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Euro Tax Flash from KPMG's EU Tax Centre

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ECOFIN Council fails to reach agreement on a revised proposal for an EU Minimum Tax Directive

BEPS 2.0 – Pillar Two – GloBE Model Rules – Commentary – GloBE Implementation Framework – Minimum Tax – EU implementation – EU Directive – Compromise Text – Unanimity

On March 15, 2022, the Economic and Financial Affairs Council (ECOFIN) failed to reach political agreement on the revised proposal for an EU Minimum Tax Directive (compromise text).

The compromise text, which continues to be closely aligned with the Model Rules, builds on the European Commission's December 2021 proposal, but provides for several amendments that refer to the ongoing work of the OECD and rectifies areas of discrepancy between the Model Rules and the initial text. In order to address concerns previously raised by Member States, the compromise text refers to:

- a transposition deadline of December 31, 2023, i.e. Income Inclusion Rule (IIR) to apply for fiscal years beginning on or after December 31, 2023 – previously January 1, 2023, and
- an option for Member States to defer the application of the IIR and the Undertaxed Payment Rule (UTPR), where no more than ten Ultimate Parent Entities (UPEs) of in-scope MNE groups are located in those Member States. The March 12 compromise text mentioned a possible deferral up to December 31, 2025. However, during the ECOFIN meeting a deferral of up to five years was mentioned.

However, four Member States (Estonia, Malta, Poland and Sweden) restated their concerns in respect of the short implementation timeline, the adoption of the rules independent of Pillar One and details of the deferral option for qualifying Member States. The four Member States were therefore not able to express support for the general approach at this stage. Accordingly, further discussions are required and the French Presidency is aiming to reach agreement during the ECOFIN meeting scheduled for April 5, 2022.

Background

The European Commission published the initial minimum tax proposal on December 22, 2021. The OECD had published its Model Rules for the Global Anti-Base Erosion Rules (GloBE Rules) on December 20, 2021. For more information on the initial text of the EU Directive, please refer to Euro Tax Flash Issue 463. In addition, for further information on the discrepancies between the OECD Model Rules and the initial text, please refer to KPMG's response letter to the related public consultation.

The implementation of the proposed Directive is considered a key priority item for the French Presidency of the Council setting a goal of reaching unanimity agreement among Member States on the implementation of the rules by spring 2022. However, during a meeting of the ECOFIN Council on January 18, 2022, several Member States had highlighted concerns with the timeframe for implementation, with Sweden in particular citing domestic constitutional law-making requirements as a barrier to transposing the rules into domestic law in advance of the January 1, 2023 deadline, which was initially proposed. Three Member States (Estonia, Hungary and Poland) had also noted a concern with implementing Pillar Two of the OECD proposals while it was unclear if the Pillar One OECD proposals would be agreed internationally (for previous coverage, please refer to E-News issue 147).

The March 12 compromise text

Similar to the text of the Directive as initially proposed by the European Commission, the provisions of the compromise text generally mirror the OECD Model Rules released on December 20, 2021. The main exceptions from this general alignment with the OECD's work have been included in order to bring the rules in line with EU law and include a broadening of the scope of the rules to cover purely domestic large-scale groups and a wider application of the IIR for parent entities in the European Union.

According to the note to the Council from the Permanent Representatives Committee accompanying the compromise text (note to the Council), the compromise text provides for several amendments in order to bring the wording of the text of the proposed Directive significantly closer to that of the Model Rules, to clarify the rules contained in the proposed Directive and to meet the converging demands of Member States in respect of certain articles of the proposed Directive.

In this context, the following sections set out a non-exhaustive overview of the key amendments that the compromise text provides for in comparison to the initial version of the Directive as well as additional compromise solutions suggested by the French presidency in order to reach political agreement.

Key amendments of general nature

The compromise text provides for the following key amendments to the preamble and provisions of general nature:

a) Deferred implementation timeline and election for a delayed application of the IIR and the UTPR

According to the note to the Council, several Member States repeated their concerns regarding the short timeline for transposing the rules into domestic law within the December 31, 2022 deadline as proposed by the initial version of the Directive. According to those Member States, the implementation date would raise important practical and domestic institutional difficulties. As a solution, the compromise text provides for a postponement of the transposition deadline to December 31, 2023.

As a result:

- the IIR is generally to be applied for fiscal years beginning on or after December 31, 2023,
- the UTPR will be applied for fiscal years beginning on or after December 31, 2024.

Accordingly, the period for the transitional relief for the substance-based income exclusion and the transitional relief for MNE Groups in the initial phase of their international activity as well as large-scale domestic groups was amended to reflect the delayed implementation timeline.

According to the note to the Council, some Member States also requested that the application of the IIR should be optional under consideration of the UTPR as a backstop mechanism in those cases where IIR was not applied at the parent level. However, since the majority of Member States consider that such a permanent derogation would undermine a coordinated implementation of Pillar Two in the internal market and would be a source of complexity for businesses, the compromise text provides Member States with the option of a temporary derogation, i.e. a deferral of the application of the IIR and the UTPR up to December 31, 2025, only where no more than ten UPEs of in-scope MNE groups are located in those Member States. In this context, during the ECOFIN meeting a deferral of up to even five years was mentioned in order to reach a compromise solution.

The compromise text further clarifies that where a Member State makes use of the deferral election, all other Member States, which have not opted for the deferral, are required to apply the UTPR in accordance with Article 13 of the proposed Directive in order to ensure a minimum level of taxation in the EU. In that case, the UTPR percentage determined for a Member State that has opted for the deferral is deemed to be zero.

b) Reference to the OECD Commentary and the GloBE Implementation Framework added

Prior to the ECOFIN meeting, the OECD/G20 Inclusive Framework on BEPS (IF) published the Commentary to the Model Rules (March 14, 2022). The Commentary is intended to provide in-scope MNE groups and tax administrations with detailed and comprehensive technical guidance on the operation and intended outcomes and clarifies the meaning of certain terms. The Commentary is intended to promote a consistent and common interpretation of the GloBE Rules. In addition, the Commentary illustrates the application of the GloBE Rules by way of examples for Chapters 2-7 of the Model Rules.

In that context, the preamble of the EU compromise text includes a paragraph indicating that Member States should rely on the Commentary to the GloBE Model Rules as a source of illustration or interpretation in order to ensure consistency in application across Member States to the extent that they are consistent with the provisions of this Directive and with EU law. In addition, the compromise text includes specific clarifications that are provided in the Commentary and that are essential to the operation of the rules (e.g. with regard to whether the revenue of excluded entities is relevant for the determination of the revenue threshold test).

In addition, the OECD announced that, as a next step, it will turn to the development of the Implementation Framework, which is supposed to provide agreed administrative procedures, such as filing obligations and the development of safe-harbours to facilitate coordinated implementation and administration of the GloBE Rules. It is also expected that the Implementation Framework will include guidance to assist tax administrations in determining whether a minimum tax is considered as a qualified IIR, a qualified UTPR or a qualified Domestic Top-up Tax (QDTT). In this context, the IF launched a public consultation to collect input from stakeholders on the matters they consider need to be addressed as part of the Implementation Framework. For more information, please refer to a KPMG TaxNewsFlash.

Accordingly, the preamble of the compromise text also adds a recital to the initial text, indicating that Member States should rely on the GloBE Implementation Framework, including its safe harbours, and notes that this should be relevant for MNE groups as well as large-scale domestic groups. In addition, the preamble notes that Member States should use the GloBE Implementation Framework for guidance on the concept of covered taxes to ensure a uniform identification of the covered taxes of all Member States and third country jurisdictions. In this context, the preamble of the compromise text also recommends the development of a common methodology for allocating taxes imposed by third country jurisdictions that have not transposed the GloBE Rules or that have domestic rules in place, which are not considered to be a qualified IIR.

c) Removal of authorization to act through delegated acts

Where the initial version of the proposed Directive empowered the Commission to add, in an Annex to the Directive, a list of third country jurisdictions that have implemented a legal framework in their domestic law, which is considered by the EU as a qualified IIR, the reference to a delegated act has been removed in the compromise text. Instead, the compromise text empowers the Council to determine the third country jurisdictions applying legal frameworks considered as equivalent to a qualified IIR based on a Commission's proposal. Such assessment shall be carried out by means of an implementing act, which requires an unanimous vote in the Council.

d) Clarification on eligible distribution tax systems

The compromise tax also adds a recital in the preamble stating that the distribution tax systems taken into account by Pillar Two should be those in force on or before July 1, 2021, which is the date of the first IF statement on the two-pillar solution. The statement confirmed a special treatment of eligible distribution tax systems which is reflected in Article 7.3 of the Model Rules and Article 38 of the proposed Directive. The preamble further notes that this should not prevent changes to a jurisdiction’s distribution tax system that are in line with its existing design.

Key amendments to specific provisions

The compromise text also provides for the following key amendments to specific provisions compared to the initial text of the proposed Directive:

a) More details on the allocation of top-up tax collected under IIR in respect of low-taxed Constituent Entities located in the same jurisdiction

In line with the initial text, the compromise text requires the application of the IIR not only in cross-border situations, but also where a low-taxed Constituent Entity is located in the same jurisdiction as the taxable parent entity. It is understood that the broadening of the scope to domestic entities is aimed at ensuring compatibility with primary EU law (i.e. the EU fundamental freedoms). As a result, the IIR applies to all domestic low-taxed Constituent Entities, including the parent entity itself, where the latter is located in a low-taxed Member State.

The revised Article 8(3) of the compromise text defines the allocable share of top-up tax that is to be collected under IIR in those domestic situations as follows:

- An UPE that is located in a low-taxed Member State and that is liable to top-up tax is required to collect top-up tax (as computed under Article 26) in full (100 percent) for itself and in proportion to its allocable share for any other low-taxed Constituent Entities located in the UPE's jurisdiction.
- An intermediate parent entity (IPE) or partially-owned parent entity (POPE) that is located in a low-taxed Member State and that is liable to top-up tax needs to collect top-up tax (as computed under Article 26) of 100 percent for itself and in proportion to its allocable share for any other low-taxed Constituent Entities located in the IPE's or POPE's jurisdiction. This means, the top-up tax should not be limited to the UPE's allocable share of the top-up tax for the IPE or POPE and its other low-taxed Constituent Entities.

b) Option to introduce a QDTT adjusted

As was the case in the initial text, the compromise text provides each Member State with the option to apply a QDTT to low-taxed Constituent Entities located in its territory. This option would allow a Member State with low-taxed Constituent Entities in its territory to collect top-up tax with respect to those entities (Article 10). Where Member States elect to apply a QDTT, they are required to notify the Commission of this election within four months following the domestic acts introducing the rules on QDTT.

Additionally, the compromise text provides a safe harbour rule where the QDTT is computed in accordance with the parent entity's acceptable accounting standard or with International Financial Reporting Standards (IFRS). In that case, the parent entity is no longer required to compute the top-up tax for the respective low-taxed Constituent Entity under Article 26. The compromise text also requires an unpaid amount of QDTT to be added to the jurisdictional top-up tax computed under Article 26, where the amount of QDTT previously subtracted from the jurisdictional top-up tax has not been fully paid within the four following fiscal years (by contrast, the initial text provided for three years).

c) More details on the application of the UTPR and the carry-forward mechanisms for UTPR top-up taxes

Under the OECD Model Rules, the UTPR top-up tax can be carried forward for imposition in a later year in the same jurisdiction to the extent that top-up tax allocations cannot be imposed immediately (Article 2.4.2 Model Rules). Such carry-forward mechanism was not explicitly reflected in the initial text of the proposed Directive.

By contrast, Article 11 and 12 of the compromise text provide that imposing UTPR top-up tax may take the form of either a top-up tax due by those Constituent Entities or a denial of deduction against the taxable income of those Constituent Entities. Where the application of a denial of deduction against taxable income does not result in a sufficient amount of cash tax expense to impose UTPR top-up tax immediately, the compromise text allows the remaining amount of UTPR top-up tax to be carried forward to a later year in the same jurisdiction in line with the Model Rules.

d) Revision of the UTPR top-up tax collection and offset mechanism

In the initial version of the Directive (Article 13(3)), full relief from UTPR was provided only where the low-taxed Constituent Entity is wholly held by:

- a UPE that applies the IIR, or
- via an IPE that applies the IIR, by virtue of being located in an EU Member State or a third country jurisdiction that applies the IIR.

Partial relief was only provided where the top-up tax has been collected in a third country that applies a qualified IIR (Article 13(4)). As a result, where top-up tax had been collected by an EU-based IPE, full relief would not have been available under the proposed Directive, which would have resulted in top-up tax seemingly being collected twice i.e. once under the IIR and a second time under the UTPR (for more details, please refer to KPMG's response letter to the public consultation).

In the compromise text, the UTPR top-up tax collection and offset mechanism has been revised to:

- provide a full reduction in the UTPR top-up tax amount where the full amount of IIR allocable to the group (i.e. the UPE's ownership interest) has been collected by a parent entity (Article 13(3) was updated in alignment with Article 2.5.2 of the OECD Model Rules); and
- provide relief for IIR amounts collected by parent entities, irrespective of whether the parent entity is located in an EU or non-EU jurisdiction (Article 13(4) was updated to reflect Article 2.5.3 of the OECD Model Rules).

e) Clarification of top-up tax collection, reporting and transitional rules for large-scale domestic groups

The initial text of the proposed Directive appeared to be drafted with a focus on MNE groups, leaving it unclear whether a number of provisions should equally apply to large-scale domestic groups. This has now been clarified in the compromise text as follows:

- The QDTT (Article 10) can equally be applied for a large-scale domestic group.
- The scope of the reporting provisions (Article 42) also applies to large-scale domestic groups.
- The transitional provisions that allow MNE groups to take into account the deferred tax assets and deferred tax liabilities reflected in the financial accounts of Constituent Entities in a transition year (Article 45) also apply to large-scale domestic groups.

f) Reference to safe harbour rules added

The OECD Model Rules provide an option for MNE Group to elect to be exempt from the requirement to compute the jurisdictional effective tax rate (ETR) and top-up tax and allow tax administrations to deem the top-up tax for the Constituent Entities located in the safe harbour jurisdiction to be zero. This option is valid for a fiscal year when the MNE group can demonstrate that those Constituent Entities meet the requirements of the GloBE safe harbour (Article 8.2 of the Model Rules). The initial text of the proposed Directive did not contain a safe harbour election or any other reference to the OECD's work on safe harbours.

The text has been updated to allow for a safe harbour election. Based on the election of the filing Constituent Entity, the jurisdictional top-up tax will be zero where the effective level of taxation of the Constituent Entities located in that jurisdiction fulfils the conditions of an international set of rules, which all Member States have consented to (Article 30a). Based on the preamble of the compromise text, this appears to refer to the GloBE Implementation Framework that is currently being developed at OECD level and is expected to be released during the course of 2022.

g) Revision of penalties

The initial text of the proposed Directive required Member States to apply administrative pecuniary penalties amounting to 5 percent of turnover for cases where Constituent Entities do not comply with the requirement to file a top-up tax information return (Article 42).

The compromise text no longer requires a fixed threshold. Instead, the compromise text simply notes that Member States shall lay down the rules on penalties applicable for infringement of national provisions in an effective, proportionate and dissuasive manner in order to ensure that Constituent Entities in their territory comply with their obligations to file and pay their share of top-up tax or to have an additional cash tax expense.

Link between Pillar One and Pillar Two

According to the note to the Council, the French presidency also proposed a compromise solution with respect to concerns raised by Member States regarding the adoption of the GloBE Rules independent of Pillar One. However, instead of providing a legal safeguard in the compromise text that would make the entry into force of Pillar Two contingent on the entry into force of the multilateral convention implementing Pillar One as requested by three Member States, the French's presidency's solution provides for a Council statement that is supposed to accompany the agreement on the compromise text. The draft Council statement confirms the Council's full commitment to the successful accomplishment of the OECD's Pillar One solution, within the agreed timeline, and including the MLC whose signing ceremony is to be organized by mid-2022 and which is envisaged to enter into force in the course of 2023.

In addition, the draft Council statement notes that the Council will reassess the situation on Pillar One, in the context of the ongoing work at IF level to ensure a swift solution on the tax challenges arising from the digitalisation of the economy.

Next steps

Due to the objections of four Member States (Estonia, Malta, Poland and Sweden) further discussions are required in respect of the issues raised by these Member States, with a view to reaching agreement on the general approach during the ECOFIN meeting scheduled for April 5, 2022.

EU Tax Centre comment

As highlighted in the note to the Council, the French Presidency has held eight working group meetings on this file since the beginning of January 2022 in order to revise the initial proposal for an EU Minimum Tax Directive. The aim was to take into account key issues raised by Member States in order to find a compromise.

In this context, we welcome the correction of the majority of the issues that were highlighted in KPMG's response letter to the public consultation on the EU Minimum Tax Directive proposal. However, we regret that, for example, several aspects of the mechanics of the QDTT remain unclear despite the amendments that the compromise text provides for. For example, the compromise text does not clarify whether the amount of qualified domestic top-up tax due should be determined for and imposed on each Constituent Entity in that jurisdiction separately, including the UPE, where it is located in a QDTT jurisdiction, or whether the QDTT should be collected by a parent entity in that jurisdiction (mirroring the mechanics of an IIR).

An important question now is whether the OECD and other IF members will agree with the EU that the proposed timeline is in keeping with commitments made in the October 2021 statement. A possibility is that the OECD will not object to the approach and leave it up to the other IF members to decide on their own approach with regard to the 2023 and 2024 deadlines, respectively. In that respect, it is important that it is still unclear whether Pillar Two will be adopted in the United States. For Pillar Two it is important that the rules become effective in the participating jurisdictions at the same time to avoid additional complexities for in-scope groups. For that reason, the proposed EU timeline - and a possible delay in implementation in the United States - could result in other countries follow that path as well.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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