GILTI high-tax exclusion, certain aggregate expenses of the CFC, such as interest, are allocated and apportioned at the CFC level without consideration as to which tested unit actually bore the expense under currently existing Reg. § 1.951A-2, although proposed regulations would change that result. Because the Attributable Income of each CE is as determined under the Blended CFC Tax Regime, it appears that these expense apportionment rules apply and will result in Attributable Income that may differ substantially from the GloBE income of the CE.

- "Applicable Rate" is defined as the "threshold for low taxation under the Blended CFC Tax Regime." This is explained as the rate at which foreign taxes on CFC income generally fully offset the CFC charge through the tax credit mechanism applicable to the CFC Tax Regime. For GILTI, the Applicable Rate is noted to currently be 13.125%.

- "GloBE Jurisdictional ETR" means the ETR as computed for a jurisdiction under the GloBE rules in Article 5.1 but without regard to any Covered Taxes allocated under a CFC Tax Regime. If a jurisdiction has a QDMTT and the Blended CFC Tax Regime provides a foreign tax credit for the QDMTT on the same terms as any other creditable Covered Tax, the QDMTT is taken into account for purposes of computing the GloBE Jurisdictional ETR. If the GloBE Jurisdictional ETR with respect to a CE is equal to or exceeds the Applicable Rate, the CE's Blended CFC Allocation Key is zero and no portion of the Allocable Blended CFC Tax is allocated to the CE.

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KPMG observation

Left unaddressed in the AG is how the Transitional CbCR Safe Harbor interacts with the GILTI allocation mechanism. In particular, the allocation mechanism assumes the GloBE Jurisdictional ETR, as computed under Article 5.1, is known. If a jurisdiction is eligible for a Transitional CbCR Safe Harbor, however, there is no requirement to compute an ETR under Article 5.1 in respect of that jurisdiction. The IF will need to coordinate the GILTI allocation mechanism and the Transitional CbCR Safe Harbor in future guidance to avoid unwinding the intended compliance benefits of the safe harbor.

The allocation methodology includes a provision to ensure that, when income of non-CEs is subject to the Blended CFC Tax Regime, an appropriate portion of the Allocable Blended CFC Tax is not allocated within the group.

KPMG observation

The allocation key may provide surprising results. For example, consider a U.S. shareholder that owns two CFCs in different jurisdictions with equal tested income, where the first CFC pays foreign tax at a 12% rate and the second CFC pays tax at a 15% rate. Because the blended rate of the CFCs exceeds 13.125%, any Allocable Blended CFC Tax will be due to the allocation and apportionment of shareholder expenses to the GILTI basket. However, because the second CFC's GloBE Jurisdictional ETR exceeds 13.125%, all the GILTI tax will be allocated to the first CFC even though some of it likely results from shareholder expenses allocable to the second CFC. Further, if both CFCs had GloBE Jurisdictional ETRs exceeding 13.125%, both would have Blended CFC Allocation Keys of 0 such that none of the Allocable Blended CFC Tax would be allocated. Although not explicitly provided, presumably the Allocable Blended CFC Tax would remain a Covered Tax of the U.S. shareholder as it is included in the U.S. shareholder's financial accounts and is not allocated to any other CE.

KPMG observation

The simplified methodology for identifying the amount of Allocable Blended CFC Tax by its terms applies except in the case of a "domestic loss." Consider a U.S. shareholder with 50 of U.S. source gross income and a GILTI inclusion of 50, all of which is reduced by a 100 Non-Operating Loss (NOL) NOL deduction. The shareholder will have Adjusted Covered Taxes of 15 in its financial accounts from the reversal of its NOL Deferred Tax Asset (DTA) some portion of which may be Allocable Blended CFC Tax. If the simplified methodology applied, 10.5 of the 15 Adjusted Covered Taxes would be Allocable Blended CFC Tax (21% of the 50 GILTI inclusion reduced by 0 GILTI deduction and 0 allowed FTCs), leaving only 4.5 of Adjusted Covered Taxes allocated to the U.S. source income and exposing it to top-up tax. In this instance, the formula for calculating the Allocable Blended CFC Tax should be modified to use 15% as the applicable tax rate since the NOL DTA of the taxpayer was recast at 15%, which would result in 7.5 of Adjusted Covered Taxes being allocated to the CFC and the US. In addition, if more than 50 of the NOL was comprised of a U.S. source loss, such excess ought to be treated as a U.S. source loss that, due to its use to offset a foreign source inclusion, can give rise to a Substitute Loss Carry-forward DTA as discussed immediately below.

Loss-making Parent Entities of CFCs

The AG includes new rules to provide that a parent entity with a domestic loss that offsets foreign income under a worldwide tax regime is not disadvantaged under the GloBE rules as compared with a parent entity operating in a jurisdiction with a territorial tax regime. As illustrated in the example below, these rules

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provide relief to a U.S. MNE with a U.S. source loss that offsets a GILTI or Subpart F inclusion, creating an overall domestic loss (ODL) account that will cause future U.S. source income to be recaptured as foreign source income that can be offset by foreign tax credits.

Consider a parent entity that operates in a jurisdiction with a tax rate of 21% and owns a foreign subsidiary that is taxed at 30% locally. In Year 1, the parent entity loses 200 and its foreign subsidiary earns 200. Under a territorial regime, the foreign subsidiary's income would not be included in the tax base of the parent entity, so that the parent entity would have a 200 loss carryforward, for which it would record a DTA of 42 that would be limited to 30 for purposes of the GloBE rules under Article 4.4.1. In year 2, if the parent entity directly earns 400 of income, pays 42 of current tax expense and utilizes its GloBE DTA of 30, it would have an 18% GloBE ETR and no top-up tax. If the foreign subsidiary again earned 200 of pre-tax income, it would have a 30% GloBE ETR.

In contrast, absent the AG, if parent entity was a U.S. entity, the 200 domestic loss in Year 1 would offset its 200 GILTI inclusion, creating a 200 ODL account, which, while a valuable attribute, does not result in a DTA for GloBE. In year 2, 200 of U.S. parent's U.S. source income is recaptured as GILTI basket income for U.S. FTC purposes. For simplicity, assume the tested income earned by CFC in year 2 resulted in FTC capacity of 21 [(200 – 100 section 250 deduction) x 21%] with respect to its 48 of deemed paid FTCs (i.e., 60 tested income taxes x 80% per the haircut in section 960(d)(1)). The 200 ODL recapture would provide an additional 42 of FTC limitation in the GILTI basket, allowing the remaining 27 of deemed paid FTCs to be utilized against the U.S. tax it would otherwise owe on the recaptured income. Therefore, absent relief, the U.S. ETR is 14% ((84 pre-credit U.S. tax liability – 27 FTCs)/400), resulting in top-up tax.

Without the relief provided in the AG, the same result would apply in respect of a U.S. parent with a Subpart F inclusion that is fully or partially offset by a U.S. operating loss, creating an ODL and an FTC carryforward on account of the U.S. operating loss reducing or eliminating the capacity to use foreign tax credits in the loss year. Because Article 4.4.1(e) of the GloBE rules disregards DTAs recognized in respect of tax credit carryforwards, using the FTC carryforward to reduce U.S. tax liability on U.S. source income that is recaptured as foreign source income pursuant to the U.S. ODL rules will reduce the numerator of the GloBE ETR computation dollar-for-dollar.

To provide greater parity for the treatment of domestic losses in the context of worldwide tax regimes as compared with territorial regimes, the AG provides a "Substitute Loss Carry-forward DTA" to serve as a replacement for the loss DTA that a parent entity would have had if it operated in a territorial regime, such that its domestic loss would not have been absorbed (in whole or in part) in the current year by foreign source income. This substitute DTA has two formulations: one that applies to FTC carryforwards from the domestic loss year (applicable, for example, in respect of domestic losses that offset Subpart F inclusions, where FTC carryforwards are generally available) and one that applies when only excess current year FTCs can be used against domestic income in the year the ODL is recaptured (primarily applicable in respect of the U.S. GILTI regime, where FTC carryforwards are not available). The reversal of this DTA will protect a U.S. parent's ETR when an ODL is recaptured and either the loss year FTC carryforward or excess FTCs in the year of the ODL recapture, as applicable, reduce tax on U.S. income that is recaptured as foreign source.

When FTCs arising in the year of the domestic loss are allowed to be carried forward, the Substitute Loss Carry-forward DTA is equal to the lesser of (1) the FTC carryforwards in respect of the foreign source income inclusion from the domestic loss year and (2) the amount of the domestic tax loss for the year multiplied by the domestic tax rate, but capped at the 15% recast rate that applies generally to DTAs under the GloBE rules.

Because there is no carryforward for GILTI FTCs, the foregoing Substitute Loss Carry-forward DTA would not provide relief when the U.S. ETR is reduced by excess GILTI credits arising in the year that domestic income is recaptured as GILTI basket foreign source income. In light of this, the AG provides that in such circumstance the amount of the domestic tax loss that is subject to recapture is treated as a Substitute Loss Carry-forward DTA that reverses as the loss is recaptured, but only to the extent additional current year FTCs are utilized on account of the recapture. Thus, if a U.S. Parent would otherwise have excess GILTI

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FTCs in the year an ODL is recaptured as GILTI basket income, a portion of the Substitute Loss Carry-forward DTA will reverse but only to the extent the ODL recapture allows for additional GILTI FTCs to be utilized.

KPMG observation

In defining the Substitute Loss Carry-forward DTA, the AG divides FTC regimes into two buckets: (1) those that allow FTC carryforwards and (2) those that do not allow FTC carryforwards but do allow additional FTC limitation to be created in the year domestic income is recaptured as foreign source. The example illustrating the application of this DTA in the context of foreign source income recapture under an FTC regime that allows for the utilization of excess credits arising in the recapture year provides that the relevant FTC regime does not allow FTC carryforwards. It is unclear how the Substitute Loss Carry-forward DTA is intended to apply when an FTC regime allows for both FTC carryforwards and the utilization of excess credits in the recapture year, as is the case with the U.S. passive and general baskets. In particular, a U.S. source loss may offset general basket income resulting from a general basket Subpart F inclusion and result in a general basket FTC carryforward. In a subsequent year when the general basket ODL is recaptured, the U.S. parent may have sufficient excess credits arising in the recapture year such that the additional FTC limitation created by the recaptured general basket income is fully absorbed by the current year excess credits rather than the FTC carryforwards from the loss year. To keep the results consistent with a territorial regime, the U.S. parent should be allowed a Substitute Loss Carry-forward DTA reversal equal to the total amount of FTCs used as a result of the loss recapture—whether sourced from current year excess credits or carryforwards—capped at the amount of the domestic loss multiplied by the lesser of the statutory rate or recast rate (15%). Clarification as to how the Substitute Loss Carry-forward DTA should apply in this situation is warranted.

The IF appears to have reserved on the application of the Substitute Loss Carry-forward DTA mechanism in the context of domestic losses that offset income arising through a permanent establishment (PE), although it is unclear why. The AG states that "[t]he Inclusive Framework will consider the case for extending the mechanism . . . in the context of Permanent Establishments to provide for similar outcomes recognizing that some differences in mechanisms may be necessary given certain differences between the two contexts."

KPMG observation

By its terms, the new guidance to be inserted in the Commentary to effectuate the relief provided in the AG does not appear limited to situations where the domestic loss reduces an inclusion under a CFC regime, although the stated intent to consider the case for "extending" the relief to domestic losses that offset PE income suggests otherwise. Thus, the question arises as to whether the relief is available when a U.S. source loss offsets foreign source general limitation income earned directly by the parent entity (e.g., foreign source royalty income), which is also subject to the U.S. ODL recapture regime.

KPMG observation

As for general basket income, the U.S. branch basket FTC regime allows both FTC carryforwards and current-year excess credits to be used when a branch basket ODL is recaptured. In adapting the mechanism of the Substitute Loss Carry-forward DTA to losses that offset PE income, an important feature will be how the rule applies in a regime that provides for both FTC carryforwards from the loss year and utilization of recapture year excess credits. As well, the Substitute Loss Carry-forward DTA in respect of PEs should also apply to Hybrid Entities that are treated as foreign

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branches for U.S. federal income tax purposes because a U.S. source loss can equally be absorbed against a Hybrid Entity's foreign income.

Transition rules

The AG clarifies the treatment of tax attributes that exist at the beginning of the first fiscal year that a group comes within the scope of the GloBE rules in respect of a jurisdiction (Transition Year), including the treatment of deferred taxes generally, as well as the treatment of certain intra-group asset transfers that occur between 30 November 2021 and the Transition Year.

Importantly, as discussed below, the definition of Transition Year is modified for jurisdictions that qualify for the Transitional CbCR Safe Harbor.

Treatment of pre-existing deferred taxes, in general

When determining the GloBE ETR for a jurisdiction in the Transition Year and each subsequent year, Article 9.1.1 provides that the MNE is permitted to take into account "all" of the DTAs and Deferred Tax Liabilities (DTLs) reflected or disclosed in the financial accounts for the Transition Year. The safe harbor document released by the OECD in December 2022 provides that the "Transition Year" referred to in Article 9.1.1 would be the first fiscal year in which the relevant Tested Jurisdiction no longer qualifies for or applies the Transitional CbCR Safe Harbor. Prior to the release of the AG, it was unclear how to interpret the word "all" in conjunction with Article 4.4, which places various exclusions and limitations on the deferred taxes that can be taken into account in the GloBE ETR numerator. Of particular note in this regard is Article 4.4.1(e) which excludes deferred tax expense related to the generation and use of tax credits.

The AG clarifies that Article 4.4.1(e) does not apply for purposes of DTAs that arise prior to the Transition Year. The AG also provides a simplified formula for recasting DTAs booked at rates higher than the 15% minimum rate:

$$\frac{\textit{Amount of deferred tax assets reflected in the financial accounts}}{\textit{Applicable domestic tax rate}} \times \textit{Minimum Rate}$$

The AG also clarifies that, except when Article 9.1.2 (an anti-abuse rule to prevent the triggering of tax losses that would be excluded from the GloBE base in a pre-GloBE year and then carrying a deferred tax benefit into the GloBE regime) applies, "attributes imported into the GloBE attributes pursuant to Article 9.1.1" are not subject to any adjustments to deferred tax expense under Article 4.4.1(a), (b), (c), or (d), or Article 4.4.4.

The AG also sets out special provisions dealing with refundable tax credits that accrued prior to the Transition Year, were booked as an increment to income for financial accounting purposes, and are carried forward for use in post-Transition years. Due to the accounting treatment, no DTA generally would be recognized that could be brought into account by Article 9.1.1. By contrast, had the refundable credit been booked in the financial accounts as relating to a future reduction to income tax expense, a DTA would have been recognized and the item would have been brought into account by Article 9.1.1. This disparity can lead to distortive results in later in-regime years. Thus, to preserve the overall neutrality of the GloBE rules, the AG provides that the settlement of any refundable tax credit arising prior to the Transition Year does not reduce covered taxes.

KPMG observation

Allowing deferred tax expense related to the utilization of pre-existing credit carryforward DTAs

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(albeit subject to recast to 15%) to be regarded in the GloBE ETR numerator will be welcome relief for many U.S. based MNEs with material carryforwards of FTCs or other nonrefundable credits.

Carryforwards of FTCs and other nonrefundable credits that arise after the Transition Year, however, will be subject to Article 4.4.1(e). As a result, deferred taxes related to the generation and use of those credit carryforwards will be excluded from Covered Taxes, which could be a key driver of low-taxed results for some U.S. MNEs.

Notably, the Transitional CbCR Safe Harbor extends the definition of "Transition Year" to the first year that the jurisdiction no longer qualifies for or applies the safe harbor. In practice, this allows credit carry-forward DTAs that arise in 2024, 2025 and 2026 (in safe harbor eligible jurisdiction) to also be taken into account.

KPMG observation

The AG also turns off several other deferred tax expense adjustments in respect of attributes imported into the GloBE rules pursuant to Article 9.1.1, including:

- Article 4.4.1(a), which excludes deferred tax expense with respect to items excluded from GloBE income or loss under Article 3
- Article 4.4.1(b), which excludes deferred tax expense with respect to uncertain tax positions and other items
- Article 4.4.1(c), which excludes the impact of valuation adjustments or accounting recognition adjustments with respect to a DTA
- Article 4.4.1(d), which excludes deferred tax expense arising from a re-measurement due to a change in the applicable domestic tax rate
- Article 4.4.4, which excludes certain DTLs that do not reverse within a five-year period

The stated rationale for not requiring these adjustments on transition is that doing so "would produce significant compliance burdens." Not requiring the adjustments may have unintended consequences, however, leading to further questions.

One example arises in the context of purchase accounting adjustments. The Model Rules and Commentary (in Chapters 3 and 6) provide a general rule that purchase accounting adjustments should be excluded from GloBE income or loss and that deferred taxes related to purchase accounting adjustments should commensurately be excluded from Adjusted Covered Taxes pursuant to Article 4.1 (presumably a reference to Article 4.1.1(b), which incorporates deferred tax expense computed under Article 4.4 into Adjusted Covered Taxes). As relevant here, Article 4.4.1(a) excludes deferred taxes that relate to items excluded from GloBE income or loss under Chapter 3, such as purchase accounting. However, the AG provides that Article 4.4.1(a) does not apply in respect of deferred tax items that exist in the Transition Year. This could imply that deferred tax expense related to purchase accounting is taken into account in computing Adjusted Covered Taxes in the Transition Year and subsequent years while purchasing accounting adjustments to asset basis related to pre-GloBE acquisitions are excluded from GloBE income or loss (pursuant to Chapters 3 and 6 in the Commentary). If so, distortive, often artificially low ETRs could result. Alternatively, the more specific guidance in the Commentary that "any deferred tax assets and liabilities associated with purchase accounting adjustments in the financial accounts must also be excluded from the computation of Adjusted Covered Taxes under Article 4.1" could be read to override the more general AG guidance on the Transition Rule which does not reference purchase accounting. Clarification as to how purchase accounting deferred tax expense is taken into account under Article 9.1.1. is needed.

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Intra-group asset transfers

The GloBE rules provide for special treatment of intra-group asset transfers that occur after 30 November 2021 and before the Transition Year. The safe harbor document released in December 2022 provides that the Transition Year referred to in Article 9.1.3 is the first fiscal year in which the tested jurisdiction no longer qualifies for or applies the Transitional CbCR Safe Harbor, unless the jurisdiction where the disposing entity is located comes within the scope of the GloBE rules or the disposal of the assets creates a taxable gain, to be further defined in future guidance.

The stated intent of Article 9.1.3 is to limit the ability of MNEs to use intra-group transactions during the pre-GloBE period to increase asset carrying values and thereby reduce GloBE income through elevated depreciation and amortization expense without the corresponding gain being included in GloBE income. Specifically, Article 9.1.3 provides that the acquiring CE's basis in the transferred assets will be based on the disposing CE's carrying value of the assets upon disposition and the acquiring CE's DTAs and DTLs for GloBE purpose will be determined on this basis. The AG provides additional clarity on how Article 9.1.3 is meant to be applied.

The AG deals with both intra-group transfers that the acquiring CE records for financial accounting purposes at cost and those that it records at fair value. When a transfer is recorded at cost, a DTA could be recognized in the financial accounts of the acquiring CE if the acquiring CE's local jurisdiction provides a higher tax basis than the historic cost at which the transfer was recorded. The AG provides that recognition of this DTA for GloBE purposes depends on whether the disposing CE paid tax on the transfer. To the extent that a gain was taxed at 15% (or above), the acquiring CE can recognize the DTA at 15%; lower levels of tax on the gain will lead to a proportionate reduction in the quantum of DTA that can be recognized. When no tax is imposed on the transfer, no DTA can be recognized for GloBE purposes. If DTAs that otherwise would be taken into account under Article 9.1.1 at the level of the disposing CE (such as NOLs) mitigate the tax paid on the gain (Other Tax Effects), a DTA may still be recognized by the acquiring CE.

The AG notes that the creation of a DTA by operation of this transition rule does not reduce the Adjusted Covered Taxes of a Constituent Entity.

In the alternative case where the acquiring CE records an intra-group transfer at fair value, the amount of tax paid by the disposing CE is similarly determinative of the effect of the transfer on the acquiring CE. The acquiring CE's GloBE carrying value of the asset is reduced to cost and, if tax was paid on the disposal gain, the acquiring CE recognizes a DTA based on the rate at which the gain was taxed.

KPMG observation

While the policy intent behind Article 9.1.3 is clear, it was widely regarded as overly punitive. Numerous comment letters called for the rule to be softened for taxable transactions. The AG is a welcome clarification for MNEs.

Notably, rather than taking an all-or-nothing approach based on whether the asset transfer was taxed at a rate of at least 15%, the AG takes a "proportional" approach based on the amount of tax paid, or DTA utilized, but capped at 15%.

The AG notes that an MNE has the burden of proving the amount of tax paid in respect of a transaction, the amount of any Other Tax Effects, and other related items. Thus, accessing the benefit of this clarification entails an additional compliance burden.

At the same time, the AG interprets a "transfer of assets" to which Article 9.1.3 applies very broadly as "any transfer of rights to an item of economic value" in which the acquiring CE creates or increases the carrying value of an asset in its financial accounts and the disposing CE recognizes the related amount of income

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before the Transition Year. Article 9.1.3, however, does not apply to a lease, license, or a total return swap when the transacting parties account for the income and expense items in the same fiscal years (i.e., where the lessor's or licensor's income is not front-loaded).

Equity Investment Inclusion Election and Qualified Flow-Through Tax Benefits

Under the GloBE rules, profit or loss in respect of an investment accounted for under the equity method of accounting is excluded from the computation of GloBE income or loss. As well, gains and losses from changes in the fair value of, or disposition of, an ownership interest (other than portfolio shareholdings) are excluded from the computation of GloBE income or loss. The foregoing exclusions are referred to in the GloBE rules as "Excluded Equity Gains or Losses." Additionally, current tax expense on income within the definition of Excluded Equity Gains or Losses is removed from the ETR numerator. However, the GloBE rules do not explicitly provide for the removal of any current tax benefit arising from losses included in Excluded Equity Gains or Losses (such losses, Excluded Equity Losses). This inconsistent treatment may artificially lower the ETR for a given jurisdiction because the Adjusted Covered Taxes taken into account in the ETR calculation will be lower on account of any tax-deductible loss included in the scope of Excluded Equity Losses while the loss itself will be removed from GloBE income (and the denominator of the ETR calculation).

The commercial arrangements used to access incentive tax credits in some jurisdictions may take the form of investment partnerships or other Tax Transparent Entities (i.e., entities that are fiscally transparent in both the jurisdiction of the entity and the owner). These investments are often accounted for by the MNE pursuant to the equity method of accounting. When the investment vehicles are Tax Transparent Entities, the credits flow through to the owner and reduce its tax liability. The AG provides that the impact of such credits should generally be the same regardless of whether the owner derives the credit directly or through a Tax Transparent Entity or whether the results of the Tax Transparent Entity are consolidated with the results of the owner or instead accounted for under the equity method of accounting. In each case, a Qualified Refundable Tax Credit (QRTC) is treated as income of the holder and other credits are generally treated as reductions to Adjusted Covered Taxes of the owner.

At the time of the March 2022 Commentary, questions remained as to the proper treatment in the ETR calculation of tax benefits arising from Excluded Equity Losses, as well the treatment of incentive credits arising from an investment partnership when the investment would be uneconomic absent the credits.

The AG does not allow an MNE Group to simply increase Adjusted Covered Taxes by the amount of any reduction in taxes caused by an Excluded Equity Loss, but instead provides an election to remedy the distortive effect of the loss. More specifically, MNEs can make a 5-year election (an Equity Investment Inclusion Election) on a jurisdictional basis that requires any CE located in the jurisdiction that owns an ownership interest (other than a Qualified Ownership Interest (defined below)) to include in its GloBE income or loss certain items arising with respect to the ownership interest that would otherwise be treated as Excluded Equity Gains or Losses when such items are included in the taxable income of the owner. Such items include fair value gains and losses, impairments, and disposition gains or losses with respect to an ownership interest that are included in the taxable income of the owner (without any participation exemption or similar directly allocable deduction) as well as profit or loss related to the Tax Transparent Entity that is accounted for under the equity method. When this election is made, all associated current and deferred tax expense and benefits are included in Adjusted Covered Taxes. As a result, the impacts of an Excluded Equity Loss will no longer distort the ETR of the owner because the Excluded Equity Loss will be included as a reduction to GloBE income. No adjustment in respect of an Excluded Equity Loss or related tax benefit is allowed absent an MNE making an Equity Investment Inclusion Election.

As mentioned above, the adjustments provided for in the preceding paragraph do not apply in respect of a Qualified Ownership Interest; a different set of rules apply to a Qualified Ownership Interest when the Equity Investment Inclusion Election has been made. A "Qualified Ownership Interest" is an ownership interest in a Tax Transparent Entity that is not consolidated in the financial statements of the MNE Group when a

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portion of the owner's investment is expected to be returned in the form of credits other than QRTCs because the sum of the amount of distributions, tax-effected losses, and QRTCs resulting from the Tax Transparent Entity is expected to be less than the owner's investment. The owner of a Qualified Ownership Interest is allowed a positive adjustment for any credits or tax-effected losses derived through the interest to the extent such credits or tax benefits otherwise reduced the owner's tax expense. Importantly, these positive adjustments are only allowed to the extent such credits or tax benefits do not exceed the owner's investment, reduced by the amount of any distributions, tax-effected losses, or other tax credits derived through the Qualified Ownership Interest as well as proceeds from the sale of all or part of the interest. Once the holder's investment has been returned, additional credits and tax-effected losses will reduce the owner's Adjusted Covered Taxes. As well, distributions and sales proceeds received after the owner has recovered its investment may result in a reduction to the owner's Adjusted Covered Taxes to the extent the owner has previously made a positive adjustment to its Adjusted Covered Taxes in respect of credits or tax-effected losses. The AG notes that further guidance will be developed to clarify which credits would be covered by this provision and thus "protected" from GloBE tax, to clarify how the election would work in connection with different GAAPs, and to provide anti-avoidance rules for artificial structuring in connection with the election.

KPMG observation

Absent the Equity Investment Inclusion Election, common tax equity structures in the US, including affordable housing credit structures, could result in a GloBE ETR for the U.S. below 15% because the nonrefundable credits and losses that flow through these investments would reduce the owner's Adjusted Covered Taxes even though the investor's return would be negative absent these credits.

The AG provides relief for these types of structures to the extent of the return *of* investment. However, the portion attributable to the return *on* investment will continue to be a drag on the GloBE ETR. The extent to which the drag is material enough to bring a GloBE ETR below 15% will depend on a number of factors, including the size of the profit element of the structure and the GloBE ETR in the jurisdiction on other income.

To access the relief, an investor will have to include in its ETR calculation items that are typically excluded as Excluded Equity Gains or Losses, including items arising outside of the particular credit-generating investment that the investor may be primarily concerned about. An investor will need to evaluate other items that will be included in its GloBE income or loss pursuant to the Equity Investment Inclusion Election and determine whether any of these items may have an unfavorable impact on its ETR calculation. Finally, the investor will need to carefully track the distributions, credits, tax losses, and sales proceeds it receives from a tax equity investment to determine whether its investment has been fully recovered and if such amounts could cause a negative impact on its Adjusted Covered Taxes.

KPMG observation

Notably, the AG is silent on transferable credits. These types of credits may not be structured using tax equity arrangements and thus may not be covered by the Equity Investment Inclusion Election discussed above. In the absence of guidance on transferable credits, the treatment of many credits in the Inflation Reduction Act is uncertain, at least outside of the direct pay period.
At a recent public consultation, the OECD Secretariat noted that there is a "strong argument" for treating transferable credits as QRTCs under the GloBE rules. We expect future guidance in this area.

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Excess Negative Tax Expense administrative procedure

Article 4.1.5 of the GloBE rules may result in top-up tax being owed in a year a GloBE loss arises. The intention of the provision was to forestall potential GloBE tax planning, whereby an MNE might seek to book permanent benefits (e.g., depreciation in excess of cost) in a GloBE loss year without paying top-up tax. However, many commentators considered it less than ideal that a global minimum tax on profits would apply in loss years. The AG now adapts the application of Article 4.1.5. Rather than imposing top-up tax in a GloBE loss year, an Excess Negative Tax Expense amount can be calculated and carried forward. This carryforward would then reduce the ETR in a subsequent profitable year, potentially leading to the payment of additional top-up tax at that time. For an MNE with a GloBE loss that otherwise would be subject to Article 4.1.5, the Excess Negative Tax Expense administrative procedure is elective.

KPMG observation

An MNE electing to apply this mechanism will not incur top-up tax in a GloBE loss year and may be able to avoid top-up tax in a future year if the reduction in Adjusted Covered Taxes is not sufficient to reduce the MNE's ETR below 15%. This procedure will help address some of the practical challenges MNEs may have faced if they were required to pay tax in jurisdictions where they have suffered losses.

If there is GloBE income in a jurisdiction, the GloBE ETR may be negative as a result of deferred tax expense arising in respect of a permanent item, such as creating a DTA for depreciation in excess of cost. The same mechanism is used to avoid the possibility of an MNE having a top-up tax percentage higher than 15% (which would result from subtracting the negative ETR from 15%), by modifying the application of Article 5.2.1. In a year when the GloBE ETR is determined to be negative in a jurisdiction, an Excess Negative Tax amount is calculated and carried forward. This would reduce the ETR in a later year. When an MNE is subject to Article 5.2.1, the Excess Negative Tax Expense administrative procedure is mandatory. The mandatory application of the procedure in this scenario limits the potential benefit an MNE could achieve by using the SBIE to reduce (potentially to zero) the excess profit to which the top-up tax percentage would be applied.

Deemed consolidation test

In addition to groups that have prepared consolidated financial statements (CFS) with revenue exceeding €750 million in two of the four prior fiscal years, the GloBE rules apply to collections of entities (related through ownership or control) that would have exceeded the revenue threshold if they had been required to prepare a set of CFS. A question of particular concern to the investment fund industry is whether investment funds, their investees, and investment managers would be treated as an MNE group for GloBE purposes given the nature of their control relationships. The AG clarifies that the application of the deemed consolidation test respects exemptions that apply under the relevant accounting standard, such as the consolidation exemptions for investment funds contained in accounting standards, such as IFRS 10.

However, the AG makes clear that the deemed consolidation test may apply to other unconsolidated investment arrangements such as those used by high-net-worth families to invest in various businesses. This brings more clarity to the intended targets of the GloBE rules.

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Brief summaries of other AG guidance

AG of general applicability

Rebasing monetary thresholds (Articles 1.1, 1.2, etc.)

The GloBE rules include various monetary thresholds expressed in euros. For example, the revenue threshold for scope, the de minimis exclusion (jurisdictions where over a three-year period an MNE's aggregate revenue is less than €10 million and GloBE income or loss less than €1 million) and the material competitive distortion measurement between certain accounting standards are all denominated in euros.

The AG provides for an annual rebasing of thresholds denominated in non-euro currencies using the average foreign exchange rate for December of the preceding calendar year. For thresholds that reference a previous fiscal year, the local currency threshold is determined using the average foreign exchange rate for December of the preceding calendar year. For example, for 2024 thresholds the local currency threshold would always be set using the average foreign exchange rate for December 2023.

Consolidated deferred tax amounts (Article 4.1.1)

The AG clarifies that deferred tax expense with respect to a CE should be included in the Deferred Tax Adjustment Amount, even when the expenses are recorded in the MNE Group's CFS, rather than the financial accounts of individual CEs.

KPMG observation

The AG states this is a requirement, not an option. MNEs that record deferred tax expense in their Group CFS will, when relevant, need to trace the deferred tax expense to the CEs to which it relates.

Sovereign Wealth Funds (SWFs) and the definition of UPE (Article 1.4.1, 10.1)

The AG confirms that an SWF is not to be treated as the UPE of an MNE Group when it meets the definition of a Governmental Entity. This avoids an SWF being treated as a UPE in scenarios where the SWF cannot avail itself of the IFRS 10 investment entity consolidation exclusion (or other similar exclusions).

Clarifying the definition of Excluded Entities (Article 1.5.2)

Excluded Entities are not subject to the GloBE rules. Article 1.5.1 provides a list of Excluded Entities, which is extended through Article 1.5.2 to include an entity that is 95% owned by an Excluded Entity (as defined by Article 1.5.1) and that holds assets (or invests funds) for the benefit of the Excluded Entity. Another exception applies to an entity which carries out functions ancillary to those of the Excluded Entity, such as certain special purpose vehicles held by an Investment Fund that is a UPE (and hence meets the Excluded Entity definition). The AG confirms that the 95% held entity can be excluded when it both holds assets or invests funds and performs the ancillary functions, in response to comments asking whether it was required to do one or the other, but not both.

Meaning of "ancillary" for Non-Profit Organizations (NPOs) (Article 1.5.2)

Though the income of an Excluded Entity will not be subject to GloBE top-up tax, it can still be a member of an MNE Group (including a UPE). The revenue of an Excluded Entity is counted for determining whether an MNE Group meets the revenue threshold. This means the revenue of large NPOs, such as universities or international aid organizations, could cause the MNE Group as a whole to be in scope, such that

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subsidiaries that undertake limited commercial activities (e.g., operating a conference center) would be exposed to top-up tax.

The IF has agreed that the GloBE rules were not intended to impose top-up tax in this scenario. The AG provides a bright-line test, such that if the revenue of all group entities (excluding entities that are Excluded Entities) owned by a NPO is the lower of €750 million or 25% of the revenue of the MNE Group (including all Excluded Entities), said group entities will be regarded as conducting 'ancillary' activities and hence will be Excluded Entities for purposes of the GloBE rules under Article 1.5.2(a)(ii).

Intra-group transactions accounted at cost (Article 6.3.1)

The design of the GloBE rules assumed that intra-group transfers of assets would be accounted for at fair market value. This would generally be the case for accounts prepared under IFRS but under other accounting standards (such as U.S. GAAP) intra-group transfers can be booked at historic cost. To address the distortions that might otherwise occur, the AG provides that, pursuant to the arm's length principle found in Article 3.2.3, an arm's length price must be used to determine the GloBE income/loss of the disposing CE when a transaction occurs cross-border. The AG notes that further guidance will be developed for the acquiring CE to avoid any possible double taxation attributable to the MNE Group's accounting for intra-group transactions.

KPMG observation

For U.S. groups, this clarification will increase the GloBE income (or reduce the loss) of the disposing CE when the fair market value of the assets exceeds their historic cost. Because the current revisions do not provide symmetry by allowing the acquiring CE to recognize the asset at this higher price there is a risk of double taxation, which the AG recognizes and indicates will be addressed in future guidance.

Excluded Equity Gains or Loss and hedges of investments in foreign operations (Article 3.2.1)

The GloBE rules provide that gains or losses on the disposal of (non-portfolio) equity interests will be excluded from GloBE income or loss. The exclusion also extends to fair value gains or losses on such equity interests and profit or loss from ownership interests that are subject to an equity method accounting. To the extent that equity interests are denominated in a currency other than the functional currency of the holding entity, the MNE may choose to hedge the foreign exchange risk associated with the investment. The AG provides a five-year election to treat gains or losses on the hedging instruments themselves as also being an Excluded Equity Gain or Loss.

KPMG observation

This election enables an MNE to achieve symmetry in the treatment of foreign exchange gains and losses that hedge currency risk in investments, where the gain or loss in the investment is excluded from GloBE income. As some jurisdictions exclude such gains and losses from corporate tax, there was concern that the lack of symmetry in the treatment of foreign exchange gains or losses could cause jurisdictions in which large foreign exchange gains are recognized to be low taxed for GloBE purposes.

Excluded Dividends – Asymmetric treatment of preference shares (Article 3.2.1)

The AG clarifies the definition of Excluded Dividends when a dividend or distribution is received in respect of a compound financial instrument (i.e., one that has both equity and liability components) or when a financial instrument issued by one CE and held by another is not classified consistently by the issuer and

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holder. This is intended to deal with accounting mismatches that the IF was concerned could artificially increase the ETR of an MNE Group.

For example, if Co A holds preference shares issued by related party Co B that Co A treats as equity and Co B treats as debt for financial accounting purposes, Co B would account for the dividend payments in respect of the preference shares as interest expense, reducing GloBE income but increasing the ETR when the payments are not deductible for local tax purposes.

The AG counteracts this by clarifying that Co A must be treated as receiving interest income for GloBE purposes to conform the recipient' treatment to the accounting treatment of issuer Co B. To the extent that other forms of financing instruments are bifurcated by Co B into debt and equity elements there would be a proportional decrease in the amount treated as Excluded Dividends by Co A.

Treatment of debt releases (Article 3.2.1)

The AG excludes income related to a debt release from GloBE income under certain conditions, including that the income must be exempt from domestic tax and the debt release must occur in the context of a corporate rescue.

Accrued Pension Expenses (Article 3.2.1)

The GloBE rules allow deductions for pension liabilities to the extent of the contributions to a pension fund during the fiscal year in order to better align GloBE income with the local tax base and neutralize differences between accounting standards that reflect some of the effects of pension accounting in Other Comprehensive Income (OCI) rather that the income statement.

The AG makes several clarifications. First, if a company actually pays pensions to its retired employees, rather than paying them to a fund, Article 3.2.1(i) has no application; direct pension payments are taken into account in computing GloBE income in the period they accrue in the financial accounts. Second, GloBE income adjustments are made if pension fund earnings exceed the pension expense for the current year and the excess is distributed to a CE rather than retained by the pension fund.

Covered Taxes on deemed distributions (Article 4.3.2(e))

Article 4.3.2(e) allocates taxes paid in respect of distributions to the distributing CE. The AG clarifies that this rule also applies to taxes imposed on deemed distributions.

Application of GloBE rules to Insurance Companies

Application of Article 7.6 to Insurance Investment Entities (Article 7.6)

The GloBE rules require the ETR and top-up tax calculations to be done on a separate entity basis for Investment Entities and Insurance Investment Entities. Article 7.5 provides an election to treat an Investment Entity or an Insurance Investment Entity as a Tax Transparent Entity, while Article 7.6 provides an elective Taxable Distribution Method for accounting for income earned through Investment Entities. An Article 7.5 election can be made when the owner is subject to a mark-to-market tax regime in respect of fair value changes in the investment entity. An Article 7.6 election can be made to the extent the Investment Entity makes distributions to the owner within a 4-year period.

The Model Rules provided that Article 7.5 could cover Insurance Investment Entities as well as Investment entities, but Article 7.6 did not. The AG extends the application of Article 7.6 to Insurance Investment Entities.

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Exclusion of Insurance Investment Entities from the definition of Intermediate Parent Entity and Partially-Owned Parent Entity (Article 3.1.3)

The AG clarifies that the definition of Intermediate Parent Entity and Partially-Owned Parent Entity, which excludes Investment Entities, also excludes Insurance Investment Entities.

Restricted Tier One Capital (Article 3.2.10)

The GloBE rules treat Additional Tier One Capital, which banks are required to issue pursuant to prudential regulatory requirements, in the same way as debt instruments. While these instruments may be treated as equity for accounting purposes, the GloBE rules treat payments on them as deductible in the same manner as interest. The AG now provides for the same treatment for Restricted Tier One Capital issued by insurance companies.

Liabilities related to Excluded Dividends and Excluded Equity Gain or Loss from securities held on behalf of policyholders (Article 3.2.1)

The GloBE rules provide income exclusions for Excluded Dividends and Excluded Equity Gain or Loss. For simplicity, the GloBE rules do not disallow expenses related to this excluded income. However, the AG introduces an exception for equity investments held on behalf of policyholders, e.g., unit-linked insurance. Under these arrangements, the insurance company must pay all investment earnings to policyholders, less an investment management fee. To avoid allowing an insurance company to exclude income but still get a deduction for the liability recognized to policyholders (giving rise to a GloBE loss), this movement in insurance reserves will now be treated as non-deductible.

Simplification for Short-term Portfolio Shareholdings (Article 3.2.1)

The GloBE rules provide a GloBE income exclusion for dividend income from equity interests, other than short-term portfolio holdings. This places a burden on in-scope MNEs to prove equity holding periods. As a simplification, the AG provides for a 5-year election to include all dividends from portfolio holdings of a CE in GloBE income. It is expected that this election will largely be used by insurance companies, but it is open to all groups.

Application of Article 7.5 to mutual insurance companies (Article 7.5)

Mutual insurance companies are owned exclusively by their policyholders. A mutual insurance company has no profit from an accounting perspective because all investment returns are accounted for as liabilities to policyholders. However, if a mutual insurance company controls an Investment Entity (a separate CE for GloBE purposes), investment income may be realized at the Investment Entity level with the offsetting liability to policyholders realized at the mutual insurance company level.

An election under Article 7.5 would attribute the Investment Entity income to the mutual insurance company (and allow for income-liability offset), but the election required that the mutual insurance company be taxed under a mark-to-market tax regime. As this is typically not the case, the AG relaxes the mark-to-market requirement for mutual insurance companies.

Looking ahead

As noted above, the release on 2 February 2023 was only a first tranche of AG. More will follow, though it is not clear which items are being prioritized or when the next tranche of AG will arrive.

Highlighted below are some of the areas for which the AG document notes further guidance is at least under consideration:

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- Treatment of the acquirer in respect of intra-group asset transfers
- Extension of the rules for Loss-making Parent Entities to branches
- Treatment of the creditor in respect of debt releases
- Fuller guidance on the Equity Investment Inclusion Election
- Further guidance on the operation of the QDMTT, including:
    - Design features such as the threshold for material competitive distortions, PE income allocation, jurisdictional blending, treatment of investment entities and transparent entities
    - Allocation of QDMTT liability among entities in a jurisdiction
    - Identification of benefits that would invalidate “qualified” status
    - Information collection/exchange arrangements
    - QDMTT safe harbor

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