Pillar Two Model Rules

February 2022

Pillar Two model rules - overview

Pillar Two Model Rules released by OECD on December 20, 2021

- Model Rules are the first of three expected sets of guidance
  - Model Rules
  - An explanatory **Commentary** (expected in February/March 2022)
    - Will provide some background and examples
    - Clarify complex concepts and language in the Model Rules
  - Detailed **Implementation Framework** (expected late 2022 at earliest) - this is the actual mechanics

- Model Rules cover:
  - The income inclusion rule (IIR), and
  - The undertaxed payments rule (UTPR) (collectively referred to as 'GloBE')

- Pillar Two implementation timeline
  - **2022** - aim to be brought into law
    - March/April 2022 - public consultation event on the implementation framework after release of Commentary
  - **2023** - IIR to come into effect
  - **2024** - UTPR to come into effect

EU/UK action

- EU released a **draft EU Directive** on minimum taxes on December 22, 2021
- The European Commission announced that the EU rules will differ from the IIR to be compatible with other relevant EU rules
- UK undertaking a **public consultation**; has indicated IIR will take effect in 2023

Pillar Two model rules – key concepts

Scope of Pillar Two is large companies with cross-border income

- Pillar Two applies to multinational enterprises (MNEs) with **annual global revenues above €750m**
- Certain organizations (e.g., government bodies, non-profits, investment funds) are excluded, without regard to size.

Two Main Components of minimum tax – IIR and UTPR

IIR (Income Inclusion Rule) is a minimum tax imposed by the Parent of the MNE on its foreign subs

- **Ultimate parent entity** (UPE) under original proposal UPE had primary responsibility for applying IIR
- To the extent foreign subs do not pay tax of at least 15% in their country, the UPE would impose a **"top up" tax** to ensure a taxation rate of 15% applies to the subs – however, **Qualified Domestic Minimum Top-up Tax** has scrambled this by allowing source country the right to tax this before UPE country.
- IIR is computed on a **per country** basis – tax paid in a high-taxed foreign sub cannot be used to "shelter" low-taxed income earned in another country.

UTPR (Undertaxed Payments/Profits Rule) is a "backstop" that only applies if income is not taxed by IIR

- UTPR permits a country to increase the tax imposed on entities operating within that country if those entities have affiliates in other countries that are taxed at a rate below 15%.
- Amount of UTPR "top up" tax is the amount of tax that would have been imposed if the affiliates in the other jurisdictions had been subject to the Pillar Two IIR minimum tax of 15%.
- If more than one country asserts the right to impose additional tax under the UTPR, increased tax is allocated among those countries under a formula based on assets and employees in each UTPR country.
- **NB.** The UTPR can also apply in respect of the UPE country (which by definition cannot be covered by an IIR on foreign income) if the Pillar Two ETR in the UPE country is below 15% (e.g., because of credits or incentives).

Pillar Two model rules – Based on adjusted financial statements

Starting point for determining income for Pillar Two is a company's public financials prepared under GAAP/IFRS

- Some adjustments are required to exclude certain categories of income not within scope for the Pillar Two rules
- Income must be determined on a **per country** basis
- Pillar Two only applies to a company's "**excess profit**" in a country, which is defined as profit that exceeds a routine return on the company's assets and payroll in that country (referred to as the "substance based carveout").

Starting point for determining tax paid in a jurisdiction is a company's financial statement tax provision

- Taxes include both **current** and **deferred** taxes based on provision
- Numerous adjustments are required -- for example, deferred tax liabilities that do not reverse within 5 years must be excluded from computation
- In addition, deferred taxes are subject to a "cap" of 15%. This cap, in combination with other factors, will often push a company's ETR in a jurisdiction below 15%, even where the GAAP ETR may be much higher than 15%.
- Put differently, a country's corporate income tax base and Pillar Two tax base can differ quite substantially – as they do in the U.S.
- **=> Cannot rely on GAAP ETR to conclude sufficient tax has been imposed!**

Pillar Two model rules - Mechanics

Pillar Two concepts apply on a per jurisdiction basis, including the home country of the Ultimate Parent Entity

Participating Countries are not required to adopt the GloBE rules (IIR and UTPR)

- If members adopt, must be done consistently with the intended outcomes

Step	Reference	Summary
1	a	Calculate **GloBE income** on jurisdictional basis
2	b	**Covered Taxes** calculated on jurisdictional basis
3	c = b / a	**Jurisdiction level ETR** = **Covered Taxes** / **GloBE Income**
4	d = 15% (-) c	Top up tax percentage = Minimum ETR - **Jurisdiction level ETR**
	e	Tangible assets plus payroll
	f = e * 5%	**Substance based carve-out**
5	g = a (-) f	**Excess Profit** (e.g., the tax base for top up tax) = **GloBE income** - **Substance based carve out**
6	h = d * g	Top up tax

Pillar Two Model Rules – Beware Double Tax Potential!

Pillar Two rules are designed to impose additional tax only when a company's tax rate on income earned in a jurisdiction is less than 15%

- The use of deferred taxes is intended to prevent tax being imposed under Pillar Two when a timing difference (e.g., accelerated depreciation on new capital investment) results in a temporary reduction of a company's tax payments.
- Because the Model Rules require deferred taxes to be "capped" at 15%, a company with significant timing differences and modest permanent differences (e.g., R&D credits) can fall below 15% under the Pillar Two rules, even though the GAAP ETR is significantly higher

Pillar Two Model Rules – Example of DTL “cap” resulting in double tax

Assume Company X has $100 of GAAP income in a 25% rate jurisdiction. Company X has $5 of R&D credits in the current year, such that its GAAP effective tax rate in the current year is 20%

- Company X also has a tax deduction of $80 for expensing of new capital investment.
- For GAAP, Company X books a deferred tax liability (DTL) of $20, resulting in a total tax provision of $20, all of which is deferred.
- Under Pillar Two, Company X is required to “cap” the DTL to the amount that would apply under a 15% tax rate. Accordingly, the Company X DTL is limited to $12.
- For Pillar Two purposes, Company X has a total tax provision of $12 for the year, and Company X has a top-up tax liability of $3.
- In year 2, this timing difference reverses – Company X has $100 of GAAP income but $180 of taxable income. Company X still has $5 of R&D credits and a GAAP ETR of 20%
- For Pillar Two, this DTL reversal is also “capped” at 15%, so the Pillar Two ETR will be 28% ($45 cash tax – $12 DTL reversal – $5 R&D credits =$28 tax provision on $100 of GAAP income)
- “Excess” ETR in Year 2 cannot be carried back to Year 1 – result is economic double tax.