OECD releases administrative guidance on the Pillar Two global minimum tax rules

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In brief

On 2 February 2023, the Organisation for Economic Co-operation and Development (OECD) released the administrative guidance (Guidance)[1] on the Pillar Two Global Anti-Base Erosion Rules (GloBE rules)[2] under Base Erosion and Profit Shifting (BEPS) 2.0. The Guidance was approved by the OECD/G20 Inclusive Framework on BEPS (IF) and is therefore not subject to public consultation.

The Guidance addresses a wide range of issues identified by IF members as being most in need of immediate clarification and simplification. The Guidance will be incorporated into a revised version of the GloBE commentary and examples that will be released later this year, replacing the original version issued in March 2022[3]. The IF will release further guidance on an ongoing basis to ensure that the GloBE rules continue to be implemented and applied in a coordinated manner.

Meanwhile, the International Accounting Standards Board (IASB) has proposed amendments to IAS 12 *Income Taxes* in response to stakeholders' concerns about the potential accounting implications of Pillar Two.

This News Flash highlights the key points in the Guidance and the amendments proposed by the IASB. For a detailed discussion, please refer to the *PwC Global Tax Policy Alert*[4].

In detail

The Guidance

Qualified domestic minimum top-up tax (QDMTT) (Article 10.1)

The QDMTT was not covered at length by the model GloBE rules released in December 2021. In general, it is defined to mean a minimum tax provided under the domestic law of a jurisdiction which, among others, is implemented and administered in a way that is consistent with the outcomes provided for under the GloBE rules and the commentary, provided that such jurisdiction does not provide any benefits that are related to such rules (i.e. functionally equivalent to the GloBE rules).

The Guidance provides two guiding principles in determining whether a minimum tax is functionally equivalent to the GloBE rules and therefore qualifies as a QDMTT:

(1) the minimum tax must be consistent with the design of the GloBE rules; and
(2) the minimum tax must provide for outcomes that are consistent with the GloBE rules.

The following clarifications with respect to a QDMTT are worthy of note:

- The domestic minimum tax rules of a jurisdiction are not required to mirror all the requirements of the GloBE rules to be considered consistent with the GloBE rules. In particular, they are not required to incorporate provisions that are redundant. For example, a jurisdiction is not required to include the rules applicable to GloBE reorganisations if it does not have tax-deferred reorganisation rules in its domestic tax law.

- Generally, QDMTT computations will require the same data points as the GloBE rules. However, the Guidance allows for some degree of customisation in the design of a QDMTT. Furthermore, variations in outcomes between the domestic minimum tax and the GloBE rules will not prevent that tax from being treated as a QDMTT if those variations systemically produce a greater incremental tax liability. For example, a QDMTT is not required to have a substance-based carve-out or de minimis income exception; however, if it does, it cannot be more expansive than that permitted under the GloBE rules.

- A QDMTT will apply first before controlled foreign company (CFC) allocations and application of the income inclusion rule or undertaxed payment / profits rule under the GloBE rules. In other words, the QDMTT is prioritised with the result that a jurisdiction with a QDMTT becomes the first in line to collect any top-up tax from constituent entities (CEs) located in its jurisdiction[5].

- The jurisdictional top-up tax that is subject to a QDMTT must be based on the whole amount of the jurisdictional top-up tax computed under the GloBE rules, irrespective of the ownership interests held in the CEs located in the QDMTT jurisdiction by any parent entity of the multinational entity (MNE) group. Such a requirement would mean that in some situations, the QDMTT imposed will be greater than the tax charge that would otherwise have been imposed under the GloBE rules (e.g. the parent entity imposing the income inclusion rule does not own 100% of the ownership interests in the low-taxed CEs). If this outcome is considered undesirable, a jurisdiction may choose to apply its QDMTT only to MNE groups where all of the CEs located in that jurisdiction are 100% owned by the ultimate parent entity (UPE) or a partially-owned parent entity for the entire fiscal year.

- The QDMTT can be computed based on an accounting standard that differs from the one used in the consolidated financial statements of the UPE, provided that such accounting standard is an ‘acceptable financial accounting standard’ or an ‘authorised financial accounting standard’ that is adjusted to prevent material competitive distortions.

- To reduce compliance burden, a QDMTT could be designed for all the liability for the tax to be imposed on a single CE of an MNE group that is subject to tax under the laws of the jurisdiction. Nonetheless, the Guidance remarks that jurisdictions should ensure that the legal liability for the tax is enforceable against at least one CE in that jurisdiction.

The IF will consider providing further guidance on the information collection and reporting requirements under a QDMTT. The IF will also work on a QDMTT safe harbour and a multilateral review process for assessing jurisdictions’ QDMTTs.

Guidance on scope (Article 1.1)

Rebasing monetary thresholds

Thresholds contained in the GloBE rules in Euros are to be rebased annually where they have been enacted in local law in another currency. The applicable rate is the average for the December prior to the relevant calendar year (i.e. in which each referenced fiscal year starts). Generally, the European Central Bank rate should be applied.

Our observations: The Guidance does not address foreign currency translation of amounts other than for the purposes of rebasing the relevant thresholds discussed above. Foreign currency translation for the purposes of undertaking effective tax rate (ETR) calculations under the GloBE rules will be dealt with in subsequent guidance.

Deemed consolidation test

The deemed consolidation test is applied where the relevant MNE group or entity does not prepare consolidated financial statements using an authorised financial accounting standard. The Guidance clarifies the application of this test and includes several illustrative examples involving privately held businesses and investment entities that are not required to and do not prepare financial statements.

The Guidance clarifies that the test does not seek to alter the outcomes of applying an authorised financial accounting standard. Specifically, it does not require an entity to consolidate the assets, liabilities, income, expenses, and cash flows of another entity on a line-by-line basis where the authorised financial accounting standard does not require such consolidation.

The Guidance also states that an entity excluded from the deemed consolidated financial statements, on the basis that it is not material or is held for sale, is still a member of the group.

Consolidated deferred tax amounts

The financial accounts of a CE, which are used to prepare the UPE's consolidated financial statements, are normally used to determine the total deferred tax adjustment amount for that CE. However, if the CE's individual financial accounts do not contain its deferred tax expense (whether due to an internal accounting practice of the MNE group or the accepted financial accounting standard used to prepare its accounts), the deferred tax expense with respect to the CE recorded in the MNE group's consolidated financial statements will be included instead.

Excluded entity

Entities that meet the definition of 'excluded entities' are excluded from the GloBE rules. Under Article 1.5.2(a), where an entity is at least 95% owned (either directly or indirectly) by an excluded entity or entities, that entity will also be considered an excluded entity if it: (1) operates exclusively or almost exclusively to hold assets or invest funds for the benefit of the excluded entity or entities; or (2) only carries out activities that are ancillary to those carried out by the excluded entity or entities (the 'activities test').

The Guidance clarifies that where all of the activities undertaken by the entity fall within the combined scope of conditions (1) and (2), the entity should also be considered as satisfying the activities test and regarded as an excluded entity. The Guidance also makes clear that the activity of borrowing funds and applying the funds for direct acquisitions of assets falls within the meaning of 'holding of assets or investment of funds' and is not considered 'ancillary' for the purpose of the activities test.

Income and taxes

Intra-group transactions accounted for at cost and arm's length pricing (Article 6.3.1)

Where intra-group transactions are accounted for at cost, the GloBE rules generally require MNE groups to apply the arm's length principle to cross-border intra-group transactions. The rationale for this rule is to protect the integrity of jurisdictional blending. The Guidance confirms that the same treatment applies under the QDMTT regime, and that the IF will undertake further work to address double taxation issues without increasing compliance burdens.

Our observations: The GloBE rules are premised on the assumption that intra-group transactions are accounted for at fair market value. Nevertheless, under some accounting standards, treatment at cost can occur between companies in the same group, irrespective of whether the legal transfer is at fair market value. Companies should therefore consider the treatment of intra-group transfers under the applicable accounting principles and evaluate that for purposes of the QDMTT and the GloBE rules.

Excluded equity gains or losses and hedges of investments (Article 3.2.1)

Article 3.2.1(c) of the GloBE rules provides that 'excluded equity gains or losses' are not included in the GloBE income or losses. Recognising that many MNE groups hedge foreign currency risks arising from their equity investments in foreign operations, the Guidance clarifies that the treatment of a net investment hedge should follow the treatment of the investment it is hedging. Therefore, a filing CE may make a five-year election to treat the foreign exchange gains or losses attributable to hedging instruments that give rise to 'excluded equity gains or losses' as also being 'excluded equity gains or losses' for the purposes of Article 3.2.1(c). The Guidance also contains several examples to illustrate how to allocate excluded equity gains or losses on hedging instruments.

Excluded dividends – asymmetric treatment of dividends and distributions (Article 3.2.1)

The Guidance addresses stakeholders' concerns that MNE groups may rely on the accounting treatment of financial instruments (i.e. classification as debt or equity) and the broad definition of 'excluded dividends' to artificially increase their ETR. It provides for certain modifications to the commentary to ensure consistent accounting treatment of equity portions of financial instruments.

Treatment of debt releases (Article 3.2.1)

The GloBE rules have not included any adjustment for income arising from debt releases for the purpose of computing the GloBE income or loss. Recognising that debt releases could significantly increase top-up tax liability in some cases, the Guidance provides a relief mechanism for income from debt releases. To minimise the scope for tax planning, the relief is limited

to prescribed corporate rescue scenarios.

Equity gain or loss inclusion election (Article 3.2.1(c))

The GloBE rules generally exclude certain equity gains and losses from GloBE income or loss that may be exempt from taxation under some domestic tax rules. However, the relevant article that provides for the adjustment to covered taxes does not explicitly refer to an excluded loss. When such items are within the scope of domestic taxation, an understated GloBE jurisdictional ETR may occur if the loss is excluded from the GloBE income without a corresponding adjustment to the adjusted covered taxes. This may produce a top-up tax liability in an otherwise high-tax jurisdiction.

The Guidance provides for an ‘equity investment inclusion election’, which allows an MNE group to take certain excluded equity gains or losses and the associated tax attributes into account for purposes of computing the GloBE income or loss and adjusted covered taxes. The election is a five-year election and cannot be revoked with respect to an ownership interest if a loss on that interest has previously been taken into account for GloBE purposes when the election was in effect.

Excess negative tax carry-forward guidance (Articles 4.1.5 and 5.2.1)

Article 4.1.5 of the GloBE rules provides for the imposition of top-up tax for a jurisdiction in a loss year when a permanent difference causes the domestic tax loss to be greater than the GloBE loss for the jurisdiction. The Guidance allows MNE groups to elect an administrative procedure to carry forward the ‘excess negative tax expense’ (i.e. the top-up tax that would have otherwise arisen under this provision). Upon election, the ‘excess negative tax expense’ will be carried forward and used to reduce the positive adjusted covered taxes in subsequent fiscal years in which there is GloBE income, until it is exhausted.

Similarly, Article 5.2.1 of the GloBE rules could impose top-up tax for a jurisdiction in excess of the minimum rate of 15% when adjusted covered taxes are negative in a fiscal year in which there is GloBE income (i.e. a negative ETR). The Guidance provides that in such cases, an MNE group must apply the above administrative procedure.

Insurance companies

A number of updates have been made to Chapter 7 of the GloBE rules in relation to insurance companies, primarily to reflect the fact that some elements of the rules as initially published did not appear to operate as intended for the industry as a whole or were difficult to apply in practice.

Intra-group asset transfers during the transition period

The GloBE transition period began on 30 November 2021 and will run until the commencement of the transition year (i.e. the first accounting period for which an MNE group falls within the scope of the GloBE rules). During this period, certain transactions and attributes are subject to special rules known as transition rules. The transition rules provide basis for taxpayers to use carried forward deferred tax assets (DTAs) and liabilities as part of their jurisdictional top-up tax calculations.

One of the main concerns of stakeholders was in respect of the position outlined for intra-group transfers of assets (other than inventory) that take place in the transition period. Article 9.1.3 of the GloBE rules provides that the acquiring entity must use the disposing entity’s carrying value at the time of the transfer for the purposes of GloBE computations. This is despite the fact that the acquiring entity may have taken a cost or fair value basis in the asset for local tax purposes and regardless of whether the transfer was taxable. The objective of this rule is to prevent a step-up in value of the asset for the acquirer where the asset has been transferred tax-free or subject to low tax prior to the GloBE rules, and the rule was worded such that it applies to all commercial asset transfers.

The Guidance aims to clarify the application of Article 9.1.3 at the level of the acquiring entity. Generally, the Guidance provides that for transactions booked at cost, the acquiring entity may take into account a DTA to the extent the disposing entity paid tax in respect of the transaction. Where no tax is paid as the disposing entity has tax losses to offset against the intercompany gain on the asset transfer, the acquiring entity would still be allowed a DTA up to the amount of the DTA that would have been recognised by the disposing entity under Article 9.1.1 of the GloBE rules in the absence of such offsetting. The DTA allowed under the aforesaid rules would be based on the lower of the 15% minimum rate and the domestic tax rate applicable to the disposing entity in respect of the intercompany gain.

For transactions booked at fair value, the acquiring entity may, instead of calculating the DTA as described above, use the booked value (i.e. fair value) if it would have been entitled to a DTA for the difference between fair value and historic carrying value multiplied by the minimum rate of 15%.

The Guidance further indicates that to achieve the intended objective, 'transfer of assets' should be interpreted broadly to include not only asset sales, but also any transaction that has a similar effect to a transfer, such as leases and licenses which are accounted for in the same or similar manner as sales of assets; prepayments of royalties/rents where the licensor/lessor records the prepayments as income and the licensee/lessee capitalises and amortises the assets in its financial accounts; total return swaps where the underlying assets are transferred to the accounts of an acquiree; and adjustments to the carrying value of the asset arising from a change to fair value accounting.

Our observations: The broad coverage of the types of transactions that trigger the application of the transitional intra-group transfer rules may result in harsh outcomes for some commercial transactions. The DTAs that can be created where the asset transfer has been taxed have limited usage.

Accounting development

On 9 January 2023, the IASB issued an exposure draft proposing amendments to IAS 12 *Income Taxes* in response to stakeholders' concerns about the potential implications of Pillar Two for the accounting for income tax in financial statements[6]. The proposed amendments would introduce:

- a temporary (but mandatory) exception to the accounting for deferred taxes arising from the implementation of the Pillar Two rules; and
- targeted disclosure requirements for affected companies.

Subject to comments to be received by 10 March 2023, assuming that the proposed amendment is finalised in the second quarter of 2023 as planned (and endorsed in the relevant jurisdiction, where applicable), the amendments to IAS 12 providing the above exception to the requirements in the standard will be applied immediately upon their issuance (subject to any local endorsement processes) and retrospectively. The amendments providing the disclosure requirements with regard to the periods in which Pillar Two legislation is enacted or substantively enacted, but not yet in effect, shall apply for annual reporting periods beginning on or after 1 January 2023.

On 1 February 2023, the staff of Financial Accounting Standards Board (FASB) shared that they believe the GloBE top-up tax is an alternative minimum tax as provided for under US GAAP, and as such no deferred taxes would be recorded for the future estimated impact of Pillar Two. Instead, any top-up taxes would be accounted for in the period in which they are incurred[7].

The takeaway

The Guidance is helpful for some issues, although many uncertainties remain with respect to the interpretation of the GloBE rules. The QDMTT provisions appear to allow divergence between jurisdictions, and businesses will hope that more work will be done to ensure alignment of jurisdictions' implementation of these rules. It will take time to analyse the full implications of the Guidance to specific fact patterns and business models. Taxpayers should model the outcomes of the Guidance as soon as possible given the rapid influx of individual jurisdictions moving forward with implementing these rules. Meanwhile, businesses should continue to monitor updates from the IASB on the accounting implications of Pillar Two.

Pillar Two implementation has gained momentum globally since December 2022. Several major economies such as the European Union, Japan and South Korea have announced their plans to make the GloBE rules effective in 2024. As regards Hong Kong, the Financial Secretary announced in the 2023/24 Budget last week that Hong Kong plans to apply the GloBE rules on in-scope MNE groups and implement a domestic minimum top-up tax starting from 2025 onwards. The early announcement gives the much-needed certainty to businesses about Hong Kong's tax policy direction. A public consultation will be launched to allow affected MNE groups to make early preparation.

Notwithstanding the 2025 start date, the interlocking nature of the GloBE rules would mean that some MNEs with operations in Hong Kong may still be impacted in 2024 due to other jurisdictions' implementation. Other in-scope MNEs not impacted in 2024 are strongly advised to take full advantage of the two-year lead time and continue gearing up their people and systems for the complicated GloBE rules.

Endnotes

1. The Guidance can be accessed via this link: https://www.oecd.org/tax/beps/agreed-administrative-guidance-for-the-pillar-two-globe-rules.pdf

2. The model GloBE rules can be accessed via this link: https://www.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two_782bac33-en

3. The original GloBE commentary and examples released in March 2022 can be accessed via these links: https://www.oecd-ilibrary.org/taxation/tax-challenges-arising-from-the-digitalisation-of-the-economy-commentary-to-the-global-anti-base-erosion-model-rules-pillar-two-first-edition_1e0e9cd8-en
https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-erosion-model-rules-pillar-two-examples.pdf

4. The *PwC Global Tax Policy Alert* can be accessed via this link: https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-oecd-releases-admin-guidance-on-the-p2-global-min-tax-rulesB.pdf

5. The Guidance confirms the status of the United States' minimum tax (known as the Global Intangible Low-Taxed Income, or 'GILTI') as a CFC tax regime under the GloBE rules. Given the ordering rule, any allocation of taxes paid under GILTI will not be taken into account when determining the local QDMTT liability.

6. The exposure draft can be accessed via this link: https://www.ifrs.org/content/dam/ifrs/project/international-tax-reform-pillar-two-model-rules/exposure-draft-and-comment-letters/iasb-ed-2023-international-tax-reform-pillar-two.pdf

7. Please refer to the *PwC US In brief* via this link for further details: https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-fasb-weighs-in-on-tax-accounting-for-oecd-pillar-two-taxes.pdf

Let's talk

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