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OECD Pillar Two implementation: information return, safe harbors and certainty

Overview

On December 20, 2022, the OECD published an implementation package regarding the implementation of the Pillar Two global minimum tax rules ("Pillar Two"). The package includes guidance on safe harbors, a public consultation document on the Global Anti-Base Erosion (GloBE) information return ("information return"), and a public consultation document on tax certainty. Comments on both the information return and tax certainty document are invited by February 3, 2023. The OECD Inclusive Framework expects to release further guidance on the interpretation and administration of the global minimum tax rules on a rolling basis, with the first installment expected to be released in early 2023. It is expected that this guidance will be followed by countries that adopt the GloBE rules, including those that implement the recently approved EU Directive on Pillar Two.

Background

The income inclusion rule and undertaxed profits rule

The OECD Pillar Two global minimum tax is set out in OECD model rules published in December 2021 and subsequent OECD commentary published in March 2022. The OECD model rules apply to large multinational groups with annual consolidated group revenue of at least €750 million and have the following key components:

- An income inclusion rule (IIR) applies on a top-down basis such that in most cases any tax due is calculated and paid by the ultimate parent entity (UPE) to the tax authority in its country. The tax due is the "top-up" amount needed to bring the overall tax on the profits in each country where the group operates up to the minimum effective tax rate of 15% (after taking into account a substance-based carveout for assets and payroll).
- The undertaxed profits rule (UTPR) will apply as a secondary (backstop) rule in cases where the effective tax rate in a country is below the minimum rate of 15% but the income inclusion rule has not been fully

applied. The top-up tax is allocated based on a formula to countries that have adopted the UTPR and is to be implemented by countries either by denial of a deduction for payments or by making an equivalent adjustment.
- The OECD model rules also allow countries to introduce a qualified domestic minimum top-up tax (QDMTT) aligned with Pillar Two. Top-up taxes related to any low-taxed profits of a group's entities in that country would then be paid to the local tax authority, rather than to other countries under the income inclusion or undertaxed profits rules.

Information return

The OECD is in the process of developing a standardized information return. The public consultation document identifies a lengthy and comprehensive set of data points required for a group to calculate its top-up tax liability under the OECD model rules, including:

- General information about the group (determined by consolidated financial statements) and filing entity
- Effective tax rate (ETR) computation and top-up tax
- Top-up tax allocation and attribution

The deadline for filing the information return is 15 months after the fiscal yearend, extended to 18 months for the first year in which a group is in scope.

The OECD Inclusive Framework will continue to develop centralized filing requirements allowing for the information return to be filed with the tax authority of the ultimate parent entity (or another designated filing entity). The information return will automatically be exchanged with the tax authorities of countries in which other group entities are located (consistent with applicable information exchange rules and treaty obligations of the exchanging jurisdiction). Consideration is being given to segmenting the information reported where not all tax authorities require all the group's information and tax calculations to assess any top-up tax liability.

The OECD also is considering a coordinated framework for tax authority information requests and coordinated tax authority risk assessment with respect to information returns received.

Safe harbors

Transitional country-by-country reporting (CbCR) safe harbor: The transitional safe harbor is a short-term measure to exclude a group's operations in lower-risk countries from the compliance obligation of preparing full Pillar Two calculations. It applies for years beginning on or before December 31, 2026 (i.e., three years for most groups).

The Transitional CbCR Safe Harbor operates by using simplified jurisdictional revenue and income information contained in a multinational entity's (MNE's) Qualified CbC Report, and jurisdictional tax information contained in an MNE's Qualified Financial Statements. It applies to jurisdictions in which Constituent Entities of the MNE are located ("Tested Jurisdiction").

For these purposes Qualified CbC Report means a CbCR prepared and filed using Qualified Financial Statements.

Qualified Financial Statements means:

- The accounts used to prepare the Consolidated Financial Statements of the UPE (to mirror the requirement under Article 3.1.2 of the Model Rules);
- Separate financial statements of each Constituent Entity provided they are prepared in accordance with either an Acceptable Financial Accounting Standard or an Authorized Financial Accounting Standard if the information contained in such statements is maintained based on that accounting standard and it is reliable; or
- In the case of a Constituent Entity that is not included in an MNE Group's Consolidated Financial Statements on a line-by-line basis solely due to size or materiality grounds, the financial accounts of that Constituent Entity that are used to prepare the MNE Group's CbC Report.

The transitional safe harbor uses information taken from a business's Qualified CbC Report and Qualified Financial Statements to determine whether its operations in a country meet any of three tests:

- ***De minimis* test:** This test applies where the business reports total revenues of less than €10 million and profit before income tax of less than €1 million on its Qualified CbC Report for a country. The MNE Group's Total Revenue and Profit (Loss) before Income Tax for each jurisdiction are extracted directly from the Qualified CbC Report. If a Tested Jurisdiction produces revenue and income that meet the *de minimis* test, then the Tested Jurisdiction qualifies for the safe harbor.
- **Effective tax rate test:** This test applies where the business has a "simplified ETR" for a country that is equal to or greater than the "transition rate" for the year. The transition rate is 15% for years beginning in 2023 and 2024, increasing to 16% and then 17% for years beginning in 2025 and 2026, respectively. The ETR is calculated using Profit (Loss) before Income Tax data from the Qualified CbC Report and the income tax expense reflected in the Qualified Financial Statements. The income tax expense used for the ETR test therefore includes deferred items and does not require any adjustments under GloBE (such as the allocation of CFC or Main Entity taxes, or the 15% cap on deferred taxes), other than the removal of taxes that are not Covered Taxes and Uncertain Tax Positions.
- **Routine profits test:** This test applies where the business's profit before income tax in a country is equal to or less than the "substance-based income exclusion" (SBIE) amount (as calculated under the OECD model rules). Under this test, an MNE would calculate the jurisdiction's SBIE in accordance with the GloBE Rules (including the Commentary and any Agreed Administrative Guidance) and compare that to the jurisdiction's Profit (Loss) before Income Tax as reported in the MNE's Qualified CbC Report. If a Tested Jurisdiction's SBIE amount is equal to or exceeds its Profit (Loss) before Income Tax, it means the Tested Jurisdiction is less likely to have excess profits on which top-up tax could be applied, and the Tested Jurisdiction would qualify for the safe harbor.

Where the transitional safe harbor applies, and any of these tests are satisfied, the top-up tax for that country will be zero.

A “once out, always out” approach will apply: if a business has not applied the transitional safe harbor to a country in one year, it cannot use the safe harbor for that country in a subsequent year.

Note that the safe harbors only apply to reduce the top-up tax to zero. If an entity does not satisfy the safe harbor for any reason (for example, the ETR under the effective rate test is less than 15%), then the filing entity must do a full GloBE calculation of the top-up tax for that jurisdiction. The document also provides that “[a]n MNE that qualifies for the Transitional CbCR Safe Harbour on a jurisdictional basis is still subject to the GloBE Rules and the safe harbour does not discharge the MNE Group from complying with group-wide GloBE requirements. For example, an MNE Group would still need to prepare and file its GloBE Information Return, including the information concerning the application of the Transitional CbCR Safe Harbor in a jurisdiction where applicable.” It is anticipated that in situations in which a safe harbor applies, the information required on the Globe Information Return would be tailored to take into account the application of the safe harbor. How the Globe Information Return will be tailored in such instances is the subject of ongoing work.

There are also special rules to harmonize various transition rules in the GloBE Model Rules with the application of the transitional safe harbors, such as extending the period to which the GloBE Model Rules’ transition rules apply.

A number of special rules may apply in specific circumstances such as:

- Where there are joint ventures or joint venture subsidiaries;
- Where there are entities held for sale;
- Where the UPE is a flow-through entity or is subject to a deductible dividend regime;
- Where a business is “multi-parented”; and
- Where a business includes investment entities or insurance investment entities, stateless entities, or entities subject to eligible distribution tax systems.

There is also a special rule that requires “net unrealized fair value losses” arising from changes in fair value of shareholdings (ownership interests) to be excluded if the loss exceeds €50 million in a country.

Potential permanent safe harbors: simplified calculations: The report sets out a framework for the future development of permanent safe harbors (“simplified calculations safe harbors”) that, if agreed, would reduce the number of computations and adjustments a business is required to make.

The framework envisages that future guidance would set out simplified calculation rules to enable businesses to demonstrate for a country that:

- The GloBE income is equal or less than the amount of the substance-based income exclusion;
- Revenue is less than €10 million, and income (profits) are less than €1 million (*i.e.*, that the country qualifies for the *de minimis* exclusion within the OECD model rules); or
- The effective tax rate is at least 15%.

For example, the simplified calculations safe harbor will apply for non-material constituent entities excluded from consolidated financial statements solely on size or materiality grounds. Simplified source of information rules, and calculations of revenue, income, and tax amounts, are expected to apply to these entities, using CbC reporting data.

The OECD Inclusive Framework is also considering a safe harbor for businesses that prepare a qualified domestic minimum top-up tax calculation under local rules.

Transitional penalty relief: Transitional penalty relief will require tax authorities to give "careful consideration" before applying penalties where a group has taken reasonable measures to apply the global minimum tax rules. The document provides some illustration of what a jurisdiction might consider "reasonable measures," such as a business demonstrating in good faith that it has put in place the appropriate systems to understand and comply with the rule. Relief will apply for years beginning on or before December 31, 2026 (*i.e.*, three years for most groups).

Tax certainty

The global minimum tax rules include several mechanisms to facilitate consistent and coordinated adoption, but differences could still arise in interpreting or applying domestic rules among different tax authorities. The OECD Inclusive Framework is exploring mechanisms to provide increased tax certainty, including dispute prevention mechanisms such as:

- Reliance on the OECD model rules, commentary, and guidance to support consistency in applying the rules, noting there may be interpretative questions that have not been considered or resolved;
- A multilateral review process to determine whether a country has implemented a "qualified" income inclusion rule, undertaxed profits rules, and/or domestic minimum top-up tax;
- Tax authority referral to the OECD Inclusive Framework for clarification of questions of general interpretation through the release of additional guidance;
- Common risk assessment and coordinated compliance programs, e.g., similar to the OECD International Compliance Assurance Programme (ICAP); and
- Binding certainty mechanisms, including bilateral and multilateral advance pricing arrangements (APAs).

Dispute resolution related issues are also being explored, including:

- How existing mutual agreement procedure (MAP) rules in double tax treaties could be adapted as the basis for dispute resolution;
- The scope of disputes that need to be covered, e.g., where the dispute has resulted in double taxation or taxation not in conformity with the GloBE rules;
- The basis for resolving disputes, e.g., the use of the OECD model rules, commentary, and guidance as the common standard for competent authorities to reach an agreement; and

- Possible instruments available for a dispute resolution mechanism, including: a new multilateral convention; under the Convention for Mutual Administrative Assistance in Tax Matters; under existing tax treaties; or a common dispute resolution mechanism in domestic law.

The documents described above constitute the first tranche of expected implementation guidance to help businesses prepare for the implementation of Pillar Two around the world. As noted above, we expect further guidance from the OECD Inclusive Framework early in 2023. Given that MNEs are likely to be subject to both IIRs and QDMTTs beginning in 2024, they will want to embark on (or continue) efforts to understand both the substantive impact of such rules on the amount of tax they pay around the world, as well as whether and how to comply with the various administrative requirements on a timely basis.

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