ACCOUNTANCY EUROPE.

EU PILLAR 2 DIRECTIVE: IMPACTS ON BUSINESSES

Ensuring a minimum level of taxation with Global Anti-Base Erosion Rules (GloBE)

Factsheet

FACTS.

TAX
MARCH 2023

HIGHLIGHTS

This factsheet highlights the main provisions in the OECD's Pillar Two GloBE proposals. The European Union's (EU) Directive to implement these could considerably impact some very large businesses.

Large groups based in Europe need to take action to determine whether they are in the Directive's scope, what information systems need to be implemented, what the likely impact will be and whether any exemptions are available.

The number of affected businesses should remain limited but the Directive is long and complex. Those businesses and their advisors should therefore begin risk analysis as soon as possible.

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INTRODUCTION

The EU Pillar 2 Directive codifies into EU law additional anti-BEPS measures developed in parallel with the OECD's work on re-distributing the tax base for certain Multi-National Entities (MNEs).

The Directive is now effective and was published in the Official Journal on 22 December 2022.

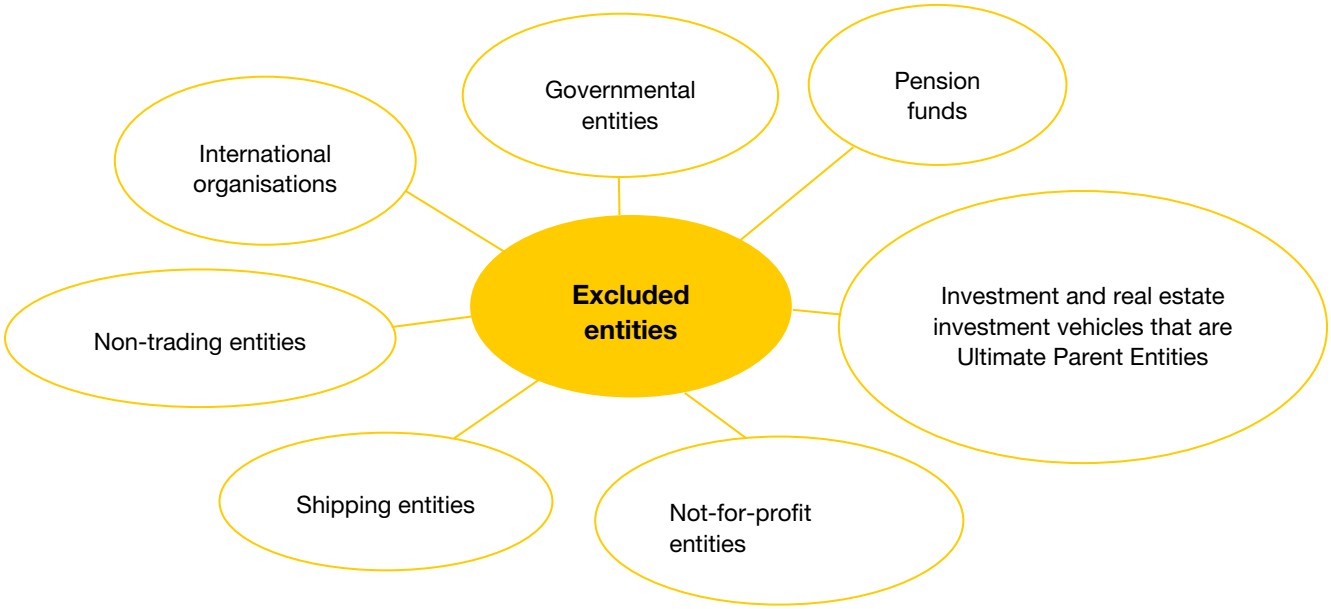
This factsheet summarises the Directive's main points. The Global Anti-Base Erosion Model Rules (GloBE) provisions are complex and extensive. Businesses likely to fall within the scope of GloBE should consult the full rules and seek independent advice, if appropriate.

The income inclusion rule will be effective from 31 December 2023. The undertaxed profits rule will be effective from 31 December 2024.

SCOPE

The Directive's overall scope is for MNE and 'large-scale domestic' groups with total group income of €750 million – excluding income from 'excluded entities'. This is in line with the Directive on Administrative Cooperation that imposes country-by-country reporting (DAC4).

This €750 million threshold must be exceeded for at least two of the 4 fiscal years preceding the year under review.



The rules can apply to excluded entities through their subgroups.

There is a per-country **de-minimis exclusion**. This is covered in the *reliefs* section below.

TAXING MEASURES

The measures affect in-scope groups with 'constituent entities' in jurisdictions where their effective tax rate (ETR) is less than 15% (the 'minimum tax rate' or MTR).

A constituent entity is:

a) any entity that is part of an MNE group or a large-scale domestic group; and

b) any permanent establishment of a main entity that is part of an MNE group referred to in point a)

The ETR is computed at the jurisdictional level. I.e., the ETR for all in-scope constituent entities in each jurisdiction where the group carries out activities should be compared to the MTR. Where it is less, top-up tax is due to bring the ETR of each jurisdiction to 15%.

There are two mechanisms by which top-up tax may arise:

THE INCOME INCLUSION RULE (IIR)

This rule imposes a top-up tax on an ultimate parent entity (UPE) for all constituent entities whose jurisdictional ETR is less than the MTR.

The IIR applies to:

- UPEs in Member States in respect of low tax constituent entities in its group
- constituent entities (intermediate parent entities) where the UPE is in a low-tax jurisdiction or is an excluded UPE (i.e., a flow-through entity)
- partially-owned parent entity located in the Member State (in which case the parent entity's share of the top-up tax will be pro-rated based on the percentage of its ownership)

UNDERTAXED PROFIT RULE (UTPR)

The UTPR acts as a backstop if the UPE is not subject to a qualifying IIR or the parent does not collect top-up tax for other reasons.

This rule raises an additional tax expense equal to an entity's share of the top-up tax that hasn't been charged through an IIR, either through a constituent entity top-up tax or via a denial of relief for an undertaxed deduction.

FILING RESPONSIBILITIES AND PAYMENT OF TOP-UP TAX

The UPE is responsible for ensuring the top-up tax is calculated and returned to the relevant tax authority of each jurisdiction affected. However, if the UPE is not resident in the EU, a constituent entity located in a Member State must file a top-up tax return with its tax administration.

Regardless, an in-scope group can appoint a designated local entity in a Member State to file the top-up tax return, etc., with every Member State where the in-scope group is present.

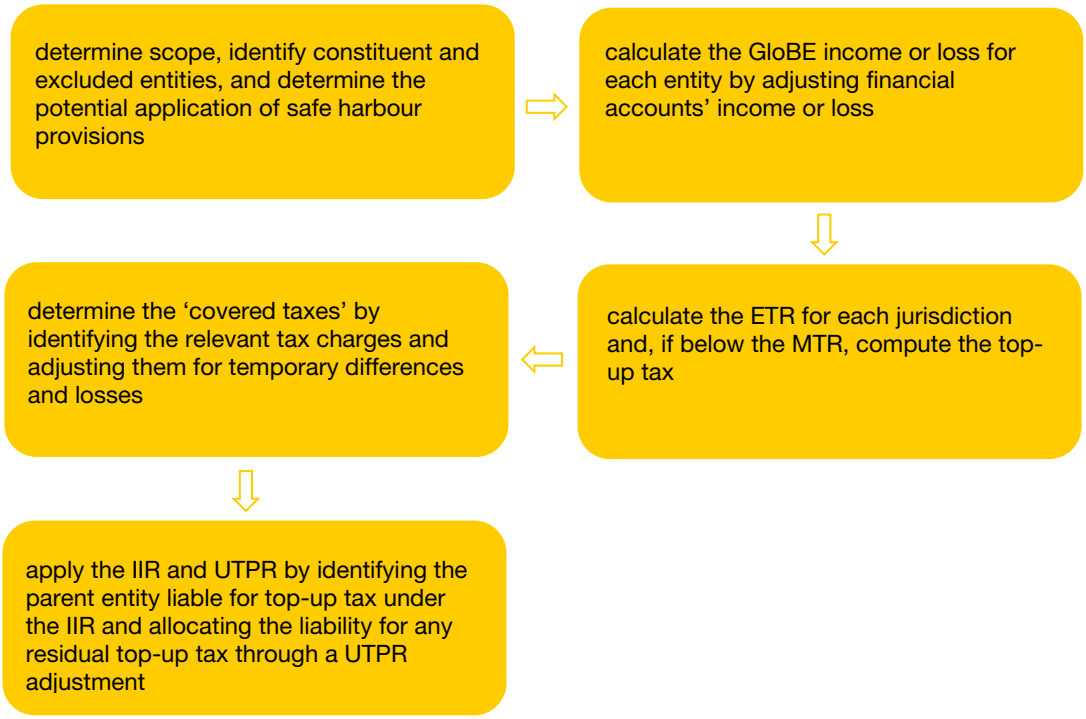
The payment of top-up tax is generally from the UPE to the tax authority of the jurisdiction in which it is based. The obligation remains even though the UPE may be able to take advantage of exemptions, special regimes and tax holidays in its established location.

However, there is a Member State option (that originates from the OECD's GloBE proposals) to apply a qualified domestic top-up tax system. In this scenario, the top-up tax is paid to the Member State regarding constituent entities in their jurisdiction that may have low-taxed entities. Any tax paid because of qualified domestic top-up systems can be offset against the UPE's total top-up tax liability.

In respect of tax incentives, the OECD has issued a paper considering how tax incentives may change in a post-GloBE world.

OVERVIEW

The main steps involved are as follows:



GLOBE QUALIFYING INCOME CALCULATION

Normally, financial statements prepared following International Financial Reporting Standards (IFRS) or comparable national standards (listed in Article 25) are the starting point for calculating the qualifying income or loss and the amount of covered taxes.

QUALIFYING INCOME OR LOSS

A constituent entity's qualifying income or loss is the financial accounting profit or loss before consolidation adjustments.

A limited number of adjustments are then applied, covering:

- net tax expenses of 'covered taxes', deferred tax etc.
- excluded dividends from holdings that provide greater than 10% ownership
- excluded equity gains or losses arising from changes in fair value or from equity accounting
- included revaluation method gains or losses – where all PPE are periodically revalued, the change in income goes through OCI and doesn't subsequently appear in profit or loss
- asymmetric foreign currency gains and losses (i.e. arising from a currency other than that of the functional currency)
- policy disallowed expenses - for illegal payments and fines exceeding €50 000
- prior period errors and accounting policy changes
- accrued pension expenses
- **by-election** at the jurisdictional level, stock-based compensation
- any group transaction recorded by constituent entities at different values or non-arm's length – these are adjusted to arm's length values

- **by-election**, gains and losses in respect of assets subject to adjustment of fair value \ impairment can be accounted for on the realised basis
- group financing arrangements where one entity is in a low tax jurisdiction and one in a high tax jurisdiction, and throughout the arrangement, taxable expenses will be increased more than income

An election can use the group's consolidation tax adjustments if the group's members are in the same jurisdiction and if a group election is in place.

There are specific adjustments for insurance companies and bank tier-one payments (Articles 16.10 &.11).

There are also specific rules for allocating profit to permanent establishments and branches.

The net qualifying income of the jurisdiction is the total qualifying income of all constituent entities in the jurisdiction, less the qualifying losses of all constituent entities in the jurisdiction.

ADJUSTED COVERED TAXES

'Covered taxes' are corporate income taxes and equivalents thereof. Article 20 contains details of the taxes to be included and excluded.

The starting point is the accrued current tax expense in the financial statements, adjusted for deferred tax and any movements in covered taxes that have been recorded in other comprehensive income but are taxable under local tax rules.

The following adjustments are then required:

Additions	Reductions
any covered tax included as an expense in profit before tax	amount of covered tax in respect of adjustments to income
any qualifying loss deferred tax asset used	any amount repaid of a qualified refundable tax credit paid and not accrued for
covered taxes related to an uncertain position paid during the year	covered taxes refunded or credited to a constituent entity
any amount repaid of a qualified refundable tax credit accrued	current tax expenses related to an uncertain tax position
	any current tax expense not expected to be paid in 3 years

The deferred tax figure is the amount accrued in the financial statements where the tax rate used is equal to or below the minimum rate.

As with covered taxes, the deferred tax figure is subject to adjustments:

Increases	Decreases
any disallowed or unclaimed accrual paid during the year	deferred tax on excluded items
any recaptured DT liability from the preceding year paid during the year	DT on disallowed\unclaimed accruals
	valuation adjustments\accounting recognition adjustments in respect of DT assets
	adjustments to DT in respect of change in the domestic applicable tax rate
	DT in respect of the use and generation of tax credits

A deferred tax liability that is not reversed and whose amount is not paid within the 5 subsequent fiscal years shall be recaptured to the extent that it was previously considered in the total deferred tax adjustment amount of a constituent entity. This rule has several exclusions, such as changes in deferred tax liabilities from research and development expenses, detailed in Article 22, paragraph 8.

EFFECTIVE TAX RATE (ETR) AND TOP-UP TAX CALCULATION

ETR CALCULATION

The ETR must be computed each year for each jurisdiction for which the in-scope group has net qualifying income in that year.

The ETR is calculated as:

$$\frac{\text{adjusted covered taxes of the constituent entities in the jurisdiction}}{\text{net qualifying income of constituent entities in the jurisdiction}}$$

Investment entities are excluded from the computation of the ETR and the net qualifying income.

If the ETR falls below the minimum tax rate for a jurisdiction for a fiscal year, the amount of top-up tax must be calculated for that jurisdiction.

TOP-UP TAX COMPUTATION

The top-up tax is to be computed separately for each constituent entity in a jurisdiction included in the computation of net qualifying income.

A jurisdictional top-up tax is the top-up tax percentage multiplied by excess profit plus additional current top-up tax less domestic top-up tax.

Where:

- the top-up tax percentage is the 15% minimum tax rate, less the effective tax rate
- excess profit is the combined tax base of constituent entities less the substance-based exclusion (see below)
- additional current top-up tax is an additional top-up tax in respect of a prior period, such as the 'recaptured' deferred tax
- domestic top-up tax is any amount payable to the jurisdiction's tax authority based on the GloBE rules

Top-up tax is allocated across constituent entities in the jurisdiction in proportion to the entity's share of the qualifying income of all entities.

There are special rules for corporate restructuring and holding structures.

There are also detailed transitional rules (Ch IX Article 47).

Substance-based income exclusion rule (SBIE)

The SBIE covers situations where the group's economic activities require a significant material presence in a low-tax jurisdiction. It provides an additional deduction against net qualifying income for:

- most payroll costs (including independent contractors) - initially a 10% mark-up that reduces to 5% over 10 years
- the carrying value of tangible assets (including property, plant and equipment and natural resources) – initially an 8% mark-up that reduces to 5% over 10 years

An election is available **not** to apply the substance-based exclusion.

Tangible assets exclude the carrying value of a property for sale, lease or investment.

RELIEFS AND EXCLUSIONS

DE MINIMIS EXCLUSION ELECTION (ARTICLE 30)

By-election, no top-up tax will be due in jurisdiction if for a fiscal year:

- the average qualifying revenue of all constituent entities in the jurisdiction is less than €10 000 000 and
- the average qualifying income or loss of all constituent entities in a jurisdiction is a loss or otherwise below €1 000 000

'Average qualifying' revenue and income is the average of the current fiscal year and the two preceding fiscal years.

NEW CROSS BORDER ACTIVITIES (ARTICLE 49)

The top-up tax due will be reduced to zero:

a) in the first five years of the 'initial phase' of international activity of the MNE

b) for a large-scale domestic group, in the first five years, the group falls within the scope of this Directive

In both situations, if the group is in scope when the Directive enters force, the five years start on 31 December 2023.

An MNE group is in the initial phase of international activities if for a fiscal year:

- it has constituent entities in max 6 jurisdictions **and**
- a sum of net book value of the tangible assets of all the group's constituent entities located in all jurisdictions other than that of the reference jurisdiction does not exceed €50 000 000

These rules also apply when the parent entity is in a third country, and the UTPR is in effect. In this case, if already in scope when the Directive comes into force, the five-year period starts on 31 December 2024.

TRANSITIONAL SAFE HARBOUR PROVISIONS

Member States must allow the top-up tax in its jurisdiction to be reduced to zero if a constituent entity files an election in that Member State based on a 'qualifying international agreement on safe harbours'.

All Member States must consent to the internationally agreed safe harbour. No specific agreement is mentioned in the Directive. Still, it is likely to be the safe harbour agreement of the OECD Inclusive Framework, which is detailed in this paper.

The OECD transitional safe harbour model has three tests based on the simplified data submitted from BEPS Action 13 Country by Country (CBC) reports. The top-up tax for a jurisdiction is zero if the group fulfils any of the following tests:

- **de minimis test** – very similar to the de-minimis test in the Directive detailed above but is calculated using simplified CBC information and only for the fiscal year in question (i.e. no requirement to average)
- **simplified ETR test** – using simplified information from CBCR, the safe harbour applies if the ETR equals or exceeds the transition rate (15% for 2023-24, 16% for 2025 and 17% for 2026 onwards). Uncertain tax positions need to be excluded from the tax expense figure, but deferred tax is included
- **routine profits test** – applies where the group's profit\loss before tax is equal or less to Substance-based Income Exclusion amount for constituent entities resident in that jurisdiction included in the CbC reports

The transitional rules are effective for accounting periods commencing on or before 31 December 2026 but do not include a fiscal year that ends after 30 June 2028.

A permanent safe harbour framework is in development.

EU SPECIFICS

The EU Directive closely follows the OECD's model rules but with some specificities, such as:

- Large-scale domestic groups included have been included in the scope to avoid disputes about the Directive being discriminatory to non-EU groups
- Member States with fewer than 12 relevant MNEs can elect to avoid implementing the IIR and the UTPR for up to six consecutive fiscal years commencing on 31 December 2023. However, groups located in Member States that make this election may still be impacted, as:
    - constituent entities located in other Member States could be subject to a UTPR imposed by the Member State where they are located
    - The UPE must nominate a designated entity to act as the filing entity

POSSIBLE INTERACTIONS WITH EU LEGISLATION

It is uncertain how this Directive will interact with existing and proposed EU legislation. For example, there could be impact from:

- the double tax relief mechanisms for eligible dividend proceeds under the EU Parent-Subsidiary Directive on the calculation of the ETR for Pillar 2 purposes
- the mandatory tax deferral for eligible business reorganisations under the EU Merger Directive on the calculation of the ETR
- the fair value step-up of asset values upon inbound asset movements under the first Anti-Tax Avoidance Directive on the calculation of the ETR
- the allowance for corporate equity (DEBRA) which has no equivalent in the GloBE rules. Its impact on ETR's calculation is uncertain
- the proposed Unshell rules on shell entities that may fall under the GloBE participation exemption

PLANNING CONSIDERATIONS

Although the number of groups in scope in the EU may be relatively low, the potential impact on these groups may be significant. It is vital that groups that may potentially be in scope urgently:

- implement information systems to assist with the identification of constituent entities and excluded entities and for the transfer of information necessary to assess the impact of the rules on the group
- consider the applicability and usefulness of available exemptions and the impact of the transitional safe harbour rules
- check whether the group is expected to be in the scope of Pillar Two rules or may be in scope in the future. In both situations, the transition rules will likely already apply
- identify the items in the transition rules that require attention.
- monitor MS transposition and adoption in other countries where the group has a presence
- consider the equivalency of IIR regimes – it does not appear that, as currently written, the United States' GILTI will qualify as an IIR equivalent (although the taxes raised can be considered for calculating the ETR). This could mean that US group constituent entities are in this Directive's

ACCOUNTING AND AUDITING ISSUES

ACCOUNTING ISSUES

The GloBE proposals are complex, with limited time for potentially in-scope groups to consider and quantify their impact on the corporate income tax charged in financial statements. This is made more complex by

uncertainty about when Member States will transpose the Directive into national law and when 3rd countries will implement the GloBE model rules into their domestic legislation.

The International Accounting Standards Board (IASB) and European Financial Reporting Advisory Group (EFRAG) have recognised this problem and launched fast-track projects.

The IASB has published an Exposure Draft of proposed amendments to IAS 12 *Income Taxes*, open for comment until 10 March 2023. The draft is currently proposing reducing the disclosure requirements of IAS 12 concerning possible changes to the tax charge in profit or loss that could arise from the implementation of GloBE rules.

Broadly, the proposed amendment would introduce a temporary exception for the requirement to account for deferred taxes arising from Pillar Two implementation but require that entities would disclose information about:

- legislation enacted in jurisdictions in which the entity operates
- the entity's operations in jurisdictions with a tax rate below the 15% minimum rate
- jurisdictions in which the entity's ETR is less than 15%, with aggregate information on accounting profit, the income tax expense and the weighted ETR
- whether preliminary work indicates that the entity may be responsible for paying top-up tax

AUDITING ISSUES

Auditors of financial statements will need to evaluate the impact of the GloBe proposals, if any, on their audit and audit report. This impact might differ depending on the timing of implementation of GloBe in different jurisdictions.

RESOURCES

OECD resources on *Agreed Administrative Guidance and Safe Harbours*.

OECD paper *Tax Incentives and the Global Minimum Corporate Tax*.

IAS 12 Revisions

IASB *International Tax Reform–Pillar Two Model Rules*.

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