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EU Pillar Two FAQs

European Commission – FAQ – Pillar Two – Minimum Tax – Model Rules – Commentary – Administrative Guidance – Safe Harbours

On December 22, 2023, the European Commission published non-binding "frequently asked questions" (FAQs) on the interpretation of the EU Minimum Tax Directive (2022/2523) that constitute the outcome of informal discussions between the EU Member States and the Commission Services.

The FAQs reinforce the reference to the OECD's work under Recital 24 of the Preamble to the EU Minimum Tax Directive and confirm that the Commentary to the OECD Model Rules could be used as a source of illustration or interpretation to ensure consistency in application of the rules across Member States, to the extent that those sources are consistent with the Directive and EU law. Reference to the OECD Model Rules, the Commentary, and the Administrative Guidance is made throughout the FAQs in the context of the interpretation of certain Directive terms and provisions. Since the third tranche of Administrative Guidance was released just a couple of days before the publications of the FAQ, i.e., on December 18, 2023, the FAQs do not refer to those recent supplementary provisions and clarifications.

The FAQs also include clarifications in relation to provisions in the EU Minimum Tax Directive that are specific to EU implementation and not derived from the OECD Model Rules (e.g. the deferral option as per Article 50 of the EU Directive and the scope of the Safe Harbour placeholder in Article 32 of the Directive). In addition, the FAQs provide for certain clarifications that relate to specific EU considerations (e.g. Acceptable Accounting Standards in EU Member States, treatment of tax schemes approved under an EC State aid assessment, the treatment of domestic windfall taxes on surplus profits).

Background

On December 15, 2022, the Council of the EU unanimously adopted the EU Minimum Tax Directive. The final text of the Directive was published in the Official Journal on December 22, 2022 and entered into force on the following day.

The agreed Directive requires Member States to transpose the rules into domestic law by December 31, 2023, and to start applying the Income Inclusion Rule (IIR) for fiscal years beginning on or after this date. The Undertaxed Profits Rule (UTPR) will be applied for fiscal years beginning on or after December 31, 2024. In addition, the agreed text provides the option for Member States to implement a Domestic Minimum Top-up Tax (DMTT) and to defer the application of the IIR and the UTPR up to December 31, 2029, where a maximum number of 12 Ultimate Parent Entities (UPEs) are based in that EU Member State.

Following the entry into force of the EU Minimum Tax Directive, the Inclusive Framework published a number of additional rules and clarifications that supplement the OECD GloBE Model Rules:

- Release of GloBE Implementation Framework including the agreed design of the transitional Country-by-Country (CbyC) Reporting Safe Harbour.
- Release of February Administrative Guidance including guidance on the QDMTT design, election to exclude income attributable to debt releases under certain conditions, election to include portfolio shareholding income, application of an Excess Negative Tax Expense carry forward, special methodology to allocate taxes arising under blended CFC tax regimes.
- Release of the standardized template of the GloBE Information Return (GIR) with accompanying explanatory notes and certain administrative relief provisions.
- Release of July Administrative Guidance including the agreed design of the permanent QDMTT Safe Harbour and the transitional UTPR Safe Harbour as well as guidance on the QDMTT design, treatment of transferrable tax credits, general currency conversion rules and the Substance-based Income Exclusion.
- Agreement on the Multilateral Convention for the Subject to Tax Rule (STTR).
- Release of December Administrative Guidance including further guidance on the Transitional CbyC Reporting Safe Harbour.

On November 9, 2023, EU Member States approved a Council statement as well as an accompanying statement from the European Commission reconfirming their political support for Pillar One and Pillar Two of the OECD's BEPS project. In addition, the statements confirm the compatibility of the Safe Harbour rules and the Administrative Guidance that were agreed by the OECD/G20 Inclusive Framework with the EU Minimum Tax Directive.

EU Pillar Two FAQs

According to the Commission release, the FAQs represent the outcome of informal reflections of the Commission Services and therefore cannot be interpreted as binding on the EC and the EU Member States.

Application and interpretation in accordance OECD Model Rules, Commentary and Administrative Guidance

The FAQs refer to Recital 24 of the Preamble to the EU Minimum Tax Directive, which notes that the Commentary to the OECD Model Rules could be used as a source of illustration or interpretation in order to ensure consistency in application across Member States to the extent that those sources are consistent with the Directive and EU Law.

Consequently, simple reference to the OECD Model Rules, the Commentary as well as the Administrative Guidance is made throughout the FAQs as to the interpretation of certain Directive terms (e.g., ‘value of the entity’ and ‘almost exclusively’ in the context of Excluded Entities, ‘deemed consolidation test’, ‘transfer of assets’). The EC also notes that EU Member States may specify more concretely the meaning of the terms 'widely held entity' and 'holds predominantly immovable property' in the context of Real Estate Investment Vehicle, in accordance with national legislation.

In addition, the FAQs confirm that the EU Minimum Tax Directive should be applied and interpreted in accordance with certain elements of the rules that were settled through Administrative Guidance released after the adoption of the EU Minimum Tax Directive rules. This includes for example:

- exclusion of Insurance Investment Entities from the definition of the Intermediate Parent Entity (IPE) and Partially-Owned Parent Entity (POPE);
- election to exclude foreign exchange gains (or losses) as an Excluded Equity Gain or Loss;
- treatment of pension expenses that are accrued for direct pension payments (i.e. not contributed to a fund);
- election to include portfolio shareholding income.

Further notable clarifications that are provided by the FAQs under consideration of the OECD Model Rules, the Commentary and Administrative Guidance include those related to:

- *Definition of the term 'Entity'[1]:* a legal person is considered as an 'Entity' even if it does not prepare financial accounts.
- *Definition of the term 'Permanent Establishment'*: taxation on a net basis[2] requires the deductibility of expenses, i.e. source-based taxation on a gross basis (e.g. withholding taxes) is excluded.
- *Definition of the term 'POPE':* the qualification as a POPE requires persons or entities outside of the group to be entitled to more than 20 percent of the profits of an entity, irrespective of whether those persons or entities have a lower share in the capital of that entity (in addition to certain additional requirements of the POPE definition).
- *Definition of the term 'Ownership Interest'[3]*: the treatment of financial instruments under the financial accounting standard used in the preparation of the Consolidated Financial Statement is decisive for the purpose of the term 'Ownership Interest', e.g. preference shares that are accounted for as debt in the financial accounts should not be considered 'Ownership Interests'.
- *Definition of the term 'Refundable Tax Credit'[4]:* tax preferences that allow for an additional deduction from the tax base are not tax credits in the context of Refundable or Non-Refundable Tax Credits.
- *Treatment of tax credit carry-forwards:* Deferred Tax Assets (DTAs) upon transition that are attributable to tax credit carry-forwards can be taken into account in computing Adjusted Covered Taxes in the Transition Year and subsequent Fiscal Years.

[1] According to Article 3 para. 1 of the EU Directive, 'entity' means any legal arrangement that prepares separate financial accounts or any legal person.

[2] According to Article 3 para. 13 of the EU Minimum Tax Directive, 'permanent establishment' means […] b) if there is no applicable tax treaty, a place of business or a deemed place of business located in a jurisdiction which taxes the income attributable to such place of business on a net basis in a manner similar to which it taxes its own tax residents; […].

[3] According to Article 3 para. 23 of the EU Minimum Tax Directive, 'ownership interest' means any equity interest that carries rights to the profits, capital or reserves of an entity or of a permanent establishment.

[4] According to Article 3 para. 38 of the EU Minimum Tax Directive, a 'refundable tax credit' is to be paid as a cash payment or a cash equivalent to a constituent entity within four years from the date when the constituent entity is entitled to receive the refundable tax credit under the laws of the jurisdiction granting the credit.

- *Rebasing non-Euro denominated thresholds:* Member States may implement the EU Minimum Tax Directive using non-EU denominated thresholds provided that thresholds are rebased annually and in accordance with the OECD Administrative Guidance.
- *Determination of the allocable share*[5] *in the Top-up Tax:* where the UPE does not prepare Consolidated Financial Statements, the deemed Consolidated Financial Statements are relevant, which may be based on an Authorised Financial Accounting Standard as adjusted to prevent any material competitive distortion.
- *QDMTT accounting standard:* for QDMTT purposes, the financial net income or loss can be computed based on an accounting standard different from the one used in the preparation of the Consolidated Financial Statement, under certain conditions[6].
- *Allocation of QDMTT and UTPR charges:* the method of allocation of QDMTT and UTPR is left to the discretion of the Member States. At the same time, implementing an allocation approach that is in line with the allocation approach already included in the EU Minimum Tax Directive should in any event be acceptable.
- *Allocation of withholding taxes:* Covered Taxes that are withheld in respect of interest payments would generally be allocated to the interest recipient. Covered Taxes that are withheld in respect of distributions (e.g. dividends) should be allocated to the distributing Constituent Entity.
- *Classification of financial instruments:* financial instruments shall be classified as debt or equity by both the issuer and the holder and accounted for accordingly in the computation of the GloBE Income. In case of discrepancy, the classification adopted by the issuer should be applied by the issuer and the holder.
- *Stock-based compensation election:* the election applies to stock-based compensation for both employees and non-employees. However, if the local tax base applies different rules for employees and non-employees, the election will apply differently, in conformity with the local tax rules.
- *Arm's length principle:* GloBE Income adjustments should be made if the amount is not at arm's length, even if the same amount is reflected in the financial statements of both related parties.
- *Exclusion of Covered Taxes imposed on excluded income:* Covered Taxes that are imposed on income that is partially excluded, would be excluded only to the extent of the excluded income portion.
- *Exclusion of uncertain tax positions:* uncertain tax positions generally result when a Constituent Entity takes a filing position that is not more likely than not to be sustained upon examination. In such cases, a reserve must be established based on financial accounting standards. When the reserve is released, expenses are reversed and a corresponding amount of income is reflected in the financial accounts. The

[5] According to Article 9 para. 2 of the EU Minimum Tax Directive, a parent entity's allocable share in the top-up tax with respect to a low-taxed constituent entity shall be the proportion of the parent entity's ownership interest in the qualifying income of the low-taxed constituent entity. That proportion shall be equal to the qualifying income of the low-taxed constituent entity for the fiscal year, reduced by the amount of such income attributable to ownership interests held by other owners, divided by the qualifying income of the low-taxed constituent entity for the fiscal year. The amount of qualifying income attributable to ownership interests in a low-taxed constituent entity held by other owners shall be the amount that would have been treated as attributable to such owners under the principles of the acceptable financial accounting standard used in the UPE's Consolidated Financial Statements if the low-taxed constituent entity's net income were equal to its qualifying income, subject to conditions.

[6] According to Article 11 para. 1 and Article 15 para. 5 of the EU Minimum Tax Directive, a QDMTT may be computed based on an accounting standard different from the one used in the preparation of the Consolidated Financial Statements of the UPE in case it is an acceptable financial accounting standard or an authorised financial accounting standard permitted by the authorised accounting body and adjusted to prevent any material competitive distortions. Please, note, that the OECD's QDMTT Safe Harbour guidance (July 2023) requires a QDMTT to be computed based on the UPE's financial accounting standard except where it is not reasonably practicable to use such account (in accordance with Article 3.1.2 and 3.1.3 of the OECD Model Rules). Alternatively, the guidance provides the option for jurisdictions to require for the QDMTT computations to be based on a Local Financial Accounting Standard. In this case, it is required that all of the local entities in the group prepare accounts using a local accounting standard and that each of the local entities needs to have a Fiscal Year that aligns with the Fiscal Year of the Consolidated Financial Statements of the UPE. Where this is not the case, the QDMTT provisions would need to require the application of the UPE accounting standard (i.e. fall back clause).

movement in these amounts may not be included in Adjusted Covered Taxes unless and until the amount is actually paid.

- *Treatment of UPE that is a Flow-through Entity*[7]*:* the GloBE Income of the UPE cannot be reduced in proportion to the income taxed in the hands of the owners if the latter are not subject to tax at or above the minimum rate of 15 percent.
- *Revocation of elections:* it is left to the discretion of the Member States to adopt a procedure for the revocation of elections. For example, this could be done by clarifying that if a filing Constituent Entity does not tick the box for an annual election in the GIR, that is considered a revocation of the election for that fiscal year, which is deemed to have been made by the end of the preceding Fiscal Year.
- *Shorter local filing deadlines:* Member States may set in their national legislation a shorter deadline for filing of the GIR (less than 15 months/18 months in the transitional period). However, the FAQs highlight that this could lead to timing issues for MNE Groups, especially when filing is centralized and subject to exchange of information by the group in another jurisdiction.

EU-specific clarifications

The FAQs provide for certain clarifications that relate to special provisions in the EU Minimum Tax Directive (not included in the OECD Model Rules) or EU-specific direct tax considerations.

Applicable Safe Harbours

Under Article 32 of the EU Minimum Tax Directive, the top-up tax due by a group in a jurisdiction shall be deemed to be zero for a fiscal year if the effective level of taxation of the constituent entities located in that jurisdiction fulfils the conditions of an international set of rules and conditions which all Member States have consented to.

The FAQs clarify that all Member States (including Cyprus that is not a member of the OECD/G20 Inclusive Framework) are considered to have agreed to such qualifying international agreement on Safe Harbours. It is further specified that such agreement includes the CbyC reporting Safe Harbour (December 2022), QDMTT Safe Harbour and the UTPR Safe Harbour (July 2023). It can therefore be inferred that, in the EC's view, Member States are required — as per the provisions of Article 32 of the Directive, to ensure that these Safe Harbours are available to filing Constituent Entities in their jurisdictions.

In addition, the FAQs note that the Safe Harbours can be implemented also with reference to large-scale domestic groups. In this respect the EC emphasizes that Article 32 refers to 'a group' in general, and no distinction is made between an MNE Group or large-scale domestic group.

Acceptable EU accounting standards

The FAQs confirm that accounting standards of EU Member States are considered acceptable financial accounting standards where they comply with the International Financial Reporting Standards (IFRS or IFRS as adopted by the Union pursuant to Regulation (EC) No 1606/2002) and where they transpose the provisions of EU Directive 2013/34/EU.

EU State aid approved schemes

The FAQs note that tax schemes that have been approved under EC State aid assessments are not subject to a more favorable treatment under the EU Minimum Tax Directive. In this context, the FAQs clarify that corporate income

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[7] According to Article 38 of the EU Minimum Tax Directive, the qualifying income of a flow-through entity that is a UPE shall be reduced, for the fiscal year, by the amount of qualifying income that is attributable to the holder of an ownership interest subject to certain conditions.

taxes that are retained by an entity (i.e., taxes which are not payable but should be invested by the entity as per the conditions under EU State aid approved schemes) would not qualify as a qualified refundable tax credit.

Windfall taxes on surplus profits

The FAQs clarify that domestic windfall taxes on surplus profits could qualify as Covered Taxes under Article 20 of the EU Minimum Tax Directive.

Transition rules for large-scale domestic groups

The FAQs note that the large-scale domestic groups are not excluded from the scope of the GloBE Rules but shall benefit from the initial phase exclusion for the first five years starting from the first day of the fiscal year in which they fall within the scope of the Directive for the first time. In that case, the large-scale domestic group would need to inform the tax administration of their Member State about the start of its in-scope status.

Election for a delayed application of the IIR and UTPR

The FAQs also provide clarifications regarding the option as per Article 50 of the EU Minimum Tax Directive, which allows EU countries to defer the application of the IIR and UTPR up to December 31, 2029, where a maximum number of 12 UPEs are based in that EU Member State. As per the EC notice published on December 12, 2023, Estonia, Latvia Lithuania, Malta, and Slovakia have notified the EC of their intention to elect for a delayed application of the IIR and UTPR.

The FAQs clarify that countries have the right to introduce a DMTT during the deferral period. For UTPR purposes, the Member State that has made the deferral election should not qualify as a UTPR jurisdiction (i.e., the UTPR percentage for that Member State should be considered zero). According to the FAQs, these Member States would nevertheless need to legislate for Pillar Two (including the notification and information exchange requirements as set out in Article 50(2)) of the EU Minimum Tax Directive.

Next steps

It is expected that the Inclusive Framework will release further agreed Administrative Guidance in the first half of 2024 on the application of deferred tax liability recapture rules and the allocation of deferred taxes relating to cross-border taxes such as CFC Tax Regimes.

It is further understood that the IF is working on a procedure to assess whether the domestic implementation of the GloBE rules meets the agreed criteria (e.g. whether a DMTT is qualified or whether a QDMTT meets the stricter standards for the Safe Harbor, whether the IIR mechanism is qualified, etc.). It is understood that this will be conducted through a peer review process at the level of the OECD Inclusive Framework. This process is currently under development, meaning that there will be a period of uncertainty as to whether a Member States's implementation is acceptable by the international forum. This step is important to ensure that jurisdictions that introduce the GloBE rules are able to apply the appropriate offset mechanisms so that top-up tax is not collected multiple times with respect to a low-taxed entity. It is yet to be clarified whether – in the interest of timely certainty, jurisdictions will be subject to an initial high-level assessment, to be confirmed following a fully-fledged peer review process.

In this context, the FAQs note that the European Commission does not intend to issue a separate list of jurisdictions with “qualified” IIR, UTPR and DMTT. Instead, the FAQs make reference to the ongoing work of the OECD Inclusive Framework. The FAQs further note that the EC is generally not planning to develop a list of Covered Taxes for purposes of the EU Minimum Tax Directive and that the establishment of such a list would need to be decided at the level of the OECD Inclusive Framework. Furthermore, the FAQs note that the consistency of deadlines for amended top-up tax information returns among jurisdictions would be a desirable outcome and further work may be dedicated to this issue.

ETC Comment

Whilst the FAQs may not be interpreted as binding on the EC and the Member States, the reinforced message from the EC that the EU Minimum Tax Directive is to be applied and interpreted by Member States in accordance with the OECD Commentary and Administrative Guidance (even when issued after the adoption of the Directive) is welcomed. It is nevertheless important for in-scope taxpayers to monitor how each Member State makes use of the options available to them (in terms of e.g., QDMTTs design, administration, specific definitions), as there are likely to be local specifics that must be considered when preparing for compliance (e.g., the use of local accounting standards, different filing deadlines, different qualifications of certain entities depending on domestic definitions).

Additional relevant links

- KPMG's Pillar Two implementation tracker
- Euro Tax Flash 500: Council adopts EU Minimum Tax Directive
- Euro Tax Flash 527: ECOFIN Council and European Commission endorse progress made by the Inclusive Framework in respect of Pillar One and Pillar Two
- KPMG's observations regarding the GloBE Implementation Framework, GloBE Information Return and Administrative Guidance releases

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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