Navigating BEPS 2.0

Key considerations for Asset Managers, Sovereign Wealth Funds and Pillar Two

What do asset managers and sovereign wealth funds need to do to get ready for Pillar Two?

The OECD's Pillar Two global anti-base erosion ("GloBE") rules, which were agreed to by the OECD/G20 Inclusive Framework on BEPS ("IF") in December 2021, are beginning to be enacted into law now. In December 2022, South Korea adopted legislation applying the GloBE rules from 2024, while the European Union ("EU") agreed a Directive committing EU member states to implement to a similar timeline. In the past couple of months we have seen similar announcements from other jurisdictions, including Hong Kong (SAR), China, Japan, Singapore, and the UK.

A common misconception is that asset managers and sovereign wealth funds ("SWFs") are automatically "excluded" from Pillar Two. Like everything Pillar Two related, the rules are not quite that simple. This article sets out the steps that firms in the asset management space need to take to determine whether or not they are in-scope of Pillar Two following the Administrative Guidance for the Pillar Two GloBE Rules[1] released by the OECD on February 2, 2023.

For asset managers or SWFs that are potentially in-scope of Pillar Two, or where the application of the scope rules outlined below are uncertain, now is the time to think about next steps. The OECD is still seeking to issue clarificatory guidance and this could help to address areas where the Pillar Two rules have unintended consequences. As discussed below, seeking an external review of how the rules apply could help groups identify these scenarios, and quantify their potential Pillar Two exposure, but also design and develop the processes they will likely need to introduce to manage their compliance and reporting obligations. For a three-year transition period, an external review may also help to protect against penalties.

Scope rules for asset managers

The first question that asset managers should ask is, are either the investment funds we manage, or management group itself, in-scope of Pillar Two?

Investment funds

Pillar Two rules are limited to multinational enterprise ("MNE") groups with annual revenue of 750 million Euros (EUR) or more in the consolidated financial statements of the ultimate parent entity ("UPE") in two of the four prior fiscal years. Both United States Generally Accepted Accounting Principles ("US GAAP") and International Financial Reporting Standards ("IFRS®") have specific consolidation requirements for investment companies or entities. As a result, most investment funds do not consolidate their portfolio companies, but account for these investments at fair value through the profit or loss account. The effect of this is that many investment funds will fall out of scope of Pillar Two because their annual revenue will not exceed EUR 750 million,[2] or they will be excluded by specific exclusions contained within the Model Rules themselves.

[1] https://www.oecd.org/tax/beps/agreed-administrative-guidance-for-the-pillar-two-globe-rules.pdf
[2] If gains or losses on the fund's investments are reported at fair value, then these gains or losses would be reflected in the profit or loss account but would not be included in the revenue line. Hence, it is unlikely that the fund's consolidated financial statements would report revenue in excess of EUR 750 million.

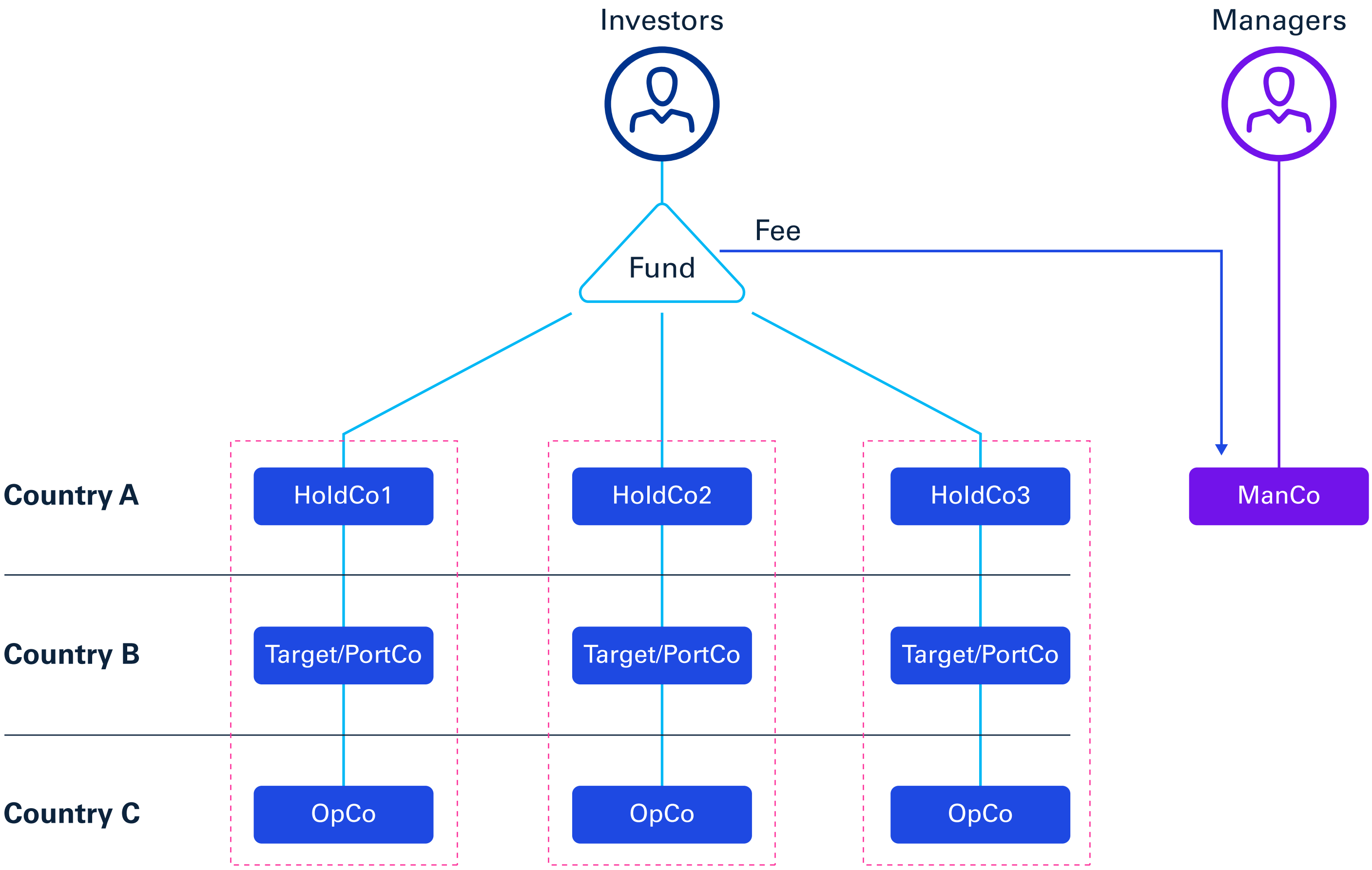
Prior to the release of the *Administrative Guidance*, there had been concern that the deemed consolidation requirement in the Pillar Two rules could have been interpreted to override the consolidation rules that apply to investment companies or entities under US GAAP, IFRS Standards and other authorized financial accounting standards, and that as a result, funds would be required to prepare consolidated financial statements including their portfolio companies, leading many more funds to meet the EUR 750 million scope threshold and therefore bring more portfolio companies within scope of the rules. The *Administrative Guidance* clarifies that this is not the case, stating that the deemed consolidation requirement is not intended to modify the rules in circumstance where an authorized financial accounting standard does not require consolidation.

Example

The guidance includes a series of examples that are designed to provide further clarity on the application of the deemed consolidation requirements. One of these examples is designed to show that in a simplified fund structure, the deemed consolidation rules would not require a fund to consolidate its portfolio companies, where this was not required under an accounting standard, such as IFRS 10.

The example below sets out a simplified fund structure (see Figure 1). Investors invest in Fund, which owns all the shares of HoldCo1, HoldCo2 and HoldCo3 (all resident in Country A). The HoldCo each owns all the shares in separate Target/PortCo (all resident in Country B), which owns all the shares in three separate OpCos (resident in Country C). Separately, Managers own all the shares in ManCo (also resident in Country A), which receives a fee from Fund for its management services. The treatment of ManCo is discussed further below.

Figure 1: Fund holding structure



The Fund is assumed to be an investment company for the purposes ASC 946, or an investment entity for IFRS 10. It prepares Consolidated Financial Statements, but does not consolidate HoldCo1, HoldCo2 or HoldCo3 or their subsidiaries. This would be respected for the purpose of the Pillar Two rules and thus Pillar 2 would have no direct impact on the Fund, because the Fund itself is specifically excluded from Pillar 2. The *Administrative Guidance* also state that this should be the outcome where the Fund does not prepare Consolidated Financial Statements but would be treated as an investment company under ASC 946 or an investment entity under IFRS 10. This does require the investment fund to ask and answer the counterfactual question about whether they would be required to apply ASC 946, IFRS 10 or other equivalent accounting standards.

The question of whether the HoldCos and their subsidiaries are in-scope of Pillar Two is a separate question, that will depend on whether they have consolidated revenue in excess of EUR 750 million.

Management group

The question of whether the management group (ManCo in the example above) is in-scope of Pillar Two is also a separate question. ManCo would need to apply the Pillar Two scope rules, first to determine whether it constituted an MNE Group (i.e., in simple terms whether it has subsidiaries and/or permanent establishments in other countries) and second whether its consolidated revenue exceed the EUR 750 million threshold. The question for management groups, therefore, is do they meet these requirements.

KPMG professional's observation

- The Pillar Two scope rules rely heavily on the accounting standards used to prepare a group's Consolidated Financial Statements. Where investment funds consolidate their investments either because they do not meet the definition of an investment company for the purposes of ASC 946 or an investment entity for the purposes of IFRS 10, or because they apply an accounting standard that does not include equivalent provisions, they may want to revisit their current application of the relevant accounting standards.

  Where an investment fund does not prepare Consolidated Financial Statements, it should seek advice on whether or not it would hypothetically be required to prepare accounts under ASC 946 or IFRS 10.

- When considering the Pillar Two implications, asset managers will need to think about the implications from an investment fund, portfolio company and management company perspective. Even in situations where Pillar Two will not result in additional tax being paid, it is important for firms to establish who is responsible for any compliance and reporting obligations. If situations arise where independent portfolio companies are treated as a being part of the same MNE Group, issues around data access will become particularly important.

Scope rules for sovereign wealth funds

As for investment funds, the first question SWFs should ask is, am I in-scope of Pillar Two?

Like investment funds, SWFs must turn to accounting standards when assessing the application of the Pillar Two rules. Where a SWF is not required to prepare Consolidated Financial Statements, for example because it is treated as an investment entity for the purpose of IFRS 10, then for the purpose of the Pillar Two rules the SWF will not be treated as a UPE of a Group. The effect of this, is that the Pillar Two rules would potentially only apply at the level of the portfolio companies.

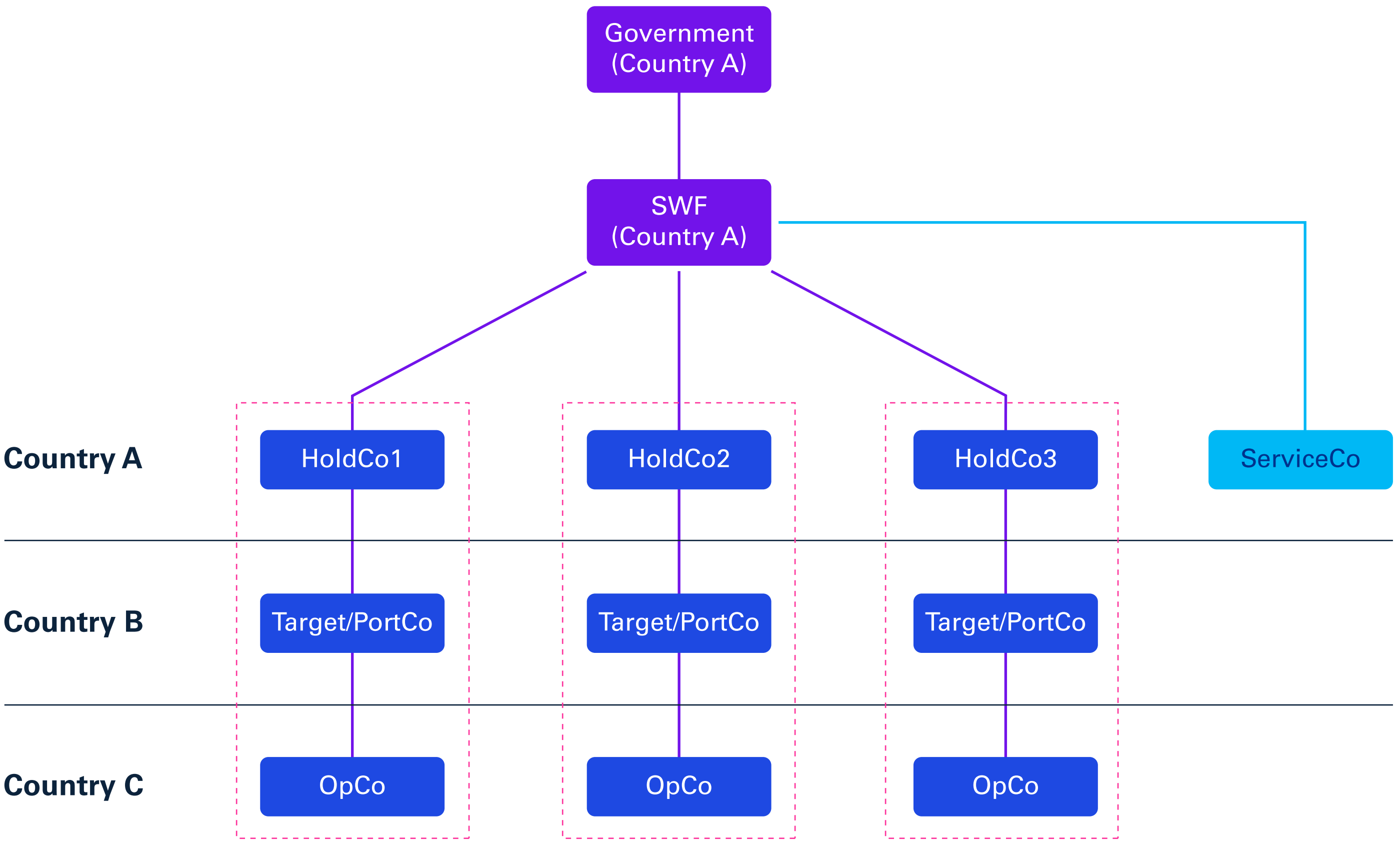
In other circumstances, a SWF may be required to prepare Consolidated Financial Statements because the accounting standards to which they are subject do not have exceptions to consolidation requirements for investment companies or entities, or because the SWF does not meet the conditions required to access such exceptions (e.g., because the SWF does not have an exit strategy for its investment.) The IF was concerned that this could bring into the scope of the Pillar Two rules portfolio companies that meet the EUR 750 million revenue threshold solely because their revenue is consolidated with the revenue of other portfolio companies owned by a SWF.

To address this issue the *Administrative Guidance* states that SWFs that meet the definition of a Governmental Entity (provided in Article 10.1 of the Pillar Two Model Rules) will not be considered to be a UPE or part of a MNE Group for the purpose of the Pillar Two rules. This clarification should ensure that for most SWFs the Pillar Two rules could only apply at the level of the portfolio company, provided that the SWF can demonstrate it falls within the definition of a Governmental Entity.

Example

The example below (see Figure 2 below) illustrates the practical effect this guidance will have for SWFs. Where an SWF meets the definition of a Governmental Entity, then it will be ignored for the purpose of the Pillar Two rules. Instead, the rules will apply at the level of the holding companies or ServiceCo, which will be required to test whether the revenue in their Consolidated Financial Statements exceed EUR 750 million.[3]

Figure 2: Sovereign wealth fund holding structure



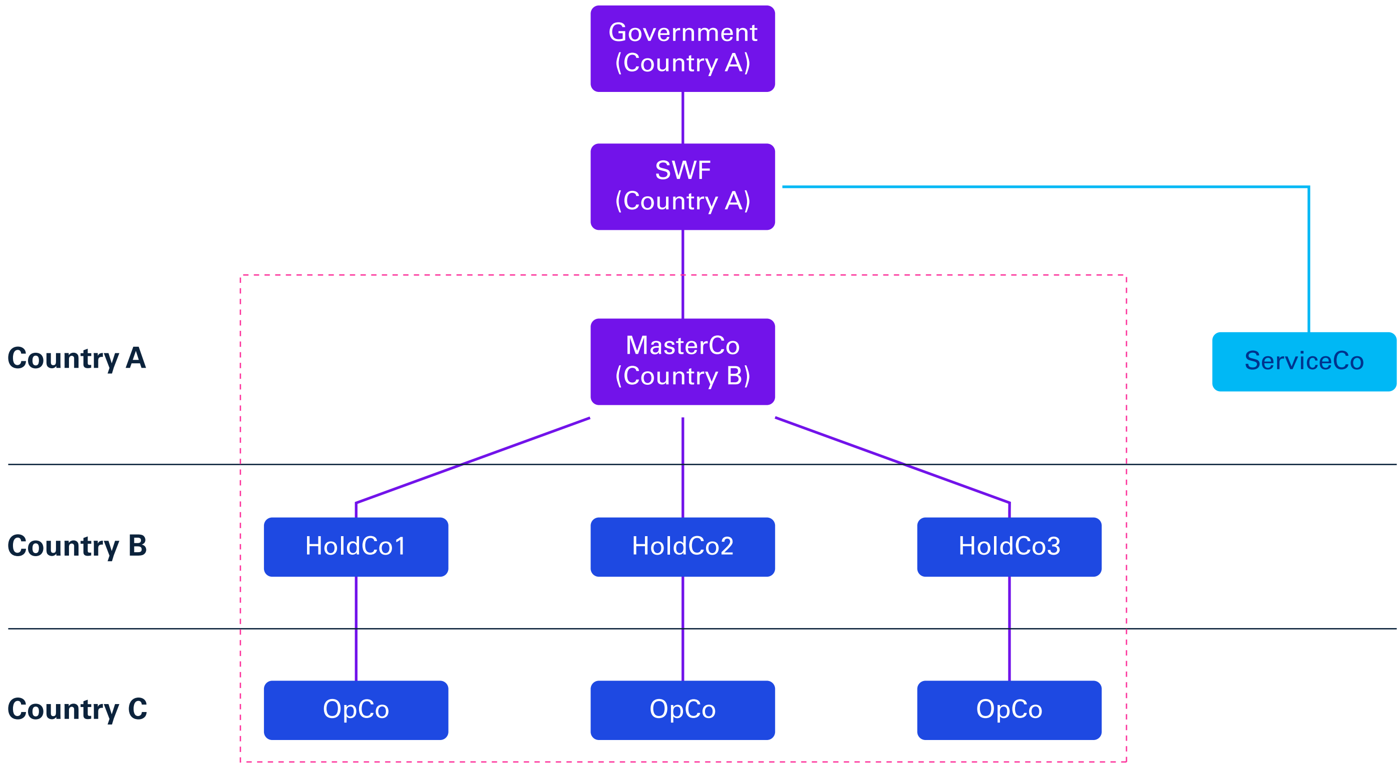
Sovereign wealth funds with master holding companies

The *Administrative Guidance* may have addressed concerns faced by some SWFs, but those with master holding company structures may continue to face challenges. This is because the *Administrative Guidance* clarifies that a SWF cannot be a UPE, but leaves open the possibility that a holding company, including a master holding company, could be a UPE for the purpose of the Pillar Two rules. Why is this a concern? The Pillar Two rules set the parameters of an MNE Group based on the entities owned by a UPE; and if the rules apply at the level of a master holding company (as opposed to the holding company above individual operating companies) there is an increased risk that the group as a whole exceeds the EUR 750 million consolidated revenue threshold.

Consider the example below (see Figure 3 below), where the Country A SWF has established a master holding company (MasterCo) a tax resident in Country B, as a treaty platform to hold and manage the rest of its portfolio. The effect of this is that the MasterCo would be a UPE for the purpose of the Pillar 2 rules, and hence would be required to prepare Consolidated Financial Statements to determine whether its revenue exceeded EUR 750 million. If so, the MasterCo and its subsidiaries would be in-scope of Pillar 2. As demonstrated in Figure 2, the EUR 750 million revenue threshold would apply individually to HoldCos and their subsidiaries, where no MasterCo exists.

[3] The Pillar Two rules would typically not apply to ServiceCo, for example, because if it does not have any subsidiaries or permanent establishments in foreign jurisdictions it will not be considered an MNE Group and hence will be outside the scope of the Pillar Two rules.

Figure 3: Sovereign wealth fund with master holding company structure



Those familiar with the Pillar Two rules might ask — whether MasterCo could be an "Excluded Entity" for purposes of the Pillar Two rules? The Pillar Two rules state that Excluded Entities are not subject to Pillar Two, and the definition includes "an Investment Fund that is an UPE". Thus, MasterCo may fall within the scope of this definition and thus be excluded from Pillar Two as an Excluded Entity.

However, even if MasterCo is itself an Excluded Entity, it could still be a UPE. The intention of Excluded Entity provision is to remove tax neutral investment vehicles from the scope of Pillar Two, but to allow the relevant accounting standards to continue to set the boundaries of an MNE Group for the purpose of the other scope criteria and EUR 750 million revenue threshold. This brings us back to the question of whether MasterCo is required to apply ASC 946, IFRS 10 or another equivalent accounting standard, which would switch-off any potential deemed consolidation requirement.

KPMG professional's observation

- The Pillar Two scope rules rely heavily on the accounting standards used to prepare a group's Consolidated Financial Statements. SWFs should review the accounting standards they apply today, and where they could apply a different accounting standard consider the implications this would have for Pillar Two.

- The clarifications provided in the OECD's *Administrative Guidance* are helpful, but SWFs should review the impact these clarifications have for them and consider whether there are additional areas where the OECD should consider issuing additional clarificatory guidance.

- From a practical standpoint, SWFs with master holding company structures (or other structures that result in Pillar Two applying to an aggregation of portfolio companies that have historically operated independently) raises the question of who within the MNE Group will be responsible for performing the Pillar Two calculations and completing the relevant returns. The design of Pillar Two means that the person responsible needs access to financial information for every constituent entity in the MNE Group and thus, it is unlikely that responsibility can be delegated to the portfolio companies, without significant support from the SWF.

What next?

For asset managers and SWFs, the key Pillar Two question is — am I in-scope? Unfortunately, there is no easy answer to this question and further analysis will be required.

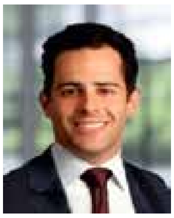
There will likely be some groups where the answer may not be readily apparent, either because their revenue is close to the EUR 750 million threshold or because accounting standards or the Pillar Two rules creates judgement calls. For these groups there may be benefit in an external review. The Pillar Two rules are new and have been drafted at speed to potentially apply in over 140 jurisdictions. The OECD is seeking to clarify the application of the rules in certain fact patterns, as the *Administrative Guidance* demonstrates, and may be willing to issue further clarificatory guidance to address facts where the application of the rules is currently unclear. The iterative issuing of guidance means that groups will also need to continue to monitor potential further clarification to the GloBE rules that the OECD may issue.

The other benefit of an external review is that the OECD has stated that for a Transition Period (which for most groups will cover the periods 2024, 2025 and 2026) penalties should not be applied where a group has taken "reasonable measures" to ensure the correct application of the Pillar Two rules. What constitutes "reasonable measures" will be interpreted in light of each jurisdictions' existing rules and practices, but an external review may be a good starting point for satisfying the requirement.

KPMG professionals are assisting asset managers and SWFs that are in-scope of the Pillar Two rules with their preparations given the impending January 1, 2024, start date for some groups. Though, in-scope groups should be thinking about the Pillar Two implications of current transactions, as well as transactions entered into after November 30, 2021. At this stage, a focus area for many groups is the Transitional CbCR Safe Harbor, which runs for a Transition Period through to 2026.

The Pillar Two rules include a series of provisions that have been developed to ensure the rules deliver reasonable outcomes for the asset management and SWF industries. However, it appears that these rules require careful review to help ensure that they do truly deliver reasonable outcomes.

Contacts



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